

**Proposing Release:**

**Amendments to PCAOB Auditing Standards  
related to a Company's Noncompliance with  
Laws and Regulations**

**And Other Related Amendments**

PCAOB Release No. 2023-003

June 6, 2023

PCAOB Rulemaking  
Docket Matter No. 051

**Summary:** The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing amendments to its auditing standards related to an auditor's consideration of a company's noncompliance with laws and regulations in the performance of an audit. The proposal would:

- (1) Replace:
  - *AS 2405, Illegal Acts by Clients*, and retitle the standard *A Company's Noncompliance with Laws and Regulations*;
- (2) Amend:
  - *AS 2110, Identifying and Assessing Risks of Material Misstatement*;
  - and
  - Other auditing and related professional practice standards; and
- (3) Rescind:
  - *AS 6110, Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance*;
  - *AI 13, Illegal Acts by Clients: Auditing Interpretations of AS 2405*; and
  - *AI 21, Management Representations: Auditing Interpretations of AS 2805*.

**Public**

**Comment:** Interested persons may submit written comments to the Board. Comments should be sent by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [pcaobus.org](http://pcaobus.org). Comments also may be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All

comments should refer to PCAOB Rulemaking Docket Matter No. 051 in the subject or reference line and should be received by the Board by August 7, 2023.

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**TABLE OF CONTENTS**

**I. EXECUTIVE SUMMARY ..... 4**

**II. BACKGROUND & REASONS TO IMPROVE STANDARDS ..... 8**

A. CURRENT REQUIREMENTS..... 9

B. OBSERVATION FROM OVERSIGHT ACTIVITIES ..... 15

C. REASONS FOR THE PROPOSAL ..... 17

**III. DISCUSSION OF PROPOSAL ..... 20**

A. OVERVIEW OF AN AUDITOR’S CONSIDERATION OF NONCOMPLIANCE WITH LAWS AND REGULATIONS IN AN AUDIT..... 20

B. DEFINITION OF NONCOMPLIANCE WITH LAWS AND REGULATIONS ..... 23

C. PROPOSED AMENDMENTS RELATED TO A COMPANY’S NONCOMPLIANCE WITH LAWS AND REGULATIONS ..... 26

D. AMENDING OTHER PCAOB STANDARDS TO IMPROVE THE AUDITOR’S CONSIDERATION OF NONCOMPLIANCE WITH LAWS AND REGULATIONS IN THE AUDIT ..... 54

E. OTHER AMENDMENTS ..... 58

F. ADDITIONAL QUESTIONS REGARDING CERTAIN ASPECTS OF THE PROPOSAL..... 60

**IV. ECONOMIC ANALYSIS ..... 60**

A. BASELINE..... 60

B. NEED..... 68

C. ECONOMIC IMPACTS..... 72

D. ALTERNATIVES CONSIDERED ..... 88

**V. SPECIAL CONSIDERATIONS FOR AUDITS OF EMERGING GROWTH COMPANIES..... 91**

**VI. EFFECTIVE DATE ..... 94**

**VII. OPPORTUNITY FOR PUBLIC COMMENT ..... 94**

**APPENDIX 1 – PROPOSED AMENDMENTS TO AS 2405, *ILLEGAL ACTS BY CLIENTS***

**APPENDIX 2 – OTHER RELATED PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS**

**APPENDIX 3 – PROPOSED CONFORMING AMENDMENTS TO PCAOB AUDITING STANDARDS**

## I. EXECUTIVE SUMMARY

We are proposing amendments to PCAOB auditing standards related to the auditor's responsibility for considering a company's noncompliance with laws and regulations, including fraud,<sup>1</sup> in an audit. Auditors have a fundamental obligation to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports. This obligation includes a responsibility to identify and evaluate information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred and to make appropriate communications to management and the audit committee about such information.

Under PCAOB standards, the auditor plans and performs the audit to obtain reasonable assurance that the company's financial statements are free of material misstatement, whether due to error or fraud. This is a well-established responsibility. Misstatements in the financial statements can arise by intentional conduct, such as fraud, or by unintentional conduct, such as errors in the financial statements. Intentional misstatements may be made to purposefully achieve a particular financial statement presentation.

Companies are subject to a variety of legal and regulatory environments depending on a number of factors, including, among others, geographic location, the product or services provided, and the particular industry. As a result, companies are also subject to a range of consequences from noncompliance with laws and regulations. We have observed and empirical evidence has shown that companies' noncompliance with laws and regulations may lead to sanctions, fines, and civil settlements, resulting in substantial financial damage to investors, especially when such noncompliance goes undetected for longer periods of time. Share prices may also be negatively affected by reputational consequences for the companies resulting from such noncompliance, including lower future earnings and increases in the cost of capital. Highly publicized matters have drawn attention to the role of the auditor in detecting violations of laws and regulations, including consumer, environmental, or other laws and regulations.

The Board believes that improving auditing standards can: (i) protect investors from the resulting harm of noncompliance with laws and regulations when the effect of such noncompliance has a material effect on the financial statements and (ii) improve audit quality

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<sup>1</sup> Except as noted in Section IV, the term "fraud" used in this proposing release and its appendices has the same meaning as it does in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (i.e., an intentional act that results in a material misstatement in financial statements that are the subject of an audit). To be clear, the definition of "noncompliance with laws and regulations" includes both fraud as defined under AS 2401.05 and all other types of fraud, such as non-scienter based fraud.

through the auditor's identification of noncompliance with laws and regulations that could reasonably result in a material effect on the financial statements.

We are proposing to establish and strengthen requirements for (i) identifying, through inquiry and other procedures, laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, (ii) assessing and responding to the risks of material misstatement arising from noncompliance with laws and regulations, (iii) identifying whether there is information indicating noncompliance has or may have occurred, and (iv) evaluating and communicating when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including 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. These standards have few requirements related to the auditor's identification of other noncompliance (which has an indirect effect on the financial statements). The proposal does not carryforward this distinction between laws and regulations with which noncompliance would have a direct effect on the financial statements and those with which noncompliance would have an indirect effect. Our research has indicated that laws and regulations considered to have indirect effects on the financial statements, such as anti-money laundering regulations and environmental regulations, among others, can lead to substantial fines and penalties if violated. Moreover, our outreach has indicated that the distinction in dividing illegal acts into categories of those with direct effects and those with indirect effects on the financial statements has been a source of confusion to investors. The auditing standards have historically used the distinction to limit the auditors' responsibilities – such that the auditor need only perform certain audit procedures depending on the category.

We believe the auditor should focus on those laws and regulations with which noncompliance could reasonably result in a material effect on the financial statements. We also believe that removing this distinction will improve the auditor's identification of a company's noncompliance with laws and regulations with which noncompliance could have a material effect on the financial statements, potentially resulting in the auditor's conducting better risk assessments, and in turn, designing and implementing better responses to the identified risks of material misstatement due to noncompliance with laws and regulations, and, in doing so, better protect investors.

The proposal would establish specific requirements for auditors to understand management's processes regarding compliance with laws and regulations, which can provide insight into the company's control environment, and to identify, through inquiry and other procedures, laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements. To facilitate this identification, we are proposing amendments that include a requirement for the auditor to obtain an understanding of the regulatory environment and management's processes related to, among

other things, identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. While the existing standards include references to understanding the regulatory environment, the proposal would enhance such requirements by describing the nature of the laws and regulations that the auditor should understand as part of the audit.

The proposal would also strengthen current requirements by requiring auditors to plan and perform specified procedures, including risk assessment procedures, to identify whether there is information indicating noncompliance with laws and regulations has or may have occurred. Auditors would be required to assess and respond to risks of material misstatement due to noncompliance with those identified laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, which could enhance their ability to identify whether there is information indicating that noncompliance with such laws and regulations has or may have occurred. We believe that an auditor's consideration of laws and regulations with which noncompliance could result in a material effect on the financial statements would improve auditor's risk assessment, and correspondingly, the nature, timing, and extent of the audit procedures deployed in response to those risks.

Currently, AS 2405, *Illegal Acts by Clients*, prescribes the nature and extent of the consideration the auditor should give to the possibility of illegal acts by an audit client in an audit of financial statements. Existing AS 2405, which operates in conjunction with the illegal acts provisions of Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1 ("Exchange Act") for the audits of issuers, states that normally, an audit in accordance with PCAOB auditing standards does not include audit procedures designed to detect illegal acts with an indirect effect on the financial statements.<sup>2</sup> The proposed amendments would change that presumption and strengthen existing practice by enhancing identification and communication obligations that are in addition to the baseline identification and communication requirements set forth in Section 10A. Further, while Section 10A does not apply to audits of SEC-registered brokers or dealers, we believe the requirements of the statute and those additional obligations would be appropriate for all audits conducted under PCAOB standards to protect investors.

In addition to the changes noted above, we are proposing to change the term "illegal acts" throughout the standard to "noncompliance with laws and regulations." The proposed change is due, in part, because auditors may interpret the term "illegal acts" to exclude instances of noncompliance perceived not to be significant enough to examine pursuant to the requirements in existing AS 2405 without considering the effect those instances could have on the financial statements. While the Board interprets the current requirements to include any noncompliance by the company whose financial statements are under audit, or by the

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<sup>2</sup> See existing AS 2405.08. Section 10A(a)(1) requires that issuer audits include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."

company's management, its employees, or others that act in a company capacity or on the company's behalf, for avoidance of doubt, the proposal would make this more explicit. The proposal also makes explicit that fraud is a type of noncompliance with laws and regulations by including fraud, as described in AS 2401, *Consideration of Fraud in a Financial Statement Audit*, in the proposed definition of "noncompliance with laws and regulations."

The proposed amendments would also require the auditor to make specific inquiries of management, the audit committee, internal audit personnel, and others regarding noncompliance with laws and regulations. These proposed inquiries would assist the auditor in identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements as well as the auditor's assessment of risks of material misstatement due to noncompliance. This would enable the auditor to better design and perform procedures that are responsive to the risk of material misstatement due to noncompliance with laws and regulations which could enhance their ability to identify whether there is information indicating noncompliance has or may have occurred. These risk assessment procedures may also directly provide the auditor with information indicating that noncompliance with laws and regulations has or may have occurred. In developing the proposed procedures, we took into account developments in corporate governance since the standard's original issuance in 1988, which include the growth of whistleblower and ethics and compliance programs.

When the auditor has identified or otherwise becomes aware of information indicating that noncompliance has or may have occurred, the auditor would be required to evaluate whether it is likely that noncompliance has occurred, and if so, the possible effects on the financial statements and the implications of such likely noncompliance on other aspects of the audit. The auditor would be required to communicate potential noncompliance, and the subsequent results of the auditor's evaluation of such potential noncompliance, to management and the audit committee. Under the proposal, the auditor would be required to determine the effect, if any, of any likely noncompliance on the engagement report and the ongoing relationship with the client.

In addition to these changes specifically related to consideration of noncompliance with laws and regulations, we are also proposing certain amendments that are intended to generally enhance the auditor's risk assessment procedures relating to sources of information used as part of those procedures. Specifically, companies currently have more varied mediums to provide information, including information beyond that required by federal securities laws or other regulations, to investors compared to when the risk assessment standards were originally adopted. The volume of information about the company from sources external to the company, such as media reporting and analyst reports, has also become more prevalent. The proposal enhances the risk assessment requirements by expanding the sources of information the auditor looks to when assessing risks of material misstatement in the financial statements, which should lead to more informed and complete audit responses.

The proposed amendments also would require specific coordinated procedures and communications concerning noncompliance when auditors' specialists or other auditors participate in the audit. These proposed requirements would address two-way communication between the lead auditor and the other auditors or auditors' specialists and would improve the auditor's awareness of a company's potential noncompliance with laws and regulations. The proposed amendments would also require the auditor to evaluate implications for the audit when transactions or relationships with a related party indicate noncompliance has or may have occurred regardless of how the auditor becomes aware of such transactions or relationships (that is, whether or not such transactions or relationships were disclosed by the company to the auditor). We are also proposing amendments to the standard on reviews of interim financial information to provide specific procedures, including additional inquiries, related to potential noncompliance.

The Board believes that the proposed amendments will enhance audit quality and, in doing so, better protect investors.

The Board seeks comment on the proposed amendments (including proposed AS 2405, *A Company's Noncompliance with Laws and Regulations*), alternatives to the proposed amendments, the economic impacts of the proposal, and data on current practices and potential benefits and costs. Throughout this release, the Board requests additional comment on specific issues. Readers are encouraged to answer questions in the release and to comment on any aspect of the release or the proposed amendments, regardless of whether specific questions address the issue. Readers are especially encouraged to provide the reasoning to support their views and any relevant data.

Instructions on how to comment, including by e-mail or postal mail, can be found on the cover sheet of this release. The release can be found at the docket page of PCAOB Rulemaking Docket Matter No. 051.

## II. BACKGROUND & REASONS TO IMPROVE STANDARDS

Companies across many industries and countries operate in various regulatory environments. These regulatory environments, including the applicable financial reporting framework and the legal environment, can be complex. Violations of laws and regulations that a company is subject to can materially affect the financial statements.

Investors and others continue to be interested in auditors' roles and responsibilities related to potential or actual illegal acts. Highly publicized matters have drawn attention to the role of the auditor in detecting violations of laws and regulations, including consumer,



environmental, or other laws and regulations.<sup>3</sup> We have observed that investor harm from violations of laws or regulations can be significant.<sup>4</sup>

Below, we discuss the current requirements under PCAOB auditing standards and the Exchange Act and rules thereunder for the identification, evaluation, and communication and reporting of noncompliance; observations regarding current practices; and the need to improve auditing standards in this area.

## A. Current Requirements

### 1. Auditor Responsibilities Under AS 2405, *Illegal Acts by Clients*, and other PCAOB Standards

Existing AS 2405 is the Board's principal standard prescribing the auditor's responsibilities for (i) considering the possibility of illegal acts by a company and (ii) responding when a possible illegal act is detected. Existing AS 2405.05 states that the auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud. The standard describes the auditor's obligations with respect to illegal acts that have a direct or indirect effect on amounts and disclosures in the financial statements. These obligations fall into three main areas: identification, evaluation, and communication and reporting.

*Identification.* Existing AS 2405 imposes different responsibilities for identifying illegal acts based on two categories: (i) illegal acts that have a direct and material effect on financial statement amounts, and (ii) illegal acts that have an indirect effect on the financial statements. The auditor's responsibility to identify illegal acts that have direct and material effects on financial statement amounts, such as violations of tax or pension laws, is to obtain "reasonable

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<sup>3</sup> See Alexander Dyck, Adair Morse, and Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 *Journal of Finance* 2213 (2010); see also Letter from Senators Warren and Markey to PCAOB dated April 25, 2017, available at <https://www.warren.senate.gov/oversight/letters/senators-raise-concerns-with-accounting-regulator-about-wells-fargo-auditor-kpmg>; *SEC Charges Volkswagen, Former CEO with Defrauding Bond Investors During "Clean Diesel" Emissions Fraud*, SEC Litigation Rel. No. 24422 (Mar. 15, 2019); Donald L. Ariail, Dalton Cobb, and D. Larry Crumbley, *Anatomy of a Non-Financial Fraud: VW's Dieseldate*, 6802 *Oil, Gas & Energy Quarterly* 3.1 (2019)..

<sup>4</sup> See *Brazilian Mining Company to Pay \$55.9 Million to Settle Charges Related to Misleading Disclosures Prior to Deadly Dam Collapse*, SEC Press Rel. No. 2023-63 (Mar. 28, 2023), and *SEC v. Vale S.A.*, No. 1:22-cv-02405, ECF Nos. 1 and 51 (E.D.N.Y.) (complaint and consent final judgment); *In the Matter of Compass Minerals International, Inc.*, SEC Rel. No. 34-95889 (Sept. 23, 2022) (settled order); *In the Matter of Health Insurance Innovations, Inc., now named Benefytt Technologies, Inc.*, SEC Rel. No. 34-95323 (July 20, 2022) (settled order); *In the Matter of Fiat Chrysler Automobiles N.V.*, SEC Rel. No. 34-90031 (Sept. 28, 2020) (settled order); *In the Matter of Wells Fargo & Company*, SEC Rel. No. 34-88257 (Feb. 21, 2020) (settled order).

assurance” that the financial statements are free of material misstatements from such illegal acts.<sup>5</sup>

Other illegal acts, such as violations of occupational safety, health, and environmental laws, may have an indirect effect on the financial statements. The laws involved often relate more to a company’s operations than its financial reporting and by themselves would ordinarily not result in financial reporting obligations. These laws ordinarily only result in recording obligations when the company does not comply and a penalty, fine, or contingency needs to be recorded. Existing AS 2405.07 requires the auditor to be aware of the possibility that illegal acts with an indirect effect on financial statements may have occurred and that information about such violations may arise from performing other procedures. Auditors are required to make inquiries, including inquiries about: (i) the company’s knowledge of violations or possible violations of laws or regulations; and (ii) policies relative to the prevention of illegal acts.<sup>6</sup> Auditors are also required to obtain written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.<sup>7</sup>

*Evaluation.* Under existing AS 2405, once the auditor becomes aware of a possible illegal act, the auditor’s evaluation of the possible illegal act is the same regardless of whether such act has a direct or indirect effect on the financial statements. Specifically, existing AS 2405.10 requires the auditor to obtain an understanding of the nature of the act and the circumstances in which it occurred and to evaluate the effect on the financial statements. In performing these steps, the auditor is required to make inquiries of management at a level above the individuals involved, if possible. When the auditor concludes that an illegal act has or is likely to have occurred, the auditor is required to consider the effect on the financial statements, including the materiality of the act (considering quantitative and qualitative factors), as well as the adequacy of the disclosure in the financial statements of the potential effects of the illegal act on the company’s operations.<sup>8</sup> Existing AS 2405.16 further requires the auditor to consider the implications of an illegal act in relation to other aspects of the audit, including the reliability of management representations.

*Communication and Reporting.* Under existing AS 2405.17, the auditor is required 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 come to the auditor’s attention, unless the illegal act is “clearly inconsequential.” The communication to the audit committee is required to describe the act, the circumstances of its occurrence, and the

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<sup>5</sup> See AS 1001, *Responsibilities and Functions of the Independent Auditor*.

<sup>6</sup> See AS 2405.08.

<sup>7</sup> See AS 2405.08; see also AS 2805, *Management Representations*.

<sup>8</sup> See AS 2405.13-.15.

effect on the financial statements. If the auditor concludes that an illegal act has a material effect on the financial statements and has not been properly accounted for or disclosed, existing AS 2405.18 requires the auditor to express a qualified opinion or an adverse opinion on the financial statements. Furthermore, the auditor may conclude that withdrawal is necessary when the client does not take the remedial action that the auditor considers necessary in the circumstances, even when the illegal act is not material to the financial statements.<sup>9</sup>

Under existing AS 2405.23, disclosure of an illegal act directly to third parties (i.e., parties other than the client's senior management and its audit committee or board of directors) is not ordinarily part of the auditor's responsibility. Existing AS 2405.23 acknowledges, however, that auditors may have a duty to notify parties outside the client in certain circumstances. These circumstances include those in which: (i) notice is required by Section 10A; (ii) the company reports an auditor change under federal securities law on Form 8-K; (iii) a successor auditor makes an inquiry under AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*; and (iv) the auditor receives a subpoena.<sup>10</sup>

In addition to existing AS 2405, several other PCAOB auditing standards inform the auditor's consideration of a company's possible illegal acts.

AS 2110, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to obtain an understanding of: (i) relevant industry factors, which encompass the company's competitive environment and technological developments; (ii) the regulatory environment, including the applicable financial reporting framework and the legal and political environment; and (iii) external factors, including general economic conditions.<sup>11</sup> In addition, as part of the required inquiries related to fraud risk factors, AS 2110.56 requires the auditor to inquire of management and the audit committee whether they received or are aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists<sup>12</sup>) and, if so, management's and the audit committee's responses to such tips and complaints. Such

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<sup>9</sup> See AS 2405.22.

<sup>10</sup> The auditor may also have reporting or notification obligations regarding noncompliance with laws, rules, and regulations to regulators or other third parties, such as to the SEC pursuant to Exchange Act Rule 17a-5(h), 17 C.F.R. § 240.17a-5(h), for brokers and dealers.

<sup>11</sup> See AS 2110.09.

<sup>12</sup> Under Section 10A(m)(4) and Exchange Act Rule 10A-3(b)(3), 17 C.F.R. § 240.10A-3(b)(3), audit committees of listed issuers must establish procedures for (1) handling of complaints regarding accounting, internal accounting control, or auditing matters; and (2) confidential, anonymous submission by the issuer's employees of concerns regarding questionable accounting or auditing matters.

procedures may help the auditor to identify, among other things, possible illegal acts, including fraud.

AS 2401 requires the auditor to perform specific procedures to address risks of misstatement arising from fraudulent financial reporting and from misappropriation of assets.<sup>13</sup> Although such procedures are not specifically designed to detect other illegal acts with an effect on a company's financial statements, they may inform the auditor's understanding of the company and, in some cases, bring other illegal acts to the auditor's attention.

AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, requires the auditor to perform procedures to identify litigation, claims, and assessments, including unasserted claims and assessments that management considers to be probable of assertion and as to which a lawyer has been engaged.<sup>14</sup> These procedures include inquiries of management, examination of documents, and obtaining management representations.<sup>15</sup>

AS 2805 requires the auditor to obtain various representations from management, including representations regarding the following: (i) knowledge of any fraud or suspected fraud, (ii) violations or possible violations of laws or regulations whose effects are required to be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and (iii) unasserted claims or assessments that the company's lawyer has advised are probable of assertion and are required to be disclosed in accordance with the applicable financial reporting framework.<sup>16</sup>

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, requires the auditor, when planning an integrated audit, to evaluate whether there are legal or regulatory matters of which the company is aware that are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures.<sup>17</sup> In addition, AS 2201 requires the auditor to evaluate the effect of the findings with respect to illegal acts on the effectiveness of internal control over financial reporting.<sup>18</sup>

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<sup>13</sup> AS 2401.06 states that with respect to misappropriation of assets, "the scope of this section includes only those misappropriations of assets for which the effect of the misappropriation causes the financial statements not to be fairly presented, in all material respects."

<sup>14</sup> See AS 2505.05.

<sup>15</sup> See AS 2505.05.

<sup>16</sup> See AS 2805.06.

<sup>17</sup> See AS 2201.09.

<sup>18</sup> See AS 2201.B8.

## 2. Certain Auditor Responsibilities Under Select Federal Securities Laws

*Section 10A.* Firms auditing public companies are required to comply with the illegal acts provisions<sup>19</sup> of Section 10A, as well as the requirements stated in existing AS 2405.<sup>20</sup> Similar to the PCAOB's auditing standards, Section 10A(a)(1) requires that issuer audits include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."

Section 10A(b)(1) establishes further requirements if the auditor detects or otherwise becomes aware of information indicating that an illegal act "has or may have occurred." These requirements apply to all illegal acts, regardless of whether the act has a direct or indirect effect and regardless of whether it is "perceived to have a material effect on the financial statements."<sup>21</sup> Under Section 10A, upon learning information indicating an illegal act has or may have occurred, the auditor is required to:

- Determine whether it is likely that an illegal act has occurred, and, if so, determine and consider its possible effect on the financial statements (including any contingent monetary effects, such as fines, penalties, and damages);<sup>22</sup> and
- As soon as practicable, inform the appropriate level of management and assure that the audit committee<sup>23</sup> is adequately informed of any illegal act that has been detected or has otherwise come to the auditor's attention, unless the act is clearly inconsequential.<sup>24</sup>

Under Section 10A(b)(2), after determining that the audit committee has been adequately informed of the illegal act, the auditor is required to communicate the illegal act to the board of directors when the following three circumstances are present:

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<sup>19</sup> The illegal acts provisions of Section 10A discussed in this release are contained in subsections (a), (b), and (f). Paragraph (a)(1) addresses illegal acts that have a direct and material effect on the determination of financial statement amounts; subsection (b) specifies responsibilities when an auditor detects or otherwise becomes aware of an illegal act; and subsection (f) contains the definition of an "illegal act." Under Section 10A(f), an "illegal act" is broadly defined as "an act or omission that violates any law, or any rule or regulation having the force of law."

<sup>20</sup> Section 10A does not apply to audits of brokers and dealers unless the broker or dealer is an issuer.

<sup>21</sup> Section 10A(b)(1).

<sup>22</sup> Section 10A(b)(1)(A).

<sup>23</sup> In the absence of an audit committee, the auditor obtains assurance that the board of directors is adequately informed. Section 10A(b)(1)(B).

<sup>24</sup> Section 10A(b)(1)(B).

- The illegal act has a material effect on the financial statements;<sup>25</sup>
- Senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act;<sup>26</sup> and
- The failure to take remedial action is reasonably expected to warrant either a departure from a standard audit report or resignation from the engagement.<sup>27</sup>

If the board of directors receives a communication from an auditor in the above circumstances, the issuer has one business day to notify the SEC of that communication from the auditor and provide the auditor with a copy of the notice to the SEC.<sup>28</sup> If the auditor fails to receive a copy of the notice, the auditor is required within one business day to either (i) resign from the engagement<sup>29</sup> and furnish the SEC a copy of the auditor's communication (or the documentation of any oral communication given) to the board of directors;<sup>30</sup> or (ii) furnish the SEC a copy of the auditor's communication (or the documentation of any oral communication given) without resigning.<sup>31</sup>

*Exchange Act Rule 17a-5.* Firms auditing brokers and dealers are required to comply with the notification provisions of Exchange Act Rule 17a-5.<sup>32</sup> Rule 17a-5(h) requires auditors of registered brokers or dealers to notify the SEC (and the designated examining authority) in circumstances where (1) an auditor has identified noncompliance with certain financial responsibility rules or a material weakness in the broker or dealer's internal control over compliance; (2) the auditor has brought the situation to the attention of the chief financial officer of the broker or dealer; and (3) the broker or dealer fails to notify the SEC (and the

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<sup>25</sup> Section 10A(b)(2)(A).

<sup>26</sup> Section 10A(b)(2)(B).

<sup>27</sup> Section 10A(b)(2)(C).

<sup>28</sup> Section 10A(b)(3); *see also* Exchange Act Rule 10A-1, 17 C.F.R. § 240.10A-1.

<sup>29</sup> An auditor's resignation triggers public disclosure requirements for the company under SEC rules, including discussion of any disagreements between the company and the auditor over accounting or audit matters. Regulation S-K Item 304, 17 C.F.R. § 229.304 (Changes in and disagreements with accountants on accounting and financial disclosure); *see also* SEC Form 8-K, Item 4.01(a).

<sup>30</sup> Section 10A(b)(3)(A), (b)(4).

<sup>31</sup> Section 10A(b)(3)(B).

<sup>32</sup> 17 C.F.R. § 240.17a-5.

designated examining authority) of the noncompliance or material weakness, as required under Commission rules,<sup>33</sup> or provides a notice with which the auditor does not agree.

## B. Observation from Oversight Activities

The proposal is based, in part, on our observations from oversight activities and our understanding of current practices. The proposal is meant to promote audit quality by enhancing the auditor's identification, evaluation, and communication of noncompliance with laws and regulations and improving investor protection.

Our understanding of current practice has been informed by observations from review of current firm methodologies, PCAOB oversight activities, and relevant enforcement actions. The sources reviewed included audit deficiencies identified in our inspections related to noncompliance with existing AS 2405 and enforcement activities where the firm failed to adequately comply with existing AS 2405 or the provisions of Section 10A, or both.

*Firm methodologies.*<sup>34</sup> In addition to existing AS 2405 requirements, many firms' methodologies include requirements of International Standard on Auditing (ISA) 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* (ISA 250), issued by the International Auditing and Assurance Standards Board (IAASB), and AU-C Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AU-C 250), issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA). Many of these methodologies use the terms "illegal act" and "noncompliance with laws and regulations" interchangeably, and firms often apply the same procedures in their public and private company audits.

Staff has observed disparate practices among accounting firms. Some firms' relevant audit methodologies adhere closely to the requirements of existing AS 2405 and Section 10A. Other firms' audit methodologies go beyond the current requirements. For example, some firm methodologies include procedures to use work performed as part of their overall risk assessment procedures and testing of internal controls to identify instances of noncompliance.

In another example, some firm methodologies include requirements to obtain an understanding of a company's whistleblower and ethics and compliance programs, including

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<sup>33</sup> See 17 C.F.R. §§ 240.15c3-1, 240.15c3-3, 240.17a-11.

<sup>34</sup> The staff reviewed methodologies relating to the auditor's consideration of illegal acts used by PCAOB-registered firms, including Global Network Firms and Non-Affiliated Firms, and two methodologies typically purchased by smaller firms. According to a report by Audit Analytics, for companies with a market cap greater than \$75 million, Global Network Firms audit approximate 75 percent of the total market cap. *Who Audits Public Companies, by Market Cap – 2021 Edition*, (June 30, 2021), available at <https://blog.auditanalytics.com/who-audits-public-companies-by-market-cap-2021-edition/>.

tips and complaints received. Other examples of procedures performed by some, but not all firms, on their PCAOB audits include inspecting company's correspondence with the relevant licensing or regulatory authorities; making inquiries to others within the company familiar with compliance-related activities, such as the general counsel, compliance officers, or internal audit personnel; and in multi-location audits providing specific audit instructions to other auditors, including performing specific audit procedures related to risks of noncompliance.

Although some firms' methodologies require auditors to perform procedures beyond those required by existing PCAOB standards (like the examples discussed above), practices vary among firms. We believe our proposal would lead to greater conformity among all firms' current methodologies while enhancing the procedures for auditors to perform. For example, we have observed that firm methodologies generally do not include specific procedures for auditors to plan and perform procedures to identify noncompliance with law and regulations that typically are viewed to have an indirect effect of the financial statements.

*Inspection and Enforcement Findings.* Staff has observed some inspection and PCAOB and SEC enforcement activity relating to existing AS 2405 and the illegal acts provisions of Section 10A. Inspection findings generally involved failures by auditors to identify issuer loans to officers as illegal acts prohibited by Section 13(k) of the Exchange Act.<sup>35</sup> Although the loans were disclosed in the financial statements or other information accompanying the audited financial statements, the auditors did not properly apply the evaluation and communication procedures in existing AS 2405 with respect to the prohibited loans.<sup>36</sup> Enforcement cases generally involved failures by auditors to appropriately respond to evidence of potential securities law violations<sup>37</sup> or to include procedures designed to obtain reasonable assurance of detecting illegal acts that would have a direct and material effect on financial statement amounts.<sup>38</sup> The latter cases generally involved prohibited loans or similar financial

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<sup>35</sup> See 15 U.S.C. § 78m(k).

<sup>36</sup> PCAOB inspections are designed to assess a firm's compliance with PCAOB standards and rules and other applicable regulatory and professional requirements with respect to the firm's quality control system and in the portions of engagements selected for review. An inspection does not necessarily involve a review of all of a firm's engagements, nor is it designed to identify every deficiency in the reviewed engagements.

