

**PCAOB STAFF BRIEFING PAPER<sup>1</sup>**  
**ROUNDTABLE DISCUSSION OF PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS  
RELATED TO A COMPANY'S NONCOMPLIANCE WITH LAWS AND REGULATIONS**

**FEBRUARY 26, 2024**

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On June 6, 2023, the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) proposed [Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments](#), referred herein throughout as “proposal” based on recommendations by the staff. The PCAOB received 140 comment letters on the proposal. The Board is considering all comments received. In light of the significant public interest in the proposal, including requests from commenters for the Board to engage in additional public outreach, on March 6, 2024 the staff of the Office of the Chief Auditor (“OCA”) and the Office of Economic and Risk Analysis (“OERA”) (together, the “staff”) will host a roundtable to discuss certain aspects of the proposal and related comments received.

In order to further inform the staff's consideration of the comments received, the Board unanimously voted to re-open the comment period for an additional 21-days.

Interested parties and the general public are invited to view the roundtable and submit additional feedback to the PCAOB on the proposal and matters raised at the roundtable. The staff is particularly interested in substantive comments from the public concerning the roundtable topics, as discussed below, and any points raised during the roundtable.<sup>2</sup> This staff Briefing Paper is meant to assist panelists in preparing for the roundtable and interested parties in submitting additional comments on the proposal.

***I. TOPICS OF INTEREST***

Based on the comments received, the staff are particularly interested in further engagement regarding the proposal's requirements relating to auditors' identification of laws and regulations and assessment of noncompliance with those laws and regulations. The staff are also interested in the costs and the benefits of the proposal, including a potential quantification of each. We ask each panelist to be prepared to discuss these topics and questions of interest, which are provided in detail below. Commenters are also encouraged to submit comments on these topics as well as other topics relating to the proposal.

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<sup>1</sup> This paper was developed by the staff of the Office of the Chief Auditor and the Office of Economic and Risk Analysis to foster discussion among the members of the roundtable and solicit additional feedback from interested parties. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

<sup>2</sup> The roundtable will be live-streamed, and a video archive will be made available. A transcription of the roundtable will become part of the proposal's public record.

## **II. PANEL FORMAT**

The roundtable will be co-chaired by OCA Director and Chief Auditor Ms. Barbara Vanich, CPA, and OERA Director and Chief Economist Prof. Martin Schmalz, Ph.D. The co-chairs will introduce each topic and will pose follow-up questions to panelists. As noted throughout the proposal and below, panelists are encouraged to discuss with specificity the proposed requirements as they relate to the topics below. Panelists who believe the Board should adopt an alternative approach should be prepared to present such alternatives with sufficient detail and discuss and respond to questions.

## **III. PANELIST SELECTIONS**

After considering comments received, staff have identified and invited three cohorts of panelists to participate in the roundtable. Each of these cohorts consists of individuals who represent an array of perspectives and viewpoints. These cohorts include: a subset of commenters with diverse viewpoints including those representing investors, auditors, preparers, and audit committees; subject matter experts in the fields of economics, corporate and securities laws, accounting, financial reporting, and auditing; and commenters and experts who serve on the Board's Advisory Groups.

## **IV. LINKS TO RELEVANT DOCUMENTS, STANDARD, AND RULE**

Participants and commenters should refer to the materials noted below. The proposing release, among other things, includes the proposed changes to PCAOB standards, a discussion of the need for the proposed rule, and a summary of the current requirements.

- [PCAOB Rel. No. 2023-003, Proposing Release: Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments \(June 6, 2023\)](#)
- [AS 2405, Illegal Acts by Clients](#)
- [Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1](#)
- [Rulemaking Docket 051: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations](#)

The roundtable is just one opportunity for commenters to weigh in. We encourage interested parties to submit comments during the re-opened comment period.

