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March 18, 2024

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, D.C. 20006-2803

Re: Roundtable Discussion of Proposed Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations

Dear Office of the Secretary:

RSM US LLP (RSM, "we") values the opportunity to offer our comments on the Public Company Accounting Oversight Board's (PCAOB) *Proposed Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations* (the proposal) and the PCAOB's *Roundtable Discussion of Proposed Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations* (the roundtable discussion).[1] RSM is a registered public accounting firm serving middle-market issuers, brokers and dealers.

Overall Comments on the Proposal and Roundtable Discussion

Appreciation for and encouragement of continued discussion

We thank the PCAOB for hosting the roundtable discussion and for the opportunity it provided for a discussion of the topics of interest identified following the initial comment period. We appreciate the PCAOB's outreach and encourage continued discussion on this topic and future proposals. Through dialogue and discourse comes evolvement of thought and practice. This dialogue also promotes investor awareness of the audit practice and establishes clear expectations about the role of the auditor. It has become more evident that there is a gap between what investors expect of auditors and the responsibilities of the auditors. It is important to foster an environment of open discussion between various stakeholders with open minds to reach a mutual understanding of goals and how we can achieve them together.

Request for revised proposal

As we observed during the roundtable discussion, there were various perspectives debated, many different interpretations of the language in the proposal, and even disagreements and misunderstandings regarding the objective of the proposal. Despite the proposal being in circulation for nine months, there is continued confusion about how the proposal would be executed. The wide range of interpretations by multiple stakeholders calls for refinement and clarification in a new proposal. As we described in our first comment letter on this proposal[2] and in our responses below, we believe the proposal needs significant revisions, including application material, to achieve the intended objective. In addition to a revised proposal, we encourage the Board to continue various stakeholder outreach activities, as this will contribute to reducing the expectations gap between stakeholders. Precision of language matters, and we believe the various stakeholders should be given an opportunity to discuss and provide comments on a

[1] Throughout this letter we refer to the panelists and their remarks made during the roundtable discussion. We are not writing on behalf of any individuals or other organizations. The language contained herein is our interpretation of the comments made by panelists related to the proposal. Panelist bios and recordings of the roundtable discussion can be found on the PCAOB's website.
[2] Refer to Comment Letter No. 77 submitted by us on August 7, 2023.

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revised proposal, given the wide range of interpretations and opinions on the first iteration. The interpretations are too vastly different, and the implications are too significant, for the Board to approve this proposal without further input on a revised proposal. [3] The requirements of a new standard must be clear. We believe continued outreach and discussions among various stakeholders, as well as another round of comment letters on a new proposal, would be in the best interest of multiple stakeholder groups, as it would ultimately result in a revised standard that achieves the intended objectives. Therefore, we strongly encourage the Board to consider the comments from the various stakeholders and issue a revised proposal and continue their stakeholder outreach on the matter. Importantly, we also request the Board give stakeholders sufficient time to evaluate a new revised proposal and to provide meaningful comments on it.

Acknowledgement of compressed timeline

Given the compressed timeline for response to the roundtable discussion and questions in the PCAOB staff briefing paper, as well as the interrelatedness of many of the questions, we did not respond to each individual question, but rather we have structured our response by the panel topics.

Comments by Panel Topic Posed by the Board

Panel I: Identification

Topic (1): Threshold for Identification of Laws and Regulations

Threshold language

The scope of the proposal, or the threshold for identification of laws and regulations, is in our view one of the most widely interpreted areas of the proposal; however, what appeared clear during the roundtable discussion was a general agreement on the need for greater clarity in the intended scope. As noted in our first comment letter,[4] the threshold of "identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements" is being interpreted differently by various stakeholders. Despite the preamble to the proposed standard noting that the scope "would not represent every law or regulation to which the company is subject,"[5] the scope was still heavily debated in various comment letters and during the roundtable discussion.

The threshold for identification of laws and regulations is an area where we believe revised, agreed-upon language can achieve the varying desires expressed by stakeholders during the roundtable discussion while also accomplishing the objectives of the standard. Despite various interpretations of the language used, investors[6] and auditors[7] alike agree alternative language should or could be used to replace "could reasonably have a material effect" to achieve a more reasonable, consistent and attainable scope. As panelist Ms. Peters described during the roundtable discussion on this topic, investors are not interested in auditors spending an exorbitant amount of time cataloguing every law and regulation that could reasonably have an effect on the financial statements. [8]

[3] We share the same views expressed by panelist Mr. Croteau during *Panel III – Economic Impacts* from approximately 50:23 to 51:02.
[4] Refer to our response to question 7 in Comment Letter No. 77.
[5] Refer to the proposal release text, page 22.
[6] Refer to page 8 of Comment Letter No. 135 submitted by the CFA Institute and page 7 of Comment Letter No. 121 submitted by the Members of the Investor Advisory Group.
[7] Refer to Comment Letter No. 91 submitted by the Center for Audit Quality and various comment letters submitted by audit firms, including our own (Comment Letter No. 77).
[8] Refer to Ms. Peters' comments made during *Panel I – Identification* from approximately 35:35 to 40:39.