<sup>37</sup> See, e.g., *In the Matter of Brian Dee Matlock, CPA*, SEC Rel. No. 34-89552 (Aug. 13, 2020) (settled order involving alleged offering fraud and failure by auditor to determine whether suspicious circumstances constituted evidence of illegal acts).

<sup>38</sup> See, e.g., *In the Matter of Seale and Beers CPAs, LLC*, PCAOB Rel. No. 105-2017-038 (Sept. 14, 2017) (settled order involving auditor's failure to, among other things, include procedures to determine whether cash transactions in corporate officer's personal bank account represented prohibited loan or other illegal act).



improprieties.<sup>39</sup> The inspection findings and enforcement cases show failures by auditors to scrutinize the effects that illegal acts may have on the financial statements and the conduct of the audit.

### C. Reasons for the Proposal

Detection of a company's noncompliance with laws and regulations that could reasonably have a material effect on the financial statements is important because such noncompliance can lead to a material misstatement of the financial statements and substantial adverse consequences for its investors, including as a result of monetary sanctions imposed by regulators, restrictions upon business operations, increases in the cost of capital, and reputational harm. In recent years, highly publicized matters have drawn attention to the role of the auditor in detecting violations of consumer, environmental, or other laws and regulations relating to the company's operations. In many cases, the failures to comply with the applicable laws and regulations resulted in penalties, fines, damages, or other material adverse consequences to the company and harm to investors.

Several factors necessitate the amendments set forth in this proposal. First, current AS 2405 predates the enactment of federal securities law provisions that fundamentally altered or affected the auditor's responsibilities for detecting and responding to illegal acts. AS 2405, originally AU Section 317, *Illegal Acts by Clients*, ("AU 317"), was adopted by the PCAOB in April 2003<sup>40</sup> based on a standard issued by the ASB in 1988.<sup>41</sup> After the ASB's issuance of AU 317, in 1995, Congress enacted the illegal acts provisions of Section 10A, which codified certain requirements contained in AU 317 and imposed additional obligations.<sup>42</sup> Subsequently, in 2002,

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<sup>39</sup> *Id.*; see also, e.g., *In the Matter of EFP Rotenberg, LLP*, SEC Rel. No. 34-78393 (July 22, 2016) (settled order in which auditor failed, among other things, to perform procedures concerning whether issuer should have reported security deposits of customers as assets).

<sup>40</sup> Shortly after the Board's inception, the Board adopted the existing standards of the AICPA, as in existence on April 16, 2003, as the Board's interim auditing standards. *See Establishment of Interim Professional Auditing Standards*, PCAOB Rel. No. 2003-006 (Apr. 18, 2003) (adopting Rule 3200T, Interim Auditing Standards); *Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002*, SEC Rel. No. 34-47746 (Apr. 25, 2003) (approving adoption of Rule 3200T); *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Rel. No. 2015-002 (Mar. 31, 2015); *Order Granting Approval of Proposed Rules to Implement the Reorganization of PCAOB Auditing Standards and Related Changes to PCAOB Rules and Attestation, Quality Control, and Ethics and Independence Standards*, SEC Rel. No. 34-75935 (Sept. 17, 2015) (approving reorganization of audit standards).

<sup>41</sup> See SAS No. 54, *Illegal Acts by Clients* (Apr. 1988).

<sup>42</sup> Section 10A was passed as part of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, § 301 (Dec. 22, 1995). Subsections (a), (b), and (f) of the originally enacted statute have undergone minor terminology changes, but the substantive obligations for auditors remain the same.

Congress passed Sarbanes-Oxley, which included provisions requiring (i) audit committees to establish procedures for the receipt of complaints about accounting, internal control, and auditing matters;<sup>43</sup> and (ii) issuers to assess, and auditors to attest to, internal control over financial reporting.<sup>44</sup> These and other laws led companies to develop more sophisticated ethics and compliance systems, of which auditors are required to obtain some understanding under PCAOB audit standards.<sup>45</sup> Notably, the Department of Justice and the SEC adopted policies explicitly incorporating these systems into decisions over whether and how to pursue organizational wrongdoing, particularly with regard to the Foreign Corrupt Practices Act (“FCPA”).<sup>46</sup> We believe the proposed amendments would assist auditors in detecting noncompliance with laws and regulations by incorporating these developments in corporate governance into the Board’s standards.

Additionally, investors and investor-related groups, including the Board’s Investor Advisory Group (IAG), have recommended that the Board take on a project related to noncompliance with laws and regulations. These groups have cited many of the same reasons as noted throughout this proposal. In the 2017 IAG Working Group Recommendations, the IAG advised, among other things, that existing AS 2405 was outdated.<sup>47</sup> The IAG Working Group concluded that the existing standard did not clearly articulate the auditor’s obligations for identifying and responding to potential noncompliance with laws and regulations. Similar to the staff’s observations, the IAG Working Group noted that existing standards do not expressly include an obligation for assessing risks of material misstatement due to noncompliance with laws and regulations as part of audit planning, including any requirements for the auditor to consider developments in corporate governance and whistleblower programs. Further, the IAG recommended that the auditor should be responsible for planning and performing procedures

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<sup>43</sup> Sarbanes-Oxley § 301 (adding subsection (m) to Section 10A, which directed the SEC to require national securities exchanges and associations to prohibit the listing of any security of an issuer not in compliance with certain standards, including the establishment of complaint procedures by the audit committee).

<sup>44</sup> Sarbanes-Oxley § 404, 15 U.S.C. § 7262.

<sup>45</sup> See AS 2110.30, AS 2110.56, AS 2405.08.

<sup>46</sup> See *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, U.S. Department of Justice, Criminal Division and U.S. Securities and Exchange Commission, Division of Enforcement, chapter 5 (Nov. 14, 2012), available at <https://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf>. The same agencies issued a second edition in July 2020. Available at <https://www.justice.gov/criminal-fraud/file/1292051/download>.

<sup>47</sup> See Report from the Working Group on Auditor's Consideration of a Client's Noncompliance with Laws and Regulations (Oct. 24, 2017), available at [https://assets.pcaobus.org/pcaob-dev/docs/default-source/news/events/documents/10242017-iag-meeting/wg-slides-noclar.pdf?sfvrsn=7106e876\\_0](https://assets.pcaobus.org/pcaob-dev/docs/default-source/news/events/documents/10242017-iag-meeting/wg-slides-noclar.pdf?sfvrsn=7106e876_0). See also Comments on the Advisory Group Frameworks, available at <https://pcaobus.org/about/advisory-groups/comments-on-advisory-groups-draft-governance-frameworks> (comments 3 and 16).

to identify noncompliance which could have a material effect on the financial statements. The IAG Working Group's recommendations also included suggestions that the auditing standards include obligations for documentation, enhancements to audit committee communications about noncompliance, and more precise obligations for the auditor's evaluation of information indicating noncompliance has or may have occurred. The IAG Working Group also noted that the auditor should be required to evaluate the effect of noncompliance on the financial statements, including the notes, and other information accompanying audited financial statements.<sup>48</sup>

Importantly, as discussed below in Section IV, auditors have disincentives that may keep them from playing a significant role with respect to identifying companies' noncompliance with laws and regulations. Highly publicized matters have drawn attention to the role of the auditor in detecting violations of laws and regulations, including consumer, environmental, or other laws and regulations. We have observed that investor harm from such violations can be significant. Consistent with the presence of disincentives, and as also further discussed in Section IV, auditors have not tended to play a significant role in early identification and minimization of these instances.

Also, as noted earlier, we have also observed that within and among firms there are disparate practices when considering noncompliance with laws and regulations in their audits. Because we have observed that firm methodologies generally do not include specific procedures for auditors to plan and perform procedures to identify noncompliance with law and regulations that typically are viewed to have an indirect effect of the financial statements, auditors may not be identifying such noncompliance that could result in the investor harm described earlier.

We believe that the proposed amendments to PCAOB standards as described in this proposal would promote audit quality by enhancing the identification, evaluation, and communication of noncompliance with laws and regulations, lead to more consistency in practice, and improve investor protection.<sup>49</sup>

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<sup>48</sup> See *id.*

<sup>49</sup> This proposal is also responsive to comments the Board and the SEC have received over the years supporting an update to AS 2405 to advance investor protection. See Comment Letters on the 2018-2022 Strategic Plan, available at <https://pcaobus.org/about/comments-on-pcaob-draft-strategic-plan-2018-2022>; April 19, 2021 Letter to Chairman Gensler, available at <https://consumerfed.org/wp-content/uploads/2021/04/PCAOB-IAG-Letter.pdf>; Comments on the Advisory Group Frameworks, available at <https://pcaobus.org/about/advisory-groups/comments-on-advisory-groups-draft-governance-frameworks> (comments 3 and 16).

### III. DISCUSSION OF PROPOSAL

#### A. Overview of an Auditor's Consideration of Noncompliance with Laws and Regulations in an Audit

This proposal is intended to modernize and strengthen auditing standards related to the auditor's consideration of a company's noncompliance with laws and regulations, including fraud, that has or may have occurred by improving the auditor's identification, evaluation, and communication requirements.<sup>50</sup> Specifically, to enhance investor protection, we are amending several standards and replacing AS 2405 to strengthen requirements for (i) the auditor's identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; (ii) the related risk assessment procedures that address noncompliance with laws and regulations; (iii) the auditor's identification of whether there is information indicating noncompliance has or may have occurred; and (iv) the auditor's responsibility when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred. The proposed amendments would change the existing presumption that normally an audit in accordance with PCAOB auditing standards does not include audit procedures designed to identify noncompliance with an indirect effect on the financial statements.<sup>51</sup> Further, we are also strengthening the related subsequent evaluation and communication requirements. The proposal is also intended to help the auditor discharge certain obligations pursuant to Section 10A.

The auditor plans and performs the audit to obtain reasonable assurance that the company's financial statements are free of material misstatement, whether due to error or fraud. This is a well-established responsibility. Misstatements in the financial statements can arise when the effects of noncompliance with laws and regulations are not properly presented (that is, recorded or disclosed) in the financial statements.

Proposed AS 2405 would establish specific requirements for the auditor to (i) plan and perform procedures to identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, (ii) assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations, and (iii) identify whether there is information indicating that noncompliance with those laws and regulations has or may have occurred. Proposed AS 2405 would also establish requirements for the subsequent evaluation and communication of instances of noncompliance

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<sup>50</sup> This release and the proposed standard occasionally use expressions such as "noncompliance with laws and regulations, including fraud" or "fraud or other noncompliance with laws and regulations" to remind the reader that noncompliance encompasses fraud.

<sup>51</sup> See existing AS 2405.08. Section 10A(a)(1) requires that issuer audits include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."

with laws and regulations that have or may have occurred—regardless of whether the effect of the noncompliance is perceived to be material to the financial statements—when the auditor identifies or otherwise becomes aware of information indicating noncompliance with laws and regulations.

Under the proposed amendments, the auditor would perform procedures to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. These procedures would include procedures that the auditor performs as part of risk assessment in planning the audit as well as other procedures in performing the audit that inform the auditor of the laws and regulations applicable to the company.

Upon identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, the proposed amendments would require the auditor to perform risk assessment procedures to assess the risk of material misstatement of the financial statements due to those laws and regulations. Amendments to AS 2110 would enhance existing required risk assessment procedures, which would also be designed to assist the auditor to better identify instances of noncompliance with laws and regulations that could reasonably have a material effect on the financial statements. The proposed amendments would more expressly direct the auditor to assess the risks of material misstatement arising from a company's noncompliance with laws and regulations. The performance of enhanced risk assessment procedures is intended to inform the auditor's understanding of how noncompliance with laws and regulations could have a material effect on the financial statements and enable the auditor to assess and respond to the related risk of material misstatement. The enhanced risk assessment procedures include more specific requirements regarding –

- Obtaining an understanding of the company and its environment, including the regulatory environment;
- Obtaining an understanding of management's processes related to
  - Identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
  - Preventing, identifying, investigating, evaluating, communicating, and remediating instances of noncompliance with laws and regulations;
  - Receiving and responding to tips and complaints from internal and external parties regarding noncompliance with laws and regulations; and
  - Evaluating potential accounting and disclosure implications of noncompliance with laws and regulations, including fraud; and

- Making specific inquiries of management, the audit committee, and others regarding noncompliance with laws and regulations.

The auditor would use information learned throughout the audit, including during the risk assessment process, which includes understanding of the company and its environment, understanding of the company's industry, and results of inquiries, and interim reviews, to identify those laws and regulations which the company's noncompliance could reasonably have a material effect on the financial statements. These laws and regulations would necessarily be relevant to the company or its operations but would not represent every law or regulation to which the company is subject. The auditor would also assess the risks of material misstatement of the financial statements due to noncompliance with those laws and regulations. The auditor's objective would be to develop appropriate audit responses to risks of material misstatement due to noncompliance with those laws and regulations and to identify whether there is information indicating noncompliance with those laws and regulations has or may have occurred.

As noted above, the amendments to AS 2110 are intended to enhance the auditor's understanding and identification of noncompliance with laws and regulations that could result in a material misstatement of the financial statements. For example,<sup>52</sup> as a result of performing procedures, the auditor of a chemical company may identify information about environmental regulations related to chemical waste disposal that create a risk of material misstatement because the effect of violations of the regulations could result in material fines, penalties, or the obligation to perform environmental remediation. The auditor would be required to obtain an understanding of management's processes related to preventing, identifying, investigating, evaluating, communicating, and remediating noncompliance with such laws and regulations. Management's processes could involve the company's specialists who tested whether the company's chemical waste disposal complied with regulatory requirements. Obtaining an understanding of management's processes could also involve obtaining reports from the company's specialist or reports from relevant regulators about the company and understanding how the company used those reports in their processes. Performing such a procedure could inform the auditor about whether noncompliance with any relevant environmental regulations has or may have occurred.

In another example, an auditor of a cloud computing service company that has millions of dollars in revenue and global service offerings would likely identify federal, state, and international privacy laws and regulations as among those with which noncompliance could reasonably result in a material effect on the financial statements. The auditor would be required to obtain an understanding of management's processes related to the identified privacy laws and regulations. Similar to the previous example, obtaining this understanding

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<sup>52</sup> This example and others in this release involve hypothetical situations and are provided for illustrative purposes only. These examples are not intended to provide guidance on the sufficiency of audit procedures to be used in specific circumstances or on other auditing issues.

could include obtaining reports from relevant regulators and understanding how the company used those reports in their processes.

The auditors' other procedures to obtain reasonable assurance that the financial statements are free of material misstatement, due to error or fraud, may also bring information to the auditor's attention that noncompliance with those laws and regulations has or may have occurred. The auditor would evaluate information obtained through performing the risk assessment procedures and other audit procedures to develop appropriate audit responses, including the evaluations in proposed AS 2405.<sup>53</sup>

When the auditor has identified, or otherwise becomes aware of, information indicating that noncompliance has or may have occurred, the auditor would be required to obtain an understanding of the nature and circumstances of any such noncompliance and determine whether it is likely that noncompliance has occurred. If it is likely, the auditor would be required to determine possible effects on the financial statements and the implications of such likely noncompliance on other aspects of the audit. At the same time, the auditor would be required to communicate, as soon as practicable, the matter (i.e., the information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred) to the appropriate level of management and the audit committee.

After the auditor has completed the evaluation of the information indicating noncompliance has or may have occurred, the auditor would determine the effect of any likely noncompliance on the engagement report and the ongoing relationship with the company. The auditor would also be required to communicate the results of that evaluation to management and the audit committee, including the effect on the engagement report.

Key aspects of the proposal are discussed in this section.

## B. Definition of Noncompliance with Laws and Regulations

We propose replacing the term "illegal acts" with "noncompliance with laws and regulations." Currently, "illegal acts" is defined in existing AS 2405 as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."<sup>54</sup>

In lieu of "illegal acts," the proposed standard would define "noncompliance with laws and regulations" as:

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<sup>53</sup> See generally AS 2301.

<sup>54</sup> See existing AS 2405.02.

An act or omission, intentional or unintentional, by the company whose financial statements are under audit, or by the company's management, its employees, or others that act in a company capacity or on the company's behalf, that violates any law, or any rule or regulation having the force of law. Noncompliance with laws and regulations includes fraud as described in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*. Noncompliance with laws and regulations does not include personal conduct by the company's personnel unrelated to the business activities of the company.

The proposed change is, in part, because the auditor may interpret the term "illegal acts" to exclude instances of noncompliance perceived not to be significant enough to examine pursuant to the requirements in existing AS 2405, irrespective of the effect those instances could have on the financial statements. Furthermore, the word "act" may incorrectly suggest that only affirmative conduct falls within existing AS 2405, whereas the word "noncompliance" more clearly includes both acts and omissions.

As with the existing definition of "illegal acts," the Board intends "noncompliance with laws and regulations" to have a broad meaning and to encompass violations of any law or any regulation having the force of law. We expect the auditor to focus on all types of noncompliance, whether the violations concern financial or operational issues or involve intentional or unintentional conduct. For example, if an auditor learned that a company filed a Form 10-K that contained inaccurate data or failed to include required information, the auditor would have to address this noncompliance without regard to the intent of the issuer or the materiality of such disclosure to the financial statements.<sup>55</sup>

The proposed definition expressly provides that noncompliance with laws and regulations by a company includes all violations of laws or regulations by the company whose financial statements are under audit, or by the company's management, its employees, or others that act in a company capacity or on the company's behalf. The definition is intended to capture the many types of noncompliance for which a company may be held responsible, including in any disciplinary or administrative proceeding, or any civil or criminal action. Such violations normally arise from acts or omissions by company personnel, other individuals affiliated with the company and acting on its behalf (such as board members or independent contractors), or any other persons or entities acting within the scope of an agency relationship with the company. The definition would encompass a wide variety of conduct, including embezzlement of company funds, misappropriation of assets, or payment of bribes, as well as other conduct that has financial consequences to the company, such as violations of employment, occupational safety and health, antitrust, or privacy laws and regulations.

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<sup>55</sup> For avoidance of doubt, we note that the current scope of illegal acts is materially the same as the proposed definition. The replacement of the terminology would provide more clarity to auditors, issuers, and investors.



However, consistent with existing AS 2405, noncompliance with laws and regulations would not include personal conduct unrelated to company business.

As the definition states, we are also proposing to expressly include fraud within the definition of noncompliance with laws and regulations. AS 2401.05 describes fraud as an “intentional act that results in a material misstatement in financial statements that are the subject of an audit.” Accordingly, by definition, such noncompliance has a material effect on the financial statements. While AS 2401 would continue to govern the auditor’s responsibilities with respect to the identification of information that may be indicative of fraud, the evaluation and communication of fraud would be addressed by proposed AS 2405, and those requirements would be applied in the same manner as for other forms of noncompliance with laws and regulations. In addition, we are proposing to combine the existing risk assessment requirements related to fraud with requirements related to other noncompliance with laws and regulations. The Board anticipates this approach would promote consistency in addressing all types of noncompliance that has or may have occurred and would allow the Board to eliminate overlapping requirements in multiple standards.<sup>56</sup>

We considered whether changing terms would lead to confusion in practice. The definition in proposed AS 2405 would be generally consistent with the definition of “illegal act” under Section 10A, as well as the term used in auditing standards promulgated by other standard-setting bodies.<sup>57</sup> This term would also be generally consistent with SEC rules for brokers and dealers that refer to noncompliance with rules, such as Exchange Act Rule 17a-5. For these reasons, we do not believe any confusion would result.

*Questions:*

1. Is the proposed definition of “noncompliance with laws and regulations” sufficiently clear? If not, why not?
2. Is the rationale for including fraud, as described in AS 2401, within the proposed definition of noncompliance with laws and regulations sufficiently clear? If not, why not?
3. Is additional clarification necessary regarding the scope of the meaning of a company’s noncompliance with laws and regulations? If so, please describe or provide examples of the types of noncompliance where additional clarification is needed.

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<sup>56</sup> See further discussion in Section III.C.1.

<sup>57</sup> ISA 250 and AU-C 250 both use the term “noncompliance with laws and regulations” rather than “illegal acts.”

## C. Proposed Amendments Related to a Company's Noncompliance with Laws and Regulations

### 1. Introduction and Objectives

*See proposed AS 2405.01-.04*

Auditors have a fundamental obligation to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports. The Supreme Court described this responsibility as a "public watchdog" function that "demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."<sup>58</sup> It is critical that auditors bear in mind their fundamental obligation to investors. Further, as noted in the proposed standard, this fundamental obligation includes a responsibility to identify and evaluate information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred and make appropriate communications to management and the audit committee about such information.

The proposed standard reiterates to auditors that noncompliance with laws and regulations can result in material misstatement of the financial statements. An auditor's report provides the auditor's opinion as to whether the financial statements are free of material misstatement. Proposed AS 2405 does not seek to change that foundational audit objective but does seek to clarify that risks of material misstatement could exist as a result of a company's noncompliance with laws and regulations.

Misstatements of the financial statements can arise when violations of laws and regulations occur and are not properly presented in the financial statements in accordance with the applicable financial reporting framework.<sup>59</sup> Such misstatements can be due to error (i.e., unintentional misstatements, such as the incorrect recording or disclosure of a contingency due to misapplication of laws and regulations) or fraud (i.e., intentional, material misstatement of the financial statements). We believe the potential risks of material misstatement due to noncompliance with laws and regulations require the auditor address them as part of planning and performing the audit.

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<sup>58</sup> See *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (also noting that an "independent certified public accountant ... [b]y certifying the public reports that collectively depict a corporation's financial status, ... assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to [the] investing public") (emphasis in original).

<sup>59</sup> See, e.g., proposed AS 2405.02. See also paragraph .03 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

The proposed standard reminds auditors that they are required to design and implement audit responses that address the risks of material misstatement, including the risk of material misstatement of the financial statements resulting from noncompliance with laws and regulations.<sup>60</sup> Additionally, one of the auditors' objectives is to assess and respond to the risks of material misstatement, whether due to error or fraud, thereby providing a basis for designing and implementing responses to the risks of material misstatement.<sup>61</sup>

The introduction reminds auditors about the effect that noncompliance with laws and regulations could have on financial statements. The introduction states that proposed AS 2405 would establish requirements regarding the auditor's identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred, and the subsequent evaluation and communication when an auditor identifies or otherwise becomes aware of such information.

We are also proposing to add objectives for the auditor. Existing AS 2405 does not provide an objective. The proposed standard states that the auditor's objectives are to:

- a. Identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
- b. Based on the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, assess and respond to the risk of material misstatement of the financial statements due to noncompliance with those laws and regulations;
- c. Identify whether there are instances of noncompliance with laws and regulations that have or may have occurred; and
- d. When the auditor identifies or otherwise becomes aware of information indicating that instances of noncompliance have or may have occurred, evaluate and communicate such instances of noncompliance (regardless of whether the effect of the noncompliance is perceived to be material).

While Section 10A requires auditors to include audit procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts,<sup>62</sup> the objective of our proposed standard

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<sup>60</sup> See generally proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023); AS 2110, *Identifying and Assessing Risks of Material Misstatement*; and AS 2301.

<sup>61</sup> See, e.g., AS 2110.03-.04.

<sup>62</sup> See Section 10A(a)(1), 15 U.S.C. § 78j-1(a)(1).

does not include the distinction between laws and regulations that have a direct or an indirect effect on financial statements. The objective of the proposed standard instead would focus the auditor's attention on any laws or regulations with which the auditor determined noncompliance could reasonably have a material effect on the financial statements, which includes but is not limited to those that have a direct and material effect on the financial statements.<sup>63</sup> Therefore, our proposed standard would go beyond the requirements of Section 10A.

These objectives seek to provide direction with respect to what the auditor would be required to achieve when performing the requirements of the proposed standard. The objectives are expected to help focus the auditor's attention during the performance of the proposed procedures.

*Questions:*

4. Is the introduction to proposed AS 2405 sufficiently clear? If not, how should the introduction be clarified?

5. Are the objectives for proposed AS 2405 sufficiently clear? If not, how should the objectives be clarified?

6. Are there other objectives that should be included in proposed AS 2405? If so, what would those objectives be?

**2. Plan and Perform Procedures Related to Noncompliance with Laws and Regulations**

*See proposed AS 2405.05-.06*

In order to achieve the proposed standard's objectives, proposed AS 2405 would require the auditor to plan and perform procedures to: (1) identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; (2) assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations; and (3) identify whether there is information indicating noncompliance with those laws and regulations has or may have occurred.

The proposed standard includes a requirement for auditors to plan and perform procedures to identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. Existing AS 2405 does not have a similar requirement. While auditors may already be identifying such laws and regulations during their

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<sup>63</sup> See Section III.C.2 for additional discussion of the auditor's identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements.

risk assessment procedures as they obtain an understanding of the legal and regulatory environment or perform other planning procedures,<sup>64</sup> the proposal expressly would require auditors to identify the laws and regulations for which noncompliance “could reasonably have a material effect” on the financial statements.

We believe the inclusion of the phrase “could reasonably have a material effect” would appropriately tailor the requirements to include those laws and regulations that relate to the way matters are presented (that is, recorded or disclosed) in the financial statements (for example, tax, pension, and certain securities laws) and other laws and regulations that may relate to the operations of a company with which the company’s noncompliance could reasonably result in material penalties, fines, or damages to the company (for example, for a chemical company, environmental protection regulations). These laws and regulations would necessarily be relevant to the company or its operations but would not represent every law or regulation to which the company is subject. We believe that the proposed standard appropriately focuses the auditor’s attention on laws and regulations that could have a material effect on the financial statements. In doing so, we believe the standard will promote audit quality by ensuring that material effects of noncompliance with laws and regulations are appropriately presented, and in so doing, the standards promote investor protection.

When identifying this population of laws and regulations, the auditor would be able to benefit from management’s process to identify these laws and regulations. Issuers currently identify and disclose material risks related to laws and regulations in periodic filings made under federal securities laws.<sup>65</sup> The auditor’s identification would not be limited to those laws and regulations identified by management when fulfilling this obligation, however, such laws and regulations are a source of information for the auditor.

In planning and performing the audit procedures to identify the laws and regulations with which noncompliance could reasonably result in a material effect on the financial statements, auditors would take into account:

1. The auditor’s planning activities (*see* paragraph .07 of AS 2101, Audit Planning);
2. The nature of the company, including the complexity of the company, its industry, and operating characteristics (*see* AS 2110.07-.15, as proposed to be amended);

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<sup>64</sup> See Section III.C.3 below for discussion of proposed amendments to risk assessment procedures.

<sup>65</sup> See, e.g., Regulation S-K Item 105, 17 C.F.R. § 229.105 (Risk factors); Regulation S-K Item 101(c)(2), 17 C.F.R. § 229.101(c)(2) (Description of business).

3. The company's disclosures in previous annual report filings and the disclosures of industry competitors;
4. Management's processes related to compliance with laws and regulations (*see, e.g., AS 2110.26 [as proposed to be amended]*);
5. The results of the auditor's inquiries of management, the audit committee, internal audit personnel, and others (*see, e.g., AS 2110.54, .56-.59 [as proposed to be amended]*); and
6. Other audit procedures performed during the audit.

We also believe that there could be instances where a pattern of noncompliance exists that could have a material effect on the financial statements. In these instances, we believe the auditor would be able to identify these laws and regulations through obtaining an understanding of the company's internal controls and management's processes for preventing and identifying noncompliance with laws and regulations.<sup>66</sup> The auditor may also be able to identify such patterns when the auditor obtains tips and complaints reported to the company.<sup>67</sup>

The proposed standard includes an unconditional responsibility (that is, a "must") for auditors to plan and perform procedures to assess and respond to risks of material misstatement in the financial statements due to noncompliance with laws and regulations that we believe is consistent with what should be required of auditors. This responsibility would be stronger than the presumptively mandatory (that is, a "should") general obligation to identify and assess risks of material misstatements in AS 2110.04.<sup>68</sup> We believe material misstatements of financial statements can occur when violations of laws or regulations occur, and the effects of those violations are not properly presented in the financial statements (that is, recorded or disclosed). We believe it is important for auditors to understand this potential for material misstatement of the financial statements due to noncompliance, to identify and assess such risks of material misstatement, and to design further audit procedures to respond to these risks when appropriate.<sup>69</sup> Therefore, proposed AS 2405 would create unconditional responsibilities for auditors to both assess and respond to risks of material misstatement due to the effects of

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<sup>66</sup> *See, e.g., AS 2110.26 and .56 (as proposed to be amended).*

<sup>67</sup> *See Id.*

<sup>68</sup> *See AS 2110.04.* Pursuant to AS 2301.03, auditors have an unconditional responsibility (that is, must) to design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with AS 2110.

<sup>69</sup> *See, e.g., AS 2110.74 and paragraph .36 of AS 2810, Evaluating Audit Results.*

noncompliance with laws and regulations when initially identifying and assessing risks of material misstatement and also throughout the audit.<sup>70</sup>

The auditor would also be required to plan and perform procedures to identify whether there is information indicating noncompliance has or may have occurred. The population of laws and regulations for which the auditor would plan and perform such procedures would be those the auditor assessed could reasonably have a material effect on the financial statements.<sup>71</sup>

The nature and extent of procedures that would be planned and performed to identify whether there is information indicating whether noncompliance has or may have occurred would depend on the specific facts and circumstances of each audit engagement. Further, as the risk of material misstatement increases the persuasiveness of the evidence the auditor would be required to obtain also increases.<sup>72</sup> In planning and performing the audit procedures to identify information indicating noncompliance, auditors could take into account:

1. The identified laws or regulations and how noncompliance could be identified by the auditor and the company (*see* proposed AS 2405.05 and .06a);
2. The design of management's processes (*see, e.g.,* AS 2110.26 [as proposed to be amended]);
3. Correspondence with the company's regulatory authorities (*see, e.g.,* AS 2110.56 [as proposed to be amended]);
4. The results of any compliance reviews by the internal audit function (*see* AS 2605);
5. The results of the auditor's inquiries of management, the audit committee, internal audit personnel, and others (*see, e.g.,* AS 2110.54, .56-.59 [as proposed to be amended]); and
6. The results of any tests of the operating effectiveness of relevant controls over the company's compliance, or the identification of noncompliance, with the laws and regulations that could reasonably have a material effect on the financial statements.

While management inquiries or other information provided by management may provide the auditor with certain audit evidence about known instances of noncompliance, we

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<sup>70</sup> See AS 2301.

<sup>71</sup> See proposed AS 2405.05.

<sup>72</sup> See, e.g., AS 1105.04.

believe that management inquiry, by itself, would not provide sufficient evidence that all instances of noncompliance that could reasonably have a material effect on the financial statements have been identified and properly presented in the financial statements in accordance with the applicable financial reporting framework. In addition, auditors may use technology-assisted audit procedures to identify information indicating that noncompliance with laws and regulations has or may have occurred.

For example, if an auditor identified the FCPA as a law that could reasonably have a material effect on the financial statements because the company's operations are in a jurisdiction where bribery may be more common, or the company or its competitors have a history of FCPA violations, the auditor in planning and performing procedures would understand management's processes around FCPA compliance, test relevant controls that were put in place to maintain compliance with the FCPA, or perform cash disbursement testing designed to identify potential bribes. These would be in addition to inquiring of management and other employees about whether any FCPA violations, or alleged or suspected violations, have been identified. These types of procedures could be performed on a standalone basis or simultaneously with other planned procedures (i.e., internal control testing of cash disbursements in an integrated audit or detail testing of cost of goods sold or other expenses).