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## **BACKGROUND ON PANEL TOPICS**

### **PANEL I: IDENTIFICATION**

As part of planning and performing an audit to obtain reasonable assurance that the financial statements are free from material misstatements, the proposed standard would require auditors to identify laws and regulations with which noncompliance “could reasonably have a material effect” on the financial statements.<sup>3</sup> As part of the proposal, the auditor would identify such laws and regulations based on information obtained from risk assessment procedures and other procedures performed in the audit of the financial statements, in reviews of interim financial information, and, if applicable, in the audit of internal control over financial reporting.

#### **Topic (1): Threshold for Identification of Laws and Regulations**

**Background:**<sup>4</sup> The proposal explained that the phrase “could reasonably have a material effect” would appropriately tailor the proposed 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).<sup>5</sup> 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.<sup>6</sup>

Some commenters generally stated that the term “could reasonably have a material effect” is overly broad and that the proposal lacked sufficient discussion of how to determine which laws and regulations meet this description. Some of these commenters and others also suggested that this requirement would either duplicate the work of the company or require auditors to perform a management function. Other commenters generally supported this proposed requirement, including one that noted directing auditors to identify laws and regulations as proposed will help auditors detect fraud and noncompliance that give rise to material misstatements in financial reporting.

Separately, although the proposal made explicit that firms need to identify only those laws and regulations that “could reasonably have a material effect” on the financial statements, and not *all* laws and regulations, some commenters stated that in order to identify laws and regulations with which noncompliance could reasonably have a material effect, the auditor would need to identify *a complete population* of all laws and regulations to which the company is subject. Other commenters emphasized that the wording in the proposal provides limits to the identification of laws and regulations to only those that could reasonably have a material effect on the financial statements.

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<sup>3</sup> See Proposed AS 2405.05a, *Proposing Release: Amendments to PCAOB Auditing Standards Related to a Company’s Noncompliance with Laws and Regulations and Other Related Amendments*, PCAOB Rel. No. 2023-003, at A1-2 (June 6, 2023).

<sup>4</sup> Throughout this document we have highlighted perspectives provided by commenters on the proposal. This is not reflective of all comments received on a particular topic, but rather certain perspectives shared by commenters to provide context to the questions below.

<sup>5</sup> See PCAOB Rel. No. 2023-003, at 29.

<sup>6</sup> *Id.*

### Questions Related to this Topic:

1. Are there other thresholds besides “could reasonably have a material effect” that would provide sufficient rigor to the auditors’ identification of laws and regulations relevant to the audit of a company’s financial statements?
2. What types of specific procedures should the auditor perform to identify the laws and regulations? Are any of these procedures already required, at least in part, by Section 10A of the Exchange Act or procedures required by existing PCAOB standards? Should auditors be able to consider the work of management in identifying laws and regulations and if so, how?
3. What potential approaches in the standard would facilitate auditors in identifying such laws and regulations (e.g., factors to determine the relevant population of laws and regulations; factors that relate to the risk of material misstatement due to noncompliance with laws and regulations)?

### **Topic (2): Direct Illegal Acts vs. Indirect Illegal Acts**

**Background:** Current PCAOB standards differentiate between direct and indirect illegal acts.<sup>7</sup> However, the current standard contains limited requirements related to the auditor’s identification of illegal acts arising from laws and regulations that have an indirect effect on the financial statements. The current PCAOB standard directs the auditor to be aware of the possibility that such illegal acts have occurred,<sup>8</sup> and the standard and Section 10A(b)(1) of the Exchange Act contain requirements on responding to illegal acts that have or may have occurred that come to the auditor’s attention.<sup>9</sup>

The proposal noted that misstatements of the financial statements harm investors regardless of whether the violation arises from noncompliance with a direct or indirect law or regulation, and the magnitude of this harm does not depend upon the direct/indirect distinction.<sup>10</sup> Moreover, the proposal noted that the distinction is often artificial in practice (e.g., violation of tax laws may directly affect accounts and disclosures and also result in a contingent liability (i.e., indirect effect)).<sup>11</sup>

Staff outreach that informed the proposal has indicated that the distinction in delineating 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,<sup>12</sup> and has caused challenges in implementation of the current standard by auditors.

