The views expressed in these slides are solely the views of the Investor Advisory Group members who prepared them and do not necessarily reflect the views of the PCAOB, the members of the Board, or the Board's staff. The PCAOB makes no representation as to the accuracy or completeness of this information.

Report from the Working Group on Auditor's Consideration of a Client's Noncompliance with Laws and Regulations (NOCLAR)

Mary Bersot (Co-Lead)
Grant Callery (Co-Lead)
Linda de Beer
Norman Harrison
Larry Shover
Damon Silvers
Judge Stanley Sporkin
Bob Tarola
Lynn Turner

NOCLAR

Introduction

What Do Investors Expect From Auditors?

- Investors have a high expectation of auditors, consistent with the high level of assurance discussed in the auditing standards
- Independence and Objectivity
- If the auditor becomes aware of material information with respect to the financial statements or financial operations of the company, investors expect auditors to ensure that information is disclosed in a timely and complete manner:
  - Includes awareness of potential or actual illegal acts or other instances of non compliance with laws and regulations
  - By Management, and if they fail to do so
  - By the Auditor

NOCLAR

Introduction
(continued)

PCAOB standards for Compliance with Laws and Regulations Need Updating and Enhancement

- AS 2405 hasn't been updated since initially adopted by the PCAOB in 2003 – the world has changed
- Is not strong enough to protect investors
- Need to better define auditors responsibility
- Needs enhanced language regarding audit steps required (must) to be performed
- When auditors become aware of material information that is expected to have an impact on the financial statements or financial operations of the company, they must act on that information

NOCLAR

Investor Concerns and Expectations

- Concerns:
  - Instances of illegal acts either not detected or not reported by auditors
    - Securities laws violations including FCPA or fraud
    - Illegal account openings
    - Violations of federal environmental laws
- Expectations:
  - Strengthen auditing standards for auditor's duty to identify and report suspected and/or confirmed illegal acts
  - Clarify steps to be taken by auditor to audit and report suspected or confirmed illegal acts in this regard, including communication with the company and its board during the process and consideration of corrective action taken.
  - Require auditor to report confirmed illegal acts to appropriate entity or authorities

NOCLAR

Comparative Standards: Audit Scope Relating to NOCLAR

PCAOB	GAO Yellow Book	'34 Act Section 10A	Intl. Auditing Stds.	AICPA
Auditor's responsibility to detect and report misstatements resulting from illegal acts is the same as that for misstatements caused by error or fraud. An audit conducted in accordance with PCAOB auditing standards **provides no assurance** that illegal acts will be detected, and **does not include audit procedures** specifically designed to detect illegal acts. When auditor concludes that an illegal act has or is likely to have occurred, the auditor **should consider** the effect on the financial statements and implications for other aspects of the audit.	GAGAS includes requirement relating to "fraud, noncompliance with laws, regulations, contracts, and grant agreements, and abuse" Auditors not required to detect abuse. But if auditor becomes aware of abuse that could be **quantitatively or qualitatively material** to the financial statements the auditor "**should apply** audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives."	Requires that audit include "procedures [as required by GAAS as established by PCAOB] designed to provide reasonable assurance of detecting illegal acts that would have **a direct and material effect** on the determination of financial statement amounts." If auditor becomes aware of information indicating that illegal act has occurred, the auditor **shall**, in accordance with GAAS, (i) determine whether it is **likely** that an illegal act has occurred and (ii) if so, determine and consider the possible effect on the issuer's financial statements	Auditor not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. Auditor is responsible for obtaining **reasonable assurance** that financial statements, **taken as a whole,** are free from material misstatement, **whether due to fraud or error**. For those laws and regulations **"generally recognized to have a direct effect"** on the determination of material amounts and disclosures, auditor's responsibility is to obtain **"sufficient and appropriate audit evidence"** regarding compliance.	An audit performed in accordance with GAAS "**provides no assurance** that all noncompliance with laws and regulations will be detected…" Overall objectives of audit include obtaining "reasonable assurance about whether the financial statements, **taken as a whole,** are free from material misstatement, **whether due to fraud or error.** " Auditor's objectives include "obtain[ing] sufficient appropriate audit evidence regarding **material amounts and disclosures** … determined by … laws and regulations generally recognized to have a **direct effect** on their determination."