In another example, the auditor could identify environmental protection regulations as those with which noncompliance could reasonably have a material effect on the financial statements. In these instances, the auditor would plan and perform procedures to understand management's process for maintaining compliance and test the design and operating effectiveness of relevant controls. However, the auditor could also obtain a company's specialist report evaluating compliance.<sup>73</sup> The auditor could also obtain reports issued by state or federal authorities (for example, the U.S. Environmental Protection Agency or the California Environmental Protection Agency). In addition, the auditor may consider whether an auditor's specialist should be involved to assist the auditor in evaluating whether any evidence obtained includes information indicating noncompliance with laws and regulations has or may have occurred.

Other procedures performed in the audit and in reviews of interim financial information can also provide the auditor with information indicating that noncompliance with laws and regulations has or may have occurred. These other procedures can also inform the auditor's identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and the continuing process of assessing risks of

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See Appendix A of AS 1105 with respect to using the work of a company's specialist.



material misstatement.<sup>74</sup> As noted in the proposed standard, the auditor would be required to use information obtained from:

- a. Risk assessment procedures,<sup>75</sup> including:
  - 1) Obtaining an understanding of the company and its environment, including the regulatory environment (*see* paragraphs .07-.13 of AS 2110, *Identifying and Assessing Risks of Material Misstatement* [as proposed to be amended]);
  - 2) Obtaining an understanding of management's processes related to (i) identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; (ii) preventing, identifying, investigating, evaluating, communicating, and remediating instances of noncompliance with laws and regulations; (iii) receiving and responding to tips and complaints from internal and external parties regarding noncompliance with laws and regulations; and (iv) evaluating potential accounting and disclosure implications of noncompliance with laws and regulations, including fraud (*see* AS 2110.26 [as proposed to be amended]);
  - 3) Making inquiries of management, the audit committee,<sup>76</sup> and others regarding noncompliance with laws and regulations (*see* AS 2110.54 and .56-.58 [as proposed to be amended]); and
- b. Other procedures performed in the audit of the financial statements, in reviews of interim financial information, and, if applicable, in an audit of internal control over financial reporting that may identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or noncompliance with laws and regulations that has or may have occurred.

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<sup>74</sup> See AS 2110.74 ("The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.").

<sup>75</sup> See Section II.C.3 below for additional discussion of proposed amendments to risk assessment procedures.

<sup>76</sup> The term "audit committee" has the same meaning as defined in Appendix A of AS 1301, *Communications with Audit Committees*.

An accompanying note to this proposed requirement identifies examples of other auditing standards that include procedures which may assist the auditor in identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or alert the auditor to noncompliance that has or may have occurred, including procedures related to (i) responses to identified fraud risk(s), (ii) internal control over financial reporting, (iii) transactions with related parties, (iv) inquiries of the company's legal counsel, (v) evaluating audit results, and (vi) reviews of interim information. Emphasizing the auditor's obligation to evaluate information from other audit procedures indicates that the requirements with respect to identification of noncompliance are not a discrete process but are integrated throughout the audit. However, the auditor may also become aware of information indicating noncompliance has or may have occurred from sources other than those listed within the proposed standard. The sources listed above are intended to be the auditor's starting point, not the only sources of information. For example, the auditor could become aware of information indicating noncompliance has or may have occurred from an employee that is not the subject of the auditor's inquiries who chooses to bring information directly to the auditor.

Some of the information obtained during the audit may inform the auditor of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements for which the auditor had not already considered. When this occurs, the auditor would assess and respond to risks related to noncompliance with those laws and regulations and identify whether there is information indicating noncompliance has or may have occurred. Other information may be of such a nature that it results in the auditor directly identifying that noncompliance has or may have occurred. The auditor's responsibility to plan and perform procedures to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, assess and respond to risks related to noncompliance with those laws and regulations, and identify whether there is information indicating noncompliance has or may have occurred is not limited to the initial phase of the audit. Rather, the auditor would be required to continue to assess information obtained throughout the audit and perform the necessary procedures as would be required by in the proposed standard.

*Questions:*

7. Is the proposed requirement for auditors to identify laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements sufficiently clear? If not, why not?

8. Will auditors be able to identify those laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements? If not, why not?

9. Are there additional procedures that should be required for auditors to perform to identify those laws and regulations applicable to the company with which

noncompliance could reasonably have a material effect on the financial statements? If so, describe.

10. Is the proposed requirement for auditors to assess and respond to the risks of material misstatement due to noncompliance with laws and regulations sufficiently clear? If not, why not?

11. Is the proposed requirement that auditors identify whether there is information indicating that noncompliance (with those laws and regulations with which noncompliance could reasonably have a material effect on the financial statements) has or may have occurred sufficiently clear? If not, why not?

12. Are there other specific procedures the auditor should be required to perform to assist them in identifying whether there is information indicating that noncompliance (with those laws and regulations with which noncompliance could reasonably have a material effect on the financial statements) has or may have occurred? If so, what are those procedures?

13. Are there other examples of procedures which might assist the auditor in identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or alert the auditor to information indicating that noncompliance has or may have occurred that should be included? If so, what are they?

14. Are there other procedures that auditors perform today that should be required to assist the auditor in (1) identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, (2) assessing and responding to risks of material misstatement due to noncompliance with those laws and regulations, or (3) identifying information indicating that noncompliance with those laws and regulations has or may have occurred? If so, what are they?

15. Are auditors using technology-assisted audit procedures to assess and respond to risks of material misstatement due to noncompliance with laws and regulations or to identify information indicating that noncompliance with laws and regulations has or may have occurred? If so, describe those audit techniques.

### 3. Assessing Risks of Material Misstatement to Enhance the Auditor's Identification of Noncompliance with Laws and Regulations

*See paragraphs .05, .09, .11, .13, .15, .26, .49, .54, .56-.58 of AS 2110, as proposed to be amended<sup>77</sup>*

Proposed AS 2405 expressly incorporates risk assessment requirements, unlike existing AS 2405. Proposed AS 2405 requires the auditor to assess and respond to risks of material misstatement due to noncompliance with laws and regulations with which noncompliance could reasonably have a material effect on the financial statements.<sup>78</sup> We are proposing to complement the requirements in AS 2405 with targeted amendments to AS 2110. These proposed amendments include more specific requirements on how to obtain an understanding of the regulatory environment of the company and would require the auditor to make specific inquiries of management, the audit committee, and others regarding noncompliance with laws and regulations. These amendments are intended to enhance the auditor's identification of noncompliance with laws and regulations that could result in a material misstatement of the financial statements and enhance the auditor's assessment of risks of material misstatement.

In order to obtain an understanding of the regulatory environment, the proposed amendments include a new note to AS 2110.09 which describes the nature of laws and regulations the auditor should understand as part of the audit. These laws and regulations include: (1) those laws and regulations that govern the determination of the form and content of the financial statements and (2) those other laws and regulations where the company's noncompliance could reasonably have a material effect on the financial statements.

Laws and regulations where the company's noncompliance results in a material misstatement of the financial statements are those that relate to the way matters are presented in the financial statements, such as tax, pension, and certain securities laws. Other laws and regulations relate to a company's operations, such as occupational safety, health, antitrust, and environmental laws. Material misstatements of the financial statements can arise when violations of laws and regulations occur and are not properly presented in the financial statements in accordance with the applicable financial reporting framework. The proposed note to AS 2110.09 would require the auditor to obtain an understanding of the laws and regulations with which, in light of risks associated with the issuer's particular business operations, the company must comply and with which the company's noncompliance could reasonably have a material effect on the financial statements.<sup>79</sup> For example, if the company

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<sup>77</sup> See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Rel. No. 2010-004 (Aug. 5, 2010).

<sup>78</sup> See proposed AS 2405.05b.

<sup>79</sup> This category of laws and regulations is similar to the laws and regulations described by issuers in SEC filings under applicable disclosure rules. See, e.g., Regulation S-K Item 101(c)(2), 17 C.F.R.

operates in foreign countries, the auditor would obtain an understanding of the FCPA, as noncompliance with the FCPA could reasonably have a material effect on the financial statements through penalties and fines.

We are also proposing to amend the auditor's procedures for obtaining an understanding of the company by requiring the auditor to perform all the procedures in AS 2110.11. The existing requirement provides a list of procedures the auditor is required to consider performing but does not require the auditor to, in fact, perform the procedures. By proposing to require the auditor to perform all such procedures as opposed to merely considering whether to perform procedures, we believe the auditor would develop a more complete understanding of the nature of the company's operations. This depth of knowledge would lead to improved identification of noncompliance, improved assessment of the risk of material misstatement, and more targeted audit responses to those risks. Further, since AS 2110 was written, there are more communications provided by companies that might indicate risks of material misstatement or noncompliance with laws and regulations. We believe these procedures should now be required rather than just considered.

One of the procedures in AS 2110.11 is for the auditor to read public information about the company. We are proposing to amend this procedure to include, in addition to information made available by the company and other sources external to the company, information publicly disclosed by the company's executive officers about the company.

We are also proposing to add a note to AS 2110.11 that provides a list of sources of public information from sources internal and external to the company that would inform the auditor's assessment of the risk of material misstatement and may provide information indicating noncompliance with laws or regulations has or may have occurred. These sources include the company's website, the company's or its executive officers'<sup>80</sup> social media accounts, media reporting, and analyst reports. Reading such information may bring to the auditor's attention statements made by the company and its executive officers, which may be contradictory to other information obtained by the auditor or within the financial statements and may indicate potential risks of material misstatement in the financial statements. Information from these sources may also assist the auditor in identifying and assessing risks of material misstatement related to accounts or disclosures in the financial statements or omitted, incomplete, or inaccurate disclosures.

Publicly available information may provide the auditor with insight into potential changes to the company's business or operations. For example, a company's sustainability reporting may indicate that the company plans to reduce greenhouse gas emissions to a certain level within a defined period of time. The company may further note that such a reduction in

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§ 229.101(c)(2); see also *Modernization of Regulation S-K Items 101, 103, and 105*, SEC Rel. No. 34-89670 (Aug. 26, 2020) (adopting release); SEC Rel. No. 34-86614 (Aug. 8, 2019) (proposed rule).

<sup>80</sup> The term "executive officer" has the same meaning as in AS 2110.A3A.

emissions would require the company to close certain facilities. In addition, assume the company's prior year annual report indicates that the company is anticipating to grow its operations through opening new facilities while continuing to operate all existing facilities. The auditor would consider the risks that information supporting the assumptions in the financial statements is incorrect or inaccurate and might create a risk of material misstatement of the financial statements. The auditor would also consider any contradictory audit evidence that the sustainability report and annual report might be presenting with respect to information supporting amounts in the financial statements.

In addition, we are proposing to add a new matter to the list within AS 2110.13 – changes to the company's operating strategy, including when and how the company will implement such strategies and the related effect on the company's accounting principles and disclosures. For instance, the company may indicate a change in strategy related to halting a line of business that is contradictory to information provided by the company to the auditor regarding assumptions used in determining the value of an asset. This change may cause the auditor to question the company's intent to continue an investment in a project or the assumptions used in a goodwill impairment analysis. Information about a strategy to replace an existing product line with a new product line may provide contradictory information to the auditor about the assumptions used by the company in assessing inventory obsolescence reserves.

We are also proposing to clarify that implementing a strategy to grow, modify, or discontinue business operations (see proposed AS 2110.15) is a potential business risk that might result in material misstatement of the financial statements or indicate potential noncompliance. For example, a company might provide the auditor with information related to its recent expansion of manufacturing operations in a location with new strict regulations on greenhouse gas emissions, including information about the regulatory environment. The auditor would consider the business risks of the new operations, including the regulatory environment, when assessing the risk of material misstatement in the financial statements. This consideration would include the potential for contingencies or reserves associated with the strict climate regulations.

The proposed amendments to AS 2110 also include expanded auditor responsibilities that would require the auditor to:

- Hold a discussion among key engagement team members about those laws and regulations with which the company's noncompliance could reasonably have a material effect on the company's financial statements; *(see AS 2110.49 [as proposed to be amended])*
- Obtain an understanding of a company's processes for (1) identifying laws and regulations with which noncompliance could have a material effect on the financial statements; (2) preventing, identifying, investigating, evaluating,

communicating (including to senior management, the audit committee, and the board of directors), and remediating instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations; (3) receiving and responding to tips and complaints from internal and external parties regarding noncompliance (including those received through a whistleblower program, if such program exists); and (4) evaluating the accounting and disclosure implications of noncompliance with laws and regulations, including fraud; (*see proposed AS 2110.26.d-g*) and

- Make and evaluate specific inquiries to management, the audit committee, internal audit personnel, and others who might be reasonably expected to have relevant information regarding (i) knowledge of instances, or alleged or suspected instances, of noncompliance with laws and regulations that could reasonably have a material effect on the financial statements; (ii) correspondence with relevant regulatory authorities; and (iii) the existence of tips or complaints regarding the company's financial reporting or instances, or alleged or suspected instances, of fraud or other noncompliance (including those received through the audit committee's or company's internal whistleblower program, if such program exists). (*See AS 2110.54, .56-58 [as proposed to be amended]*)

The proposed specific inquiries are intended to complement the understanding of the regulatory environment that is currently obtained by the auditor. These inquiries would focus on instances, or alleged or suspected instances, of noncompliance with those laws and regulations for which noncompliance could reasonably have a material effect on the financial statements. The inquiries are broad to inform the auditor's initial assessment of risks of material misstatement, including risks due to noncompliance. These inquiries are similar to the inquiries in existing AS 2405.08 of management and the audit committee concerning the company's compliance with laws and regulations and knowledge of violations or possible violations of laws and regulations and should therefore already be familiar to auditors. Auditors need to exercise professional skepticism when making and evaluating inquiries of management and others.<sup>81</sup> For example, management may indicate that identified noncompliance has been investigated and remediated, but the auditor would still plan and perform procedures to obtain appropriate audit evidence in order to evaluate the noncompliance and would not solely rely on management representations with respect to the noncompliance.

We propose integrating these new requirements into the existing risk assessment standard to underscore that noncompliance that has or may have occurred could affect the risk

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<sup>81</sup> Auditors are required to exercise due professional care, which requires exercising professional skepticism, in the planning and performance of the audit and the preparation of the report. *See proposed AS 1000, General Responsibilities of the Auditor in Conducting an Audit*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023).

of material misstatement of a company's financial statements. Such integration could also help avoid any misperception that the auditor's consideration of noncompliance exists in a silo (i.e., is performed as a discrete step in an audit). Because existing AS 2110.74 provides that the auditor's assessment of the risks of material misstatement is required to continue throughout the audit, auditors are required to remain continually alert to the possibility of noncompliance and modify planned audit procedures or perform additional procedures in response to revised risk assessments. We believe these proposed amendments would enhance the auditor's identification of noncompliance with laws and regulations through enhanced risk assessment procedures and also enhance the auditor's assessment of risk of material misstatement in the financial statements. These enhancements should also lead to improved consideration of noncompliance with laws and regulations that has or may have occurred in the auditor's planned responses to risks of material misstatement.<sup>82</sup>

*Questions:*

16. Is the proposed approach to include the requirements related to understanding (1) the laws and regulations that govern the determination of the form and content of the financial statements and (2) those other laws and regulations with which the company's noncompliance could reasonably have a material effect on the financial statements sufficiently clear? If not, why not?

17. Is the proposed approach to include the requirements related to understanding management's related processes for identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and for preventing, identifying, investigating, evaluating, and communicating compliance in AS 2110 sufficiently clear? If not, why not?

18. Are the proposed requirements related to reading publicly available information about the company sufficiently clear? If not, why not?

19. Are the proposed additional requirements in AS 2110 regarding inquiries of others within the company sufficiently clear? If not, why not?

20. Is the requirement to inquire about whether correspondence exists with the company's relevant regulatory authorities regarding instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements and the nature of such correspondence sufficiently clear? If not, why not? Would this requirement change auditors' current practices of communicating directly with regulators about the company when appropriate and necessary? If so, how?

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<sup>82</sup> See generally [proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023)], and AS 2301.



21. Are there other examples of the application of procedures that should be included for clarity? If so, please describe those examples.

22. Are the proposed requirements and examples regarding understanding changes to the company's operating strategy and the impact on the company's accounting principles and disclosures sufficiently clear? If not, why not?

23. Are there additional procedures the auditor should be required to perform to identify noncompliance with laws and regulations that are not currently contemplated by the proposed amendments? If so, what are the procedures?

#### **4. Evaluating Noncompliance with Laws and Regulations**

*See proposed AS 2405.07-.11*

##### **i. Obtaining an understanding and determining whether noncompliance with laws and regulations is likely to have occurred**

We are also proposing to establish a threshold for evaluating noncompliance with laws and regulations that is similar to the threshold in Section 10A (i.e., "...firm detects or otherwise becomes aware of information indicating that an illegal act ... has or may have occurred..."). Under the proposed standard, the threshold that triggers the requirement to evaluate would be "when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred." As noted above, there are many ways through which the auditor may identify or become aware of information indicating that noncompliance has or may have occurred. For example, the auditor may identify possible noncompliance through reading minutes or whistleblower reports or through performing substantive procedures. The auditor may also become aware of possible noncompliance through inquiries of management, inquiries of other company personnel, or from external sources.

Existing AS 2405.10 requires the auditor to obtain an understanding of the nature of an illegal act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements, including making inquiries of management. Similarly, under the proposed standard, when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred, the auditor would be required to perform procedures to obtain an understanding of the nature and circumstances of any such noncompliance and determine whether it is likely that any such noncompliance occurred.

Further, under existing AS 2405.10, when evaluating the possible illegal act, if management does not provide satisfactory information that there has been no illegal act, the auditor is required to consult with legal counsel or other specialists and apply additional audit procedures, if necessary, to obtain further understanding of the nature of the act. Similar to

existing AS 2405, the proposed standard provides the following list of procedures that the auditor may perform to obtain an understanding of the nature and circumstances of the potential noncompliance and to determine whether it is likely that any noncompliance occurred:

- Examining supporting documentation about relevant events or transactions;
- Making inquiries of company personnel who are likely to have knowledge of the events or transactions and management at a level above those involved;
- Obtaining an understanding of the nature and status of any relevant investigations internal or external to the company;
- Confirming significant information concerning the events or transactions with other parties, intermediaries, financial institutions, legal counsel, or others who may have knowledge of the events, transactions, and applicable legal requirements;
- Determining whether a transaction has been properly authorized by management;
- Determining whether other similar transactions or events may have occurred;
- Discussing the facts and circumstances with the company's legal counsel or others with specialized skill or knowledge about the application of relevant laws or regulations to the circumstances and the possible effects on the financial statements; and
- Considering the results of other audit procedures related to the matter.<sup>83</sup>

The proposed list of audit procedures that may be performed is not intended to be an all-inclusive list of audit procedures that the auditor should perform to obtain audit evidence to make the required evaluations. The proposed standard notes that inquiry alone is not sufficient to determine that noncompliance is not likely to have occurred, but inquiries may be sufficient to determine that likely noncompliance has occurred. For example, management may communicate sufficient information for the auditor to conclude that noncompliance has likely occurred. Further, the proposed standard notes the extent of procedures necessary depends on the nature and circumstances of the matter (i.e., the information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred), including whether the matter could be material, the relevance and reliability of information provided by the company

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<sup>83</sup> See proposed AS 2405.08.

about the matter,<sup>84</sup> and the effectiveness of management's process for investigating the matter.

We recognize that many companies have sophisticated ethics and compliance functions that investigate and address tips and complaints received from numerous sources. We expect that, where such systems are in place, auditors would consider such sources when evaluating and responding to noncompliance that has or may have occurred and may request the company to perform additional investigative or remedial steps to address a given matter.

The proposed standard would also require the auditor to consider whether specialized skill or knowledge is needed to assist the auditor in evaluating information indicating noncompliance has or may have occurred. Existing AS 2405 only requires the auditor to consult with specialists if management does not provide satisfactory information that there has been no illegal act. We believe this consideration could be important in various situations. For example, the auditor may need to engage legal counsel or other specialists to assist the auditor in (i) understanding certain laws and regulations; (ii) assessing and responding to the risk of material misstatement of the financial statements due to noncompliance with those laws and regulations; (iii) evaluating whether it is likely the noncompliance occurred; or (iv) developing more rigorous inquiries of management or others to understand the circumstances in which the noncompliance occurred. The auditor may also decide to involve specialists to assist in identifying other transactions that may follow the same pattern as the transaction currently being evaluated for noncompliance. If the auditor determines that specialized skill or knowledge outside of accounting and auditing is needed to assist the auditor in evaluating, the proposed standard would require the auditor to look to the appropriate requirements for using the work of specialists in an audit.<sup>85</sup>

We also recognize that AS 2101, *Audit Planning*, requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan, or perform audit procedures, or evaluate audit results. While this requirement is broad and covers all aspects of planning and performing the audit, the proposed requirement is specific to evaluating noncompliance and may not be known during the initial planning stages of the audit.

## **ii. Likely noncompliance has occurred**

Under proposed AS 2405, as discussed below, the auditor would be required to determine the possible effect of the likely noncompliance on the financial statements and

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<sup>84</sup> See paragraph .10 of AS 1105, *Audit Evidence*, for requirements for the auditor to test information produced by the company to be used as audit evidence.

<sup>85</sup> See Appendix C of AS 1201, *Supervision of the Audit Engagement* (procedures to be performed with respect to the supervision of the work of an auditor-employed specialist); and AS 1210, *Using the Work of an Auditor-Engaged Specialist* (requirements for using the work of an auditor-engaged specialist).

assess the implications of the likely noncompliance in relation to other aspects of the audit (such as the auditor's risk assessment and the sufficiency and reliability of audit evidence, including representations of management) and take appropriate action.

- a. [Determining the possible effect on the financial statements and other information and perform additional procedures \(see proposed AS 2405.09a-b and .10\)](#)

The proposed standard (see paragraph .10) provides a list of factors relevant to the auditor's determination of the possible effect of the likely noncompliance on the financial statements. These factors are (i) the materiality of the likely noncompliance; (ii) the effect on the amounts and disclosures in the financial statements, including potential contingent monetary effects, such as fines, penalties, damages, or provisions for allowances or returns; and (iii) the adequacy of any financial statement disclosure. These factors were incorporated from requirements in existing AS 2405.13-.15.

In evaluating the materiality of the noncompliance, the auditor would consider both qualitative and quantitative factors as required by AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, and AS 2810, *Evaluating Audit Results*. We view the consideration of qualitative impacts of noncompliance as equally important to the consideration of quantitative impacts. While the auditor may consider the impact on the amounts and disclosures in the financial statements due to noncompliance to be quantitatively immaterial, other qualitative factors may suggest that noncompliance is material.<sup>86</sup> For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. Similarly, an intentional misstatement that is quantitatively immaterial could be material if it affects the company's compliance with loan covenants.

The effect of noncompliance on the amounts and disclosures in the financial statements includes considerations about whether financial statements properly reflect fines, penalties, or other potential contingent monetary effects or require additional disclosure necessary to make the financial statements not misleading.<sup>87</sup> For example, if noncompliance with a particular law creates a contingency or significant unusual risks associated with material revenue or earnings, that information is required to be considered for disclosure by management.<sup>88</sup> In this example, the auditor would be required to evaluate whether management has properly reflected any

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<sup>86</sup> See AS 2105.03.

<sup>87</sup> See generally AS 2510, *Auditing Accounting Estimates, Including Fair Value Measurements*, for the auditor's requirements for auditing accounting estimates (including fair value measurements) in significant accounts and disclosures in financial statements.

<sup>88</sup> See, e.g., Regulation S-K Item 303, 17 C.F.R. § 229.303 (Management's discussion and analysis of financial condition and results of operations).

loss contingencies or penalties in its financial statements.<sup>89</sup> The auditor would also perform procedures to evaluate whether management has properly recorded expenses associated with correcting or remediating noncompliance.

In addition, we are proposing to 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 (including omitted, incomplete, or inaccurate disclosures) 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 proposed standard recognizes that some noncompliance with laws and regulations may have an impact on other information accompanying the audited financial statements and reminds the auditors that they have an obligation with respect to other information under AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

For example, a company might disclose key performance metrics in its Annual Report on Form 10-K that investors may perceive as suggestive of future sales growth. If the auditor learned of information indicating that employees had materially inflated such performance metrics, the auditor would be required to, among other things, perform procedures to determine whether the company's Annual Report contained a material misstatement of fact.<sup>90</sup> Although such noncompliance may not have a material effect on financial statement amounts or disclosures, the auditor would be required to consider whether the other information accompanying the audited financial statements was materially inconsistent with information in the audited financial statements or contained a material misstatement of fact. The auditor would also be required to determine the effect of such noncompliance on the engagement report and on the auditor's ongoing relationship with the company.<sup>91</sup>

Another factor relevant to the auditor's determination of the possible effect of the noncompliance is the adequacy of disclosure in the financial statements of the possible effects of the noncompliance on the company's operations. For example, through inquiries or the results of other audit procedures, the auditor may become aware that noncompliance with regulations has caused the company to lose the ability to export goods to a certain country. If the company has significant revenue derived from sales to that country, then sales forecasts may need to be revised, which could result in a need to further assess for impairment of goodwill or other intangible assets and possibly have other effects on the financial statements, such as the valuation of stock-based compensation if the stock price has declined. Further, if this development were significant to the company's operations, the auditor may determine the

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<sup>89</sup> See, e.g., ASC Subtopic 450-20, *Contingencies – Loss Contingencies*.

<sup>90</sup> See AS 2710.05.

<sup>91</sup> See proposed AS 2405.19.

matter is required to be disclosed in the financial statements or other information included in the document containing the audited financial statements.

**b. Assessing the implications of the noncompliance in relation to other aspects of the audit (see proposed AS 2405.09c)**

Similar to existing AS 2405, in assessing the implications of noncompliance on other aspects of the audit, the auditor would evaluate, for example, if there were any implications to risk assessment procedures; the sufficiency and reliability of audit evidence, including the reliability of representations of management; and, in an integrated audit, the effectiveness of internal control over financial reporting. The proposed standard would require the auditor to take appropriate actions to respond, which would depend on the assessment of such implications. For example, the auditor may identify new risks of misstatement in a particular account or disclosure that are based on the identified noncompliance. If any of the additional risks of misstatements are assessed as risks of material misstatement, the appropriate action would be to develop an additional audit response.

In assessing the implications of the noncompliance in relation to other aspects of the audit, a footnote to proposed AS 2405.09c states the auditor has additional responsibilities if the auditor has identified misstatements that are likely to be intentional pursuant to AS 2810.22. This footnote also states that in an audit of internal control over financial reporting, the auditor is required to evaluate the effect of the findings with respect to noncompliance with laws and regulations on the effectiveness of internal control over financial reporting under AS 2201.B8, as proposed to be amended. In such circumstances, the auditor would consider the impact of the noncompliance on the effectiveness of internal control over financial reporting and on any related control activities, including considering the effect of the noncompliance on relevant entity-level controls. The auditor would also consider the nature of any remedial actions taken in response to the noncompliance, including modifications of specific control activities, and controls that address any additional risks of material misstatement identified, to determine if any incremental control testing would be necessary.

**iii. Remedial Action (see proposed AS 2405.11)**

Existing AS 2405 does not require the auditor to determine whether senior management has taken timely and appropriate remedial action with respect to noncompliance. However, existing AS 2405.22 states that the auditor may conclude that withdrawal is necessary when management does not take the remedial action that the auditor considers necessary in the circumstances, even if the illegal act is not material to the financial statements. We believe that the auditor should be required to determine whether senior management has taken timely and appropriate remedial action to address the noncompliance. This requirement would assist auditors in discharging their obligations under Section 10A, which, as discussed above, imposes communication requirements upon the auditor if the issuer's senior management fails to take such remedial action and other circumstances are present. We believe this requirement is also appropriate for broker-dealer audits. Accordingly, under proposed AS 2405, the auditor would

be required to determine whether senior management has taken timely and appropriate remedial action with respect to noncompliance with laws and regulations that has a material effect on the financial statements.

In making this determination, the auditor would assess the timeliness and appropriateness of remedial action by senior management based on the nature and circumstances of the underlying matter. The proposed standard states that remedial actions may include conducting or cooperating with an appropriate internal investigation into the matter, taking disciplinary action against involved personnel, seeking restitution, adopting preventive or corrective company policies, or modifying specific control activities.

There may be instances where remedial actions are ongoing or planned at the time the auditor is expected to issue the audit report. In such circumstances, it is expected that the auditor would determine if the actions taken up until the time of the report issuance are appropriate and whether the auditor's standard report is required to be modified. Auditors would look to the auditing standards on auditor reporting to determine the appropriate modifications, if any. In an integrated audit, the auditor would also consider the impact of the ongoing or planned remedial actions on the effectiveness of the company's internal control over financial reporting. Auditors would look to AS 2201 to determine the appropriate audit response.

If the auditor is unsure about the appropriateness of remedial actions, under the proposed standard, as described above, the auditor could involve an auditor's specialist to help with the determination.<sup>92</sup>

*Questions:*

24. Is the proposed approach to evaluate instances of noncompliance that has or may have occurred sufficiently clear? If not, why not?

25. Is the proposed requirement for auditors to consider whether specialized skills or knowledge is needed to assist the auditor in evaluating noncompliance that has or may have occurred sufficiently clear? If not, why not?

26. Are the procedures the auditor may perform to obtain an understanding of the nature and circumstances of potential noncompliance and to determine whether it is likely the noncompliance occurred sufficiently clear? If not, why not? What additional procedures, if any, should be added?

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<sup>92</sup> See note 1 to proposed AS 2405.07.

27. Are there other procedures that the auditor should be required to perform when evaluating information indicating that noncompliance with laws and regulations has or may have occurred? If so, what are those procedures?

28. When evaluating information that may be indicative that noncompliance has or may have occurred, should the auditor consider the impact of that information on other information in documents containing the audited financial statements? If not, why not?

29. Is the proposed requirement to determine whether senior management has taken timely and appropriate remedial action, including any impact on the auditor's report sufficiently clear? If not, why not?

## **5. Communicating Noncompliance with Laws and Regulations**

*See proposed AS 2405.12-.15*

Existing AS 2405.17 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 auditor is not required to communicate to the audit committee matters that are clearly inconsequential; moreover, the auditor may reach an agreement in advance with the committee on the nature of such matters to be communicated. The communication is required to describe the act, the circumstances of its occurrence, and the effect on the financial statements. The existing standard also provides that, if senior management is involved in an illegal act, the auditor is required to communicate directly with the audit committee. Section 10A contains generally similar communication requirements.<sup>93</sup>

We are proposing communication requirements similar to those in existing AS 2405 and Section 10A when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations (whether or not perceived to have a material effect on the financial statements), including fraud, has or may have occurred. The auditor would be required, as soon as practicable and before the issuance of the engagement report, to communicate to the appropriate level of management and the audit committee (a) a description of the matter, including the auditor's understanding of the nature of the matter and the circumstances of its occurrence; and (b) if the auditor has determined that the matter is likely noncompliance, the possible effect of the noncompliance on the financial statements and information in documents containing the audited financial statements. The proposed standard contemplates that this communication may occur prior to the completion of the auditor's evaluations of the information indicating that noncompliance has or may have occurred (i.e.,

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<sup>93</sup> See Section 10A(b)(1)(B).



before the auditor obtains an understanding about the nature and circumstances of any such noncompliance and determines whether it is likely that any such noncompliance occurred).

