

# To the Point

PCAOB – proposal

PCAOB proposes expanding auditor's responsibilities for considering noncompliance with all laws and regulations

The proposal would require auditors “to proactively be on guard for all noncompliance that may have a material impact on the financial statements.”

— PCAOB Chair Erica Y. Williams

## What you need to know

- ▶ The PCAOB proposed expanding the auditor's responsibility for considering a company's noncompliance with all laws and regulations, including those related to fraud, and eliminating the distinction between direct and indirect effects on financial statements in today's standard.
- ▶ The proposal would expand the evidence auditors need to obtain, through inquiry and other procedures, to understand the registrant's processes and identify laws and regulations that could reasonably have a material effect on the financial statements if the registrant didn't comply with them. Auditors would then be required to plan and perform specified procedures to determine whether there is information indicating that noncompliance has or may have occurred.
- ▶ Two of the five PCAOB board members (both CPAs) dissented, citing a number of concerns, including their belief that the proposal would unduly expand the scope of audits of public companies.
- ▶ Comments are due by 7 August 2023.

## Overview

The Public Company Accounting Oversight Board (PCAOB) proposed amending its auditing standards to require auditors to (1) identify laws and regulations that could reasonably have a material effect on the financial statements if the company does not comply with them, (2) assess and respond to the risks of material misstatement due to noncompliance and (3) determine whether there is information indicating noncompliance or potential noncompliance.

The proposal would also require auditors to evaluate and communicate with management and the audit committee when the auditor becomes aware of information indicating that noncompliance with laws and regulations, including those related to fraud, has or may have occurred.

Current PCAOB standards require the auditor to identify noncompliance with laws and regulations that have a direct and material effect on the financial statements. They also require the auditor to be aware of the possibility that noncompliance with laws and regulations that have an indirect effect on the financial statements may have occurred and prescribe steps the auditor must take with respect to information that comes to the auditor's attention during the audit.

The PCAOB noted in its proposing release that laws and regulations considered to have indirect effects on the financial statements, such as anti-money laundering regulations and environmental regulations, can lead to substantial fines and penalties if violated.

The proposal would significantly increase the level of effort auditors expend to understand laws and regulations that may have an indirect effect on the financial statements and assess the risks that noncompliance could reasonably result in a material misstatement to the financial statements. Based on this risk assessment, an auditor performing an audit of internal control over financial reporting would have to evaluate the design and operating effectiveness of the company's legal compliance function for all identified laws and regulations (both direct and indirect) that could reasonably have a material effect on the financial statements if the company did not comply with them.

Because of the complexities associated with understanding and assessing what conduct and activities would represent noncompliance, as well as their potential effect on the financial statements, auditors would likely need to increase their use of specialists.

One dissenting board member, Duane M. DesParte, said the requirement to identify the laws and regulations for which noncompliance could reasonably have a material effect on the financial statements "is well beyond both the scope of the financial statement audit and the auditor's core competency" and could significantly increase the use of lawyers and others as specialists on many, if not all, PCAOB audits.

The PCAOB adopted the current standards, which mirror Section 10A of the Securities Exchange Act of 1934 (Exchange Act), in 2003, based on standards of the American Institute of Certified Public Accountants.

## Key considerations

The proposal would expand an auditor's responsibilities and go beyond current auditing standards and securities regulations by adding an objective to Auditing Standard (AS) 2405, which would be renamed *A Company's Noncompliance with Laws and Regulations*, for the auditor to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements.

Auditors currently are required to identify laws and regulations that have a direct and material effect and to design and execute audit procedures to detect and report material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts. This responsibility is similar to the auditor's responsibility to detect misstatements caused by error or fraud.

However, existing audit standards require that the auditor be aware of the possibility that illegal acts that have a material but indirect effect on the financial statements may have occurred. The proposal would no longer make this distinction.

Under the proposal, the auditor performing an integrated audit would be required to plan and perform procedures to understand management's process for maintaining compliance and to test the design and operating effectiveness of controls for laws and regulations that they deem to have both direct and indirect effects today.

