



The Association of
Accountants and
Financial Professionals
in Business

via email

To: comments@pcaobus.org

August 7, 2023

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: Release No. 2023-003, *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations (NOCLAR)*

Dear Secretary Brown and PCAOB Members:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on Public Company Accounting Oversight Board (PCAOB) Release No. 2023-003, *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations (Proposal)*.

The IMA is a global association representing over 140,000 accountants and finance professionals. Our members work inside organizations of various sizes, industries, and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

Overall Comments—We Disagree with the Proposal

FRC strongly disagrees with the Proposal and agrees with the dissenting Board members.

The Proposal is substantially beyond the goal and scope of an audit of financial statements prepared in accordance with generally accepted accounting principles (GAAP) and related internal

controls over financial reporting. In this context, the professional responsibility of accountants and auditors is solely limited to GAAP and related controls.

In connection with the issuance of the Proposal, PCAOB Chair Erica Y. Williams said, “By catching and communicating noncompliance sooner, auditors can help companies course correct and better protect investors from risk.”

The stated objective of an audit of financial statements is to provide users with independent assurance that the financial statements comply, in all material respects, with accounting standards. The objective is not to “help companies course correct.” It is not to “protect investors from risk” because the objective of financial statements is, per the Financial Accounting Standards Board, to provide relevant financial information for decision making.

Even when it comes to the auditor’s role in evaluating internal controls, the goal is to determine whether the internal controls—which are restricted to internal controls over financial reporting, not internal controls related to any other aspect of a company’s operations or business¹—provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in compliance with GAAP. As such, the auditor’s report acknowledges the limitations of internal controls over financial reporting to prevent or detect misstatements. The goal is not to protect investors from all types of business risk but to provide independent assurance that the audited entity has maintained effective internal control over financial reporting in all material respects.

We believe that current standards already work well in practice as related to the potential impacts of illegal acts on the reliability of the financial statements. The PCAOB has not provided evidence that current auditing standards regarding illegal acts are inadequate to allow an auditor exercising good judgment and best practices of professional responsibility to determine whether the financial statements materially comply with GAAP, which requires an accrual and/or disclosure of loss contingencies (Accounting Standards Codification Topic 450-20, *Loss Contingencies*). Inspection reports and restatements and enforcement cases show little evidence that auditors are failing to properly conclude on asserted and unasserted claims that would materially affect the financial statements. As discussed below in more detail, while we fully support the desire of the PCAOB to foster shareholder protection, we do not believe external auditors are the right stakeholders to achieve the objective of this Proposal and believe the arguments for change in the Proposal are not persuasive when considering all the significant costs and questionable benefits, including to the shareholders the PCAOB desires to protect.

¹ Also see U.S. Securities and Exchange Commission, Office of the Chief Accountant, Division of Corporation Finance, [*Management’s Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions, Question 10.*](#)

Beyond Accountant Expertise and Related Effects and Costs

The Proposal is inconsistent with the expertise of accountants as it requires auditors to form opinions on compliance with all federal, state, local laws, and regulations in all jurisdictions where the audited entity operates, including possibly multiple foreign jurisdictions. Those laws and regulations will be voluminous, including worker safety, consumer safety, cybersecurity, environmental, privacy, advertising, employee relations, money laundering, copyright, securities, medical, broker dealer, investment advisors, banking, foreign transactions, etc. We note the following.

- Auditors would need to identify all relevant laws and regulations that may apply to a company, determine what events may constitute noncompliance, design and perform audit procedures, assess the consequences of noncompliance, communicate with the audit committee, etc. In many ways, this means the auditors would now enter the practice of law. As acknowledged in Auditing Standards 2505.06, “An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention.” An example of this incongruence includes the differences in burdens of proof under common law across an almost-unlimited number of venues, precedence, and courts of competent jurisdiction, as compared with the auditing standards as promulgated in Auditing Standards 1105 regarding audit evidence, in addition to the definitions in Accounting Standards Codification Topic 450-20. The training and judgment of auditors simply would not equip them to make determinations under common law.
- Auditors would find it necessary to employ or otherwise engage lawyers with skills covering broad sets of applicable law and other specialists to undertake this new requirement for professional expertise. This will necessarily mean engaging with multiple counsel across a broad array of practices and domestic and global jurisdictions.

In our experience, law firms are generally reluctant to issue formal professional opinions regarding client compliance with applicable laws and regulations, including hypothetical consequences even in the event proceedings have been initiated. As illustrated in the American Bar Association's Statement of Policy Regarding Lawyers' responses to Auditors' Requests for Information (December 1975) (the “ABA Statement”), the ABA specifically notes that “while lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings.” When opinions are issued, they are normally limited to specific, narrow fact patterns (e.g., related to litigation of an entity in anticipation of its acquisition) and they can be expensive. The cost for procedures required to attest to broad legal compliance with all applicable laws and regulations would be

much higher, assuming law firms choose to embark on the risk of providing such an opinion at all. This is because most importantly, a legal opinion is provided to the client under the auspices of both the attorney-client privilege and work-product doctrines. If a law firm were to be subjected to potential discovery or publicization of its privileged opinion(s) to its clients, the risk to the law firm may be too great or the cost exponentially higher to the client or its auditor.

As a result, law firm opinions may cover a multitude of possibilities where regulators may determine that a particular action is in non-compliance. Auditors will then have to determine, exercising professional skepticism, whether the view of the counsel they may have retained to assist with the engagement supersedes the determinations of counsel retained by the companies undergoing an audit. Moreover, under the Proposal, the PCAOB stipulates that it is not sufficient for auditors to inquire of company personnel whether noncompliance is likely to have occurred. Thus, auditors will have to determine which legal opinion prevails, a task for which they are in no way trained or qualified.