Under existing AS 2405.17, the required communication to the audit committee occurs after an illegal act has “come to the auditor’s attention,” but the standard does not expressly state whether the communication should occur before or after the auditor evaluates the information in issue. The proposed standard gives more clarity and provides that the auditor would make an initial communication to management and the audit committee upon becoming aware that noncompliance “has or may have occurred.” The proposed standard thus would require communication with management and the audit committee even in cases where the auditor has yet to determine whether the noncompliance has or is likely to have occurred or any associated financial statement impacts. The proposed standard also notes that, when making such communications to management, the auditor need not communicate such information to any individuals within management who directly communicated the information to the auditor. The proposed standard thus seeks to avoid needlessly duplicative communications, but the exception only applies to the “source” of the information. For example, if the auditor obtains information from the controller (who received information from the chief financial officer) about noncompliance that has or may have occurred, the source of that information from the auditor’s perspective would be the controller. In this example, the auditor need not communicate the information to the controller, but would need to communicate it to the chief financial officer.

Matters that are “clearly inconsequential” would not be required to be communicated to the audit committee, although such matters would be required to be communicated to management. The auditor would be required to document the rationale for any determination that a matter was clearly inconsequential.<sup>94</sup> We believe that a matter deemed clearly inconsequential would be significantly below the threshold of materiality when considering both qualitative and quantitative factors. Any matter that requires consideration as to whether or not an experienced auditor having no previous connection to the engagement would view the matter as clearly inconsequential should also not be viewed as clearly inconsequential. The proposed standard includes a note with a presumption that any matters involving senior management are not clearly inconsequential.

Proposed AS 2405.12 would require the above communications to take place “as soon as practicable.” We believe a communication takes place “as soon as practicable” when it is made in sufficient time to allow the recipient to use the information to take necessary actions. This requirement could result in communications to management and the audit committee before the auditor completes the evaluation of the matter. Earlier communication would better enable management and the audit committee to be responsive, as necessary, to such matters. As with the current standard, proposed AS 2405 sets an outside limit on the auditor’s discretion concerning when to communicate noncompliance. Under proposed AS 2405.12, the auditor

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<sup>94</sup> See proposed paragraph .12h of AS 1215, *Audit Documentation*.

would be required to always communicate such matters before issuance of the applicable engagement report.

We propose to strengthen the communication requirements by requiring the auditor to have a more active role in making required communications to the audit committee. Auditors themselves would have to make most required communications, rather than simply assuring themselves that the audit committee is adequately informed, as is the current requirement under existing AS 2405.17. However, similar to the situation described above regarding duplicative management communications, the proposed standard recognizes that management may have already communicated information concerning noncompliance to the audit committee. Accordingly, the proposed standard indicates that the auditor need not repeat information about noncompliance that management previously communicated (i) in writing or (ii) when the auditor participated in the management discussion with the audit committee. The proposed standard emphasizes that the auditor would be required to communicate any information that management omitted, was incomplete, or was inadequately described regarding the noncompliance to the audit committee. In determining what information is necessary to communicate to the audit committee, the auditor should consider the adequacy of the information communicated by management in relation to the nature and circumstances of the noncompliance and its effect on the financial statements and other information in documents containing audited financial statements.

We are proposing an additional communication to take place after the auditor has completed the evaluations of information indicating that noncompliance has or may have occurred. The auditor would be required to communicate to management and, unless the matter is clearly inconsequential, also to the audit committee the results of the auditor's evaluations. Those communications would be required to identify the matters that the auditor determined are likely noncompliance and, for such instances of likely noncompliance, whether there is a material effect on the financial statements. If the auditor is unable to complete any required evaluations, the auditor would communicate that inability to the audit committee.<sup>95</sup>

We are proposing additional communications to the board of directors in certain circumstances. Under the proposed standard, the auditor would be required to communicate directly to the board of directors when the auditor concludes (a) the likely noncompliance has a material effect on the financial statements; (b) 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 (c) the failure to take remedial action is reasonably expected to warrant departure from an unqualified opinion or resignation from the audit engagement. These requirements parallel those required for issuer audits in Section 10A(b)(2). We believe that such obligations in our standards would help auditors discharge their Section 10A notification requirements.

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<sup>95</sup> See paragraph .23 of AS 1301, *Communications with Audit Committees*.

*Questions:*

30. Are the proposed communication requirements sufficiently clear? If not, why not?

31. Should the auditor's communication requirements differ when the information about noncompliance is identified by management, as compared to when identified by the auditor? Would the proposed exceptions for previous communications help in avoiding duplicative communications? Should the auditor communications be expanded or narrowed? If so, how?

32. Are there any additional matters related to noncompliance with laws and regulations that should be communicated to management and the audit committee? If so, what?

33. Does the timing of the proposed communications (that is, "as soon as practicable") to management and the audit committee pose any particular challenges to the auditor? If so, how should the proposed requirement be changed?

34. Is it appropriate to require the auditor to have a subsequent communication to management and the audit committee to communicate the results of the auditor's evaluation of information indicating noncompliance with laws and regulations has or may have occurred? If not, why not? Does this communication pose any particular challenges? If so, what are they?

35. Does the requirement to communicate the results of the auditor's evaluation of information indicating noncompliance with laws and regulations has or may have occurred pose any particular challenges? If so, how should the proposed requirement be changed?

36. Are there other communications the auditor should make (for example, to the PCAOB or other regulatory body, investors, other stakeholders)? If so, what should those communications include and who should those communications be made to?

## **6. Multi-location Engagement Considerations**

*See proposed AS 2405.16-.18*

For audits where other auditors participate, we propose procedures that would require certain communications between the lead auditor and the other auditor about noncompliance

with laws and regulations.<sup>96</sup> Such communication is not required under current PCAOB standards.

Specifically, we propose adding a requirement that the lead auditor would obtain two written affirmations from the other auditor that: (a) if the other auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred, the other auditor will communicate such information to the lead auditor in accordance with the lead auditor's instructions; and (b) the other auditor has communicated to the lead auditor any instances, or alleged or suspected instances, of noncompliance with laws and regulations, including fraud, identified, or of which the other auditor has otherwise become aware, in the course of the other auditor's work. We believe these affirmations from the other auditor will provide a reminder to the other auditors of their obligations regarding noncompliance under PCAOB standards.

Further, if other auditors participate in the audit and the lead auditor identifies or otherwise becomes aware of potential noncompliance with laws and regulations that may be relevant to the work of the other auditor, the lead auditor would be required to communicate the potential noncompliance to the other auditor as soon as practicable. The lead auditor also would be required to establish an understanding with the other auditor regarding (i) the respective responsibilities of the lead auditor and the other auditor for evaluating and communicating the matter and (ii) any specific procedures to be performed. These proposed requirements would allow for two-way communication between the lead auditor and the other auditors and would improve both auditors' consideration of a company's potential noncompliance with laws and regulations.

Under proposed AS 2405, the lead auditor would be responsible for establishing the responsibilities of the lead auditor and the other auditors for evaluating and communicating such instances with management and the audit committee, as well as any specific procedures to be performed.

*Questions:*

37. Is the proposed requirement for the lead auditor to obtain the written affirmations from the other auditor sufficiently clear? If not, why not?

38. Are the proposed communication requirements if either the lead auditor or other auditor identifies or otherwise becomes aware of any instances, or alleged or suspected instances, of fraud or other noncompliance that may be relevant to the audit work being performed sufficiently clear? If not, why not? Should additional communication requirements be considered, and if so, what are the requirements?

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<sup>96</sup> The terms "lead auditor" and "other auditor" have the same meanings as defined in Appendix A of AS 2101, effective for fiscal years ending on or after December 15, 2024.

## 7. Effect on the Engagement Report

*See proposed AS 2405.19*

Existing AS 2405 prescribes that, under certain circumstances, the auditor is required to make specific modifications to the standard auditor's report (such as expressing a qualified opinion) or withdraw from the engagement when a company has not properly accounted for or disclosed an illegal act.<sup>97</sup> Existing AS 2405 also recognizes that, upon withdrawal, the auditor may have a duty to notify certain parties outside the company of illegal acts, including, in certain circumstances, the SEC.<sup>98</sup>

The proposed standard does not include similar requirements specifying report modifications and withdrawals regarding a company's noncompliance with laws and regulations. Instead, the proposed standard identifies circumstances that may indicate the auditor would modify the auditor's report and directs the auditor to AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, which sets forth the relevant requirements. Additionally, PCAOB auditing standards generally recognize that the decision to accept or withdraw from an engagement with a company is dependent on the circumstances and the auditor's judgment. Therefore, we are not proposing to retain the language requiring withdrawal from an audit engagement in proposed AS 2405. We propose that the auditor would consider the effect on the engagement report and on the ongoing client relationship if the auditor:

- Is precluded by the company or the circumstances from identifying noncompliance with laws and regulations, including fraud, that has or may have occurred or from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance with laws and regulations, including fraud, has or may have occurred;
- Is unable to determine whether the likely noncompliance has a material effect on the financial statements; or
- Concludes that the likely noncompliance with laws and regulations (1) has a material effect on the financial statements, (2) has not been properly accounted for or disclosed, or (3) results in changes to the auditor's assessment of the effectiveness of internal control over financial reporting.

Based on the circumstances, the auditor would need to determine the appropriate course of action. In addition, notification requirements relating to auditor resignations or withdrawals from issuer audits are addressed in AS 1310, *Notification of Termination of the*

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<sup>97</sup> See existing AS 2405.18-.21.

<sup>98</sup> See Section II.A.22.

*Auditor-Client Relationship*,<sup>99</sup> which accompanied the proposed revisions to the Board’s quality control standards.

*Questions:*

39. Are there additional auditor reporting considerations that should be considered? If so, what are they?

40. Should the proposed standard include a requirement for communication in the engagement report regarding specific aspects of a company’s noncompliance with laws and regulations? If so, what should that communication include?

41. Should specific requirements be retained related to an auditor’s withdrawal or resignation from the audit engagement in circumstances when likely noncompliance with laws and regulations has been identified? If so, which requirements?

**D. Amending Other PCAOB Standards to Improve the Auditor’s Consideration of Noncompliance with Laws and Regulations in the Audit**

**1. Consideration of Fraud in a Financial Statement Audit**

AS 2401 describes fraud as an intentional act that results in a material misstatement in the financial statements.<sup>100</sup> As noted previously, the proposed definition of noncompliance with laws and regulations specifically references fraud as a subset of noncompliance with laws and regulations.<sup>101</sup>

While the procedures to identify fraud may differ from the procedures to identify other noncompliance, the activities to evaluate and communicate are similar. Therefore, proposed AS 2405 requires the same procedures to evaluate and communicate fraud that has or may have occurred as for other noncompliance with laws and regulations that has or may have occurred. Such changes are intended to improve audit quality by providing the same specific requirements for auditors when they identify or become aware of fraud as well as other

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<sup>99</sup> *A Firm’s System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, And Forms*, PCAOB Rel. No. 2022-006, Appendix 5 (Nov. 18, 2022).

<sup>100</sup> AS 2401.05.

<sup>101</sup> Because AS 2401 and related standards specifically address fraud, occasionally this release and the proposed amendments refer to both “fraud” and “noncompliance with laws and regulations” (e.g., proposed AS 2110.26e requires inquiries concerning “fraud or other noncompliance with laws and regulations”). Use of both terms is for clarity and not to imply that fraud falls outside the proposed definition.

noncompliance that has or may have occurred. We believe that the approach for evaluating and communicating fraud and other noncompliance should be consistent.

Under this proposed approach the requirements to evaluate and communicate matters related to fraud that has or may have occurred are included in proposed AS 2405. Therefore, those similar requirements<sup>102</sup> in AS 2401 would be removed from existing AS 2401. The documentation requirements in AS 2401 are proposed to be removed, moved to AS 1215, *Audit Documentation*, and expanded to include documentation of instances, or alleged or suspected instances, of other noncompliance with laws and regulations.

*Questions:*

42. Is the proposed incorporation of the requirements to document the auditor's consideration of fraud in a financial statement audit into AS 1215 sufficiently clear? If not, what changes are necessary and why?

43. Is the proposed documentation requirement in AS 1215.12h sufficiently clear? If not, what changes are necessary and why? Are there any specific challenges related to this documentation requirement? If so, please describe.

## **2. Auditor's Specialists Participating in the Audit**

*See AS 1201.C3 and .C6, as proposed to be amended, and AS 1210.06 and .09, as proposed to be amended*

We believe that other audit participants, including auditors' specialists, may be the first engagement team members to become aware of fraud or other noncompliance. These participants would be in the best position to bring such noncompliance to the attention of the auditor. Therefore, we propose adding new requirements for when the auditor establishes and documents their understanding with the auditor's specialist, whether employed or engaged by the auditor, regarding the specialist's responsibilities when assisting the auditor in obtaining sufficient appropriate audit evidence.

Current PCAOB standards require the engagement partner and, as applicable, other engagement team members performing supervisory activities to inform the specialist of the work to be performed, including establishing and documenting an understanding with the auditor's specialist of the work to be performed. The proposed amendments to AS 1201 and AS 1210 would build on these existing requirements, adding an obligation to establish an understanding with the auditor's specialist to communicate any instances (including alleged or suspected instances) of fraud or other noncompliance with laws and regulations of which the specialist becomes aware during the specialist's work. This includes a requirement for the auditor to obtain a written affirmation from the specialist that any instances, or alleged or

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<sup>102</sup> See AS 2401.79, .81A, and .82.

suspected instances, of fraud or other noncompliance with laws and regulations identified during the specialist's work were communicated by the specialist. This would apply to all circumstances where an auditor's specialist participates in an audit.

*Question:*

44. Are the proposed requirements to amend the understanding with an auditor's specialist – whether employed or engaged by the auditor – sufficiently clear? If not, why not?

### **3. Related Parties**

*See AS 2410.11, as proposed to be amended*

When auditing related party transactions under AS 2410, *Related Parties*, auditors have a requirement to evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred.<sup>103</sup> However, there is no express requirement in AS 2410 to conduct an evaluation when management has made appropriate disclosure of related party information that may indicate noncompliance has or may have occurred. We are proposing to amend AS 2410 to require the auditor to evaluate implications for the audit when transactions or relationships with a related party indicate noncompliance has or may have occurred regardless of how the auditor becomes aware of such transactions or relationships. This amendment is intended to provide clarity and remind the auditor of their responsibilities as it pertains to a company's noncompliance with laws and regulations. For example, regardless of whether disclosed by management, the auditor is required to evaluate whether a loan to an officer is prohibited by Exchange Act Section 13(k) after the auditor becomes aware of such transaction.<sup>104</sup>

*Question:*

45. Are the amendments to AS 2410 sufficiently clear? If not, why not?

### **4. Reviews of Interim Financial Information**

*See AS 4105.18, .23, and .32, as proposed to be amended.*

We are proposing amendments to AS 4105, *Reviews of Interim Financial Information*, to provide specific procedures related to potential noncompliance. Existing AS 4105 requires that, when an accountant performing an interim review identifies or otherwise becomes aware of

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<sup>103</sup> See AS 2410.16.f.iii.

<sup>104</sup> See, e.g., *In the Matter of Peter Goodfellow*, SEC Rel. No. 34-52865 (Dec. 1, 2005) (settled order); *In the Matter of Jae Cheol Oh*, SEC Rel. No. 34-95072 (June 8, 2022) (settled order).



information indicating that fraud or an illegal act has or may have occurred, the accountant is required to determine its responsibilities under AS 2401, AS 2405, and Section 10A.<sup>105</sup> The SEC has stated that an auditor's obligations under Section 10A apply to interim reviews as well as annual audits of financial statements.<sup>106</sup> Accordingly, the following amendments are intended to assist auditors in discharging their professional and statutory obligations:

- Proposed AS 4105.18c would require inquiries of members of management who have responsibility for financial and accounting matters. This requirement mirrors required written representations from management pursuant to existing AS 4105.24p.
- Proposed AS 4105.23 would require that if, in performing a review of interim financial information, the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred, the auditor would be required to determine their responsibilities under proposed AS 2405 and Section 10A.<sup>107</sup>
- Proposed AS 4105.32 would require that any required communication under AS 2401, proposed AS 2405, or Section 10A would be required to be made as soon as practicable and prior to the registrant's filing its periodic report with the SEC. Given review reports are not required to be issued in a review of interim information,<sup>108</sup> and if a review report is issued it would likely include a date close to the day the registrant files its periodic report with the SEC, the proposed amendment specifies that any required communications are to be made before the periodic report is filed with the SEC.

*Questions:*

46. What steps or procedures do auditors currently take or perform to comply with Section 10A obligations when information related to noncompliance is identified during an interim review?

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<sup>105</sup> AS 4105.32.

<sup>106</sup> *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, SEC Rel. No. 34-64545 (May 25, 2011) (quarterly reviews encompassed by Section 10A because they "are frequently viewed as a step in the annual audit process").

<sup>107</sup> See 15 U.S.C. § 78j-1.

<sup>108</sup> See Regulation S-X Rule 10-01(d), 17 C.F.R. § 210.10-01(d) (requiring review report to be filed only if the company's filing states that the financial statements have been reviewed by an independent public accountant).

47. Is the addition of the management inquiry in proposed paragraph .18c of AS 4105 sufficiently clear? If not, why not? Are auditors making this inquiry currently?

48. Is the proposed amendment to AS 4105.23 sufficiently clear? If not, what changes are necessary and why?

49. Is the timing for any required communications in proposed AS 4105.32 reasonable? If not, what changes are necessary and why?

50. Should an interim review requirement be added for the auditor to make specific inquiries regarding the company's ongoing investigations related to noncompliance with laws and regulations? If so, what should those specific inquiries be?

## E. Other Amendments

### 1. Rescind AS 6110, Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

AS 6110 is applicable when the auditor is engaged to audit a governmental entity under PCAOB standards, and also engaged to test and report on compliance with laws and regulations under Government Auditing Standards (the Yellow Book) or in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.<sup>109</sup> The standard was adopted by the Board in April 2003 as part of the interim standards. The staff's research indicates that this standard is no longer used in practice, as audits involving governmental entities are typically not conducted pursuant to PCAOB standards, but instead under auditing standards subsequently adopted by the ASB<sup>110</sup> and/or Government Auditing Standards. Accordingly, we are proposing to rescind AS 6110.

#### *Question:*

51. Is rescinding AS 6110 appropriate? Does this standard continue to be used by auditors? If so, what are the specific provisions that are used by auditors and when is this standard used?

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<sup>109</sup> See AS 6110.01.

<sup>110</sup> See AU-C sec. 935, *Compliance Audits*.

## 2. Rescind AI 13, Illegal Acts by Clients: Auditing Interpretations of AS 2405

AI 13 was adopted by the PCAOB in 2003. It is based on an interpretation issued by the AICPA after enactment of the FCPA in 1977.<sup>111</sup> AI 13 provides that the internal controls provisions of the FCPA do not alter the auditor's responsibilities to consider a company's internal control over financial reporting in an audit of the company's financial statements. AI 13 further provides that the standards applied by an auditor in determining a material weakness in internal control may differ from the standards for determining a violation of the FCPA. As part of a larger project to clarify its auditing standards, the ASB rescinded AI 13.<sup>112</sup> The Board believes these interpretations could lead to confusion with respect to proposed AS 2405. The Board believes the issues covered in AI 13 are encompassed within other PCAOB standards or within proposed AS 2405. In particular, the Board believes auditors understand that FCPA violations, whether related to the law's antibribery provisions or internal control and recordkeeping provisions, are a form of noncompliance and should be handled as such. Accordingly, we are proposing to rescind AI 13.

### *Question:*

52. Is rescinding AI 13 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

## 3. Rescind AI 21, Management Representations: Auditing Interpretations of AS 2805

AI 21 relates to management representations on violations and possible violations of laws and regulations under AS 2805, *Management Representations*. AI 21 states that AS 2805 did not change the relevant criteria under auditing standards or generally accepted accounting principles for evaluating the need for disclosure in the financial statements of violations and possible violations of laws or regulations. The interpretation further provides that the auditor is not asking management to speculate on all possibilities of legal challenges to its actions when responding to the auditor's request for management representations. The Board proposes rescinding AI 21 and amending AS 2805 to add a footnote to address the relevant content in AI 21.

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<sup>111</sup> AU sec. 9317, *Illegal Acts by Clients: Auditing Interpretations of Section 317* (Oct. 1978); Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (Dec. 19, 1977). The interpretation was partially rescinded by the AICPA in November 2006 and fully rescinded in March 2009. AICPA, *Codification of Statements on Auditing Standards*, at v, 225 (Feb. 2010).

<sup>112</sup> *Id.*

*Questions:*

53. Is rescinding AI 21 and replacing its content with a footnote in AS 2805 appropriate? If not, why not?

54. Are there other changes that should be made to AS 2805? If so, what are those changes?

## F. Additional Questions Regarding Certain Aspects of the Proposal

Appendix 3 contains proposed conforming amendments to proposed AS 1000, AS 1001, AS 1301, AS 2101, AS 2201, AS 2501, AS 2601, AS 2610, and AS 2810 as a result of the proposed amendments to AS 2405 and AS 2110. These conforming amendments are not intended to substantively change existing requirements. The Board invites comments on these conforming amendments. The following are specific questions on the proposed amendments in Appendix 3 and more general questions on the overall proposal.

*Questions:*

55. Are the proposed conforming amendments in Appendix 3 appropriate and clear? Why or why not? What changes to the amendments are necessary?

56. In addition to the proposed conforming amendments in Appendix 3, are other conforming amendments necessary in connection with the proposed changes to AS 2405 and AS 2110?

## IV. ECONOMIC ANALYSIS

The Board is mindful of the economic impacts of its standard setting. This economic analysis describes the economic baseline, need, and expected economic impacts of the proposed amendments, as well as alternative approaches considered. Due to data limitations, much of the economic analysis is qualitative in nature; however, where reasonable and feasible, the analysis incorporates quantitative information, including information from publicly available data and academic literature related to noncompliance.

### A. Baseline

This section establishes the economic baseline against which the impact of the proposed amendments can be considered. Section II above describes important components of the baseline, specifically current auditor responsibilities for the identification, evaluation, and communication of noncompliance; firms' current practice; and observations from the Board's and the SEC's oversight activities. We discuss below two additional components that inform our understanding of the economic baseline: (1) staff analysis of audit firm methodologies relating to the auditor's consideration of noncompliance; and (2) a summary of academic and other

literature on investor harm associated with noncompliance and auditor incentives to identify, evaluate, and communicate noncompliance.

### 1. PCAOB Staff Analysis of Audit Methodologies

PCAOB staff has reviewed the methodologies of selected registered firms to determine how those methodologies currently address the auditor's consideration of a company's noncompliance with laws and regulations as well as how those methodologies might need to be changed in order to implement the proposed amendments, if adopted as proposed.<sup>113</sup> Specifically, the staff compared methodologies of global network firms ("GNFs")<sup>114</sup> and some methodologies commonly used by U.S. non-affiliated firms ("NAFs")<sup>115</sup> to existing AS 2405 and requirements in AS 2110 related to noncompliance with laws and regulations as well as to the proposed amendments.<sup>116</sup> The review focused on the following aspects of the proposed amendments:

- Replacing the term "illegal acts" with "noncompliance with laws and regulations;"
- Requiring the auditor to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, assess and respond to the risk of material misstatement due to noncompliance with those laws and regulations, and identify whether there is information indicating that noncompliance has or may have occurred;
- More expressly incorporating the risk of material misstatement due to noncompliance with laws and regulations into the auditor's risk assessment;
- Enhancing the auditor's potential identification of noncompliance with laws and regulations through enhanced assessment of risks of material misstatement;

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<sup>113</sup> As discussed below, the costs associated with the proposed amendments include fixed costs to update audit methodologies and variable costs to change existing audit practice, both of which depend on how current methodologies compare to the proposed amendments.

<sup>114</sup> GNFs are the member firms of the six global accounting firm networks (BDO International Ltd., Deloitte Touche Tohmatsu Ltd., Ernst & Young Global Ltd., Grant Thornton International Ltd., KPMG International Ltd., and PricewaterhouseCoopers International Ltd.).

<sup>115</sup> NAFs are both U.S. and non-U.S. accounting firms registered with the Board that are not GNFs. Some of the NAFs belong to international networks.

<sup>116</sup> The staff reviewed methodologies relating to the auditor's consideration of illegal acts used by PCAOB-registered firms, including two methodologies typically purchased by NAFs.

- Using information from other procedures performed in the audits of financial statements or internal control over financial reporting, or in interim reviews;
- Requiring the auditor to apply the procedures in proposed AS 2405 to information indicating that fraud has or may have occurred;
- Expanding the extent of the auditor’s communications to management, audit committees and boards of directors regarding noncompliance; and
- Implementing audit procedures regarding noncompliance for engagements involving other auditors and an auditor’s specialist.

For the GNF methodologies reviewed, the staff observed that the methodologies generally reflect requirements in existing AS 2110 and AS 2405 and other auditing standards that address noncompliance with laws and regulations. While some of the methodologies already incorporate certain concepts included in the proposed amendments, significant changes would nonetheless be needed if the proposed amendments were adopted.

Specifically, some GNF methodologies include definitions of “noncompliance with laws and regulations” similar to the definition in the proposed amendments. Some GNF methodologies suggest, but do not require, that engagement teams use information from other audit procedures performed during the audit that may identify noncompliance that has or may have occurred.

Beyond that, however, GNF methodologies relating to AS 2405 generally would need to be revised to incorporate the proposed requirements relating to the identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, the assessment of and response to risks of material misstatement due to noncompliance with those laws and regulations, and the identification of whether there is information indicating that noncompliance with those laws and regulations has or may have occurred. Similarly, GNF methodologies relating to AS 2405 generally would need to be revised to implement the incorporation of fraud into AS 2405. Further, although GNF methodologies include guidance on assessing risks of material misstatement, communications to management, audit committees and boards of directors about noncompliance, and the use of other auditors and specialists, modifications generally would be needed to comply with the proposed amendments in those areas. For example, consistent with existing AS 2110, GNF methodologies relating to assessment of risks of material misstatement generally state that engagement teams should consider performing, and do not require engagement teams to perform all, the procedures specified in AS 2110.11 to understand the company. Similarly, GNF methodologies relating to AS 2110.54 and .56 generally would need to be revised to incorporate the expanded responsibilities to make and evaluate the proposed specific inquiries.

For the NAF methodologies reviewed, the staff observed that the methodologies generally align with but do not go beyond existing AS 2405 and AS 2110 across each of the

areas studied. Some NAF methodologies suggest that the auditor obtain an understanding of the laws and regulations that might reasonably be expected to affect the risk of material misstatement. More thorough changes would be necessary to update these methodologies if the proposed amendments were adopted.

In general, the staff's review indicates that all firms would likely need to revise the relevant portions of their methodologies to a significant extent to implement the proposed amendments, if adopted. For example, all firms would need to update their methodologies to implement the new procedures in AS 2405 and the proposed enhancements to AS 2110. We believe that GNF methodologies generally would likely need less extensive revisions, while NAF methodologies would likely require more extensive revisions.

## 2. Academic and Other Literature

The staff has reviewed academic and other literature to understand the potential harm to investors associated with corporate noncompliance with laws and regulations and the incentives for auditors to identify, evaluate, and communicate noncompliance. The literature shows that noncompliance may expose companies to legal and regulatory penalties as well as reputational loss, causing potentially significant investor harm. The literature also suggests that auditors may not have sufficient incentives to properly consider a company's noncompliance with laws and regulations. The Board has taken these considerations into account in developing its proposal to strengthen existing requirements.

Since the literature is based on noncompliance with laws and regulations that was discovered, and does not include noncompliance that went undetected or was caught so early that it never became public,<sup>117</sup> the literature may not provide a full picture of the investor harm caused by noncompliance, the role of auditors in detecting noncompliance, or the impact of existing AS 2405 on auditors.<sup>118</sup> Nevertheless, the literature provides valuable information based on available evidence, which expands our understanding of the baseline.

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<sup>117</sup> There are academic papers that estimate the undetected share of corporate noncompliance. For example, a recent study estimates that in normal times only one-third of corporate "frauds" are detected. The study uses the term "fraud" loosely to refer to "some form of misconduct or alleged fraud." It is not limited to fraud as defined under PCAOB standards. The study also estimates that corporate "fraud" destroys 1.6 percent of equity value each year, equal to \$830 billion in 2021. Alexander Dyck, Adair Morse, and Luigi Zingales, *How Pervasive Is Corporate Fraud?*, Review of Accounting Studies 1 (2023).

<sup>118</sup> There is limited academic literature on the role of auditors in detecting noncompliance with laws and regulations by clients. Section IV.A.2.ii below cites two studies as examples.

## i. Investor Harm

The staff's review of the literature reveals that noncompliance with laws and regulations by companies may result in substantial financial damage to investors through lower share prices. In addition to sanctions and fines, civil settlements, and legal costs, share prices may also be affected by reputational consequences for the companies, including lower future earnings and increases in the cost of capital.<sup>119</sup>

### a. Legal and Regulatory Penalties

Some statistics are publicly available on financial penalties imposed through the legal and regulatory system for noncompliance with laws and regulations. The available statistics suggest that enforcement activity and financial penalties are different for different types of noncompliance and industries, and that financial penalties are sometimes substantial.

For example, based on a database of federal organizational or corporate prosecutions in the United States, federal enforcement activity appears to be more frequently associated with violations of antifraud and environmental statutes,<sup>120</sup> while financial penalties seem to be higher for violations of antifraud and antitrust laws and the FCPA.<sup>121</sup> When examined by

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<sup>119</sup> For example, one study analyzes Xerox's misconduct of artificially inflating reported earnings in around 1997-1999 and estimates that the cumulated loss in market capitalization, measured over the sequence of events by which investors learned of the misconduct, was \$5 billion. Out of the \$5 billion loss, the study estimates that \$1.039 billion is the reversal of the artificial share price inflation, \$0.523 billion can be attributed to amounts Xerox paid in fines and to settle a class action lawsuit, and the rest of the loss – \$3.44 billion – is due to impaired operations because of the revelation of misconduct, or so-called reputational loss. See Jonathan M. Karpoff, *Does Reputation Work to Discipline Corporate Misconduct?*, The Oxford Handbook of Corporate Reputation (2012).

<sup>120</sup> The Corporate Prosecution Registry classifies violations of various federal statutes as "fraud" and contains separate categories for accounting, health care, securities, and tax fraud. PCAOB standards, specifically, AS 2401.05, describe fraud more narrowly ("an intentional act that results in a material misstatement in financial statements that are the subject of the audit"). References in this subsection to "antifraud" laws or statutes are intended to encompass a wide variety of laws that proscribe conduct commonly known as "fraud." The words "fraud" and "antifraud" in this subsection are not limited to fraud as defined under PCAOB standards.