There are several options to consider as alternative language:

1. Language suggested by several comments and panelists: "… is reasonably likely to have a material effect…"[9] There are two important distinctions offered by this language in comparison to the original proposed language: 1) "is" replacing "could" and 2) the insertion of "likely to." We believe both of these changes make the standard more understandable and operable within the context of comparison to extant audit standards and legal precedence.
2. Language borrowed from extant auditing standards related to "likely sources of potential misstatements,"[10] which could provide an understood framework that could be applied in a similar manner to the topic of noncompliance with laws and regulations. For example, familiar concepts such as likelihood and magnitude could be taken into consideration when evaluating the potential risks associated with laws and regulations.
3. Language to limit the scope by allowing the auditor to tailor it to be more specific to the entity (e.g., consider the nature and locations of the operations, the industry).

Each of these options should be discussed thoroughly among stakeholders prior to Board adoption, and ideally prior to the next iteration of the proposal. We encourage the Board to continue to engage with stakeholders regarding this potential language, but to provide a longer runway for stakeholders to provide feedback that is meaningful and well-vetted.

The auditor's role in detection of noncompliance with laws and regulations

During the roundtable discussion, Mr. Croteau articulated the importance of separating the discussion of the auditor's responsibilities to identify laws and regulations and the auditor's responsibilities to identify or detect violations of laws and regulations.[11] These are two separate concepts that need to be evaluated independently. Our comments above relate to the identification of laws and regulations. We echo Mr. Croteau's sentiments that detection is a compliance audit, which is different from an audit of financial statements. That is not to say auditors should not perform procedures to become aware of instances of noncompliance. We currently do perform such procedures and believe we should continue to do so. We are interested in the PCAOB hosting additional discussions on this topic to understand other types of procedures that stakeholders wish for auditors to perform to become aware of instances of noncompliance within the context of a financial statement audit. We also believe this is a topic where the PCAOB should develop implementation guidance, given the variety of views from stakeholders.

Appropriateness of an auditor's consideration of the work of management

Our takeaway from Ms. Peters' remarks on this topic was that investors believe auditors should obtain an understanding of, and assess management's process related to, the identification of noncompliance with laws and regulations to obtain reasonable assurance that the financial statements are free from material misstatement. We are generally supportive of this goal and the approach to achieve it, though an important caveat is that we disagree with the language used in the CFA Institute's comment letter on this topic, which implies absolute assurance rather than reasonable assurance.[12]

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[9] This language was suggested in several comment letters including Comment Letter No. 121 submitted by the Members of the Investor Advisory Group and Comment Letter No. 135 submitted by the CFA Institute and endorsed by panelist Mr. Jackson during *Panel I – Identification* from approximately 33:39 to 35:23.

[10] Refer to paragraph .61 of Auditing Standard (AS) 2110, *Identifying and Assessing Risks of Material Misstatement*, and paragraph .30 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[11] Refer to Mr. Croteau's comments made during *Panel I – Identification* beginning at approximately 12:20 and at approximately 57:00 and again during *Panel III – Economic Impacts* beginning at approximately 48:00.

[12] Refer to page 11 of Comment Letter No. 135 submitted by the CFA Institute which states, "we think the PCAOB needs to recognize this obligation of management and to indicate that auditors responsibilities include assessing the completeness and sufficiency of management's existing risk assessment, process and internal controls around NOCLAR, and *performing whatever additional procedures are necessary to ensure the financial statements are not materially misstated*." (Emphasis added).

More specifically, for auditors to identify the laws and regulations within the scope of the proposal, we believe it is appropriate to begin with obtaining an understanding of the entity's regulatory environment and management's process related to the items listed in paragraph .06 of the proposed standard (assuming revised language regarding scope). We believe it is appropriate for auditors to consider the work of management while applying concepts of other auditing standards, such as professional skepticism as described in AS 1015, *Due Professional Care in the Performance of Work*. In practice, we believe this could be similar to how we approach identifying related party relationships and transactions in accordance with AS 2410, *Related Parties*. Paragraph .14 of that standard requires auditors to not only assess management's process for identification of the subject matter, but also test the accuracy and completeness of the matters identified. Importantly, a long list of practical examples is provided in the Appendix to provide auditors additional guidance. We believe similar language, accompanied by helpful examples, could be an appropriate approach to the construct of the requirements of this standard. We encourage the Board to engage with various stakeholders to refine the language and generate examples. Given the condensed timeframe of this comment period, we did not generate a list of examples, but would welcome the opportunity to engage with the PCAOB and other stakeholders to provide feedback on such a list for inclusion in the next proposal.