NOCLAR

Comparative Standards: Audit Scope Relating to NOCLAR

PCAOB	GAO Yellow Book	'34 Act Section 10A	Intl. Auditing Stds.	AICPA
Auditor **should** obtain assurance prior to report that AC "adequately informed" with respect to illegal acts that come to auditor's attention. Auditor **should** communicate directly with AC if management suspected of involvement. **May be oral or written.** If auditor concludes that an illegal act has material effect and not properly accounted for or disclosed, **should express** qualified or adverse opinion "depending on materiality of the effect." If client precludes auditor from obtaining sufficient evidence to evaluate illegal act/materiality, should disclaim an opinion, and withdraw from engagement (with written explanation to AC) if client refuses to accept modified report. Notification of third parties "not normally part of auditor's responsibility" with limited exceptions.	Audit report **should describe** scope of auditor's testing of compliance with compliance with provisions of laws, regulations, contracts or grant agreements , and whether the tests provided sufficient, appropriate audit evidence. Auditor **should include** in report on internal control and compliance any findings, based on **sufficient and appropriate evidence**, about (i) fraud & noncompliance with laws and regulations that have material effect on financial statements; and (ii) noncompliance with grant agreements that has material effect on financial statement amounts. Auditor **should report** known or likely fraud or non-compliance to third parties when management (i) fails to satisfy legal/regulatory disclosure requirements or (ii) fails to take timely and appropriate steps to respond.	If auditor detects or becomes aware of illegal act, it **shall, in accordance with GAAS**, inform management and assure that audit committee is informed. If auditor concludes that illegal act (i) has **material effect** on financial statements; (ii) mgmt. has not taken, and BOD has not required, **appropriate remedial action**; and (iii) such failures likely require departure from auditor's report or require auditor's resignation, then auditor shall "as soon as practicable" directly report its conclusions to the board. Auditor **must resign** if issuer's board fails to notify SEC within one business day of receiving auditor's notification of illegal act.	Unless management aware of identified or suspected non-compliance reported by auditor, auditor shall communicate, **unless prohibited by law or regulation**, matters involving non-compliance with laws and regulations that come to auditor's attention. If **in auditor's judgment** non-compliance is intentional and material, auditor shall communicate as soon as practicable with management. If management suspected of involvement, auditor must communicate with next higher level of authority, and, if none, "**should consider** the need to obtain legal advice." If non-compliance has material effect on and is not adequately reflected in financial statements, auditor **shall** express qualified or adverse opinion. Auditor **shall determine** "whether law, regulation or relevant ethical requirements" require reporting suspected non-compliance to third parties.	If auditor suspects non-compliance, auditor **should** discuss with management and, **when appropriate**, those charged with governance. If they fail to provide sufficient information to support the entity's compliance with laws and regulations, auditor"**should consider** the need to obtain legal advice." If auditor concludes that non-compliance has material effect on and has not been adequately reflected in financial statements, auditor **should,** in accordance with Section 705, express qualified or adverse opinion. Auditor **should determine** whether it has responsibility to report identified or suspected non-compliance to third parties.