<sup>121</sup> The Corporate Prosecution Registry is a joint project of the Legal Data Lab at the University of Virginia School of Law and Duke University School of Law. It includes information about federal organizational prosecutions since 2001, as well as deferred and non-prosecution agreements with organizations since 1990. Violations of antifraud (including accounting, health care, securities, tax, and other), environmental, and antitrust laws represented the top three types of noncompliance when ranked by number of cases filed. The top three types of noncompliance ranked by fines (including fines imposed by civil enforcers) are violations of antifraud (including accounting, healthcare, securities, tax, and general fraud), FCPA, and antitrust provisions. The Corporate Prosecution Registry at <https://corporate-prosecution-registry.com/>, accessed December 19, 2022.



industry, the database appears to suggest that federal prosecutions are more common in the manufacturing and the wholesale trade industries, while financial penalties are higher in the finance and insurance and the manufacturing industries.<sup>122</sup> The database also indicates that companies are sometimes subject to substantial monetary penalties as a result of noncompliance with federal laws and regulations. For instance, total settlement amounts for violations of antifraud laws and the FCPA have been considerable in recent years and reached \$4.3 billion and \$4.2 billion, respectively, in 2020.<sup>123</sup>

#### b. Reputational Loss

The staff's review of the academic literature finds that noncompliance with laws and regulations may also lead to reputational loss. Specifically, studies suggest that significant reputational loss is associated with noncompliance directly affecting stakeholders who engage in repeat business or have an ongoing relationship with a company (e.g., customers, suppliers, employees, or investors).<sup>124</sup> Examples of such noncompliance include consumer fraud and financial misrepresentation. At the public announcement of this type of noncompliance, the decline in the company's stock market value is shown to far exceed the expected legal and regulatory penalties. The additional market value loss (i.e., the portion of market value loss that exceeds the expected legal and regulatory penalties) is considered reputational loss, which may be significantly greater than legal and regulatory penalties. For example, a study examines a large sample of companies subject to SEC enforcement actions for financial misrepresentation, and estimates that the reputational loss is over 7.5 times the sum of all penalties imposed through the legal and regulatory system.<sup>125</sup> Similarly, a more recent study on the impact of the

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<sup>122</sup> In the Corporate Prosecution Registry, the top three industries ranked by the number of cases are manufacturing, wholesale trade, and transportation and warehousing. The top three industries ranked by fines (including fines imposed by civil enforcers) are finance and insurance, manufacturing, and retail trade. The Corporate Prosecution Registry at <https://corporate-prosecution-registry.com/>, accessed December 19, 2022.

<sup>123</sup> As discussed above, violations of antifraud laws and the FCPA appear to be associated with higher financial penalties than other types of noncompliance in the database. The settlement amounts for antifraud (including accounting, healthcare, securities, tax, and general fraud) violations were \$0.4 billion, \$2.3 billion, and \$4.3 billion in 2018, 2019, and 2020, respectively. The settlement amounts for FCPA violations were \$1.7 billion, \$1.9 billion, and \$4.2 billion in 2018, 2019, and 2020, respectively. Data from 2021 was incomplete and, as such, not referenced herein. See The Corporate Prosecution Registry, available at <https://corporate-prosecution-registry.com> (accessed December 19, 2022).

<sup>124</sup> See, e.g., Jonathan M. Karpoff, *Does Reputation Work to Discipline Corporate Misconduct?*, The Oxford Handbook of Corporate Reputation (2012).

<sup>125</sup> Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 Journal of Financial and Quantitative Analysis 581 (2008). A more recent working paper written by the same authors analyzing FCPA cases from 1978 to 2013 confirms that reputational harm is

enforcement of financial regulation by the United Kingdom's regulatory authorities finds that reputational loss is nearly nine times the size of fines for noncompliance harming customers or investors.<sup>126</sup> These studies may or may not be representative of the full population of noncompliance covered by this proposal, but they give a sense of the possible magnitudes of reputational loss associated with corporate noncompliance.

In contrast, for noncompliance that may not affect stakeholders who engage in repeat business or have an ongoing relationship with a company (e.g., environmental violations and bribery), stock market reactions to announcements of noncompliance primarily reflect the financial impact of legal and regulatory penalties.<sup>127</sup> For example, studies from both 2005 and 2019 find insignificant reputational loss following announcements of environmental violations.<sup>128</sup>

## ii. Auditor Incentives

The staff's review of academic and other literature finds that auditors face ample disincentives and limited incentives with respect to a company's potential noncompliance with laws and regulations.

Potential disincentives for auditors to identify, evaluate, and communicate noncompliance with laws and regulations include:<sup>129</sup>

- The risk of losing a client without an increase in new clients;<sup>130</sup>

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large for financial fraud but negligible for bribery. Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, *Foreign Bribery: Incentives and Enforcement*, Working Paper (2017).

<sup>126</sup> John Armour, Colin Mayer, and Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets*, 52 *Journal of Financial and Quantitative Analysis* 1429 (2017).

<sup>127</sup> See, e.g., Dan Amiram, Zahn Bozanic, James D. Cox, Quentin Dupont, Jonathan M. Karpoff, and Richard Sloan, *Financial Reporting Fraud and Other Forms of Misconduct: A Multidisciplinary Review of the Literature*, 23 *Review of Accounting Studies* 732 (2018).

<sup>128</sup> The 2019 study replicated and reaffirmed the conclusions of the 2005 study. Jonathan M. Karpoff, John R. Lott, Jr, and Eric W. Wehrly, *The Reputational Penalties for Environmental Violations: Empirical Evidence*, 48 *The Journal of Law and Economics* 653 (2005). Jacob Brady, Mary F. Evans, and Eric W. Wehrly, *Reputational Penalties for Environmental Violations: A Pure and Scientific Replication Study*, 57 *International Review of Law and Economics* 60 (2019).

<sup>129</sup> In addition to auditor incentives, a study also identifies auditor knowledge, training, and experience in fraud as a factor that inhibits auditor fraud detection. Stephen K. Asare, Arnie Wright, and Mark F. Zimbelman, *Challenges Facing Auditors in Detecting Financial Statement Fraud: Insights From Fraud Investigations*, 7 *Journal of Forensic and Investigative Accounting* 63 (2015).

<sup>130</sup> Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*.

- Time and fee budget pressures;<sup>131</sup>
- Social pressures such as unpleasant interactions with client management;<sup>132</sup> and
- Punishment by an auditor's supervisor for exercising appropriate levels of professional skepticism when the evaluation of an issue does not identify a financial statement misstatement.<sup>133</sup>

In contrast, there are limited incentives for auditors to address noncompliance with laws and regulations. Auditors' regulatory accountabilities predominantly are in the form of penalties (such as legal damages and settlements and regulatory sanctions and fines) rather than rewards.<sup>134</sup> As discussed in Section II, relative to the known instances of company noncompliance with laws and regulations, there have been relatively few enforcement cases against auditors involving AS 2405 or relevant provisions of Section 10A. Further, there is evidence that auditor liability in shareholder litigation has declined in recent years.<sup>135</sup> While the risk of reputational loss to auditors also could provide incentive for auditors to identify, evaluate, and communicate noncompliance, academic research in the context of non-U.S. markets has found limited evidence of reputational loss to firms in instances of financial statement fraud.<sup>136</sup>

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<sup>131</sup> See, e.g., Jessen L. Hobson, William J. Mayew, Mark Peecher, and Mohan Venkatachalam, *Improving Experienced Auditors' Detection of Deception in CEO Narratives*, 55 *Journal of Accounting Research* 1137 (2017).

<sup>132</sup> See, e.g., Mark W. Nelson, *A Model and Literature Review of Professional Skepticism in Auditing*, 28 *Auditing: A Journal of Practice & Theory* 1 (2009). G. Bradley Bennett and Richard C. Hatfield, *The Effect of the Social Mismatch Between Staff Auditors and Client Management on the Collection of Audit Evidence*, 88 *The Accounting Review* 31 (2013).

<sup>133</sup> See, e.g., Joseph F. Brazel, Scott B. Jackson, Tammie J. Schaefer, and Bryan W. Stewart, *The Outcome Effect and Professional Skepticism*, 91 *The Accounting Review* 1577 (2016).

<sup>134</sup> See Mark E. Peecher, Ira Solomon, and Ken T. Trotman, *An Accountability Framework for Financial Statement Auditors and Related Research Questions*, 38 *Accounting, Organizations and Society* 596 (2013). Moreover, auditors are generally excluded from the set of persons eligible for monetary rewards from the whistleblowing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. See, e.g., Jessen L. Hobson, William J. Mayew, Mark E. Peecher, and Mohan Venkatachalam, *Improving Experienced Auditors' Detection of Deception in CEO Narratives*, 55 *Journal of Accounting Research* 1137, 1141 (2017).

<sup>135</sup> See Colleen Honigsberg, Shivaram Rajgopal, and Suraj Srinivasan, *The Changing Landscape of Auditors' Liability*, 63 *Journal of Law & Economics* 367 (2020).

<sup>136</sup> While academic research has found mixed evidence of auditor reputational loss associated with financial statement fraud in non-U.S. markets, there is little literature focusing on other

Consistent with the auditor incentives literature, studies suggest that auditors have played a limited role in detecting noncompliance with laws and regulations. For example, a seminal study using data from both before and after the enactment of Sarbanes-Oxley finds that auditors played a small role in detecting corporate “fraud” before Sarbanes-Oxley and a larger but still limited role thereafter.<sup>137</sup> As mentioned above, a more recent study by the same authors estimates that in normal times only one-third of corporate “frauds” are detected and that corporate “fraud” destroys 1.6 percent of equity value each year, equal to \$830 billion in 2021.<sup>138</sup>

## B. Need

In general, two attributes of the audit market support a need for the PCAOB to establish effective audit performance standards. First, the company under audit, investors, and other financial statement users cannot easily observe the services performed by the auditor or the quality of the audit. This information asymmetry leads to a risk that, unbeknownst to the company under audit, investors, or other financial statement users, the auditor may perform a low-quality audit.<sup>139</sup>

Second, the federal securities laws require that an issuer retain an auditor for the purpose of preparing or issuing an audit report. While the appointment, compensation, and oversight of the work of the registered public accounting firm conducting the audit is, per

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types of noncompliance. *See, e.g.*, Joseph Weber, Michael Willenborg, and Jieying Zhang, *Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG*, 46 *Journal of Accounting Research* 941 (2008). Douglas J. Skinner and Suraj Srinivasan, *Audit Quality and Auditor Reputation: Evidence from Japan*, 87 *The Accounting Review* 1737 (2012). Dan Hu, *Japanese Stock Market Reaction to Announcements of News Affecting Auditors’ Reputation: The Case of the Olympus Fraud*, 10 *Journal of Contemporary Accounting & Economics* 206 (2014).

<sup>137</sup> As mentioned above, the word “fraud” in this subsection is not limited to fraud as defined under PCAOB standards. *See* Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*. A recent report on occupational fraud—defined in the study as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets”—concluded that auditors only detected four percent of cases involving such noncompliance. The study was based on survey results of public and private companies throughout the world and did not break out results for companies subject to audits under PCAOB standards. *Occupational Fraud 2022: A Report to the Nations*, Association of Certified Fraud Examiners.

<sup>138</sup> The study uses “normal times” to differentiate from times where scrutiny increased substantially. Specifically, in the study, the sample of companies under enhanced scrutiny is the set of Arthur Anderson clients after the Arthur Anderson demise following the Enron scandal. *See* Alexander Dyck, et al., *How Pervasive Is Corporate Fraud?*.

<sup>139</sup> *See, e.g.*, Monika Causholli and Robert W. Knechel, *An Examination of the Credence Attributes of an Audit*, 26 *Accounting Horizons* 613 (2012).

Sarbanes-Oxley, entrusted to the issuer's audit committee,<sup>140</sup> there is nonetheless a risk that the auditor may seek to satisfy the interests of the issuer audit client rather than the interests of investors and other financial statement users.<sup>141</sup> This risk can arise out of an audit committee's identification with the company or its management (e.g., for compensation) or through management's exercise of influence over the audit committee's supervision of the auditor, which can result in a *de facto* principal-agent relationship between the company and the auditor.<sup>142</sup> Effective auditing standards help to address these risks by explicitly assigning responsibilities to the auditor that, if executed properly, are expected to lead to high-quality audits that satisfy the interests of audited companies, investors, and other financial statement users.

This section discusses the specific problem that the proposed amendments are intended to address and explains how the proposed amendments are expected to address it.

### 1. Problem to Be Addressed

The staff's research suggests that auditors may not have sufficient incentives to identify, evaluate, and communicate a company's noncompliance with laws and regulations, even though the harm to investors arising from such noncompliance may be significant. As discussed in Section IV.A above, corporate noncompliance can result in legal and regulatory penalties as well as reputational loss, causing substantial financial damage to companies and investors. To the extent that noncompliance gives an unfair advantage to noncomplying companies (e.g., when a company violates FCPA to enter a foreign market or win new business<sup>143</sup>), other companies and their investors may also be negatively affected. Also as discussed in Section IV.A, the staff's literature review suggests that the disincentives for auditors to address noncompliance are generally stronger than the incentives.

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<sup>140</sup> See Section 301 of Sarbanes-Oxley (adding subsection (m) to Section 10A); Section 10A(m)(2). As an additional safeguard, the auditor is also required to be independent of the audit client. See Regulation S-X Rule 2-01, 17 C.F.R. § 210.2-01.

<sup>141</sup> See, e.g., Joshua Ronen, *Corporate Audits and How to Fix Them*, 24 *Journal of Economic Perspectives* 189 (2010).

<sup>142</sup> See *id.*; see also, e.g., Liesbeth Bruynseels and Eddy Cardinaels, *The Audit Committee: Management Watchdog or Personal Friend of the CEO?*, 89 *The Accounting Review* 113 (2014). Cory Cassell, Linda Myers, Roy Schmardebeck, and Jian Zhou, *The Monitoring Effectiveness of Co-Opted Audit Committees*, 35 *Contemporary Accounting Research* 1732 (2018). Nathan Berglund, Michelle Draeger, and Mikhail Sterin, *Management's Undue Influence over Audit Committee Members: Evidence from Auditor Reporting and Opinion Shopping*, 41 *Auditing: A Journal of Practice* 49 (2022).

<sup>143</sup> See, e.g., *In the Matter of Goldman Sachs Group, Inc.* SEC Rel. No. 34-90243 (Oct. 22, 2020) (settled order); SEC Press Rel. No. 2020-265 ("[T]hese bribes enabled Goldman Sachs to obtain lucrative business from ... [an] investment fund, ..., including underwriting approximately \$6.5 billion in bond offerings.").

Consistent with the literature on auditor incentives, studies suggest that auditors have not played a primary role in detecting noncompliance with laws and regulations.<sup>144</sup> Anecdotal evidence also indicates that stakeholders expect auditors to play a larger role in identifying, evaluating, and communicating noncompliance. For example, in a number of recent scandals related to bribery, corruption, and consumer fraud, the auditors of the companies involved were named as defendants in securities class actions, investigated by authorities, or the subject of media attention. Examples of these situations involved Rolls-Royce, FIFA, Ballast Nedam, Siemens AG, Wells Fargo & Co., and NovaStar Financial (some, but not all, of which were issuers that required audits performed under PCAOB standards). Similarly, through outreach activities, the staff learned that many investors would prefer earlier and enhanced communication and reporting of noncompliance, which could improve financial reporting quality and thereby allow investors to make better-informed decisions regarding capital allocation and enhance their monitoring of company management.

In addition, existing requirements may give rise to information asymmetry between the auditor and the audit committee. Currently, AS 2405 only requires the auditor to “assure” that required communications with the audit committee regarding identified noncompliance have occurred, allowing for management, rather than the auditor, to have the primary responsibility for making the required communications to the audit committee. Further, current PCAOB standards do not address communications between the lead auditor and other auditors or an auditor’s specialists regarding noncompliance, leading to potential information asymmetry between the auditor and other auditors or an auditor’s specialists, even though other auditors and auditor’s specialists may be the first to become aware of noncompliance and would be in the best position to bring it to the attention of the lead auditor.

## **2. How the Proposed Amendments Would Address the Need**

### **i. Strengthen Auditor Incentives**

The proposed amendments would address the auditor incentive issue by: (1) clarifying the auditor’s responsibilities concerning a company’s noncompliance with laws and regulations and (2) setting forth clear performance requirements to strengthen the auditor’s obligations vis a vis the identification of noncompliance with laws and regulations that reasonably could have a material effect on the financial statements.

With respect to auditor responsibilities, the proposed amendments to AS 2405 would strengthen auditor incentives with respect to noncompliance by removing certain descriptive language suggesting limitations on the auditor’s competence to respond to noncompliance with laws and regulations as well as examples that are merely illustrative in nature. The proposed standard instead focuses on the auditor’s affirmative responsibilities. The proposed amendments also would replace the term “illegal acts” in existing AS 2405 with

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<sup>144</sup> See discussion in Section IV.A.2.

“noncompliance with laws and regulations.” This term helps emphasize that violations of relevant laws and regulations, regardless of the perceived significance of the violation or whether arising by act or omission, fall within the scope of the standard. The proposed definition also expressly incorporates fraud, as described in AS 2401, as a type of noncompliance.

With respect to performance requirements, the proposed amendments significantly strengthen the auditor’s regulatory accountabilities and enhance auditor incentives by imposing requirements to identify through risk assessment and other procedures noncompliance with laws and regulations that has or may have occurred as it pertains to such laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. In contrast to the current AS 2405 requirements which only direct the auditor to identify noncompliance with a direct and material effect on the financial statements, the proposed amendments to AS 2405 would require the auditor to plan and perform procedures to (i) identify laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements, (ii) assess and respond to risks of material misstatement due to noncompliance with those laws and regulations, and (iii) identify whether there is information indicating that noncompliance with those laws and regulations has or may have occurred. The proposed amendments to AS 2110 would clarify that noncompliance with laws and regulations is embedded within the auditor’s responsibility to identify and assess the risks of material misstatement due to error or fraud (via a clarification in AS 2110.05) and would provide more specific direction to auditors on obtaining an understanding of the regulatory environment as well as the nature of the company (via a strengthened requirement to read publicly available information and a newly mandatory requirement to perform all of the procedures in AS 2110.11).

The proposed amendments also would link the procedures in AS 2110 that may lead to the potential identification of noncompliance to the auditor’s obligations under proposed AS 2405. In addition, proposed AS 2405 would enhance incentives to consider noncompliance by requiring the auditor to use information from other audit procedures – including additional procedures that may be performed to respond to the enhanced risk assessment – that may indicate laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or noncompliance with laws and regulations that has or may have occurred. An accompanying note to this requirement would identify examples of other auditing standards whereby procedures performed by the auditor in compliance with such standards may assist the auditor in identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or alert the auditor to information indicating that noncompliance with laws and regulations has or may have occurred. Finally, the proposed amendments would require the same procedures to evaluate and communicate fraud that has or may have occurred as for other noncompliance with laws and regulations, promoting consistency in addressing all types of noncompliance.

## ii. Reduce Information Asymmetry

The proposed amendments would enhance auditor communication of noncompliance and mitigate information asymmetry between: (1) the auditor and audit committees and (2) the auditor and other auditors or auditor specialists.

Specifically, the proposed amendments would expand the requirements in AS 2405 for the auditor to communicate information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred to audit committees. The proposed amendments to the requirements for supervising the work of other auditors and for using the work of an auditor's specialist—employed or engaged by the auditor—would require certain communications between the lead auditor and the other auditor or the auditor's specialist about noncompliance, allowing for two-way communication and facilitating information exchange.

## C. Economic Impacts

This section discusses the expected benefits and costs of the proposed amendments and potential unintended consequences. The magnitude of the benefits and costs is likely to be affected by the risk of noncompliance by audit clients and by the degree to which firms have already adopted audit practices that are similar to those the proposed amendments would require. Overall, we expect that the benefits of the proposed amendments would justify the costs.

### 1. Benefits

The proposed amendments are expected to provide more incentive for auditors to identify, evaluate, and communicate a company's noncompliance with laws and regulations by clarifying the auditor's responsibilities concerning noncompliance and setting forth clear performance requirements that strengthen the auditor's role with respect to the identification and assessment of potential noncompliance with laws and regulations. The proposed amendments also would enhance auditor communication of noncompliance that has or may have occurred and mitigate the information asymmetry between the auditor and other stakeholders. Auditors would be better able to identify, evaluate, and communicate a company's noncompliance, which should improve audit quality by reducing the likelihood that financial statements are materially misstated due to the effects of noncompliance and therefore benefit investors and other users of a company's financial statements.

The enhanced quality of audits and financial reporting should also increase investor confidence in financial statements. Investors may use the more reliable financial information to improve the efficiency of their capital allocation decisions (e.g., investors may reallocate capital from less profitable companies to more profitable companies). Investors may also perceive less risk in capital markets generally, leading to an increase in the supply of capital. An increase in



the supply of capital could increase capital formation while also reducing the cost of capital to companies.<sup>145</sup>

In addition, earlier and enhanced identification, evaluation, and communication of information indicating noncompliance has or may have occurred should lead to more timely intervention by companies to cease and remedy noncompliance, lessen the impact of noncompliance, and thereby reduce the investor harm caused by legal and regulatory penalties as well as reputational loss discussed in Section IV.A.2. As discussed in that section, losses from noncompliance total billions of dollars annually and auditors currently play an arguably relatively small role in identifying the noncompliance underlying those losses. Increasing the auditor's role in a way that detects an additional portion of this noncompliance at an earlier stage could preserve significant shareholder value. To the extent that investors expect auditors to play a larger role in identifying noncompliance, the proposed amendments would help reduce the expectations gap between investors and auditors. Moreover, to the extent that noncompliance gives an unfair advantage to noncomplying companies, the proposed amendments may help level the playing field and decrease the financial damage to other companies and their investors by reducing the impact of noncompliance through more effective identification, evaluation, and communication of noncompliance. Further, to the extent that the proposed amendments have a deterrent effect on audit clients (either directly or through enhanced auditor performance), instances of noncompliance may decrease.

The proposed amendments also would better align the requirements for auditing noncompliance with the risk assessment standards. The improved alignment would promote efficient allocation of auditing resources by prompting more tailored audit procedures to respond to specific risks of material misstatement and directing more effort toward higher-risk areas. This may result in an overall increase in effort – a scaling-up of the procedures to be performed in response to risk – or an overall decrease in effort through efficiency gains. The improved allocation of resources to higher-risk areas may in turn increase the quality of audit work and related reports.

Moreover, to the extent that the proposed amendments could lead to enhanced consideration of the impact of noncompliance on the effectiveness of internal control over financial reporting, companies may take remedial actions to improve their internal control and thereby the quality of financial reporting.

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<sup>145</sup> See, e.g., Hanwen Chen, Jeff Zeyun Chen, Gerald J. Lobo, and Yanyan Wang, *Effects of Audit Quality on Earnings Management and Cost of Equity Capital: Evidence from China*, 28 *Contemporary Accounting Research* 892, 921 (2011); Richard Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research* 387 (2007) (discussing how "...increasing the quality of mandated disclosures should in general move the cost of capital to the risk-free rate for all firms in the economy"); William Robert Scott and Patricia C. O'Brien, *Financial Accounting Theory*, Vol. 3, Prentice Hall, (2003) at 412.

Finally, the customers of broker-dealers whose audits would be subject to the proposed amendments would experience similar benefits to those of a company's investors. Noncompliance poses analogous risks of loss for customers of broker-dealers as it does for a company's investors.<sup>146</sup> The proposed amendments to enhance the auditor's identification, evaluation, and communication of a broker-dealer's noncompliance should benefit customers through reducing the risk of those losses.

The following discussion describes the benefits of the specific proposed amendments that are expected to impact auditor behavior.

#### **i. Strengthen Auditor Incentives**

Proposed AS 2405 would remove certain descriptive language and illustrative examples from the standard that do not relate to an auditor's affirmative responsibilities. The proposed standard would focus on describing and clarifying such responsibilities. As a result, the proposed amendments would provide more concrete direction to the auditor to properly address noncompliance with laws and regulations that has or may have occurred, enhance the Board's ability to inspect and enforce compliance with the relevant auditing requirements, and increase the auditor's role in protecting investors from losses associated with noncompliance.

Replacing the term "illegal acts" with "noncompliance with laws and regulations" would emphasize that violations of relevant laws and regulations, regardless of perceived significance and whether arising from act or omission, fall within the scope of existing AS 2405. The new term should help clarify the auditor's responsibilities with respect to the consideration of noncompliance with laws and regulations.

The proposed amendments to AS 2405 would require the auditor to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, assess and respond to the risk of material misstatement due to noncompliance with those laws and regulations, and identify whether there is information indicating that noncompliance with those laws and regulations has or may have occurred. The requirements should improve the identification of instances of noncompliance, by enhancing and making more systematic the auditor's procedures. The extent of the benefits of the proposed rule will depend on several factors, most importantly the degree to which the company under audit may

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<sup>146</sup> For example, a broker-dealer's noncompliance with rules and regulations governing safekeeping of customer assets, recommendation of investments, or trading activity could lead to investor losses from improper investments, excessive fees, inefficient execution, etc. Severe noncompliance that results in a broker-dealer having to liquidate or face a limitation on its activities could cause customers harm ranging from the inconvenience of transferring accounts to a new broker-dealer, up to direct loss of account value (for investments in excess of the Securities Investor Protection Corporation (SIPC) insurance limit or otherwise not covered). On the other hand, while all noncompliance that affects the financial statements (whether directly or indirectly) will in turn affect investors, that linkage is more attenuated for customers of broker-dealers.

already have in place robust, formalized compliance programs. Benefits, including for investors, likely would be greater for companies with weaker compliance programs, which are in turn more likely to have undetected instances of noncompliance with laws and regulations, which auditors would in turn be more likely to detect by performing the enhanced procedures under the new standard. For companies with more developed and effective compliance programs, where the likelihood of material misstatement due to noncompliance with laws and regulations is lower, the benefit of the proposed standard would be lower. As discussed below, however, these benefits are expected to generally scale with costs: while the benefits for these companies may be lower, certain variable costs would be as well, if and to the extent that auditors would be able to leverage more of the companies' efforts. Given this effect, companies may respond to the increased costs by enhancing internal controls and processes for preventing and identifying noncompliance, thereby reducing instances of noncompliance, which would be an indirect benefit of the proposed standard.

To complement the proposed amendments to AS 2405, the proposed amendments to AS 2110 clarify that risks of material misstatement include risks due to noncompliance with laws and regulations. The proposed amendments to AS 2110 further strengthen the potential identification of noncompliance with laws and regulations by requiring the auditor to perform enhanced risk assessment procedures. The standard, as proposed to be amended, would give the auditor more specific direction on how to obtain an understanding of the regulatory environment as well as the nature of the company (including information outside the financial statements that is released by or concerns the company, which might materially conflict with information in the audited financial statements) and would require, among other procedures, specific inquiries designed to enhance the auditor's identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and information indicating noncompliance has or may have occurred.

Furthermore, the amendments to AS 2110 should strengthen the auditor's understanding of the risks of material misstatement arising from noncompliance with laws and regulations and thereby promote investor protection. In addition, the proposed amendments would require the auditor to more comprehensively review information outside the financial statements to evaluate whether the financial statements themselves are materially misstated, thus aiming to reduce noncompliance that degrades the quality of information available to investors.

Proposed AS 2405.06 would require the auditor to use information from other audit procedures performed during the audit that may identify potential noncompliance with laws and regulations. By removing language that emphasizes that an audit in accordance with PCAOB auditing standards normally does not include audit procedures specifically designed to detect illegal acts, and calling more attention to the auditor's obligation to use information from other audit procedures that may identify potential noncompliance, the proposed amendments are expected to improve the auditor's consideration of noncompliance and enhance investor protection.

The proposed amendments would align the requirements to evaluate and communicate instances, or suspected or alleged instances, of fraud with equivalent requirements for other noncompliance and incorporate those requirements into proposed AS 2405. Consolidating the auditor's responses in proposed AS 2405 would provide greater clarity to auditors and improve consistency in practice, promoting proper evaluation and communication of both fraud and other noncompliance.

## **ii. Reduce Information Asymmetry**

The proposed amendments would strengthen the requirements for the auditor to communicate likely noncompliance to audit committees. Well-informed audit committees should be able to protect investor interests more effectively. Specifically, the auditor may communicate information about possible noncompliance to the audit committee earlier than in current practice. The audit committee potentially would become more involved in addressing compliance issues and could resolve investigations more efficiently with earlier involvement in the process, reducing the impact of noncompliance that has or may have occurred. Moreover, to the extent that the auditor could provide the audit committee with enhanced information regarding noncompliance that has or may have occurred as a result of the strengthened requirements in the proposal, the improved flow of information may further increase the ability of the audit committee to perform its duties and promote investor protection.

The proposed amendments would also require certain communications between the lead auditor and the other auditor or the auditor's specialist about noncompliance. Since other auditors and specialists may be in a better position to identify and evaluate information indicating noncompliance has or may have occurred, the two-way communication is expected to improve the understanding and consideration of noncompliance by auditors and promote investor protection.

## **2. Costs**

The Board recognizes that imposing new requirements would result in additional, potentially substantial costs to auditors and the companies they audit.

Auditors would incur certain fixed costs (costs that are generally independent of the number of audits performed) related to implementing the proposed amendments. These include costs to update audit methodologies and tools, and to prepare training materials and conduct training. GNFs are likely to update methodologies using internal resources, whereas NAFs are more likely to purchase updated methodologies from external vendors. The costs to update methodologies likely depend on the extent to which the new requirements have already been incorporated in the firms' current methodologies. For firms that have implemented procedures like those required by the proposed amendments, the costs of updating methodologies may be lower than for firms that currently do not have such procedures. As discussed in Section IV.A, the methodologies of some GNFs already incorporate certain concepts included in the proposed amendments and likely need less extensive revisions than

the methodologies of NAFs. Even so, we expect that all firms will need to revise their methodologies to incorporate the proposed amendments. Further, large firms will likely take advantage of economies of scale by distributing fixed costs over a greater number of audit engagements.

In addition, auditors would be expected to incur engagement-level variable costs related to implementing the proposed amendments. These costs could be substantial. For example, the new requirements will lead to auditors spending more effort to identify laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements. Auditors will also need to spend more effort as part of the risk assessment to understand and assess the risk of material misstatement due to noncompliance with laws and regulations and develop related audit responses.

The magnitude of the auditor's variable costs likely will depend on the extent to which existing practice differs from the new requirements. Based on our review of audit methodologies discussed in Section IV.A, we believe that the proposed amendments likely would affect the procedures performed by all the firms reviewed, but with a greater impact on those performed by NAFs. To the extent that firms may already be performing certain procedures consistent with the proposal (e.g., due to their implementation of extant AS 2405 or AS 2110, or in response to Section 10A of the Exchange Act), variable costs attributable to the proposal would be lessened somewhat. However, we believe that all firms would need to perform additional procedures, and that the cost of the additional procedures to be performed could be sizeable.