Some commenters on the proposal specified that the elimination of the distinction between direct and indirect laws and regulations is contrary to the policy choice made by Congress when passing

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<sup>7</sup> See AS 2405.04-.07.

<sup>8</sup> See AS 2405.07 ( “The auditor should be aware of the possibility that [indirect] illegal acts may have occurred. If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.”)

<sup>9</sup> See AS 2405.08-.23.

<sup>10</sup> See PCAOB Rel. No. 2023-003, at 63-66.

<sup>11</sup> *Id.* at 90-91.

<sup>12</sup> *Id.* at 5.

Section 10A in 1995. Some of these commenters further argued that only direct laws are within the scope of internal control over financial reporting. Therefore, these commenters assert, the proposal would expand the scope of an integrated audit into areas outside the auditor’s expertise and into areas that management itself need not address in preparing the financial statements. Some of these commenters asserted that the scope of the proposal is so broad that, if adopted, auditors would effectively have to become compliance professionals by making independent determinations of legal violations, which would either lead to duplication of the company’s compliance function or give auditors oversight of and responsibility for management compliance functions which would transform the role of the auditor.

Other commenters generally supported removing the distinction between direct and indirect, and noted that eliminating the distinction would result in auditors focusing on those laws and regulations that were relevant to the preparation of the financial statements, and carrying out responsibilities investors already believe auditors are performing.

Questions Related to this Topic:

1. Given that noncompliance with both direct and indirect laws and regulations can result in material misstatements of the financial statements, what is your view of the direct/indirect distinction under the current PCAOB auditing standard?
2. How are auditors and management assessing violations of an indirect law or regulation that results in a contingent liability that when not correctly recorded or disclosed misstates the financial statements? Does the direct or indirect nature of the law violated matter to this assessment?

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**PANEL II: CONSIDERATIONS FOR AN AUDITOR’S ASSESSMENT OF NONCOMPLIANCE AND OTHER LEGAL CONSIDERATIONS**

The proposed standard would require the auditor to evaluate noncompliance with laws and regulations when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred.<sup>13</sup> Under the proposed standard, the auditor is then required to (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>14</sup>

**Topic (1): Competence to assess relevant noncompliance with laws and regulations**

**Background:** The proposed requirement for the auditor to obtain an understanding of the nature and circumstances of any noncompliance with laws and regulations that the auditor identifies or otherwise becomes aware of that has or may have occurred is similar to the requirement under existing AS 2405.10. The current standard requires the auditor to obtain an understanding of the nature of an illegal act and the circumstances in which it occurred when the auditor becomes aware of information

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<sup>13</sup> See Proposed AS 2405.07, PCAOB Rel. No. 2023-003, at A1-4.

<sup>14</sup> *Id.*

concerning a possible illegal act. The proposed requirement for the auditor to determine whether under such circumstances any noncompliance likely occurred is consistent with the requirement under Section 10A. Specifically, Section 10A(b)(1) of the Exchange Act requires that, “[i]f, in the course of conducting an audit . . . [a] registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards . . . (A)(i) determine whether it is likely that an illegal act has occurred . . .” Consistent with this requirement, the proposed standard would amend existing AS 2405 to make clear that, once an auditor detects or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred, the auditor must conduct the assessment required by Section 10A(b)(1)(A)(i).

As part of evaluating information indicating noncompliance has or may have occurred, the proposal requires the auditor to consider whether specialized skill or knowledge is needed to assist the auditor with such evaluation.<sup>15</sup> Existing AS 2405.10 only requires the auditor to consult with specialists if management does not provide satisfactory information that there has been no illegal act. However, 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.<sup>16</sup> The auditor may need to engage legal counsel or other specialists to assist the auditor in evaluating whether it is likely noncompliance has occurred or developing more rigorous inquiries of management or others to understand the underlying circumstances of such noncompliance.

