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Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
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PCAOB proposing release on *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments* (PCAOB Release No. 2023-003; Docket Matter No. 051)

Dear Ms. Brown:

Ernst & Young LLP is pleased to submit to the Public Company Accounting Oversight Board (PCAOB or Board) its comments on the *PCAOB Staff Briefing Paper: Roundtable Discussion of Proposed Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations* (Briefing Paper) and on views expressed during the PCAOB's public roundtable on 6 March 2024.

We commend the PCAOB for hosting the roundtable after it received a significant number of comment letters on its proposal to amend auditing standards related to the auditor's responsibility for considering a company's noncompliance with laws and regulations (NOCLAR), including fraud. The roundtable provided a critical forum for all panelists to express their viewpoints on the topics identified in the Briefing Paper. The discussion highlighted that, while there appeared to be consensus among the panelists on several conceptual matters, there is still a wide spectrum of interpretations on critical components of the proposal.

We believe this reinforces the need to repropose the amendments in order for the PCAOB to make sure any changes to the initial proposal, based on input from comment letters and the roundtable, meet stakeholder needs and effectively balance costs and benefits. In that spirit, we are pleased to provide additional input on the Board's proposal. Additional perspectives are found in our original comment letter dated 7 August 2023.

As stated in our prior comment letter, we generally support the PCAOB's efforts to modernize its standards and clarify auditors' responsibilities with respect to a company's NOCLAR, including fraud. We believe a clear, comprehensive and actionable standard that addresses such responsibilities would enhance audit quality.

Identification of all laws

Many commenters highlighted concerns about requiring auditors to identify a complete list of laws and regulations to assess which ones presented a risk of material misstatement. At the roundtable, panelists consistently expressed the view that it would be impractical for auditors to identify a full and complete population of all laws and regulations that a company is subject to, and that it is necessary to clarify the “scope of laws and regulations” and the “process by which they are identified” to facilitate the auditor’s risk assessment. We agree with this view and recommend that the Board clarify the wording in the proposal to make that expectation clear.

Panelists expressed mixed views regarding the laws and regulations subject to auditor consideration that “could reasonably have” a material effect on the financial statements. We continue to believe the “could reasonably have” threshold would likely create confusion. Accordingly, we believe further revisions to the threshold are needed to clarify the expectations of the auditor while balancing the costs and benefits.

We recommend that alternatives, including those discussed at the roundtable, be vetted in more detail by all stakeholders, possibly through additional public roundtables hosted by the PCAOB, to identify a threshold that would be clearly understood by auditors and other stakeholders to promote transparency and reduce the potential for an expectation gap.

Expectations to detect noncompliance for indirect laws and regulations

We believe that the extent of the auditor’s procedures to address the risk of material misstatement related to noncompliance with indirect laws and regulations needs to be clarified. Panelists at the roundtable said a company’s compliance processes should play a primary role in the auditor’s understanding of relevant laws and regulations as well as the identification of noncompliance. They also said it is both reasonable and appropriate for auditors to understand the processes put in place by management to comply with laws and regulations and not perform their own independent evaluation.

However, we continue to believe that the nature and extent of procedures that are contemplated to address the risk of material misstatement for noncompliance with indirect laws and regulations are not clear. We believe the definition of the risk associated with noncompliance is a key element that needs to be addressed. The focus of such risk should be on “material misstatement” and not “material effect” on the financial statements as Doug Carmichael, a professor at Baruch College, noted during the roundtable. We agree that this distinction is important.

Under existing standards, auditors have an obligation to design and perform procedures to provide reasonable assurance that there are no material misstatements due to NOCLAR that have a direct effect on the financial statements. This entails having responsibilities to detect both potential noncompliance and the effects of such noncompliance on the financial statements. Without further clarification of the risk of material misstatement and the extent of procedures necessary to detect noncompliance with other laws and regulations, the auditor’s response to the risk of material misstatement under the proposal would appear to require the auditor to obtain reasonable assurance that noncompliance with indirect laws and regulations has not occurred.

However, this would require expertise beyond the skills of the auditor to design and perform procedures to evaluate (1) whether the company's programs were adequately designed to identify instances of noncompliance with indirect laws and regulations and (2) whether the company's programs were operating sufficiently to prevent and detect such noncompliance. In the Appendix to our 7 August 2023 comment letter, we provided three examples of how such enhanced risk assessment procedures would be performed and how they could help the auditor address noncompliance with indirect laws and regulations under the proposal.

The Appendix to this letter provides an example of the extent of effort and expertise that would be needed if the auditor were required to determine whether noncompliance occurred, as compared to an auditor's objective of obtaining reasonable assurance that no material misstatements related to detected noncompliance with indirect laws and regulations exist.

We support the PCAOB's efforts to update its auditing standards by enhancing the auditor's focus on the company's NOCLAR (including on noncompliance that has an indirect effect on the financial statements) to increase the likelihood that auditors become aware of potential noncompliance that could materially affect the determination of financial statement amounts.

However, we believe any new requirements should allow the auditor to maintain a role that preserves their independence by preventing the perception that they are part of management's control structure. Such requirements should also align with the auditor's knowledge and skill sets, be based within the context of management's requirements today and align with the scope and objective of an audit. The auditor's risk assessment would inform the planning and performance of additional risk assessment procedures related to the potential detection of NOCLAR. Such additional procedures could relate to:

- ▶ Understanding the processes and controls management has in place to identify instances of noncompliance and the outcome of those processes (e.g., a company's compliance programs)
- ▶ An increased focus on inquiries of management, audit committees, internal audit, legal counsel, compliance personnel and others about potential noncompliance, supported by additional written representations
- ▶ Consideration of evidence of legal and regulatory concerns, such as inspection of regulatory correspondence

We believe that it is critical to define the risk that the auditor is addressing since the proposal refers to the PCAOB's risk assessment standard and the auditor's responsibility to identify risks of material misstatement, specifically for those laws and regulations that have an indirect effect. How the risk is defined, and the nature and extent of procedures necessary for the auditor to respond to that risk, would significantly impact the nature, timing and extent of procedures related to noncompliance that an auditor needs to perform, which will impact the skills required to execute them.