The magnitude of the auditor's variable costs also will likely depend on the nature of the company and its operations and the related regulatory environment. The variable costs may be higher for audit engagements with higher assessed risks of material misstatement due to noncompliance or more instances of identified noncompliance. These risks depend on all the relevant facts and circumstances, but may be associated with particular factors. For example, as shown in Section IV.A, data on federal prosecutions appears to suggest that the likelihood of noncompliance and the magnitude of financial penalties are affected by industry and specific laws or regulations violated. There is also evidence that large firms are associated with larger, more complex, lower audit risk clients.<sup>147</sup> Companies with greater inherent risk of material misstatement due to noncompliance may also have designed and implemented effective compliance programs that could lessen the degree of auditor time necessary to assess, plan, and perform audit procedures. Each of these factors may affect the variable costs.

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<sup>147</sup> See, e.g., Mark DeFond and Jieying Zhang, *A Review of Archival Auditing Research*, 58 *Journal of Accounting and Economics* 275 (2014). While larger, more complex audit clients may lead to higher variable costs associated with the proposed amendments, lower risk clients may have an opposite effect on the costs.

In addition to auditors, companies being audited may also incur costs related to the proposed amendments, both directly and indirectly. Companies could incur direct costs from engaging with or otherwise supporting the auditor performing the audit. For example, some companies could face costs of producing documents and responding to additional auditor requests related to the procedures required by the proposed amendments to AS 2110. To the extent that auditors incur higher costs to implement the proposed amendments and are able to pass on at least part of the increased costs through an increase in audit fees, companies could incur an indirect cost. Moreover, if a company takes remedial actions to improve its internal control over financial reporting as a result of the proposed amendments, additional costs may be incurred. Companies could also incur indirect costs as a result of the proposed standard insofar as a company might seek to mitigate the extent of substantive procedures that the proposed standard would require of its auditor by enhancing the company's own processes and controls over its compliance with relevant laws and regulations.

Finally, broker-dealers operate in a highly regulated environment similar to companies that operate in highly regulated industries. We believe that the proposed amendments would have similar effects on the costs of audits of broker-dealers as they would for audits of other companies that are subject to a higher level of rules and regulations.

Some proposed amendments may result in more costs than others. The following discussion describes the potential costs associated with specific proposed amendments.

#### **i. Strengthen Auditor Incentives**

To improve auditor performance, proposed AS 2405 would remove certain descriptive language and illustrative examples from the standard and focus on the auditor's affirmative responsibilities. The changes are expected to provide more concrete direction to the auditor to properly address noncompliance with laws and regulations that has or may have occurred, increasing audit effort to (1) plan and perform audit procedures to identify noncompliance with those laws and regulations with which noncompliance could reasonably result in a material effect on the financial statements and (2) evaluate and communicate noncompliance.

The proposed amendments would replace the term "illegal acts" with "noncompliance with laws and regulations." As discussed in Section IV.A, the staff's firm methodology review shows that some GNF methodologies already include definitions of "noncompliance with laws and regulations" similar to the definition in the proposed amendments. In contrast, the NAF methodologies reviewed generally align with existing AS 2405, and do not include discussion of the term "noncompliance with laws and regulations." Therefore, all else equal, the costs associated with replacing the term "illegal acts" would likely be relatively modest for GNFs and relatively higher for NAFs.

The proposed amendments to AS 2405 would require the auditor to plan and perform procedures to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, assess and respond to risks of material

misstatement due to noncompliance with those laws and regulations, and identify whether there is information indicating that noncompliance with those laws and regulations has or may have occurred. As discussed in Section IV.A, the staff's firm methodology review shows that firm methodologies generally would need to be revised to incorporate these requirements, indicating that there are both fixed and variable costs associated with the requirements. Fixed costs would include costs to update firm methodologies and train personnel on the new requirements. Variable costs would include additional per-audit efforts. These would likely be significant. Specifically, we expect costs would arise from:

- *Identification of laws.* Auditors would likely need to expend considerable additional audit effort to identify relevant laws and regulations under the proposed standard. The effort required to identify the relevant laws and regulations would depend on many factors, including the size and complexity of the company, the existence of multinational operations, the nature of the company's industry, etc. as each of these factors could affect the number of laws and regulations and the extent to which noncompliance with them could reasonably have a material effect on the financial statements. The elimination of the distinction between noncompliance that has direct versus indirect effect on the financial statements would likely further expand the number of laws and regulations that an auditor must consider as part of identifying relevant laws and regulations.

Auditors may need to retain attorneys or other legal experts, including attorneys from different legal disciplines or specializations, as auditor's specialists to assist them in identifying the population of relevant laws and regulations. These specialists could be costly to retain.

The extent of this effort may be mitigated by certain factors. Auditors already may be identifying relevant laws and regulations during the audit, for example through the risk assessment process or for purposes of compliance with Section 10A. Further, auditors may be able to make use of company-generated information. For example, issuers may already disclose certain relevant laws and regulations (e.g., as risk factors), which could serve as a starting point for the auditor's identification. Companies with a more formalized compliance program may have already identified the relevant laws and regulations for their own purposes; the auditors could potentially leverage these efforts more comprehensively, even if they would not be able to fully rely upon them without performing further procedures of their own.

Many of these costs may be most significant in the initial year of the audit (whether following the effective date of the proposed requirements, if adopted as proposed, or upon acquisition of a new audit client), as the population of relevant laws and regulations is identified for the first time; subsequent year

efforts would likely be more focused on updating the identification of relevant laws and regulations to incorporate changes in the legal environment and the company's business. Auditors with many clients, particularly concentrated in certain industries, may lower their per-client costs through economies of scale – e.g., by leveraging work performed for other similarly situated clients or by centralizing the effort.

- *Assess and respond.* Auditors will likely be required to expend additional audit effort to assess and respond to the risk of material misstatement due to noncompliance with those laws and regulations identified pursuant to proposed AS 2405.05a. Some of this effort may be lessened to the extent that the auditor currently identifies risks of material misstatement due to noncompliance with laws and regulations as part of the risk assessment process under AS 2110, and then appropriately responds to those risks pursuant to AS 2301. Enhancements to the AS 2110 assessments proposed in this release should further complement the effort required at this step; the costs attributable to those enhancements are separately analyzed below.

As with identification, the extent of the audit effort required to assess and respond may depend on many factors relating to the nature of the company and the auditor, including the size of the company, the company's industry, extent of multinational operations, and level of development/formalization of the company's existing compliance infrastructure, as well as the auditor's use of specialists.

- *Identification of information.* The auditor would likely also need to plan and perform significant additional procedures to identify whether there is information indicating noncompliance with those laws or regulations has or may have occurred, the nature and extent of which would depend on the specific facts and circumstances of each audit engagement. Conducting additional procedures to identify potential noncompliance with laws and regulations could add a significant amount of additional effort to each audit on the part of engagement team members. As before, the extent of this effort will depend on numerous company-specific factors that may tend to increase or decrease the effort the auditor would be required to expend.

Further, as described in Section III.C.2 above, careful design of audit procedures (e.g., to accomplish multiple objectives) can further attenuate the increased cost.

Auditors may also need to retain auditor's specialists to assist the auditor in understanding complex technical or legal information that could indicate whether noncompliance has occurred. These specialists may include multiple



specialists who are expert in the evaluation of physical and other characteristics (e.g., individuals who possess special skill or knowledge in materials science or environmental engineering) or attorneys from different disciplines, which as noted above could be costly to retain. While larger firms may have more auditor-employed specialists, smaller firms typically do not have such access and therefore could be more affected by the costs of retaining auditor-engaged specialists.

In sum, while the exact nature and extent of the variable costs may differ based on many factors, the proposed standard would likely result in the expenditure of considerable additional audit effort. While these proposed procedures are not tantamount to a compliance audit in their scoping or objectives,<sup>148</sup> and we therefore do not believe that the proposed standard would result in additional costs of that level of significance, we do anticipate that the costs associated with the proposed amendments nonetheless may be substantial.

To complement the risk assessment requirement in proposed AS 2405, the proposed amendments to AS 2110 would clarify that noncompliance with laws and regulations is included within the meaning of risks of material misstatement due to error or fraud. While that is the case today, expressly incorporating the requirement into the definition may cause auditors to direct more time and effort to this aspect of risk assessment.

The proposed amendments to AS 2110 also would expand the auditor's responsibilities and provide more specific direction to auditors on how to obtain an understanding of the risks of material misstatement that could arise from noncompliance. Specifically, the new requirements would lead to additional procedures performed by the auditor to understand the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements.

Further, the proposed amendments to AS 2110 would mandate the performance of procedures to understand the nature of the company, including expanded procedures to read publicly available information about the company relevant to the evaluation of the likelihood of material misstatement. While an auditor may be performing some or all of these procedures under current AS 2110 based on the discretion afforded them under that standard, the proposed amendments would require an auditor to expend additional effort to perform each of the procedures on every audit. That effort could be substantial if the company under audit releases a robust volume of information through its website or social media or if there is a

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<sup>148</sup> This is in contrast to the auditor's requirements with respect to broker-dealer assertions pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, where the auditor is required to test for compliance with certain Exchange Act rules.

robust volume of other publicly available information from sources external to the company for the auditor to read.

Moreover, the proposed amendments to AS 2110 would require specific inquiries designed to enhance the auditor's identification of information indicating noncompliance with laws and regulations has or may have occurred as it pertains to such laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. The effort to perform and evaluate the responses to the inquiries could be substantial; however, portions of these procedures (specifically, the inquiries under paragraphs .54 and .56) should already be performed today under existing AS 2405.08 and therefore the additional burden expected under the proposed standard would be lessened somewhat.

Finally, under proposed AS 2110, the auditor also would perform additional procedures to understand the company's corporate governance mechanisms, such as whistleblower and ethics and compliance programs.

As discussed in Section IV.A, both the GNF and NAF methodologies reviewed by the staff generally would need to be modified to comply with the proposed amendments to AS 2110, which would lead to related fixed costs. This also, however, indicates that there could be potentially significant additional costs added to each engagement to comply with the revised standard. As noted above, auditors may be performing certain of the enhanced risk assessment procedures already (i.e., if they are performing a robust risk assessment that includes risk of material misstatement due to noncompliance, or robust procedures to understand the nature of the company) but clarifying and adding specific requirements may prompt some auditors to need to perform more audit procedures. Other proposed amendments would add new requirements and would prompt the performance of new risk assessment procedures. As risk assessment forms the foundation of planning and performing the audit, additional risk assessment procedures may in turn lead to additional audit responses (e.g., through AS 2301), and these effects may continue to flow through the audit, with associated costs. As a result, the costs associated with the proposed amendments to AS 2110 are expected to be more substantial.

The proposed amendments to AS 2405 would require the auditor to use information from other audit procedures that may identify noncompliance and provide examples of such other audit procedures. We expect that firms may need to make changes to their methodologies to reflect the newly unconditional nature of the requirement under the proposed standard. As discussed in Section IV.A, the staff's firm methodology review finds that some GNF methodologies suggest, but do not require, that engagement teams use information from other audit procedures. The NAF methodologies reviewed generally align with and do not go beyond existing AS 2405. All else equal, the costs associated with the proposed requirement would likely be lower for GNFs than for NAFs.

The proposed amendments would align the requirements to evaluate and communicate instances, or suspected or alleged instances, of fraud with equivalent requirements for other

noncompliance and incorporate those requirements into proposed AS 2405.<sup>149</sup> The costs associated with the incorporation of fraud into AS 2405 for an individual firm would likely depend on (1) the extent to which the enhanced procedures under the proposed standard require more effort than the firm's current practice in any particular engagement where the procedures are required to be performed, and (2) the number of the firm's audit engagements in which the procedures are required to be performed. Specifically, with respect to the first, and discussed in Section IV.A, the GNF and NAF methodologies relating to AS 2405 reviewed by the staff generally would need to be revised to incorporate instances, or alleged or suspected instances, of fraud into these methodologies. The costs associated with the incorporation of fraud into AS 2405 would likely depend on how the current firm methodologies and practices compare to the requirements in the proposed amendments. With respect to the second, the costs might also depend on the likelihood that fraud would occur during the firm's audit engagements, as audit engagements with higher risks of fraud or more instances of identified fraud would require auditors to expend more time and effort to implement the proposed amendments. In general, the costs associated with the incorporation of fraud into AS 2405 are not expected to be as substantial as some of the new requirements discussed above.

## **ii. Reduce Information Asymmetry**

The proposed amendments would expand the requirements in AS 2405 for the auditor to communicate noncompliance that has or may have occurred to audit committees and, in certain circumstances, to boards of directors. The costs associated with the expanded requirements are expected to be limited, as the communication obligations only arise when information indicating noncompliance comes to the auditor's attention. As discussed in Section IV.A, the staff's firm methodology review finds that while some GNF methodologies include guidance on the auditor's communications to audit committees and boards of directors about noncompliance, modifications generally would be needed for GNF firms and for NAF firms to comply with the expanded communication requirements. The costs would likely depend on the current firm methodologies and practices as well as the risk of noncompliance and the nature and extent of any identified noncompliance by audit clients.

The proposed amendments relating to the supervision of other auditors and an auditor's specialists would require additional communications between the lead auditor and the other auditors or the auditor's specialists about noncompliance. As discussed in Section IV.A, the GNF and NAF methodologies reviewed by the staff generally would need to be modified to comply with the proposed amendments, suggesting fixed costs to firms associated with the new requirements. The variable costs associated with the new requirements would likely depend on the firm's current practices, the risk of noncompliance by audit clients, and the extent to which other auditors and specialists are used.

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<sup>149</sup> See Section III.D.1 for further discussion.

The staff's analysis of 2021 Form AP data suggests that the use of other auditors is more common in audits performed by GNFs.<sup>150</sup> Overall, other auditors are involved in about 26 percent of all issuer audit engagements. About 39 percent of U.S. GNF engagements and about 58 percent of non-U.S. GNF engagements involved the use of other auditors. In comparison, only about seven percent of U.S. NAF and 13 percent of non-U.S. NAF engagements involved other auditors.

Similarly, the staff's analysis of a sample of issuer audits selected for review in 2021 suggests that GNFs use the work of an auditor's specialists more extensively than NAFs. About 95 percent of U.S. GNF engagements involved the use of an auditor-employed or auditor-engaged specialist, compared to about 54 percent of U.S. NAF engagements.

*Questions:*

57. Are there other benefits and costs not addressed above that we should consider?

58. Are there additional academic studies or data that would inform our analysis of the expected economic impacts of the proposed amendments? If so, please provide such studies or data. Are there any sources of data that could provide a quantitative estimation of the expected benefits and costs? If so, please provide the names of such sources.

59. Which proposed amendments are likely to be associated with more substantial costs? Are the costs quantifiable?

60. Is the expansion of the auditor's responsibilities to identify information indicating noncompliance with laws and regulations has or may have occurred without regard to the effect of such noncompliance on the financial statements practical and cost effective to implement? Are small/medium firms equipped and capable of implementing these new requirements? If not, why not?

61. Will the proposed requirement for auditors to assess the risk of material misstatement, including risks of material misstatement due to noncompliance with laws and regulations, change how auditors assess risks of material misstatement and design related audit responses? If so, how and to what extent?

62. Are there substantial costs associated with an increased need to use auditor's specialists to assist the auditor in evaluating noncompliance that has or may

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<sup>150</sup> *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Rel. No. 2022-002 (June 21, 2022).

have occurred as a result of the proposed requirements? If so, are the costs quantifiable? Are there any applicable means of mitigating or reducing such costs?

63. Would the economic impacts be different for smaller firms or emerging growth companies? If so, how?

### **3. Unintended Consequences**

In addition to the benefits and costs discussed above, the proposed amendments could have unintended economic impacts. The following discussion describes potential unintended consequences we have considered and, where applicable, any mitigating or countervailing factors.

First, the proposed amendments could cause auditors to expend disproportionate effort into auditing noncompliance with laws and regulations at the expense of other audit areas. Proposed AS 2405, consistent with Section 10A and the existing standard, would require the auditor to perform procedures in response to any noncompliance of which the auditor becomes aware, regardless of whether the matter is material to the financial statements. However, materiality may influence the auditor's selection of those procedures. Moreover, the auditor may detect more instances of noncompliance based on the proposed amendments to AS 2110. The auditor may also spend additional effort in reading publicly available information disseminated by the company or publicly available information from sources external to the company at the expense of other audit areas. If additional instances of noncompliance are identified and do not have a material effect on the financial statements, the auditor may seek to reduce time spent on other aspects of the audit, including on areas involving material amounts, instead of more appropriately expanding the overall effort expended on the audit. Similarly, the audit committee may expend time and resources addressing relatively minor instances of noncompliance when other matters may warrant more attention, rather than taking additional time to evaluate all matters appropriately. We considered countervailing factors in response to these concerns. First, for issuer audits, Section 10A already requires the auditor to evaluate all noncompliance that comes to the auditor's attention without regard to materiality. Accordingly, noncompliance with laws and regulations holds special priority for auditors under the federal securities laws. Second, we believe that materiality determinations are difficult for the auditor to make before the nature and circumstances of noncompliance are known and the auditor is able to assess any financial statement impacts. Finally, many companies have ethics and compliance programs designed to efficiently resolve the large majority of minor compliance matters. For these reasons, we do not believe that auditor responsibilities to address instances of noncompliance that are immaterial to the financial statements would unduly distract the auditor from other important audit areas.

Second, if auditors increase their focus on noncompliance, companies could potentially react by seeking to disclosing less information to auditors about their ethics and compliance systems and internal investigations. Companies may withhold this information to avoid having to pay for the extended procedures required by the proposed amendments. If companies were

to place such restriction on the scope of the audit or prevent the auditor from obtaining sufficient appropriate audit evidence related to potential noncompliance, the auditor may be required to qualify the auditor's opinion or to disclaim an opinion. Such restrictions may not be obvious, if companies or their personnel impose them subtly, by being less forthcoming with their auditor in a way that the auditor might not recognize, in which case, audit quality could suffer because auditors may not identify or otherwise become aware of noncompliance materially affecting the financial statements. The risk that companies would withhold information is mitigated by the threat of an SEC enforcement action as the federal securities laws generally prohibit companies from lying to or misleading their auditor.<sup>151</sup> If companies do not provide sufficient information to their auditors to enable the auditors to identify, evaluate, and communicate noncompliance, companies run the risk of violating federal securities laws.

Third, because proposed AS 2405 would require auditors to evaluate all noncompliance that comes to their attention, auditors may retain legal counsel or other specialists even when doing so is unnecessary to obtain sufficient appropriate audit evidence. Auditors may overreact in this manner if they believe that the proposed amendments require the auditor to make legal determinations or might subject the auditor to increased liability. Although the proposed amendments do not require the auditor to make judgments outside their areas of expertise, auditors may err on the side of caution and retain counsel or other experts whenever they discover possible noncompliance. However, retaining specialists is costly and the audit market is competitive. If a competitor firm is able to use specialists more efficiently and thereby charge a lower audit fee, firms with excessive (i.e., inefficient) use of specialists would find themselves at a disadvantage.

Fourth, the proposed amendments could affect the auditor litigation environment. The standard generally gives auditors a stronger responsibility with respect to the identification of a company's noncompliance with laws and regulations. Noncompliance that is nonetheless not identified and that results in investor losses could result in auditors being named more frequently in resulting litigation. However, today auditors may be named in litigation more frequently because of noncompliance with laws and regulations that is not detected due to the lack of appropriate auditor incentive. While fewer of these cases may lead to judgments against audit firms, they nonetheless consume resources to defend and potentially settle or seek

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<sup>151</sup> For example, Exchange Act Rule 13b2-2, 17 C.F.R. § 240.13b2-2, prohibits directors and officers of an issuer from making false statements to an auditor in connection with an audit or omitting to state any material fact necessary to make any statements made not misleading. It also prohibits officers and directors, and any person acting at their direction, from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence any auditor engaged in an audit or review of the financial statements, if the person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading; this includes coercing, manipulating, misleading, or fraudulently influencing an auditor, at any time within the professional engagement period, not to perform audit procedures required by PCAOB standards, or not to communicate matters to an issuer's audit committee.

dismissal. We are unable to predict the extent to which these effects might offset (fewer, but more potentially meritorious lawsuits). But we believe that the effect of this enhanced litigation risk would tend to further enhance the auditor's incentives to detect material noncompliance and thereby reinforce the benefits of the standard.

Fifth and finally, the proposed amendments could affect the balance of work between the auditor and the company under audit, including between their respective specialists. For example, if companies believe auditors bear increased responsibility to address noncompliance, companies may lessen their own efforts to address instances of noncompliance and may rely more on auditors and the auditors' specialists to do so. In such instances, the auditor would have to perform additional work to evaluate the noncompliance, which could detract from other responsibilities and reduce audit quality. Any change in the balance of work, however, is likely to be limited. Because noncompliance by companies may trigger liability to third parties, companies are likely to continue addressing compliance issues using personnel that they control through an employment or similar relationship or through counsel bound by attorney-client privilege.

While the unintended consequences discussion has so far focused exclusively on negative potential outcomes, the proposed requirements could result in unintended positive outcomes as well. For example, expanded audit committee communications may enhance the quality of ethics and compliance programs and improve overall company compliance. Similarly, to the extent that companies respond to the enhanced auditor attention on potential noncompliance with laws and regulations by enhancing their own procedures and controls, society more broadly could benefit from fewer violations of the laws and regulations; to the extent that these laws and regulations that were enacted to promote social benefits by restricting anti-social behavior, enhanced compliance could achieve more of those benefits (e.g., cleaner air or water through better compliance with restrictions on polluting activities; more accountable governance through better compliance with prohibitions on bribing foreign officials).

*Questions:*

64. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what are the potential unintended consequences and what responses should be considered?

65. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? How would smaller firms be affected? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

66. Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits? If so, what are those factors and how should they be considered?

## D. Alternatives Considered

The development of the proposal involved considering a number of alternative approaches to address the problems described above. This section explains: (1) why standard setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (2) other standard-setting approaches that were considered; and (3) key policy choices made in determining the details of the proposed standard-setting approach.

### 1. Why Standard Setting Is Preferable to Other Policy-Making Approaches

The Board's policy tools include alternatives to standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. We considered whether providing guidance or increasing inspection or enforcement efforts would be effective mechanisms to address the auditor's responsibilities for considering a company's noncompliance with law and regulations.

Interpretive guidance inherently provides additional information about existing standards. Inspection and enforcement actions take place after insufficient audit performance (and potential investor harm) has occurred. We considered issuing staff guidance to emphasize auditors' existing responsibilities under AS 2405. In such guidance, the staff could have also addressed topics such as: (1) linking the auditor's performance of risk assessment procedures to existing considerations of the company's noncompliance with laws and regulations that have both a direct and an indirect effect on the financial statements; (2) the auditor's responsibilities under other auditing standards that could bring possible noncompliance to their attention; and (3) the relationship of the requirements of existing AS 2405 to those under Section 10A.

We believe that the issuance of guidance alone would not be an adequate approach. Devoting additional resources to interpretive guidance, inspections, or enforcement activities, without improving the relevant performance requirements for auditors, would at best focus auditors' performance on existing standards and would not provide the benefits discussed above associated with improving the standards. The proposed amendments, on the other hand, are designed to improve existing requirements for the auditor's consideration of possible illegal acts. For example, the proposed AS 2405 and the proposed amendments to AS 2110 include requirements for auditors to identify laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements, assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations, and identify whether there is information indicating noncompliance with those laws and regulations has or may have occurred.



## 2. Other Standard-Setting Alternatives Considered

We also considered, but are not proposing, limiting amendments to AS 2405 solely to minor modifications relating to terminology and removal of descriptive language and illustrative examples. Although this approach could result in fewer changes to firm methodologies, we believe there are a number of other areas discussed throughout this release, beyond amending AS 2405 to change terminology and remove descriptive language, where the existing standard could be improved. Further, as discussed in Section II.A.C above, existing AS 2405 predates Section 10A as well as Sarbanes-Oxley. We believe more extensive revisions, as outlined above, are warranted and go beyond what could be accomplished through minor amendments to existing AS 2405 alone.

## 3. Key Policy Choices

Given a preference for replacing existing AS 2405 in its entirety, we considered different approaches to addressing key policy issues.

### i. Meaning and Use of the Term Noncompliance with Laws and Regulations

We considered different approaches relating to the meaning and use of the term noncompliance with laws and regulations. In particular, we considered, but are not proposing, retaining the term illegal acts, which is also used in Section 10A.<sup>152</sup> As discussed previously, we believe auditors may incorrectly interpret the term “illegal acts” to exclude instances of noncompliance perceived not to be significant enough to examine pursuant to the requirements in existing AS 2405 irrespective of the effect those instances could have on the financial statements.

We also considered, but are not proposing, conforming to the definition used in Section 10A. In our view, our proposed definition of “noncompliance with laws and regulations” is generally consistent with the definitions of “illegal act” in Section 10A and existing AS 2405. Further, we believe that our proposed definition should specify the individuals that could cause a company’s noncompliance with laws and regulations. These individuals include “the company’s management, its employees, or others that act in a company capacity or on the company’s behalf.” This language makes it particularly clear to auditors that individuals such as board members and contractors could cause a company’s noncompliance with laws and regulations. The proposed definition would create more clarity while generally not changing the scope of the existing standard. Accordingly, we have decided in favor of the proposed language rather than the statutory language.

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<sup>152</sup> Section 10A(f) (defining “illegal act” as “an act or omission that violates any law, or any rule or regulation having the force of law”).

## **ii. Alignment with Section 10A**

Auditors of public companies are required to comply with Section 10A. We considered whether the proposed requirements should apply to all audits performed pursuant to PCAOB standards, recognizing that Section 10A is not applicable to audits of broker-dealers. As discussed above, the proposed amendments could increase costs in broker-dealer audits. However, we believe that the customers of broker-dealers whose audits would be subject to the proposed amendments would experience similar benefits to those of a company's investors. Noncompliance poses analogous risks of loss for customers of broker-dealers as it does for a company's investors. For example, a broker-dealer's noncompliance with rules and regulations governing safekeeping of customer assets, recommendation of investments, or trading activity could lead to investor losses from improper investments, excessive fees, inefficient execution, etc. Severe noncompliance that results in a broker-dealer having to liquidate or face a limitation on its activities could cause customers harm ranging from the inconvenience of transferring accounts to a new broker-dealer, up to direct loss of account value (for investments in excess of the SIPC insurance limit or otherwise not covered). Therefore, we believe the proposed amendments as aligned with Section 10A should benefit customers of broker-dealers through reducing their risk of loss due to a broker-dealer's noncompliance with laws and regulations.

## **iii. Relationship of Noncompliance with Laws and Regulations to the Financial Statements**

The effect of noncompliance with laws and regulations can vary considerably in its relationship to the financial statements. We considered, but are not proposing, retaining the distinction in extant AS 2405 between violations of laws and regulations that have a direct effect on the financial statements versus those with an indirect effect. Although retaining the direct-indirect distinction has the advantage of familiarity to auditors, we believe the disadvantages support a new approach. Most importantly, in considering investor protection, the material misstatement of financial results harms investors regardless of whether the violations arise from misapplication of corporate tax rates (direct effect) or unrecorded environmental remediation liabilities (indirect effect). The magnitude of any harm is, moreover, independent of such distinction. We believe auditors should plan and perform procedures to address material misstatements from noncompliance without regard to the type of law violated.

Furthermore, we believe the distinction can sometimes be difficult to apply or potentially artificial in practice. For example, violations of tax law may result in both known quantitative impacts (e.g., application of a new tax rate) and a contingent liability (e.g., from penalty proceedings). In such a scenario, we believe auditors should focus on the risks of material misstatement, appropriate responses, and proper evaluation and communication of any identified noncompliance, all without regard to the nature of the effect – direct or indirect.

Accordingly, we believe the proposed amendments give appropriate and improved direction to auditors.

#### **iv. Auditor's Determination of Whether an Act is Illegal**

The proposed amendments are intended to protect investors and improve audit quality. Existing AS 2405 contains certain language that does not speak to the auditor's affirmative obligations, which we believe is contrary to this proposal's purpose. For example, existing AS 2405 states that "[a]n auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations"<sup>153</sup> and also notes that "the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law."<sup>154</sup> We considered, but are not proposing, retaining this or similar language in proposed AS 2405. Such language focuses on the limits of an auditor's skillset and responsibilities as opposed to the auditor's affirmative obligations with respect to identifying and evaluating a company's noncompliance with laws and regulations.

Similar to the existing standard, the proposed amendments do not state that the auditor is required to make a definitive legal determination about whether noncompliance has occurred. Instead, the proposed amendments would also require the auditor to determine if it is likely that noncompliance has or may have occurred. We believe the requirement focuses the auditor on their affirmative obligations without creating perceived limitations on the auditor's ability. We believe whether such language is retained does not change the auditor's responsibility to determine likely noncompliance. Accordingly, we have determined that retaining similar language in the proposed amendments is unnecessary.

#### *Question:*

67. The Board requests comment generally on the alternative approaches described in this release that we considered, but are not proposing. Are any of these approaches, or any other approaches, preferable to the approaches that we are proposing? What reasons support those approaches over the approaches we are proposing? Would any other alternatives better promote investor protection, efficiency, competition, or capital formation?

## **V. SPECIAL CONSIDERATIONS FOR AUDITS OF EMERGING GROWTH COMPANIES**

The proposed amendments would apply to audits of issuers, as defined in Section 2(a)(7) of Sarbanes-Oxley. As discussed below, the PCAOB is seeking comment on whether the

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<sup>153</sup> See existing AS 2405.06

<sup>154</sup> See existing AS 2405.03.

proposed amendments should apply to audits of emerging growth companies (“EGCs”), as defined in Section 3(a)(80) of the Exchange Act.

Pursuant to Section 104 of the Jumpstart Our Business Startups (“JOBS”) Act, any rules adopted by the Board subsequent to April 5, 2012 generally do not apply to the audits of EGCs unless the SEC “determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.”<sup>155</sup> As a result of the JOBS Act, the rules and related amendments to PCAOB standards the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

To inform consideration of the application of auditing standards to audits of EGCs, PCAOB staff prepares a white paper annually that provides general information about characteristics of EGCs.<sup>156</sup> As of the November 15, 2021 measurement date, PCAOB staff identified 3,092 companies that self-identified with the SEC as EGCs and filed audited financial statements in the 18 months preceding the measurement date.

The discussion of benefits, costs, and unintended consequences in Section IV is generally applicable to audits of EGCs. The economic impacts of the proposed amendments on an EGC audit depend on factors such as the audit firm’s current methodologies and practice, the audit firm’s ability to distribute implementation costs across engagements, and the EGC’s risk of noncompliance.

EGCs are likely to be newer companies, which may increase the importance to investors of the external audit to enhance the credibility of management disclosures.<sup>157</sup> Further,

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<sup>155</sup> See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act. Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor’s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The proposed amendments do not fall within either of these two categories.

<sup>156</sup> For the most recent EGC report, see *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2021* (Jan. 5, 2023), available at <https://pcaobus.org/resources/other-research-projects>.