Panel I: Identification

Topic (2): Direct Illegal Acts vs. Indirect Illegal Acts

The scope of the proposed standard should focus on identifying likely sources of noncompliance that has a risk of material misstatement to the financial statements, regardless of whether the impact is direct or indirect. We believe the existing concept of direct versus indirect illegal acts is clear and well-understood by auditors. Under extant standards, an auditor's consideration of and responsibility for detecting misstatements resulting from illegal acts that have a direct and material effect on the financial statements is the same as that for error or fraud—to obtain reasonable assurance about whether the financial statements are free of material misstatement.[13] Based on the proposal and roundtable discussion, we believe this responsibility is not under question. Rather, it appears the issues at hand are surrounding the nature and extent of auditor's procedures to address indirect illegal acts.

In current practice, once we become aware of a potential illegal act, our initial response is not affected by the distinction between direct or indirect. We obtain an understanding of the nature of the matter, the parties involved, laws and regulations in question, and the relevant implications on the financial statements and the engagement, including our assessment of our ability to rely on management's representations. To assess the relevant implications on the financial statements, we evaluate the matter in relation to Accounting Standards Codification 450, *Contingencies*. This evaluation is not affected by the distinction between direct or indirect.

Importantly, if the desire of other stakeholders is prevention and earlier detection of illegal acts that may have an indirect material effect on the financial statements, we believe amending the auditing standard is not the appropriate corrective action to achieve this objective. As described in our comments above, the auditor's role is not to prevent illegal acts and it is not to audit an entity's compliance with laws and regulations. Therefore, if earlier awareness is the objective, we recommend stakeholders seek potential changes with other governing bodies in the financial reporting ecosystem such as the Securities and Exchange Commission, the Committee of Sponsoring Organizations of the Treadway Commission and the Financial Accounting Standards Board.

[13] Refer to paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor.*

Panel II: Considerations for an Auditor's Assessment of Noncompliance and Other Legal Considerations

Topic (1): Competence to assess relevant noncompliance with laws and regulations

Procedures auditors currently do

There are multiple procedures within the auditor's skill set that are leveraged to assist with detecting or otherwise becoming aware that an illegal act has occurred. These procedures may include risk assessment procedures; examining whistleblower hotline records; inquiring with the entity's counsel or others within the organization; and reviewing legal expenses, board minutes, legal letters from internal and external counsel, and communication from regulators that might not be an asserted claim yet but potentially could have an impact. In these procedures, we are looking at what potential non-compliance the entity may be facing, but we are not looking for potential unasserted claims.

Upon becoming aware of a potential illegal act, our initial response is not affected by the distinction between direct or indirect. We obtain an understanding of the nature of the matter; the parties involved; laws and regulations in question; and the relevant implications on the financial statements and the engagement, including an assessment of our ability to rely on management's representations. This assessment also includes the auditor evaluating governance's response to the potentially noncompliant or illegal act.

Competence

During the audit process, the auditor may identify potential non-compliance with laws and regulation, such as a cyber-security breach or an environmental violation, for which the auditor may need to involve others in the entity or a specialist to assist with understanding and assessing the potential impact of the entity's noncompliance to the risk of material misstatement, as the auditor may lack the knowledge or skill set related to the particular subject matter. We agree with the views articulated by panelist Ms. McNees regarding competence during the panel discussion.[14] Ms. McNees stated, "It depends on the nature of the noncompliance item identified. To the extent the matter identified is more closely related to financial reporting, those are going to tend to be items that the auditor is more equipped to evaluate whether noncompliance actually has occurred. The further that deviates from that proximity to financial reporting, and particularly as it might get into more operational or technical types of laws and regulations, that would be where it would be more likely that the auditor would require additional assistance from a competence standpoint (i.e., engaging specialists) to assist with that evaluation of even determining whether or not noncompliance has in fact occurred." The interaction between the auditor and those hired to assist the company is heavily dependent on the facts and circumstances of the potentially noncompliant or illegal act in question and its effect on the financial statements.

