KPMG

HOT TOPIC

# PCAOB proposal

## PCAOB proposal would expand auditors' responsibilities

July 2023

## Proposed amendments to auditing standards would require auditors to identify a company's noncompliance with laws and regulations.

### Introduction

The Public Company Accounting Oversight Board (PCAOB) is seeking public comment by August 7, 2023, on extensive changes proposed to auditing standards related to auditors' responsibilities over a company's noncompliance with laws and regulations (NOCLAR), including:

- identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
- assessing the risks of material misstatement of the financial statements due to noncompliance with those laws and regulations, and responding appropriately;
- identifying whether there are instances of NOCLAR that have or may have occurred; and
- regardless of perceived materiality, evaluating those NOCLAR instances and communicating to appropriate parties.

Companies operate across many industries, cities, states, and countries in various, often complex, regulatory and legal environments, and there is a concern from some stakeholders that the current auditing standard, AS 2405: *Illegal Acts by Clients*, may not provide adequate consideration of current conditions. Investors and other stakeholders are increasingly wary of the effects on companies from NOCLAR, including those beyond financial statement misstatements, and some expect auditors to play a bigger role in the detection and reporting of such events.

When voting to release the proposal, two of the five board members dissented. In doing so they mentioned aspects of the proposal that will be very challenging for auditors to implement. They highlighted concerns regarding the significant shift in the auditors' responsibilities and role, the substantial expansion of the population of laws and regulations that an auditor will need to consider, and the corresponding increase in the cost of an audit. We therefore suggest that stakeholders look closely at these aspects as they review the proposal and consider offering constructive suggestions that could improve the proposal.

## Summary of significant changes and potential impacts

| Proposed requirement or change | Potential impacts |
|---|---|
| Consider 'noncompliance with laws and regulations,' including fraud, instead of 'illegal acts'. | Change in definition alone may not significantly affect practice. |
| Identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. | Incorporates a significant change from the current requirements, which focus audit efforts on those laws and regulations that have a direct and material effect on the financial statements.<br><br>Under the current standard, the auditor is not required to identify those laws and regulations that may indirectly affect the financial statements until they are determined to have a direct effect (e.g. through a material fine that needs to be recorded or a contingent obligation that needs to be disclosed). The proposal would require auditors to consider laws and regulations with which noncompliance could reasonably have either a direct or indirect material effect on the financial statements. The proposal uses noncompliance with environmental regulations that may result in material fines and penalties as an example with an indirect effect on the financial statements.<br><br>This change appears to require auditors to determine a complete population of laws and regulations to identify those that 'could reasonably have a material effect on the financial statements'; however, the meaning of this phrase is not defined in the proposal. Instead, the proposal provides examples of laws and regulations that may be relevant because of potentially significant fines, penalties or other damages to a company in the event of noncompliance. This may include laws and regulations in the areas of securities, environmental, privacy, and occupational health and safety, among others, and auditors and issuers would likely need to involve additional specialists with expertise in these areas. |
| Assess and respond to risks of material misstatement of the financial statements due to noncompliance with the identified laws and regulations. | Includes more explicit, unconditional requirements for assessing and responding to risks related to noncompliance compared to the current AS 2405, and ties the auditors' responsibilities related to NOCLAR to the risk assessment concepts elsewhere in the auditing standards.<br><br>While current auditing standards encompass risks of material misstatement due to error or fraud, the current standards do not explicitly address risk of material misstatement due to NOCLAR. Also, the proposal would require the auditor to perform certain enhanced risk assessment procedures. |
| Plan and perform procedures to identify whether there is information indicating noncompliance with the | Incorporates a significant change from the current requirements, which require the auditor to plan and perform procedures responsive to those laws that have a direct and material effect and includes explicit procedures over the potentially large population of laws and |