The proposal would also amend AS 2110, *Identifying and Assessing Risks of Material Misstatement*, to include more specific requirements on how to obtain an understanding of the regulatory environment of the company and require the auditor to make specific inquiries of management, the audit committee and others regarding noncompliance with laws and regulations.

For example, auditors would be required to perform procedures as part of obtaining an understanding of the company that are currently described as procedures an auditor should consider performing, including reading public information about the company or its executive officers, obtaining an understanding of compensation arrangements with senior management other than executive officers, obtaining information about trading activity and holdings in the registrant's securities and inquiring of the chair of the compensation committee and any compensation consultants engaged by the registrant about the registrant's compensation structure for executive officers.

The proposal also would require the auditor to plan and perform procedures to determine whether there is information indicating noncompliance has or may have occurred for all laws and regulations that could reasonably have a material effect on the financial statements.

In addition, the proposal would require the auditor to consider whether specialized skill or knowledge is needed to assist the auditor in understanding certain laws and regulations and performing risk assessment procedures. The auditor would also be required to consider whether specialists are needed to assist in evaluating whether it is likely noncompliance occurred or in developing more rigorous inquiries of management or others to understand the circumstances in which noncompliance may have occurred.

The proposal wouldn't substantially change how an auditor that determines that noncompliance has likely occurred would assess the implications. The proposal would add a requirement for the auditor to perform additional procedures as necessary to determine whether the noncompliance results in material misstatement of the financial statements or results in other information in documents containing audited financial statements, or the manner of its presentation, being materially inconsistent with information appearing in the financial statements or containing a material misstatement of fact.

The proposal would explicitly require the auditor to determine whether senior management has taken timely and appropriate remedial action to address noncompliance with laws and regulations that has a material effect on the financial statements, in connection with its obligations under Section 10A of the Exchange Act.

### **Communications with management and the audit committee**

When the auditor becomes aware of information indicating that noncompliance with laws and regulations, including those related to fraud, has or may have occurred, the auditor would be required to make an initial communication to management and the audit committee. This communication would be required before the auditor determines whether the noncompliance has or is likely to have occurred or whether it has a material effect on the financial statements. Mr. DesParte questioned whether it would be an appropriate use of audit committee time to be informed of possible noncompliance before any auditor evaluation occurs.

The proposal would significantly increase the volume of communications auditors are required to make to the audit committee when noncompliance has or may have occurred.

One exception to this communication requirement would be for matters that are “clearly inconsequential.” Auditors would not be required to communicate these matters to the audit committee, although they would have to communicate them to management.

Additional communications to management and (unless the matter is clearly inconsequential) the audit committee would be required after the auditor has completed an evaluation of whether the noncompliance has or may have occurred or if the auditor is unable to complete its evaluations.

Auditors also would be required to make additional communications directly to the board of directors when they conclude (1) the likely noncompliance has a material effect on the financial statements, (2) senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial action with respect to the likely noncompliance and (3) the failure to take remedial action is reasonably expected to cause the auditor to not issue an unqualified opinion or to resign from the audit. These requirements would be consistent with those required for issuer audits in Section 10A(b)(2) of the Exchange Act.

### How we see it

- ▶ The proposal would significantly expand the scope of public company audits by establishing new auditor obligations and responsibilities that go beyond existing PCAOB and International Auditing and Assurance Standards Board requirements, as well as requirements of Section 10A of the Exchange Act. Auditors would likely need to rely heavily on lawyers and other specialists to comply.
- ▶ The proposal could lead auditors to request more information from registrants that could be subject to the attorney-client privilege or another legal protection, and registrants may be concerned about waiving such protections. Failure of registrants to provide that information could impact the auditor’s ability to obtain sufficient audit evidence.
- ▶ The proposal would likely increase the volume of matters that auditors discuss with audit committees when noncompliance has or may have occurred. Such communications would likely vary substantially in significance.
- ▶ The proposal would introduce, without defining, new concepts such as “could reasonably have a material effect,” “has or may have occurred” and “likely to have occurred” to guide the auditor’s effort.

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