Generally, commenters expressed concerns related to the auditor’s skillset to carry out this responsibility. Specifically, many commenters stated that the required responsibilities are in the purview of legal counsel, and auditors lack the necessary competence and expertise to comply with the proposal’s requirements. As a result of the alleged lack of expertise, some commenters noted that there would be a need for increased auditor training, certifications, and use of specialists, which may constrain resources.

Other commenters generally expressed that auditors will be able to identify applicable laws and regulations and that auditors will not be required to function as lawyers.

#### Questions Related to this Topic:

1. How are auditors currently complying with the existing requirements of Section 10A(b)(1)(A)(i) which requires auditors to determine whether it is likely that an illegal act has occurred, when the firm detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred?
2. When an auditor detects or otherwise becomes aware that an illegal act may have occurred, does the evaluation of a potential illegal act differ with respect to direct and indirect laws and regulations? What are those differences in the evaluation process?
3. When an auditor has identified or otherwise becomes aware of a potential illegal act, what is the interaction between the auditor and those hired or employed by the company to perform

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<sup>15</sup> *Id.* at 43.

<sup>16</sup> *See* AS 2101.16-.17.

an investigation? For example, do auditors evaluate the work performed by such personnel as part of performing their assessment? If so, what does such an evaluation entail? Do auditors have input into how the investigation is conducted for purposes of its sufficiency for the audit? Do auditors receive debriefings on interviews of key witnesses in such investigations?

4. What specific auditing procedures can auditors perform to identify and assess either (1) laws and regulations with which noncompliance could reasonably have a material effect on a company's financial statements or (2) the related assessment of the risk of material misstatement that are within the auditor's skillset (e.g., reading relevant minutes, inquiring of compliance personnel, examining whistleblower hotline records, reading regulatory correspondence)?

## **Topic (2): Concerns Regarding Potential Waiver of Attorney-Client Privilege**

**Background:** The proposal requires auditors to strengthen their risk assessment procedures concerning noncompliance with laws and regulations with respect to the identification of laws and regulations, including through obtaining a stronger understanding of company compliance systems and conducting more robust inquiries of company personnel. The existing planning and risk assessment standards, AS 2101 and AS 2110, already require the company to understand a company's regulatory environment and relevant laws and regulations.<sup>17</sup>

Some commenters have indicated that the proposed expanded procedures will lead to auditors' requiring greater access to legal files and other attorney-client privileged information, which would result in waiver of a company's attorney-client privilege and an undermining of a company's attorney-client relationship. For example, commenters from public companies have highlighted that company personnel would be less likely to share information with counsel if those privileged communications would ultimately be waived, which would result in fewer disclosures to counsel about noncompliance.

### Questions Related to this Topic:

1. In light of the attorney-client privilege issues raised by some commenters, how do audit firms currently comply with requirements of PCAOB standards and Section 10A of the Exchange Act?
2. How would the proposed amendments affect the privilege differently than current audit requirements?
3. Commenters and staff have observed that noncompliance with laws and regulations are typically identified by issuers through means (which are nonprivileged) such as, systems designed to address violations of laws and regulations or company policy (e.g., ethics and compliance hotline). Are there other common areas of identification of noncompliance such as through privileged communications? Where privileged communications are the source for a company's knowledge of noncompliance, in what situations do companies disclose the noncompliance to third parties including auditors, investors, regulators, and/or criminal authorities?

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<sup>17</sup> See PCAOB Rel. No. 2023-003, at 29-30.

4. In addition to commenters' concerns regarding the potential waiver of attorney-client privilege, how do the considerations above relate to the potential waiver of work-product protection? Do the proposed amendments affect work product differently?