| Proposed requirement or change | Potential impacts |
|---|---|
| identified laws and regulations has or may have occurred. | regulations. The proposal would also remove existing language making it clear that currently auditors do not make legal judgments and often are not able to determine definitively that noncompliance has occurred. This change combined with the increase in the number of laws and regulations that are in scope for the audit could create an expectation that the audit will be providing some degree of assurance regarding the company's compliance with laws and regulations. |
| Perform procedures to evaluate the possible effect of likely NOCLAR on the financial statements (including material misstatements) and on other information and assess management's remediation of such NOCLAR. | Adds to the procedures in the current AS 2405, including more specific consideration of involving specialists, evaluating the impact of likely NOCLAR on other information in documents containing audited financial statements (e.g. risk factors, MD&A and other sections of a 10-K), and assessing management's remedial actions. |
| Communicate likely instances of NOCLAR to appropriate parties at appropriate times during the audit, regardless of whether the effect of the noncompliance is perceived to be material to the financial statements. | Incorporates management and audit committee communication requirements in Section 10A of the Securities Exchange Act of 1934 and would require communication at multiple points after a likely instance of NOCLAR has been identified.<br><br>The proposal would require initial communication to management and the audit committee when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations has or may have occurred. It also would require a subsequent communication of whether an act was likely to be noncompliant after the auditor has evaluated whether it is likely noncompliance has occurred. |

## Amendments to other PCAOB auditing standards

The PCAOB is also proposing to amend other auditing standards to better incorporate consideration of NOCLAR, including the following:

| Proposed requirement or change | Potential impacts |
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| Risk assessment (AS 2110: *Identifying and assessing risks of material misstatements*): Obtaining an understanding of the relevant regulatory environment, management's processes related to identifying relevant laws and regulations and preventing or addressing instances of actual or | Provides more specific requirements for the auditor to obtain an understanding of management's process to:<br>• identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;<br>• prevent, identify, investigate, evaluate, communicate and remediate potential noncompliance;<br>• receive and respond to tips and complaints; and<br>• evaluate potential accounting and disclosure implications. |

| Proposed requirement or change | Potential impacts |
|---|---|
| suspected NOCLAR (including any financial statement effects, and making specific inquiries related to NOCLAR). | Expands the specific sources of information used in risk assessment, including executive officers' social media accounts. |
| Interim reviews (AS 4105: *Reviews of Interim Financial Information*): Clarifying the required interim procedures, including when likely NOCLAR may have occurred. | Unclear as to extent of evaluation needed, which could impact timing of completing an interim review. |

The PCAOB also proposes updates to AS 2401: *Consideration of Fraud in a Financial Statement Audit*, AS 1201*: Supervision of the Audit Engagement*, AS 1215: *Audit Documentation*, AS 2410: *Related Parties*, and AS 2805: *Management Representations* that may not have as significant an impact on current practice.

## Potential impacts to management

In addition to the direct effects the proposal will have on audits, the proposed amendments will likely also affect the company, its processes and controls, and the level of effort required of management including:

- a need to evaluate the design, implementation and operating effectiveness of controls over compliance in addition to controls over financial reporting;
- increased inquiries of management regarding NOCLAR;
- a need for management to compile complete lists of relevant laws and regulations across the company and its operations, including across multiple jurisdictions and expand its risk assessment process to consider this population;
- additional process documentation and resources for walkthroughs over the identification and investigation of NOCLAR;
- tests over the relevance and reliability of information provided by management regarding NOCLAR; and
- increased costs, including additional resources, legal fees, auditor fees, and other costs that could be substantial.

## Economic analysis

The proposal outlines the economic benefits and economic costs, and states that the benefits are expected to justify the costs. In the proposal, the PCAOB acknowledges that the new requirements would result in additional, potentially substantial costs to auditors and the companies they audit.

## Opportunity for public comment

> *"The fact that today's vote is not unanimous underscores the importance of our public notice and comment process. While I believe this proposal strengthens requirements on the auditor to identify, evaluate, and communicate noncompliance, the standard can only improve with the benefit of our stakeholders' comments. Today's proposal, if adopted, represents significant change, I therefore encourage all of our stakeholders to provide their feedback." - Anthony C. Thompson, Board Member*

All board member statements requested feedback on the proposal through comment responses due by August 7, 2023. The Board as a whole requested comments on all aspects of the proposal, including "alternatives to the proposed amendments, the economic impacts of the proposal, and data on current practices and potential benefits and costs." KPMG LLP (US) is planning to submit a response to the proposal and is participating in discussions with industry organizations (e.g. Center for Audit Quality) and encourages other stakeholders to also provide comments to the PCAOB.

## For further information

For more information, read the Proposed Rule and Board Member statements.

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