<sup>157</sup> Researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs. To the extent that EGCs exhibit one or more of these properties, there may be a greater degree of information asymmetry for EGCs than for the broader population of companies, which increases the importance to investors of the external audit to enhance the credibility of management disclosures. See, e.g., Steven A. Dennis and Ian G. Sharpe, *Firm Size*

compared to non-EGCs, EGCs are more likely to be audited by NAFs.<sup>158</sup> As discussed in Section IV.A, NAFs are expected to make more changes to their methodologies and practice to comply with the proposed amendments. Therefore, all else equal, the benefits of the higher audit quality resulting from the proposed amendments may be larger for EGCs than for non-EGCs, including improved efficiency of capital allocation, lower cost of capital, and enhanced capital formation. In particular, because investors who face uncertainty about the reliability of a company's financial statements may require a larger risk premium that increases the cost of capital to companies, the improved audit quality resulting from applying the proposed amendments to EGC audits could reduce the cost of capital to those EGCs.<sup>159</sup> While the associated costs may also be higher for EGC audits than for non-EGC audits, they are unlikely to be disproportionate to the benefits due to the scalability of the risk-based requirements.

The proposal could impact competition in an EGC product market if the costs of the proposed amendments disproportionately impact the EGCs relative to their competitors. EGCs may be forced to raise prices and thereby divert market share toward their non-EGC competitors. This could increase competition in markets where EGCs have a dominant market share and decrease competition in markets where EGCs have a less than dominant market share. The potential impact to competition in EGC product markets would be reduced to the extent EGCs' auditors have already implemented certain concepts in the proposed amendments or otherwise would choose not to pass on their additional costs arising from the proposed requirements in the form of higher audit fees.

Overall, the proposed amendments are expected to enhance audit quality and contribute to an increase in the credibility of financial reporting by EGCs, thereby fostering efficiency. Because of the scalability of the risk-based requirements, the costs of performing the procedures are unlikely to be disproportionate to the benefits of the procedures. Conversely, if any of the proposed amendments were determined not to apply to the audits of EGCs, auditors would need to address differing audit requirements in their methodologies, or policies and

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*Dependence in the Determinants of Bank Term Loan Maturity*, 32 *Journal of Business Finance and Accounting* 31 (2005); Michael J. Brennan and Avaniidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361 (1995); David Aboody and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 *Journal of Finance* 2747 (2000); Raymond Chiang and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, 43 *Journal of Finance* 1041 (1988); Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 *Accounting Horizons* 185 (2004).

<sup>158</sup> *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2021* (Jan. 5, 2023), p.22.

<sup>159</sup> For a discussion of how increasing reliable public information about a company can reduce risk premium, see David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *Journal of Finance* 1553 (2004).

procedures, with respect to audits of EGCs and non-EGCs, which would create the potential for confusion.

Accordingly, and for the reasons explained above, the Board believes that, if it adopts the proposed amendments, it will request that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the proposed amendments to audits of EGCs.

*Question:*

68. The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

## VI. EFFECTIVE DATE

We seek comment on the amount of time auditors would need before the proposed amendments would become effective, if adopted by the Board and approved by the SEC. Specifically, the Board is considering whether compliance with adopted amendments and a revised auditing standard should be required for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval, if SEC approval occurs in the fourth quarter of a calendar year).

*Questions:*

69. Would requiring compliance for fiscal years beginning after the year of SEC approval provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

70. How much time following SEC approval would audit firms need to implement the proposed requirements?

## VII. OPPORTUNITY FOR PUBLIC COMMENT

The Board is seeking comments on all aspects of its proposal, as well as specific comments on the proposed amendments. Among other things, the Board is seeking comment on the economic analysis relating to its proposal, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data regarding the proposed amendments and standard.

Comments should be sent by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [pcaobus.org](http://pcaobus.org). Comments also may be sent to the Office of the Secretary, PCAOB,

1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 051 in the subject or reference line and should be received by the Board by August 7, 2023.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the proposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under Sarbanes-Oxley.

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On the 6<sup>th</sup> day of June, in the year 2023, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown  
Secretary

June 6, 2023



## APPENDIX 1

### Proposed Amendments to AS 2405, *Illegal Acts by Clients*

AS 2405, *Illegal Acts by Clients*, is proposed to be retitled and replaced in its entirety with the following:

\* \* \* \* \*

#### AS 2405: A Company's Noncompliance with Laws and Regulations

##### Introduction

.01 Auditors have a fundamental obligation to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports, and that obligation governs this standard to identify and evaluate information indicating that **noncompliance with laws and regulations**,<sup>1</sup> including fraud,<sup>2</sup> has or may have occurred and make appropriate communications to management and the audit committee about such information.<sup>3</sup>

.02 Noncompliance with laws and regulations can result in material misstatement of the financial statements. Some laws and regulations relate to the manner in which matters are presented<sup>4</sup> in the financial statements, such as tax and pension laws. Other laws and regulations may relate to operations of a company. With respect to all laws or regulations, misstatements of the financial statements can arise when violations occur and are not properly presented in the financial statements. The auditor is required to design and implement audit

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<sup>1</sup> The term defined in Appendix A, Definition, is set in **boldface type** the first time it appears.

<sup>2</sup> The term "fraud" has the same meaning as in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (i.e., an intentional act that results in a material misstatement in financial statements that are the subject of an audit).

<sup>3</sup> See also Section 10A(a)(1), (b), and (f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(a)(1), (b), (f). These provisions require auditors of issuers to: (1) include audit procedures "designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts"; and (2) take certain action in response to information indicating that illegal acts have or may have occurred, including determining whether the acts likely occurred, evaluating the possible effects of such acts on the financial statements, informing appropriate management of the acts (and assuring that the audit committee is adequately informed), and, in certain circumstances, making additional communications to the board of directors and the Securities and Exchange Commission. See also, [footnote X to proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023) as proposed to be amended].

<sup>4</sup> See paragraphs .30-.31 of AS 2810, *Evaluating Audit Results*.

responses that address the risks of material misstatement, including the risk of material misstatement of the financial statements resulting from noncompliance with laws and regulations.<sup>5</sup>

.03 This standard establishes requirements regarding the auditor's identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and information indicating that noncompliance with such laws and regulations, including fraud, has or may have occurred, and the subsequent evaluation and communication when the auditor identifies or otherwise becomes aware of such information.

#### Objectives

.04 The objectives of the auditor are to:

- a. Identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
- b. Based on the laws and regulations identified under paragraph .04a, assess and respond to the risk of material misstatement of the financial statements due to noncompliance with those laws and regulations;
- c. Identify whether there are instances of noncompliance with laws and regulations that have or may have occurred; and
- d. When the auditor identifies or otherwise becomes aware of information indicating that instances of noncompliance have or may have occurred, evaluate and communicate such instances of noncompliance (regardless of whether the effect of the noncompliance is perceived to be material).

#### Plan and Perform Procedures Related to Noncompliance with Laws and Regulations

.05 The auditor must plan and perform procedures to:

- a. Identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;

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<sup>5</sup> See generally [proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023)], AS 2110, *Identifying and Assessing Risks of Material Misstatement*, "Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting;" and AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

- b. Assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations; and
- c. Identify whether there is information indicating noncompliance with those laws and regulations has or may have occurred.

.06 As part of planning and performing procedures in accordance with paragraph .05, the auditor must use the information obtained from:

- a. Risk assessment procedures, including:
  - 1) Obtaining an understanding of the company and its environment, including the regulatory environment (*see paragraphs .07-.15 of AS 2110, Identifying and Assessing Risks of Material Misstatement [as proposed to be amended]*);
  - 2) Obtaining an understanding of management's processes related to (i) identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; (ii) preventing, identifying, investigating, evaluating, communicating, and remediating instances of noncompliance with laws and regulations; (iii) receiving and responding to tips and complaints from internal and external parties regarding noncompliance with laws and regulations; and (iv) evaluating potential accounting and disclosure implications of noncompliance with laws and regulations, including fraud (*see AS 2110.26 [as proposed to be amended]*);
  - 3) Making inquiries of management, the audit committee,<sup>6</sup> internal audit personnel, and others regarding noncompliance with laws and regulations (*see AS 2110.54 and .56-.58 [as proposed to be amended]*); and
- b. Other procedures performed in the audit of the financial statements, in reviews of interim financial information, and, if applicable, in an audit of internal control over financial reporting that may identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or noncompliance with laws and regulations that has or may have occurred.

Note: AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and AS 2401, *Consideration of Fraud in a Financial Statement Audit*, establish requirements for responding to risks of material misstatement, including identified fraud risks. Procedures performed pursuant to other auditing standards also may assist the auditor in identifying laws and regulations with which noncompliance

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<sup>6</sup> The term "audit committee" has the same meaning as defined in Appendix A of AS 1301, *Communications with Audit Committees*.

could reasonably have a material effect on the financial statements or alert the auditor to information indicating that noncompliance with laws and regulations has or may have occurred. These standards include (i) AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, (ii) AS 2410, *Related Parties*, (iii) AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, (iv) AS 2810, *Evaluating Audit Results*, and (v) AS 4105, *Reviews of Interim Financial Information*.

### Evaluating Noncompliance with Laws and Regulations

.07 When the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred (regardless of whether the effect of such noncompliance is perceived to be material to the financial statements), the auditor must (1) obtain an understanding of the nature and circumstances of any such noncompliance; and (2) determine whether it is likely that any such noncompliance occurred.<sup>7</sup>

Note 1: The auditor should consider whether specialized skill or knowledge is needed to assist the auditor in evaluating the noncompliance.<sup>8</sup>

Note 2: The auditor's procedures to evaluate information indicating noncompliance with laws and regulations described in this standard involve the application of professional skepticism in gathering and evaluating audit evidence, including information that supports and corroborates management's assertions and information that contradicts such assertions.<sup>9</sup>

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<sup>7</sup> Information from the auditor's client acceptance and retention evaluation, audit planning activities, past audits, and other engagements may inform and assist the auditor when evaluating information that the auditor has identified or becomes aware of that might indicate that noncompliance with a law or regulation has occurred. See *generally* AS 2110.41-.45.

<sup>8</sup> If the auditor determines that specialized skill or knowledge outside of accounting and auditing is needed to assist the auditor in evaluating the noncompliance, the auditor should look to the appropriate requirements for using the work of specialists in an audit. See Appendix C of AS 1201, *Supervision of the Audit Engagement* (procedures to be performed with respect to the supervision of the work of an auditor-employed specialist); and AS 1210, *Using the Work of an Auditor-Engaged Specialist* (requirements for using the work of an auditor-engaged specialist).

<sup>9</sup> See paragraphs .10-.11 of [proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023)]. See also paragraph .02 of AS 1105, *Audit Evidence* (audit evidence consists of both information that supports and corroborates management's assertions and information that contradicts such assertions).

.08 Obtaining an understanding about the nature and circumstances of any such noncompliance with laws and regulations and determining whether it is likely that any such noncompliance has occurred may include the following procedures:

- a. Examining supporting documentation about relevant events or transactions;
- b. Making inquiries of company personnel who are likely to have knowledge of the events or transactions and management at a level above those involved;

Note: Inquiry alone is not sufficient to determine that noncompliance is not likely to have occurred.

- c. Obtaining an understanding of the nature and status of any relevant investigations internal or external to the company;
- d. Confirming significant information concerning the events or transactions with intermediaries, financial institutions, legal counsel, or others who may have knowledge of the events, transactions, and applicable legal requirements;
- e. Determining whether a transaction has been properly authorized by management;
- f. Determining whether similar transactions or events may have occurred;<sup>10</sup>
- g. Discussing the facts and circumstances with the company's legal counsel or others with specialized skill or knowledge about the application of relevant laws or regulations to the circumstances and the possible effects on the financial statements; and
- h. Considering the results of other audit procedures related to the matter.

Note: The extent of procedures necessary depends on the nature and circumstances of the matter (i.e., the information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred), including whether the matter could be material, the relevance and reliability of information provided by the company about the matter,<sup>11</sup> and the effectiveness of management's process for investigating the matter.

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<sup>10</sup> When determining whether similar transactions or events may have occurred, the auditor might determine it is necessary to perform forensic auditing procedures to analyze the company's transactions.

<sup>11</sup> See paragraph .10 of AS 1105, *Audit Evidence*.

.09 When the auditor determines, based on information obtained, that it is likely that noncompliance with laws or regulations has occurred, the auditor must:

- a. Determine the possible effect of the likely noncompliance on the financial statements (see paragraph .10 of this standard);<sup>12</sup>
- b. Perform additional procedures as necessary to determine whether the likely noncompliance (1) results in material misstatement of the financial statements (including omitted, incomplete, or inaccurate disclosures) or (2) 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;<sup>13</sup> and
- c. Assess the implications of the noncompliance in relation to other aspects of the audit (such as the auditor's risk assessment; the sufficiency and reliability of audit evidence, including representations of management; and, in an integrated audit, on the effectiveness of internal control over financial reporting) and take appropriate action.<sup>14</sup>

.10 The auditor should take the following factors into account when determining the possible effect of the likely noncompliance:

- a. The materiality of the likely noncompliance on the financial statements;<sup>15</sup>

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<sup>12</sup> See also paragraphs .10-.23 of AS 2810, *Evaluating Audit Results*.

<sup>13</sup> When it is likely that noncompliance with laws and regulations has occurred and may have an impact on other information accompanying the audited financial statements, the auditor refers to paragraph .04-.05 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

<sup>14</sup> If the auditor has identified misstatements that are or might be intentional, the auditor has additional responsibilities under AS 2810.22. In an audit of internal control over financial reporting, the auditor is required to evaluate the effect of the findings with respect to noncompliance with laws and regulations on the effectiveness of internal control over financial reporting under AS 2201.B8 (as proposed to be amended).

<sup>15</sup> The auditor considers both qualitative and quantitative factors in evaluating materiality. The materiality of likely noncompliance should be evaluated individually and in the aggregate with similar instances. See AS 2105, *Consideration of Materiality in Planning and Performing an Audit*; see also AS 2810.

- b. The effect on the amounts and disclosures in the financial statements, including potential contingent monetary effects, such as fines, penalties, damages, or provisions for allowances or returns;<sup>16</sup> and
- c. The adequacy of disclosure in the financial statements of the possible effects of the likely noncompliance on the company's operations.

.11 If the auditor determines that the likely noncompliance has a material effect on the financial statements, the auditor should determine whether senior management has taken timely and appropriate remedial action with respect to the matter.

Note: Possible remedial actions may include conducting or cooperating with an appropriate internal investigation into the matter, taking disciplinary action against involved personnel, seeking restitution, adopting preventive or corrective policies, or modifying specific control activities.

#### Communicating Noncompliance with Laws and Regulations

.12 When the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations (whether or not perceived to have a material effect on the financial statements), including fraud, has or may have occurred, the auditor must, as soon as practicable<sup>17</sup> and before the issuance of the engagement report,<sup>18</sup> communicate the matter(s) to:

- a. The appropriate level of management;<sup>19</sup> and
- b. The audit committee, unless the matter is clearly inconsequential<sup>20</sup> or has been communicated as provided for in the note to paragraph .13 below.

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<sup>16</sup> See generally AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*.

<sup>17</sup> Making this communication "as soon as practicable" could result in the auditor communicating the matter prior to the completion of the auditor's evaluation of the information indicating that noncompliance has or may have occurred (see paragraphs .07-.11 of this standard).

<sup>18</sup> The term "engagement report" has the same meaning as in footnote 1 to AS 1220, *Engagement Quality Reviews*.

<sup>19</sup> When making such communications to management, the auditor need not communicate such information to any individuals within management who directly communicated the information to the auditor.

<sup>20</sup> See [proposed paragraph .12h of AS 1215, *Audit Documentation*].

Note: The auditor should presume that a matter involving senior management is not clearly inconsequential.

- .13 The communication pursuant to paragraph .12 should describe the matter, including:
- a. The auditor's understanding of the nature of the matter and the circumstances of its occurrence; and
  - b. If the auditor has determined that the matter is likely noncompliance, the possible effect of the noncompliance on the financial statements and other information in documents containing the audited financial statements.

Note: As part of its communications to the audit committee, management might communicate some or all of the information regarding the noncompliance required under paragraphs .12 and .13. The auditor does not need to repeat information about such noncompliance that management previously communicated in writing to the audit committee or if the auditor participated in management's discussion with the audit committee about the noncompliance. The auditor must communicate any omitted, incomplete, or inadequately described information regarding the noncompliance to the audit committee.

- .14 After the auditor has completed the evaluation of the information indicating that noncompliance has or may have occurred, the auditor should communicate to management and, unless the matter is clearly inconsequential, also to the audit committee the results of the auditor's evaluation, including:
- a. Which of the matters, if any, communicated pursuant to paragraphs .12-.13 are likely noncompliance; and
  - b. For instances of likely noncompliance, whether there is a material effect on the financial statements.

- .15 If after the auditor has communicated noncompliance with laws and regulations in accordance with paragraphs .12-.14 to the audit committee, the auditor concludes that:
- a. Such noncompliance has a material effect on the financial statements;
  - b. 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 such noncompliance; and



- c. The failure to take remedial action is reasonably expected to warrant departure from an unqualified opinion<sup>21</sup> or warrant resignation from the audit engagement,<sup>22</sup>

the auditor must directly communicate these conclusions to the board of directors or equivalent, as soon as practicable.<sup>23</sup>

#### Multi-location Engagement Considerations

.16 If other auditors participate in the audit, the lead auditor should obtain written affirmations from the other auditors that:

- a. If the other auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred, the other auditor will communicate such information to the lead auditor in accordance with the lead auditor's instructions;<sup>24</sup> and
- b. The other auditor has communicated to the lead auditor any instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations identified or otherwise become aware of in the course of performing the other auditor's work.

.17 If other auditors participate in the audit and the lead auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred that may be relevant to the work of an other auditor, the lead auditor should communicate the information to the other auditor as soon as practicable.

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<sup>21</sup> See AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

<sup>22</sup> See also [Proposed AS 1310, *Notification of Termination of the Auditor-Client Relationship*, PCAOB Release No. 2022-006 (Nov. 18, 2022)], for the auditor's responsibilities to notify the SEC upon termination of the auditor-client relationship.

<sup>23</sup> The auditor may also have reporting or notification obligations regarding noncompliance with laws, rules, and regulations to regulators or other third parties. For example, auditors may be required under certain circumstances to make a report to the SEC relating to an illegal act that has a material effect on an issuer's financial statements pursuant to Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

<sup>24</sup> The terms "lead auditor" and "other auditor" have the same meanings as defined in Appendix A of AS 2101, *Audit Planning* [when adopted].

.18 In circumstances described in paragraph .17 or if the other auditor has communicated information indicating noncompliance with laws and regulations has or may have occurred, the lead auditor should establish an understanding with the other auditors regarding (i) the respective responsibilities of the lead auditor and the other auditors for evaluating and communicating the noncompliance with laws and regulations, including fraud; and (ii) any specific procedures to be performed.

#### Effect on the Engagement Report

.19 The auditor should determine the effect on the engagement report<sup>25</sup> and on the ongoing relationship with the company,<sup>26</sup> if the auditor:

- a. Is precluded by the company or the circumstances from identifying noncompliance with laws and regulations, including fraud, that has or may have occurred or from obtaining sufficient appropriate audit evidence to evaluate whether it is likely that noncompliance with laws and regulations, including fraud, occurred;
- b. Is unable to determine whether the likely noncompliance has a material effect on the financial statements; or
- c. Concludes that the likely noncompliance with laws and regulations (1) has a material effect on the financial statements, (2) has not been properly accounted for or disclosed or (3) results in changes to the auditor's assessment of the effectiveness of internal control over financial reporting.

#### Appendix A – Definition

.A1 For purposes of this standard, the term listed below is defined as follows:

.A2 Noncompliance with laws and regulations – An act or omission, intentional or unintentional, by the company whose financial statements are under audit, or by the company's management, its employees, or others that act in a company capacity or on the company's behalf, that violates any law, or any rule or regulation having the force of law. Noncompliance with laws and regulations includes fraud as described in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*. Noncompliance with laws and

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<sup>25</sup> See paragraph .11 of AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*; and AS 2201.B8 [as proposed to be amended].

<sup>26</sup> See [proposed paragraph .41 of QC 1000, *A Firm's System of Quality Control*, PCAOB Release No. 2022-006 (Nov. 18, 2022)].

regulations does not include personal conduct by the company's personnel unrelated to the business activities of the company.

## APPENDIX 2

### Other Related Proposed Amendments to PCAOB Auditing Standards

In connection with the proposed revision of AS 2405, *Illegal Acts by Clients*, the Board is proposing amendments to several of its auditing standards (“other proposed amendments”).<sup>1</sup>

Language that would be deleted by the other proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of the other proposed amendments by showing deletions and additions to existing sentences, paragraphs and footnotes is intended to assist readers in easily comprehending the Board’s proposed changes to auditing standards. The Board’s other proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of a standard that may be amended.

The Board is requesting comments on all aspects of the proposed amendments.

#### Auditing Standards Proposed to be Amended<sup>2</sup>

| PCAOB Standard | Title  | Paragraphs Amended  |
|----------------|--|---|
| AS 2110        | Identifying and Assessing Risks of Material Misstatement | .05, .09, .11, .13, .15, .26, .49, .54, and .56-.58                               |
| AS 2401        | Consideration of Fraud in a Financial Statement Audit    | .01, heading after .78 (deleted footnote), .79 (deleted), .81A, .82-.83 (deleted) |
| AS 1201        | Supervision of the Audit Engagement                      | .C3 and .C6   |

<sup>1</sup> The Board’s pending rulemaking projects, *A Firm’s System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms*, PCAOB Rel. No. 2022-006 (Nov. 18, 2022); *Proposed Auditing Standard – The Auditor’s Use of Confirmation, and Other Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2022-09 (Dec. 20, 2022); and *Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023) include proposed changes that may supersede, amend, or delete paragraphs of PCAOB auditing standards for which other proposed amendments are included in this appendix. If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the other proposed amendments in this release, the Board may make conforming changes to these other proposed amendments.

<sup>2</sup> This table is a reference tool for the proposed amendments that follow.

| PCAOB Standard | Title   | Paragraphs Amended |
|----------------|---|--------------------|
| AS 1210        | Using the Work of an Auditor-Engaged Specialist | .06 and .09        |
| AS 1215        | Audit Documentation                             | .09A and .12       |
| AS 2410        | Related Parties                                 | .03, .11, and .16  |
| AS 2805        | Management Representations                      | .06                |
| AS 4105        | Reviews of Interim Financial Information        | .18, .23, and .32  |

### Auditing Standard and Auditing Interpretations Proposed to be Rescinded

|   |
|---|
| <i>AS 6110, Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance</i> |
| <i>AI 13, Illegal Acts by Clients: Auditing Interpretations of AS 2405</i>                                      |
| <i>AI 21, Management Representations: Auditing Interpretations of AS 2805</i>                                   |

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#### **AS 2110: Identifying and Assessing Risks of Material Misstatement**

##### *Performing Risk Assessment Procedures*

\* \* \* \* \*

.05 Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, ~~or~~ financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework, or when the effects of noncompliance with laws and regulations are not properly presented in the financial statements. Thus, the audit procedures that are necessary to identify and

appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

- a. Obtaining an understanding of the company and its environment (paragraphs .07-.17);
- b. Obtaining an understanding of internal control over financial reporting (paragraphs .18-.40);
- c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs .41-.45);
- d. Performing analytical procedures (paragraphs .46-.48);
- e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs .49-.53); and
- f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs .54-.58).

Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.<sup>5</sup>

<sup>5</sup> AS 1105.11 discusses financial statement assertions.

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#### *Industry, Regulatory, and Other External Factors*

.09 Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses (1) industry factors, including the competitive environment and technological developments; (2) the regulatory environment, including the applicable financial reporting framework<sup>6</sup> and the legal and political environment;<sup>7</sup> and (3) external factors, including general economic conditions.

Note: Obtaining an understanding of the regulatory environment includes understanding (1) the laws and regulations that govern the determination of the form and content of the financial statements and (2) those other laws and regulations with

which the company's noncompliance could reasonably have a material effect on the financial statements.<sup>7</sup>

<sup>6</sup> The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

<sup>7</sup> AS 2405, ~~Illegal Acts by Clients~~ A Company's Noncompliance with Laws and Regulations, discusses the auditor's responsibilities for identifying, evaluating, and communicating information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred. See AS 2405.05-.06 for requirements related to assessing the risks or material misstatement due to noncompliance with laws and regulations—consideration of laws and regulations relevant to the audit.

\* \* \* \* \*

#### *Nature of the Company*

\* \* \* \* \*

.11 As part of obtaining an understanding of the company as required by paragraph .07, the auditor should ~~perform~~ consider performing the following procedures ~~and the extent to~~ understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement to which the procedures should be performed:

- ~~Reading publicly available information about the company, including such information disclosed by the company or its executive officers about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company issued press releases, company prepared presentation materials for analysts or investor groups, and analyst reports;~~

Note: Publicly available information disclosed by the company or its executive officers about the company includes company-issued press releases; company-prepared presentation materials for analysts or investors; and public statements made or issued by the company or its executive officers, including on the company's website or the company's or its executive officers' social media accounts. Publicly available information about the company also includes information from sources external to the company, such as media reporting and analyst reports.

- ~~Observing or reading~~ transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph .10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;
- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (*e.g.*, from Forms 3, 4, 5, 13D, and 13G);
- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and
- Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

*Selection and Application of Accounting Principles, Including Related Disclosures*

\* \* \* \* \*

.13 The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;
- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- Changes to the company's operating strategy, including when and how the company will implement such strategies and the related effect on the company's disclosures or significant accounting principles;
- The methods the company uses to account for significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions");<sup>7A</sup> and



- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

<sup>7A</sup> See AS 2401.66-.67A.

### *Company Objectives, Strategies, and Related Business Risks*

\* \* \* \* \*

.15 The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, *e.g.*, that the company does not have the personnel or expertise to deal with the changes in the industry.)
- New products and services (a potential related business risk might be, *e.g.*, that the new product or service will not be successful.)
- Use of information technology ("IT") (a potential related business risk might be, *e.g.*, that systems and processes are incompatible.)
- New accounting requirements (a potential related business risk might be, *e.g.*, incomplete or improper implementation of a new accounting requirement.)
- Expansion of the business (a potential related business risk might be, *e.g.*, that the demand for the company's products or services has not been accurately estimated.)
- The effects of implementing a strategy, for example to grow, modify, or discontinue business operations, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, *e.g.*, incomplete or improper implementation of the strategy.)
- Current and prospective financing requirements (a potential related business risk might be, *e.g.*, the loss of financing due to the company's inability to meet financing requirements.)
- Regulatory requirements (a potential related business risk might be, *e.g.*, that there is increased legal exposure.)

Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's industry could affect its ability to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to, *e.g.*, the classification of long-term liabilities

or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern. Other business risks could affect the risks of material misstatement for particular accounts, disclosures, or assertions. For example, an unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

\* \* \* \* \*

#### *The Company's Risk Assessment Process*

.26 The auditor should obtain an understanding of management's process for:

- a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks");
- b. Assessing the likelihood and significance of misstatements resulting from those risks;  
~~and~~
- c. Deciding about actions to address those risks;
- d. Identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
- e. Preventing, identifying, investigating, evaluating, communicating (including to senior management, the audit committee, and the board of directors), and remediating instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations;
- f. Receiving and responding to tips and complaints from internal and external parties regarding instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations (including those received through a whistleblower program, if such program exists); and
- g. Evaluating potential accounting and disclosure implications of noncompliance with laws and regulations, including fraud.

\* \* \* \* \*

#### *Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement, Including Likely Sources*

.49 The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements;~~and~~ (2) laws and regulations with which the company's noncompliance could reasonably have a material effect on the company's financial statements; and (3) the susceptibility of the company's financial statements to material misstatement due to error or fraud.

Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.<sup>28</sup>

Note: As discussed in paragraph .67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures.

<sup>28</sup> Paragraphs .52-.53 of this standard.

\* \* \* \* \*

*Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement*

.54 The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks and instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements.

\* \* \* \* \*

*Inquiries Regarding Fraud Risks and Noncompliance with Laws and Regulations*

.56 The auditor's inquiries regarding fraud risks and noncompliance with laws and regulations should include the following:

a. Inquiries of management regarding:

(1) Whether management has knowledge of instances, or alleged or suspected instances, of fraud, alleged fraud, or suspected fraud affecting the company;

(2) Whether management has knowledge of instances, or alleged or suspected instances, of noncompliance with laws and regulations that could reasonably have a material effect on the financial statements;

(3) Management's process for identifying and responding to:

a. Fraud risks in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is

likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

b. Instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations;

- ~~(43)~~ Controls that the company has established to address fraud risks the company has identified, or controls that otherwise help to prevent and detect fraud or other noncompliance with laws and regulations, including how management monitors those controls;
- ~~(54)~~ For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a fraud risk or noncompliance with laws and regulations might be more likely to exist;
- ~~(65)~~ Whether and how management communicates to employees its views on business practices and ethical behavior;
- ~~(76)~~ Whether management has received tips or complaints regarding the company's financial reporting or instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements (including those received through the audit committee's or company's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints;
- ~~(8)~~ Whether correspondence exists with the company's relevant regulatory authorities regarding instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements, and if so, the nature of that correspondence;
- ~~(79)~~ Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud or other noncompliance with laws and regulations; and
- ~~(810)~~ Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.<sup>31A</sup>

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

- (1) The audit committee's views about fraud risks in the company;

- (2) Whether the audit committee has knowledge of instances, or alleged or suspected instances, of fraud, alleged fraud, or suspected fraud affecting the company;
- (3) Whether the audit committee has knowledge of instances, or alleged or suspected instances, of other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements;
- (~~3~~4) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting or instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements (including those received through the audit committee's or company's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints;
- (45) How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks or that otherwise help to prevent and detect fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements; and
- (56) Whether the company has entered into any significant unusual transactions.
- c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:
- (1) The internal auditors' views about fraud risks in the company;
- (2) Whether the internal auditors have knowledge of instances, or alleged or suspected instances, of fraud, alleged fraud, or suspected fraud affecting the company;
- (3) Whether the internal auditors have knowledge of instances, or alleged or suspected instances, of other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements;
- (~~3~~4) Whether internal auditors have performed procedures to identify or detect fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements during the year, and whether management has satisfactorily responded to the findings resulting from those procedures;
- (45) Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides; and
- (56) Whether the company has entered into any significant unusual transactions.

31A See AS 2401.66-.67A.