Panel II: Considerations for an Auditor's Assessment of Noncompliance and Other Legal Considerations

Topic (2): Concerns Regarding Potential Waiver of Attorney-Client Privilege

Compliance with current standards and Section 10A

The initial evaluation and assessment of a potential illegal act is necessary to understand the facts and circumstances of what occurred and to allow the auditor to consider any modifications to the nature,

[14] Refer to Ms. McNees' comments made during *Panel II – Considerations for an Auditor's Assessment of Noncompliance and Other Legal Considerations* beginning at approximately 16:05.

timing and extent of their procedures. In this process, auditors may be involved in discussions with the audit committee and those hired to assist the company (e.g., legal counsel, forensic specialists) to understand the entity's next steps in regard to the potential noncompliance. The auditor's involvement with the investigation and the working relationship with those hired to assist the company will typically be dependent on the type of noncompliance identified and its significance to the financial statements.

The proposal's effect on attorney-client privilege and waiver of work-product protection

Currently, the standards acknowledge that "normally, an audit in accordance with PCAOB auditing standards does not include audit procedures specifically designed to detect illegal acts." The proposal imposes a duty to detect. This puts the auditor in a position to gather evidence of potential noncompliance. To discharge that duty, the auditor would need to inquire with legal counsel about potential noncompliance that may be part of a confidential and privileged investigation. The investigation may be underway or may not have concluded that there was indeed noncompliance. Revealing information gathered through the investigation (facts told to attorneys in confidence or mental impressions of attorneys about such communications) would waive the attorney-client privilege. This would disincentivize frank discussions with attorneys or even contacting an attorney of the organization to determine if noncompliance has occurred.

Further, in imposing a duty of detection, the proposal requires that auditors "determine whether it is likely that any such noncompliance occurred."[15] The current standard acknowledges that "whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence."[16] The proposal encourages the auditor "to consider whether specialized skill or knowledge is needed to assist the auditor in evaluating the noncompliance."[17] Therefore, under the proposal, an auditor can come to a noncompliance conclusion on his or her own that may differ with counsel for the company, or the auditor can hire an attorney to come to that conclusion. That tension will force a company to reveal attorney client communications and attorney mental impressions, normally kept confidential, to convince the auditor or the hired specialist that the company is in compliance.

In contrast, current standards and Section 10A focus on suspected noncompliance based on evidence that has come to the attention of an auditor. These matters are raised to management and the audit committee, and typically the audit committee hires independent counsel to advise the committee on the extent of noncompliance, the individuals involved, the effect—if any—on the financial statements and corrective actions. In those instances, attorneys for the audit committee share work product with the auditor so that the auditor can discharge his or her duties under the standards. Importantly, auditors do not typically receive attorney-client communications or attorney mental impressions during these investigations. Because noncompliance is established, the work product doctrine applies[18] and work product protections are not waived because the auditor is not in an adversarial role with the client.

Lastly, the proposal creates another category of privilege issues with no guidance for auditors. If an auditor seeks input from an attorney specialist in identifying laws that may have a material effect on financial statements or evaluating noncompliance, are the auditor's communications privileged and confidential? If the audit firm's internal counsel is used as a specialist, will they become witnesses in future enforcement or professional liability litigation? Will the auditor be forced to waive privilege to defend his or her actions? These issues need further development, discussion and guidance before the proposal is deliberated upon by the Board.

Disclosure of privileged communications and noncompliance with laws and regulations

Company counsel are frequently involved in investigating allegations of noncompliance. In these situations, privileged communications will contain unsubstantiated allegations of noncompliance. It is the

[15] Refer to proposed AS 2405.07.
[16] Refer to AS 2405.03.
[17] Refer to proposed AS 2405.07, Note 1.
[18] Work product doctrine protects records created in anticipation of litigation. Fed. R. Civ. P. 26(b)(3).

role of the company counsel to determine whether noncompliance has occurred and advise the organization appropriately. As discussed above, allowing an auditor to view attorney-client communications and attorney mental impressions about such communications would invade the privilege.

In situations where privileged communications clearly establish noncompliance, the attorney must advise the organization appropriately, including up-the-ladder disclosures as necessary to the audit committee pursuant to the obligations set forth in the Sarbanes-Oxley Act and implementing regulations. The auditor should be made aware of such up-the-ladder disclosures because the disclosures are only required in instances where company counsel believes there has been a material violation of law.[19] After an auditor is made aware of such a violation, the auditor will discharge his or her duties as discussed above under current standards and Section 10A.