- For audit firms, one of the significant costs of doing business is professional indemnity (commonly known as errors and omissions) insurance. Due to the significant risks involved in auditing legal compliance, we expect this cost will also increase significantly, if such policies even cover this unknown risk. Audit firms will pass these significant increases in their costs of doing business (including insurance, additional internal and external specialists, etc.) to clients, and ultimately to their shareholders, i.e., investors.
- Smaller audit firms may find that they do not have sufficient scale to justify carrying a broad range of legal expertise to assess their clients' compliance with all applicable laws and regulations and may choose to withdraw from auditing public companies altogether, further narrowing down choices of audit firms.
- Thus, FRC believes that the costs to both public accounting firms and businesses would be substantial and would exceed the benefits.

We also note that even though the PCOAB is not expressly asking for a formal opinion, it is asking auditors to do all the work that would underlie such a report—identify laws and regulations applicable to the company that could have a material effect if not complied with, require the auditor to evaluate information about whether noncompliance has occurred, and then communicate their findings to the audit committee. But the PCAOB attestation standards would seem to prohibit an auditor from rendering any such report because there are no suitable criteria for the auditor to use as a basis for its evaluation. The criteria need to be objective, measurable, complete, and relevant. That is in addition to the requirement to have adequate knowledge of the subject matter.

If the Proposal is finalized, we note that some companies may need to bear significant costs to adapt or revise their internal controls as well as their systems/operations to support the new audit

scope requirements. That means companies may need to develop, inventory, or refine a consolidated list of what laws and regulations could potentially be material to their financial statements. For example, the legal definition of “applicable law” or “court of competent jurisdiction” is a highly debated and negotiated term in almost every legal agreement, and its interpretation is just as wide and uncertain—wholly dependent on the legal matter, venue, personal jurisdiction, an almost-unlimited source of global treatises, statutes, regulation, and interpretations. As a result, auditors will want companies to have effective controls in place that are appropriately documented and tested such that the audit firm can rely on such controls to reduce the scope of its testing. Company lawyers would need to have global subject matter expertise, and companies would likely need to extensively rely on their outside counsel networks, which may not exist today. Such networks would likely involve law firms specializing in a variety of subject matters in each country in which the company operates—not just one law firm per country. The company accountants would need to have the expertise in applying materiality to an almost-unlimited number of legal jurisdictions, and correspondingly adapt its controls and the type of documentation that audit firms need. Stated differently, companies may be compelled to add a significant amount of additional prevention/detection/monitoring controls globally to enhance the breadth and depth of their procedures. These changes would also come at substantial cost to registrants and their investors. This would clearly be a burden to registrants and auditors if the objectives are attainable to begin with.

In our view, this Proposal is beyond the scope of the PCAOB’s mission. If the PCAOB believes that investors would benefit from an external review of registrants’ practices to identify potential noncompliance with laws and regulations, it should refer the matter to Congress and the SEC for consideration. Congress and the SEC could then determine the appropriate professionals who could perform such a review, which would likely be lawyers and not auditors. They could further determine whether lawyers would be willing and able to do such a review and whether investors would be willing to pay for it. Lawyers would be faced with all of the challenges previously cited in this letter and these changes would come at considerable cost.

Other Comments

We have the following additional comments.

- We are concerned about the auditor/CPA talent pipeline problem if the Proposal is finalized. An aspiring accountant would need to become knowledgeable about all applicable laws and regulations and expose him or herself to the risk of determining what constitutes compliance, audit compliance, attempt to guess the consequences of noncompliance, and then directly or indirectly express a view. The CPA exam would now need to encompass global laws, and universities would bear the cost burden of revised curriculums.

We even wonder if this is realistically achievable under generally accepted auditing standards. A profession with unachievable standards is likely to be unattractive to potential entrants.

- The Proposal might lead to the implicit waiver of attorney-client privilege and therefore could have significant consequences to the client, as well as the attorney. The ABA Statement states these consequences in a clear and concise fashion: “The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.”

Furthermore, the ABA Statement continues with “... disclosure to a third party [such as its auditors] may result in loss of the ‘confidentiality’ essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.” Therefore, similar to the ABA’s concerns at that time concerning their members’ responses to auditors’ requests for information, the same concerns apply to the Proposal, as “The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.”

- We believe that the Proposal might not be helpful to communications between the auditor and the audit committee. Existing guidance requires auditors to assure themselves that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor’s report with respect to illegal acts that have come to the auditor’s attention. The Proposal requires the auditor to make an initial communication to management and the audit committee upon becoming aware that noncompliance “has or may have occurred.” This requirement could result in communications to management and the audit committee before the auditor completes an evaluation of the matter.

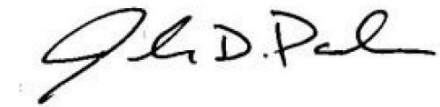
This approach is inconsistent with current communications that are based on known facts that have been appropriately evaluated and vetted in the context of rendering an opinion on the financial statements. Such requirements would likely result in the audit committee receiving false flags that over time could erode confidence in the audit firm, and to the earlier point above, “such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.” The company management may also disagree with the judgment of its audit firm (or its law firm).

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Substantial financial reporting matters would take a back seat in the audit committee meeting to review the minutiae of legal compliance.

We would be pleased to discuss our comments with you or your staff at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "J.D. Paul". The signature is fluid and cursive, with the first letters of each word being capitalized and prominent.

Josh Paul
Chair, Financial Reporting Committee
Institute of Management Accountants

cc: Paul Munter, Chief Accountant, Securities and Exchange Commission
oca@sec.gov