Recommendation for reproposal

Based on the significant number of comment letters received by the PCAOB and the various viewpoints raised in these letters and expressed at the roundtable, we recommend that the PCAOB repropose the amendments to its auditing standard to give stakeholders another opportunity to consider potential changes to the auditor's evaluation of noncompliance. We believe a reproposal would be imperative to help the PCAOB make sure that the scope and extent of changes in the auditor's work are clear, their impact to audit quality adequately addresses stakeholders' concerns, and the costs and benefits of those changes are sufficiently considered.

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We want to again thank the Board and its staff for considering our comments. We would be pleased to discuss them with the Board or its staff at their convenience.

Very truly yours,

Ernst & Young LLP

Example of skills needed if the auditor's responsibility is to determine whether noncompliance occurred under the proposal¹**Background:**

Consider an audit of a bank and the risk of noncompliance with respect to discrimination in residential mortgage lending (see Example 2 in our comment letter dated 7 August 2023 for the enhanced risk assessment procedures an auditor could perform with respect to this type of indirect law). After performing enhanced risk assessment procedures, the auditor has determined that potential fines to the bank could be material if its lending policies do not comply with the Fair Housing Act (FHA) or the Equal Credit Opportunity Act (ECOA), which means these laws could have a material effect on the bank's financial statements. The FHA and ECOA prohibit banks and other creditors from discriminating against persons on the basis of race, color, national origin or other characteristics when engaging in residential mortgage lending. One of the forms of discrimination is "redlining," which denies people access to credit because of where they live, even if they are personally qualified for loans or other credit services. Federal regulators examine the bank's assessment area in evaluating whether the bank is meeting the credit needs of the entire community.

Procedures:

The procedures that an auditor would need to perform include:

- ▶ Understanding the bank's process to comply with FHA/ECOA requirements, including underlying policies, procedures and processes to prevent, detect and evaluate noncompliance.
- ▶ Evaluating the design of the bank's programs to determine the likelihood that, if noncompliance was detected, it was not appropriately evaluated for disclosure/accrual.
- ▶ Engaging specialists to assist in evaluating the design of the bank's programs and to determine whether the bank participated in lending discrimination, which could include:
 - ▶ Obtaining, or independently performing, a mapping of the bank's policies and procedures to the FHA and ECOA to identify potential areas of noncompliance/discrimination.
 - ▶ Performing directed inquiries of bank management and branch employees in each bank lending area to understand the bank's lending policies and whether they are being followed.
 - ▶ Determining and evaluating the completeness and accuracy of the bank's lending area(s) relative to the expectations of the law and evaluating the lending practices relative to those demographics.

¹ This example is provided for illustrative purposes only and is based on a general understanding of certain FHA and ECOA requirements. It is not based on any specific financial or lending institution.

- ▶ Obtaining data regarding the staffing of loan officers to evaluate the adequacy across the markets where the bank operates.
- ▶ Performing procedures to identify indicators that the bank could be viewed as insufficiently providing credit to certain demographic groups. This could include for each of the bank's lending areas reviewing information about loan applications and originated loans and comparing it across different markets in which the bank operates and evaluating the statistical significance of differences between the bank and its peers. The auditor would most likely engage a specialist to perform the statistical analysis and would also need to identify sources of reliable and relevant information on peer banks' lending businesses. Such information would need to be both sufficiently detailed to be relevant to the auditor's analysis while also being publicly available.
- ▶ Obtaining information on the bank's advertising spending for all of its lending areas and assessing whether the spending/allocation may be inequitable or insufficiently targeted toward demographic groups that exhibit low loan demand.
- ▶ Concluding, with the help of specialists, whether the bank engaged in discriminatory residential lending.
- ▶ Determining the financial statement impact of instances of noncompliance (e.g., potential fines, the potential for regulators to provide a probationary period for the bank to meet certain standards and improve certain metrics potentially foregoing the imposition of a penalty or fine) for disclosure and accrual in the financial statements in accordance with Accounting Standards Codification (ASC) 450, *Contingencies*.

Contrast these procedures with an auditor's objective of obtaining reasonable assurance that material misstatements related to detected noncompliance with indirect laws and regulations do not exist. In this case, since noncompliance with discriminatory lending laws could result in fines that are material to the financial statements, the auditor could perform enhanced risk assessment procedures to focus on understanding the company's policies and procedures related to lending practices, as well as evaluate the design and operating effectiveness of the bank's processes and controls to disclose and/or accrue contingent liabilities associated with NOCLAR.

With an increased understanding of the bank's lending policies, the auditor would be better positioned to conduct inquiries of management, including with those who are responsible for preventing and detecting noncompliance, evaluate communications with regulators, identify information indicating that instances of noncompliance with the lending laws have or may have occurred, communicate with the audit committee, and determine the appropriate disclosure and accrual of contingencies in the financial statements in accordance with ASC 450.

While the auditor may still involve specialists to assist in the enhanced risk assessment procedures, the skills required to obtain reasonable assurance that a material misstatement related to detected noncompliance with indirect laws and regulations does not exist would be more in line with the objectives of the auditor and the purpose of the financial statement audit.