The Board should carefully consider the important role that privilege and confidentiality rules play in the American legal system. The U.S. Department of Justice took years to develop its policy balancing cooperation credit and privileged investigations. As memorialized in the Justice Manual, "waiving the attorney-client and work product protections has never been a prerequisite under the Department's prosecution guidelines for a corporation to be viewed as cooperative."[20] During the roundtable discussion, a panelist suggested that it would be appropriate for an auditor to withhold an audit opinion to force a privilege disclosure.[21] This is precisely the scenario in which the Department of Justice chose to exercise restraint. The Board should do the same.

Panel III: Economic Impacts

Topic: Benefits and Costs of Proposal

Prior to the Board analyzing the potential economic benefits and costs of the proposal, the issues described above and in our first comment letter on this proposal must be addressed. Specifically, we and several other commenters and panelists believe that the threshold should be revised, but there is not consensus on what the revised language should be. As described above, we encourage the Board to continue to engage with stakeholders regarding potential language, but to provide a longer runway for stakeholders to provide meaningful feedback. This is one of many issues that could affect the analysis of benefits and costs.

Benefits analysis methodology

Several panelists referred to specific data and studies based on recent fraud cases. When determining whether to include these studies and data sets in the Board's analysis, we encourage the Board to consider the relevance. While noncompliance with laws and regulations is inclusive of fraud, fraud is not the subject of the proposal. We ask the Board to consider how the proposed standard would have prevented or detected these specific fraud cases and whether that is sufficiently clear.[22] These examples may be better suited to be included in the economic analysis related to the Board's mid-term standard-setting project on fraud.

Cost analysis methodology

We agree with the approach that several panelists suggested the Board take in its economic analysis to focus on the incremental benefits and costs.[23] This involves obtaining an understanding of the baseline

[19] Refer to 17 C.F.R. § 205.3.
[20] Refer to § 9-28.710 - Attorney-Client and Work Product Protections.
[21] Refer to Mr. Turner's comments made during *Panel II – Considerations for an Auditor's Assessment of Noncompliance and Other Legal Considerations* beginning at approximately 1:56:17.
[22] Refer to our earlier comments regarding the auditor's role in preventing and detecting noncompliance with laws and regulations.
[23] Refer to comments made by panelists Mr. Croteau, Ms. McNees and Ms. Honigsberg during *Panel III – Economic Impacts* beginning at approximately 48:50, 51:55 and 56:45, respectively.

procedures (i.e., what management and auditors do today), the desired incremental procedures of both management and auditors, and the perceived required incremental procedures based on the language in a revised proposal. Understanding the differences between these three distinct sets of procedures is imperative to understanding the incremental costs. As Ms. Honigsberg described in the panel, once this is understood, the Board can then begin to quantify the types, levels, hours and costs of resources that would be needed to achieve the perceived requirements.

Potentially disproportionate costs to small- and medium-sized issuers and firms

Several panelists and commenters alike agreed that the proposal, even if revised substantially, will likely require firms and issuers alike to hire attorneys, whether internally or externally. This could be true for firms and issuers of all sizes. However, it's important to note that this could disproportionally affect small- and medium-sized issuers and firms that do not have an established department of attorneys to provide similar services.[24]

Additionally, due to the privilege concerns discussed in Panel II, Topic 2, we anticipate needing to hire additional attorneys dedicated specifically to client work to address the requirements of the proposal and assist our auditors with the assessment and evaluation of noncompliance matters. This would avoid the potential pitfalls of existing professional liability counsel becoming witnesses in a matter. Whether staffed internally or outsourced, attorney input would result in an increase in fees which would be passed on to issuers and would in effect be paid for by investors.

Phased approach for implementation

During the roundtable discussion, the concept of a phased approach for implementing the standard was discussed.[25] While we agree with commentary that the standard should be written in a way that is scalable to all sizes of firms and entities, we do believe there is merit and value in having a phased approach similar to the effective dates of the critical audit matter requirements.[26] Given the significance of the amendments needed to the proposal, we cannot comment on the timing of an appropriate effective date.

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We would be pleased to respond to any questions the PCAOB or its staff may have about our comments. Please direct any questions to Adam Hallemeyer, Deputy Chief Auditor, at 619.641.7318, or Sara Lord, Chief Auditor, at 612.376.9572.

Sincerely,

RSM US LLP

RSM US LLP

[24] Refer to comments made by panelist Mr. Martin during *Panel I – Identification* beginning at approximately 53:13. While FedEx may have 500 attorneys on staff, our firm and our client base do not.
[25] Refer to Mr. Croteau's comments made during *Panel III – Economic Impacts* from approximately 50:00 to 50:20.
[26] Refer to PCAOB Release No. 2017-001.