.57 In addition to the inquiries ~~specified~~outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, ~~including, in particular, and whether they have knowledge of instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations, alleged fraud, or suspected fraud.~~ The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might be reasonably expected to have additional knowledge about instances, or alleged or suspected instances, of fraud or other noncompliance, ~~alleged fraud, or suspected fraud~~ or might be able to corroborate fraud risks identified in discussions with management or the audit committee. Examples of other individuals within the company to whom inquiries might be directed include:

- a. Employees with varying levels of authority within the company, including, *e.g.*, company personnel with whom the auditor comes into contact during the course of the audit while (a1) in obtaining an understanding of internal control, (b2) in observing inventory or performing cutoff procedures, or (c3) in obtaining explanations for significant differences identified when performing analytical procedures;
- b. Operating personnel not directly involved in the financial reporting process;
- c. Employees involved in initiating, recording, or processing complex or unusual transactions, *e.g.*, a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction; and
- d. In-house legal counsel or others within the organization likely to have knowledge regarding (1) the legal and regulatory environment applicable to the company; (2) the company's processes for preventing, identifying, investigating, evaluating, and communicating instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations; or (3) the existence of instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations.

.58 The auditor should evaluate responses to inquiries made pursuant to paragraphs .56 and .57 when evaluating management's responses to inquiries about fraud risks, and instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations to determine when it is necessary to corroborate management's responses and assess the consistency of all responses to inquiries with other audit evidence. In determining when it is necessary to corroborate management's responses, the auditor should take into account the fact that management is often in the best position to commit fraud and other noncompliance with laws and regulations. If responses to the auditor's inquiries are inconsistent with audit evidence obtained through other sources, the auditor should perform audit procedures necessary to address inconsistencies and determine the effect, if any, on other aspects of the

audit.<sup>31B</sup> ~~Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.~~

<sup>31B</sup> AS 2405 discusses the auditor’s responsibilities to evaluate and communicate noncompliance with laws and regulations, including fraud, that the auditor has identified or that has otherwise come to the auditor’s attention.

\* \* \* \* \*

### **AS 2401: Consideration of Fraud in a Financial Statement Audit**

.01 Paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*, states, “The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. [footnote omitted]”<sup>1</sup> This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements.<sup>2</sup>

<sup>1</sup> ~~The auditor’s responsibilities when consideration of illegal acts~~ the auditor has identified or otherwise become aware of noncompliance with laws and regulations, including fraud, that has or may have occurred, and responsibility for detecting misstatements resulting from illegal acts are described defined in AS 2405, *A Company’s Noncompliance with Laws and Regulations Illegal Acts by Clients*. For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor’s responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud. AS 2405 requires the auditor to plan and perform procedures to identify noncompliance with those laws and regulations, including fraud, that could reasonably have a material effect on the financial statements.

<sup>2</sup> For purposes of this standard, the term “audit of financial statements” refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

\* \* \* \* \*

### *Communicating About ~~Possible Fraud Risks to Management, and the Audit Committee, the Securities and Exchange Commission, and Others~~*<sup>37</sup>

<sup>37</sup> ~~—The requirements to communicate noted in paragraphs .79 through .82 extend to any intentional misstatement of financial statements (see paragraph .03). However, the communication may use terms other than fraud—for example, irregularity, intentional misstatement, misappropriation, or defalcations—if there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms.~~

~~.79 — Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee in a timely manner and prior to the issuance of the auditor's report. In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower level employees.~~

~~\* \* \* \* \*~~

~~.81A If the auditor identifies or otherwise becomes aware of information indicating that instances, or suspected or alleged instances, of fraud have or may have occurred, the auditor should determine the auditor's responsibilities for communicating to management and the audit committee under AS 2405 and, with respect to audits of issuers, The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to under Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.~~<sup>39</sup>

<sup>39</sup> See 15 U.S.C. § 78j-1(b).

~~.82 — The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:-~~

- ~~a. To a successor auditor when the successor makes inquiries in accordance with AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*.~~<sup>40</sup>
- ~~b. In response to a subpoena.~~
- ~~c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.~~

<sup>40</sup> — AS 2610 requires the specific permission of the client.

#### ~~*Documenting the Auditor's Consideration of Fraud*~~

~~.83 — The auditor should document the following:~~



- ~~▪ The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed (See AS 2110.52 and .53.)~~
- ~~▪ The procedures performed to obtain information necessary to identify and assess the fraud risks (See AS 2110.47, AS 2110.56 through .58, and AS 2110.65 through .69.)~~
- ~~▪ The fraud risks that were identified at the financial statement and assertion levels (see AS 2110.59 through .69.), and the linkage of those risks to the auditor's response (see AS 2301.05 through .15.)~~
- ~~▪ If the auditor has not identified in a particular circumstance, improper revenue recognition as a fraud risk, the reasons supporting the auditor's conclusion (See AS 2110.68.)~~
- ~~▪ The results of the procedures performed to address the assessed fraud risks, including those procedures performed to further address the risk of management override of controls (See AS 2301.15.)~~
- ~~▪ Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions (See AS 2810.05 through .09.)~~
- ~~▪ The nature of the communications about fraud made to management, the audit committee, and others (See paragraphs .79 through .82.)~~

\* \* \* \* \*

## **AS 1201: Supervision of the Audit Engagement**

\* \* \* \* \*

### **Appendix C – Supervision of the Work of Auditor-Employed Specialists**

\* \* \* \* \*

#### **Informing the Auditor-Employed Specialist of Work to be Performed**

.C3 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;

- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate);
- c. The degree of responsibility of the specialist for:
1. Testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company;
  2. Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and
  3. Evaluating the methods used by the company or the company's specialist, or using his or her own methods;~~and~~
- d. The responsibility of the specialist to communicate, as soon as practicable, to the engagement partner and, as applicable, other engagement team members performing supervisory responsibilities, information about instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that the specialist becomes aware of in performing the specialist's work;<sup>2A</sup> and
- ~~e~~. The responsibility of the specialist (1) to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist; and (2) to affirm in writing that any instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that the specialist became aware of in performing the specialist's work were communicated by the specialist.

<sup>2A</sup> The auditor should look to the requirements of AS 2401, *Consideration of Fraud in a Financial Statement Audit*, and AS 2405, *A Company's Noncompliance with Laws and Regulations*, as applicable, for the auditor's responsibilities regarding instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations.

\* \* \* \* \*

#### Evaluating the Work of the Auditor-Employed Specialist

.C6 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .C3~~e~~ above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and

- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

\* \* \* \* \*

### **AS 1210: Using the Work of an Auditor-Engaged Specialist**

\* \* \* \* \*

#### **Informing the Auditor-Engaged Specialist of Work to be Performed**

.06 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate);
- c. The degree of responsibility of the specialist for:
  - 1. Testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company;
  - 2. Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and
  - 3. Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
- d. The responsibility of the specialist to communicate, as soon as practicable, to the engagement partner and, as applicable, other engagement team members performing supervisory responsibilities, information about instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that the specialist becomes aware of in performing the specialist's work;<sup>2A</sup> and
- e. The responsibility of the specialist (1) to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist; and (2) to affirm in writing that any instances, or alleged or suspected instances, of fraud or other

noncompliance with laws and regulations that the specialist became aware of in performing the specialist's work were communicated by the specialist.

<sup>2A</sup> The auditor should look to the requirements of AS 2401, *Consideration of Fraud in a Financial Statement Audit*, and AS 2405, *A Company's Noncompliance with Laws and Regulations*, as applicable, for the auditor's responsibilities regarding instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations.

\* \* \* \* \*

### Evaluating the Work of the Auditor-Engaged Specialist

.09 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .06de above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

\* \* \* \* \*

### AS 1215: Audit Documentation

\* \* \* \* \*

.09A Documentation of risk assessment procedures and responses to risks of misstatement should include:

- a. The discussion among engagement personnel regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed;
- b. The procedures performed to obtain information necessary to identify and assess fraud risks;
- c. (1) A summary of the identified risks of misstatement, including fraud risks, and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels;~~and~~

Note: If the auditor has not identified improper revenue recognition as a fraud risk in a particular circumstance, the auditor should document reasons supporting the auditor's conclusion.

- d. ~~(2)~~ The auditor's responses to the risks of material misstatement, including fraud risks, and including linkage of to the responses to those risks; and
- e. The discussion of significant matters related to fraud and other noncompliance with laws and regulations with management, the audit committee, and others.

\* \* \* \* \*

.12 The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached in connection with each engagement. *Significant findings or issues* are substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached, and include, but are not limited to, the following: ...

f. Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.<sup>2C</sup>

~~f.1~~ g. Risks of material misstatement that are determined to be significant risks, including fraud risks, and the results of the auditing procedures performed in response to those risks, including those procedures to address the risk of management override of controls.

h. Instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that the auditor has identified or that have come to the auditor's attention, including (1) the results of the auditor's procedures to evaluate and communicate the noncompliance; (2) the implications of the fraud or other noncompliance in relation to other aspects of the audit and the actions taken to respond to these implications; and (3) the rationale for any determination by the auditor that the noncompliance was clearly inconsequential.<sup>2D</sup>

Note: In documenting the results of audit procedures to evaluate the possible effect of noncompliance with laws and regulations on the financial statements, the auditor should document the qualitative and quantitative factors considered to determine the materiality of any noncompliance.

~~g.i.~~ i. Any matters that could result in modification of the auditor's report.

<sup>2C</sup> See AS 2110.74, AS 2810.05-.09, and AS 2810.36.

<sup>2D</sup> See AS 2405, A Company's Noncompliance with Laws and Regulations.

\* \* \* \* \*

**AS 2410: Related Parties**

\* \* \* \* \*

.03 The auditor should perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph .04);
- b. Performing inquiries (paragraphs .05-.07); and
- c. Communicating with the audit engagement team and other auditors (paragraphs .08-.09).

Note 1: Obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

Note 2: Performing the risk assessment procedures described in paragraphs .04-.09 of this standard in conjunction with the risk assessment procedures required by AS 2110 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

\* \* \* \* \*

**Responding to the Risks of Material Misstatement**

.11 The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.<sup>11</sup> This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.<sup>12</sup>

Note 1: The auditor also should look to the requirements in paragraphs .66-.67A of AS 2401, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AS 2401.67 requires that the auditor evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the

transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Note 2: In performing audit procedures to address the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor may become aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred. In such circumstances, the auditor must determine his or her responsibilities under AS 2405, A Company's Noncompliance with Laws and Regulations.

<sup>11</sup> See paragraph .03 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>12</sup> See generally, AS 2301 and paragraph .17 of AS 1105, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

\* \* \* \* \*

.16 If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;<sup>17</sup>
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph .12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk; and
- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:

- i. Evaluate the implications on the auditor’s assessment of internal control over financial reporting, if applicable;
- ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk;<sup>18</sup> and
- iii. Evaluate the implications for the audit if management’s nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or noncompliance with laws or regulations~~an illegal act~~ may have occurred. If the auditor becomes aware of information indicating that fraud or ~~another illegal act~~ other noncompliance with laws and regulations has ~~occurred~~ or might ~~may~~ have occurred, the auditor must determine his or her responsibilities under AS 2401.~~7980~~-821A, AS 2405-~~Illegal Acts by Clients~~, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

<sup>17</sup> See AS 2805.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management’s representations relating to other aspects of the financial statements is appropriate and justified.

<sup>18</sup> See AS 2110.74, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

\* \* \* \* \*

**AS 2805: Management Representations**

\* \* \* \* \*

.06 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:<sup>3</sup>

\* \* \* \* \*

*Recognition, Measurement, and Disclosure*

- g. Management’s belief that the effects of any uncorrected financial statement misstatements<sup>4</sup> aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the



aggregate, to the financial statements taken as a whole.<sup>5</sup> (A summary of such items should be included in or attached to the letter.)<sup>6, 7</sup>

\* \* \* \* \*

- o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.<sup>10</sup>

\* \* \* \* \*

<sup>7</sup> The communication to management of immaterial misstatements aggregated by the auditor does not fully satisfy ~~constitute a~~ the communication(s) that may be required pursuant to paragraphs ~~.12-.13~~<sup>17</sup> of AS 2405, *A Company’s Noncompliance with Laws and Regulations/Illegal Acts by Clients*, Section 10A of the Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. § 78j-1, or paragraphs ~~.7980 through .821A~~ of AS 2401, *Consideration of Fraud in a Financial Statement Audit*. The auditor may have additional communication responsibilities pursuant to AS 2405, Section 10A of the ~~Securities Exchange Act of 1934,~~ 15 U.S.C. § 78j-1, or AS 2401.

\* \* \* \* \*

<sup>10</sup> This representation does not change the relevant criteria under the applicable financial reporting framework for evaluating the need for disclosure in the financial statements of noncompliance with laws or regulations. In requesting this representation, the auditor is not asking for management’s speculation on all possibilities of legal challenges to its actions. The representation concerns matters that have come to management’s attention and that could reasonably have a material effect on the financial statements and should be considered in determining whether financial statement disclosures or the recording of loss contingencies are necessary. See also AS 2405.

**AS 4105: Reviews of Interim Financial Information**

\* \* \* \* \*

*Analytical Procedures, Inquiries, and Other Review Procedures*

\* \* \* \* \*

.18 Inquiries and other review procedures. The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

\* \* \* \* \*

- c. Inquiring of members of management who have responsibility for financial and accounting matters concerning:

\* \* \* \* \*

- Their knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
- Whether they are aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others.
- Their knowledge of instances, or alleged or suspected instances, of other noncompliance with laws and regulations that could reasonably have a material effect on the interim financial information.

\* \* \* \* \*

.23 *Coordination with the audit.* The accountant performing the review of interim financial information ordinarily will also be engaged to perform an audit of the annual financial statements of the entity. Certain auditing procedures may be performed concurrently with the review of interim financial information. For example, information gained from reading the minutes of meetings of the board of directors in connection with the review also may be used for the annual audit. Also, there may be significant or unusual transactions occurring during the interim period under review for which the auditing procedures that would need to be performed for purposes of the audit of the annual financial statements could be performed, to the extent practicable, at the time of the interim review, for example, business combinations, restructurings, or significant revenue transactions.

Note: If, in performing a review of interim financial information, the accountant identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred, the accountant must determine its responsibilities under AS 2405, *A Company's Noncompliance with Laws and Regulations*, and Section 10A of the Securities Exchange Act of 1934.<sup>15A</sup>

<sup>15A</sup> AS 2405.06 requires the accountant to use information from other procedures performed that may indicate laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or noncompliance with laws and regulations that has or may have occurred. The other procedures described in AS 2405.06 include those performed under this standard.

\* \* \* \* \*

*Communications to Management, Audit Committees, and Others*

\* \* \* \* \*

.32 If the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under paragraph .81A of AS 2401, Consideration of Fraud in a Financial Statement Audit, AS 2405, A Company's Noncompliance with Laws and Regulations~~Illegal Acts by Clients~~, and Section 10A of the Securities Exchange Act of 1934.<sup>21</sup> Any required communications under those standards or rule should be made as soon as practicable and prior to the registrant filing its periodic report with the SEC.

<sup>21</sup> See 15 U.S.C. § 78j-1.

\* \* \* \* \*

**AS 6110: Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance**

AS 6110, "Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance", as amended, is rescinded.

\* \* \* \* \*

**AI 13: Illegal Acts by Clients: Auditing Interpretations of AS 2405**

AI 13, "Illegal Acts by Clients: Auditing Interpretations of AS 2405", as amended, is rescinded.

\* \* \* \* \*

**AI 21: Management Representations: Auditing Interpretations of AS 2805**

AI 21, "Management Representations: Auditing Interpretations of AS 2805", as amended, is rescinded.

## APPENDIX 3

### Proposed Conforming Amendments to PCAOB Auditing Standards

In connection with the proposed amendments to AS 2405, *Illegal Acts by Clients*; and other proposed amendments, the Board is proposing conforming amendments to several of its auditing standards (“proposed conforming amendments”).<sup>1</sup>

Language that would be deleted by the proposed conforming amendments is ~~struck through~~. Language that would be added is underlined. The presentation of the proposed conforming amendments by showing deletions and additions to existing sentences, paragraphs and footnotes is intended to assist readers in easily comprehending the Board’s proposed changes to auditing standards. The Board’s proposed conforming amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of a standard that may be amended.

The Board is requesting comments on all aspects of the proposed amendments.

#### Auditing Standards Proposed to be Amended<sup>2</sup>

| PCAOB Standard     | Title  | Paragraphs Amended        |
|--------------------|--|---------------------------|
| [Proposed] AS 1000 | General Responsibilities of the Auditor in Conducting an Audit | .13                       |
| AS 1001            | Responsibilities and Functions of the Independent Auditor      | .02                       |
| AS 1301            | Communications with Audit Committees                           | .08, .24, .25, Appendix B |
| AS 2101            | Audit Planning   | .07                       |

<sup>1</sup> The Board’s pending rulemaking projects, *A Firm’s System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms*, PCAOB Rel. No. 2022-006 (Nov. 18, 2022); *Proposed Auditing Standard – The Auditor’s Use of Confirmation, and Other Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2022-09 (Dec. 20, 2022); and *Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023) include proposed changes that may supersede, amend, or delete paragraphs of PCAOB auditing standards for which other proposed amendments are included in this appendix. If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the other proposed amendments in this release, the Board may make conforming changes to these other proposed amendments.

<sup>2</sup> This table is a reference tool for the proposed amendments that follow.

| PCAOB Standard | Title  | Paragraphs Amended      |
|----------------|--|-------------------------|
| AS 2201        | An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements | .09, .84, .B8, .C14     |
| AS 2501        | Auditing Accounting Estimates, Including Fair Value Measurements   | .16                     |
| AS 2601        | Consideration of An Entity’s Use of a Service Organization   | .23, .61                |
| AS 2610        | Initial Audits—Communications Between Predecessor and Successor Auditors                                       | .09                     |
| AS 2810        | Evaluating Audit Results   | .17, .21, .23, .B1, .B2 |

### **[Proposed] AS 1000: General Responsibilities of the Auditor in Conducting an Audit<sup>3</sup>**

\* \* \* \* \*

.13 The auditor must plan and perform the audit to obtain sufficient appropriate audit evidence to:

a. Obtain reasonable assurance about whether:

- (1) In an audit of financial statements, the financial statements are free of material misstatement,<sup>22</sup> whether due to error or fraud;<sup>23</sup>
- (2) In an audit of internal control over financial reporting, material weaknesses exist as of the date specified in management’s assessment; and

<sup>22</sup> The term “misstatement,” as used in this standard, has the same meaning as defined in Appendix A of AS 2810, *Evaluating Audit Results*.

<sup>23</sup> See AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, for requirements regarding the auditor’s consideration of materiality in planning and

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<sup>3</sup> See *Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023).

performing an audit. See also AS 2401, *Consideration of Fraud in a Financial Statement Audit*; ~~See also~~ paragraphs .06-.07 of AS 2405, ~~*Illegal Acts by Clients*~~ *A Company's Noncompliance with Laws and Regulations*. Misstatements due to error or fraud include misstatements from noncompliance with laws and regulations that result in a material misstatement of the company's financial statements.

\* \* \* \* \*

### **AS 1001: Responsibilities and Functions of the Independent Auditor**

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.02 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.<sup>1</sup> Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected.<sup>2</sup> The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

<sup>1</sup> See AS 2105, *Consideration of Materiality in Planning and Performing an Audit*. The auditor's consideration of ~~illegal acts and responsibility for detecting misstatements a~~ company's noncompliance with laws and regulations resulting from illegal acts is defined in AS 2405, *A Company's Noncompliance with Laws and Regulations* ~~*Illegal Acts by Clients*~~. Misstatements due to error or fraud include misstatements from noncompliance with laws and regulations that result in a material misstatement of the company's financial statements. ~~For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for error or fraud.~~

<sup>2</sup> See paragraphs .10 through .13 of AS 1015, *Due Professional Care in the Performance of Work*.

### **AS 1301: Communications with Audit Committees**

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.08 The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit,<sup>5</sup> including, but not limited to, violations or possible violations of laws or regulations.<sup>6</sup>

<sup>5</sup> In addition to this inquiry, paragraphs .05f and .54-.57 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*, describe the auditor's inquiries of the audit committee, or equivalent (or its chair) regarding the audit committee's knowledge of the risks of material misstatement, including fraud risks and other noncompliance with laws and

regulations that has or may have occurred. These inquiries include, among other things, whether the audit committee is aware of tips or complaints regarding the company's financial reporting.

<sup>6</sup> See AS 2405, ~~*Illegal Acts by Clients*~~ *A Company's Noncompliance with Laws and Regulations*, for a description of the auditor's responsibilities when ~~a~~ the auditor identifies or otherwise becomes aware of possible information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred ~~illegal act is detected~~. For audits of issuers, see also Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and Rule 10A-1 under the Exchange Act, 17 C.F.R. § 240.10A-1.

\* \* \* \* \*

.24 The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.<sup>40</sup>

<sup>40</sup> AS 2401.7980-.81A and AS 2405.12-.1417 include specific communication requirements relating to fraud or other noncompliance with laws and regulations ~~illegal acts~~, respectively.

### **Form and Documentation of Communications**

.25 The auditor should communicate matters to the audit committee ~~the matters in this standard~~, either orally or in writing, unless otherwise specified in this or other standards. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.<sup>42</sup>

Note: If, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs .12 or .18 and, as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor must include a copy of or a summary of management's communications provided to the audit committee in the audit documentation.

\* \* \* \* \*

### *Appendix B - Communications with Audit Committees Required by Other PCAOB Rules and Standards*

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.

- AS 6115, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, paragraphs .60, .62, and .64

- AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraphs .78-.81, .91, .C7, and .C14
- AS 2110, *Identifying and Assessing Risks of Material Misstatement*, paragraphs .05f and .54-.57
- AS 2410, *Related Parties*, paragraphs .07 and .19
- Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, paragraphs 34 and 35
- Attestation Standard No. 2, *Review Engagement Regarding Exemption Reports of Brokers and Dealers*, paragraph 15
- PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*
- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*
- AS 2401, *Consideration of Fraud in a Financial Statement Audit*, paragraphs ~~.7980~~-.81A
- AS 2405, *A Company's Noncompliance with Laws and Regulations ~~Illegal Acts by Clients~~*, paragraphs ~~.08, .12-.14~~17, and ~~.20~~
- AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*, paragraphs .04-.07 and .09
- AS 2805, *Management Representations*, paragraph .05
- AS 2710, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 and .06
- AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*, paragraph .13
- AS 4105, *Reviews of Interim Financial Information*, paragraphs .08-.09, .30-.31, and .33-.36

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### **AS 2101: Audit Planning**

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.07 The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit



plan, as discussed in paragraphs .08-.10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,<sup>5</sup> risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee<sup>6</sup> or management;
- Legal or regulatory matters, including noncompliance with laws and regulations that has or may have occurred, of which the auditor has identified or the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

<sup>5</sup> AS 2105, *Consideration of Materiality in Planning and Performing an Audit*.

<sup>6</sup> If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

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### **AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements**

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.09 The auditor should properly plan the audit of internal control over financial reporting and properly supervise the engagement team<sup>7A</sup> members. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee<sup>8</sup> or management;
- Legal or regulatory matters, including noncompliance with laws and regulations that has or may have occurred, of which the auditor has identified or the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company’s internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor’s client acceptance and retention evaluation; and
- The relative complexity of the company’s operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

<sup>7A</sup> The term “engagement team,” as used in this standard, has the same meaning as defined in Appendix A of AS 2101, *Audit Planning*.

<sup>8</sup> If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

\* \* \* \* \*

.84 When auditing internal control over financial reporting, the auditor may become aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred.~~possible illegal acts.~~ In such circumstances, the auditor must determine his or her responsibilities under AS 2401, AS 2405, *A Company’s Noncompliance with Laws and Regulations*~~Illegal Acts by Clients~~, and Section 10A of the Securities Exchange Act of 1934.<sup>17</sup>

<sup>17</sup> See 15 U.S.C. § 78j-1.

\* \* \* \* \*

#### *Appendix B - Special Topics*

.B8 *Effect of Substantive Procedures on the Auditor’s Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum -

- The auditor’s risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to noncompliance with laws and regulations~~illegal acts~~ and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor’s judgment about the effectiveness of controls.

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*Appendix C - Special Reporting Situations*

.C14 If the auditor believes that management’s additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor’s views concerning the information. AS 2405, *A Company’s Noncompliance with Laws and Regulations*~~*Illegal Acts by Clients*~~ and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.<sup>2</sup>

Note: If management makes the types of disclosures described in paragraph .C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company’s financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor’s responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

<sup>2</sup> See 15 U.S.C. § 78j-1.

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**AS 2501: Auditing Accounting Estimates, Including Fair Value Measurements**

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.16 The auditor should evaluate the reasonableness of the significant assumptions used by the company to develop the estimate, both individually and in combination. This includes evaluating whether:

- a. The company has a reasonable basis for the significant assumptions used and, when applicable, for its selection of assumptions from a range of potential assumptions; and

- b. The significant assumptions are consistent with the following, when applicable:
- (1) Relevant industry, regulatory, and other external factors, including economic conditions;
  - (2) The company’s objectives, strategies, and related business risks;<sup>17</sup>
  - (3) Existing market information;
  - (4) Historical or recent experience, taking into account changes in conditions and events affecting the company; and
  - (5) Other significant assumptions used by the company in other estimates tested.

Note: If the auditor evaluates the reasonableness of a significant assumption by developing an expectation of that assumption, the auditor should have a reasonable basis for that expectation.

Note: Paragraph .A10 in Appendix A of this standard sets forth additional requirements related to evaluating the reasonableness of unobservable inputs used in the valuation of financial instruments.

<sup>17</sup> The understanding of the company and its environment obtained in performing the procedures required by AS 2110.07–~~09.15~~ can provide information relevant to evaluating the reasonableness of significant assumptions pursuant to paragraphs .16b(1) and .16b(2) of this standard.

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### **AS 2601: Consideration of an Entity’s Use of a Service Organization**

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.23 As a result of procedures performed at the service organization, the service auditor may become aware of noncompliance with laws and regulations~~illegal acts~~, fraud, or uncorrected errors attributable to the service organization’s management or employees that may affect one or more user organizations. The terms *errors*, *fraud*, and noncompliance with laws and regulations~~illegal acts~~ are discussed in AS 2810, *Evaluating Audit Results*, AS 2401, Consideration of Fraud in a Financial Statement Audit, and AS 2405, A Company’s Noncompliance with Laws and Regulations~~Illegal Acts by Clients~~; the discussions therein are relevant to this section. When the service auditor becomes aware of such matters, he or she should determine from the appropriate level of management of the service organization whether this information has been communicated appropriately to affected user organizations,

unless those matters are clearly inconsequential. If the management of the service organization has not communicated the information to affected user organizations and is unwilling to do so, the service auditor should inform the service organization's audit committee or others with equivalent authority or responsibility. If the audit committee does not respond appropriately to the service auditor's communication, the service auditor should consider whether to resign from the engagement. The service auditor may wish to consult with his or her attorney in making this decision.

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.61 Regardless of the type of report issued, the service auditor should obtain written representations from the service organization's management that—

- Acknowledge management's responsibility for establishing and maintaining appropriate controls relating to the processing of transactions for user organizations.
- Acknowledge the appropriateness of the specified control objectives.
- State that the description of controls presents fairly, in all material respects, the aspects of the service organization's controls that may be relevant to a user organization's internal control.
- State that the controls, as described, had been placed in operation as of a specific date.
- State that management believes its controls were suitably designed to achieve the specified control objectives.
- State that management has disclosed to the service auditor any significant changes in controls that have occurred since the service organization's last examination.
- State that management has disclosed to the service auditor any noncompliance with laws and regulations~~illegal acts~~, fraud, or uncorrected errors attributable to the service organization's management or employees that may affect one or more user organizations.
- State that management has disclosed to the service auditor all design deficiencies in controls of which it is aware, including those for which management believes the cost of corrective action may exceed the benefits.
- State that management has disclosed to the service auditor any subsequent events that would have a significant effect on user organizations.

If the scope of the work includes tests of operating effectiveness, the service auditor should obtain a written representation from the service organization's management stating that management has disclosed to the service auditor all instances, of which it is aware, when

controls have not operated with sufficient effectiveness to achieve the specified control objectives.

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**AS 2610: Initial Audits—Communications Between Predecessor and Successor Auditors**

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.09 The successor auditor should make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement. Matters subject to inquiry should include—

- Information that might bear on the integrity of management.
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters.
- Communications to audit committees or others with equivalent authority and responsibility<sup>4</sup> regarding fraud, noncompliance with laws and regulations~~illegal acts by clients~~, and internal-control-related matters.<sup>5</sup>
- The predecessor auditor’s understanding as to the reasons for the change of auditors.
- The predecessor auditor’s understanding of the nature of the company’s relationships and transactions with related parties and significant unusual transactions.<sup>5A</sup>

The successor auditor may wish to consider other reasonable inquiries.

<sup>4</sup> For entities that do not have audit committees, the phrase “others with equivalent authority and responsibility” may include the board of directors, the board of trustees, or the owner in owner-managed entities.

<sup>5</sup> See AS 2401, *Consideration of Fraud in a Financial Statement Audit*; AS 2405, *A Company’s Noncompliance with Laws and Regulations*~~*Illegal Acts by Clients*~~; and AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*.

<sup>5A</sup> AS 2401.66 describes significant unusual transactions.

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**AS 2810: Evaluating Audit Results**

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*Accumulating and Evaluating Identified Misstatements*

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.17 *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.<sup>7</sup> (See Appendix B.)

Note 1: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is “a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>8</sup> As the Supreme Court has noted, determinations of materiality require “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him. . . .”<sup>9</sup>

Note 2: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility<sup>10</sup> that it could lead to a material contingent liability or a material loss of revenue.<sup>11</sup> Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

Note 3: If the reevaluation of the established materiality level or levels, as set forth in AS 2105,<sup>12</sup> results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

<sup>7</sup> If the financial statements contain material misstatements, AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105.18 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

<sup>8</sup> *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). See also *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>9</sup> *TSC Industries*, 426 U.S. at 450.

<sup>10</sup> There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either “reasonably possible” or “probable,” as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

<sup>11</sup> AS 2405, *A Company’s Noncompliance with Laws and Regulations—Legal Acts by Clients*.

<sup>12</sup> AS 2105.11–.12.

\* \* \* \* \*



.21 If the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statements could be material or cannot be readily determined, the auditor should perform the procedures in AS 2405, A Company's Noncompliance with Laws and Regulations, to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

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.23 If the auditor identifies or otherwise becomes aware of information indicating that fraud or ~~another noncompliance with laws and regulations illegal act~~ has or may have occurred ~~or might have occurred~~, he or she also must determine his or her responsibilities under ~~AS 2401.79-82A~~, AS 2405, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

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#### *Appendix B - Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements*

.B1 Paragraph .17 of this standard states:

The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.<sup>1</sup>

Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is “a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>2</sup> As the Supreme Court has noted, determinations of materiality require “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him. . . .”<sup>3</sup>

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility<sup>4</sup> that it could lead to a material contingent liability or a material loss of revenue.<sup>5</sup> Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

\* \* \* \* \*

<sup>5</sup> AS 2405, A Company's Noncompliance with Laws and Regulations~~Illegal Acts by Clients.~~

.B2 Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

\* \* \* \* \*

- g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and ~~possible~~ other noncompliance with laws and regulations that has or may have occurred~~illegal acts~~, violations of contractual provisions, and conflicts of interest.

\* \* \* \* \*