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### **PANEL III: ECONOMIC IMPACTS**

The expected benefits of the proposal include improving audit quality by requiring auditors to better identify, evaluate, and communicate a company's noncompliance with laws and regulations, which can lead to more timely intervention by companies to cease and remedy noncompliance, thereby reducing the harm to investors and the public caused by noncompliance.<sup>18</sup> To the extent that investors currently expect that auditors play a larger role in identifying noncompliance than they actually do, as some commenters have indicated, the proposal would help reduce the expectations gap between investors and auditors, which can increase investor confidence in financial statements and the capital markets generally.<sup>19</sup>

The proposal identified costs of the proposed standard to firms that would include certain fixed costs related to updating audit methodologies and tools and training staff.<sup>20</sup> Variable costs for firms would include efforts to identify the relevant laws and regulations, assess risks of material misstatement due to noncompliance, and develop audit responses. The magnitude of the costs will likely depend on the nature of the company and its operations and the related regulatory environment. The proposal also highlighted that the likely cost of the proposed standard to companies would include engaging with the auditor to respond to information requests and increased audit fees.<sup>21</sup>

#### **Topic: Benefits and Costs of Proposal**

**Background:** Several commenters stated that the proposal would enhance audit quality by increasing the focus on the auditor's assessment of material misstatements resulting from noncompliance with laws and regulations.

At least one commenter expressed concerns that the economic benefits of the proposal were only hypothetical or uncertain (whereas the costs would be substantial and tangible). Some commenters perceived a lack of evidence presented in the proposal that the proposed requirements would reduce the instances of noncompliance with laws and regulations compared to the current baseline. Many commenters expressed concerns regarding the potential increase in costs and in audit fees due to the proposal. Concerns include the need for involvement of legal specialists and experts; the potential need for companies to allocate more internal resources to comply with the proposal; the potential for increased cost, time, and inefficiencies that could arise from duplicative compliance-related tasks; and the potential for increased costs of professional indemnity insurance for firms.

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<sup>18</sup> *Id.* at 72-76.

<sup>19</sup> *Id.* at 73.

<sup>20</sup> *Id.* at 76-84.

<sup>21</sup> *Id.* at 78.



One commenter noted that both the projected cost and economic detriment arguments are common refrains investors hear and are regularly used to defer or cease progress on issues of importance to investors. The commenter indicated that the projected costs and economic detriment never manifest in the degree projected by those opposed to changes. Other commenters pointed to the costs associated with undetected noncompliance with laws and regulations, supporting the proposal's benefits.

Questions Related to this Topic:

1. What do panelists or commenters perceive as the economic benefits and costs of the proposal and how do they differ from the *status quo*, both quantitatively and qualitatively? Whenever possible, provide your responses separately by firm size (e.g., large, medium, small) and stakeholder (e.g., preparers).
2. Please share any additional data or studies to clarify the economic impacts. Are panelists or commenters aware of additional data or studies on the current cost of unidentified noncompliance with laws and regulations on investors?
3. What do panelists or commenters perceive as the impact of the proposal on small- and medium-sized audit firms and how have you quantified such impact?
4. What broader impacts have you determined of auditors' identification of noncompliance with laws and regulations that could reasonably have a material effect on the financial statements to the capital formation or, more broadly, macro socioeconomic environment? Are there data or studies that can help us estimate those impacts? For instance, is there evidence to suggest that capital costs would be lower if investors had greater confidence that auditors would identify noncompliance with laws and regulations that could reasonably have a material effect on the financial statements?
5. To the extent panelists or commenters provide additional alternatives, are there data or studies that can help us estimate the benefits and costs of any of these alternatives?
6. In light of the discussion of costs and benefits, how do investors, issuers, and auditors view the justification of the proposal?

In discussing these costs and benefits, we strongly encourage panelists to be prepared to discuss the quantitative impact of the proposal on audit fees; issuers' internal costs as a result of identification, evaluation, and communication of information indicating that noncompliance with laws and regulations has or may have occurred; auditors' existing reliance on compliance work and legal analyses already carried out by issuers; and potential costs associated with auditor's use of specialists.

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