NOCLAR

Current Requirements

U.S. financial statement audits for public companies are governed by a combination of Section 10A of the Securities Exchange Act of 1934 and PCAOB Accounting Standard 2405

NOCLAR

Section 10A

- Enacted in 1995 as part of PSLRA
- Based on existing Professional Auditing Standards
- Requires audit firms to notify the SEC of material illegal acts when an entity's management and board of directors have failed to take timely and appropriate remedial action
- Auditor's obligation to design audit to <u>detect</u> NOCLAR exists only for acts having a "direct and material effect" on financial statement amounts
- Other illegal acts reportable only <u>if</u> auditor becomes aware of

NOCLAR

PCAOB AS 2405

- Adopted by PCAOB in 2003
  - Substance is same as previous AICPA standard
  - Unchanged since adoption
  - Audit testing is limited and lacks clarity with respect to what is "material and direct" illegal acts
  - No obligation to consider other illegal acts unless someone tells the auditor about them
  - Weak reporting standard when compared to other standards such as by GAO
  - 2016 - PCAOB commenced a standard-setting project on the auditor's consideration of noncompliance with laws and regulations.

NOCLAR

PCAOB AS 2405 Provisions

- In evaluating materiality of illegal act that comes to auditor's attention, the auditor should consider both the quantitative and qualitative materiality of the act
- In considering the financial statement effect of an illegal act, the auditor should consider contingent monetary effects, such as fines, penalties, and damages
- Auditor should evaluate adequacy of disclosure in financial statements about potential effects of an illegal act on the issuer’s operations
- For example, if illegal acts create significant unusual risks associated with material revenue sources or earnings, such as the loss of a significant business relationship, such information should be considered for disclosure.

NOCLAR

Requirements of Other Regimes NOT Followed by PCAOB/10A

- GAO Yellow Book
  - Audit Report to describe scope of testing for NOCLAR, contracts and grant agreements
  - Report on internal control and compliance should include findings on NOCLAR that will have a material effect on financial statements

NOCLAR

Requirements of Other Regimes NOT Followed by PCAOB/10A

- International Auditing Standards
  - Enumerate Categories of laws and regulations, compliance with which may be material to the financial statements including
    - Fraud
    - Money laundering
    - Securities Markets and Trading
    - Data Protection
    - Environmental Protection
    - Tax and Pension Liabilities

NOCLAR

Summary of Current State

- Investors expect auditors to uncover non-compliance with laws and regs.
- Auditing standards in this area are outdated, confusing and inconsistent across audit regulators.
- Inquiry requirements are superficial – too much “should” and not enough “must”.
- Assessment and reporting requirements allow for rationalization around materiality – permits delays in accounting and reporting.
- The standard must make it impossible for a situation known to management - regardless of stage of legal development - to exist and not be disclosed to auditors.

An Untenable Gap in PCAOB Standards

NOCLAR

Working Group Recommendations for AS 2405 Changes

- Revise the standard to clarify those audit procedures auditors MUST do versus SHOULD do
- Require auditor to assess the risk of an illegal act as part of the audit planning process, including the audit procedures to be performed
- Clarify that auditor is responsible for detecting illegal acts which could have a material effect on the financial statements and their obligation when they are aware of, or should have been aware of, significant other illegal acts
- Include a non exclusive list of example illegal acts as the IAASB has done

NOCLAR

Working Group Recommendations for AS 2405 Changes (continued)

- Discuss expectations for documentation of illegal acts. Documentation brings discipline to the auditing process
- "Beef up" steps an auditor should perform when a suspected illegal act has come to his or her attention, in order to resolve or confirm the legality of the matter.
- Require the auditor to gain an understanding of the Whistle Blower hot line system, including how it is operated, who calls are reported to, and whether calls and tips have been resolved to the satisfaction of the auditor.

NOCLAR

Working Group Recommendations for AS 2405 Changes (continued)

- Adopt a reporting requirement for both suspected and confirmed illegal acts, including for fraud
- Report using GAO approach and report format
- Require written report to the audit committee and when appropriate, to the applicable authority, regulator and/or law enforcement agency

NOCLAR

Working Group Recommendations for AS 2405 Changes (continued)

- Auditor should be obligated to consider if disclosures are misleading or not, including failure to adequately and timely disclose
- When assessing materiality, the auditor should consider, as a qualitative factor, the "visibility and sensitivity" of the matter to the operations, financial condition and reputation of the company.

NOCLAR

Questions