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This is a lightly edited version of a newsletter published on The Dig on October 24, 2023.[1]

PCAOB NOCLAR is necessary but not for the reasons you think *The proposal should be approved. It should not be necessary.*

The PCAOB's proposal, *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations,* NOCLAR, is intended to be an update of existing auditing standard AS 2405*, Illegal Acts by Clients*. I think the PCAOB's proposal should be approved.

But it should not have been necessary.

Why is the PCAOB proposing NOCLAR now? Because too many times the auditors are nowhere to be found when their clients have been subject to major fines and legal judgments as a result of illegal or fraudulent conduct that materially impacts the financial statements!

PCAOB Chair Erica William's *Statement on the Proposed New Standard Regarding Noncompliance With Laws and Regulations* this past June explains:

[1] Available at: https://thedig.substack.com/p/the-pcaobs-noclar-proposal-is-necessary

> "A company's noncompliance with laws and regulations, including fraud, can have devastating consequences for investors. **When sanctions, fines, and civil settlements directly affect a company's bottom line, or reputational damage causes a company's stock value to decline, innocent investors pay a price.**
>
> Unfortunately, there is no shortage of examples. **Well-publicized issues relating to Wells Fargo offer just one.** Last month, Wells Fargo agreed to pay $1 billion to settle a class-action lawsuit from investors alleging it made misleading statements about compliance with consent orders imposed by federal regulators."
>
> A lawyer for those investors underscored just who gets hurt when these incidents happen, saying the settlement would "help compensate hundreds of thousands of investors — state employees, nurses, teachers, police, firefighters and others — whose critical retirement savings were impacted by Wells Fargo's fraudulent business practices."

What did Wells Fargo auditor KPMG say about its audit client when the account opening fraud story broke? I wrote

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about it for MarketWatch[2], and even I was shocked at the firm's sprezzatura, its studied nonchalance in the face of chronic illegal acts.

> KPMG wrote to Senators who questioned "where were you" that it did become aware, as early as 2013, of "instances of unethical and illegal conduct by Wells Fargo employees, including incidents involving these improper sales practices." But the firm said it was "satisfied that the appropriate members of management were fully informed with respect to such conduct."
>
> Yet the auditor said nothing about these issues to investors, either in its audit opinion, its opinion on the bank's internal controls, or elsewhere.
>
> Instead, KPMG told the senators[3], its view is that "not every illegal act has a meaningful impact on a company's financial statements or its system of

[2] "Where was Wells Fargo's auditor KPMG while the funny business was going on?" MarketWatch, Francine Mckenna and Andrea Riquier, August 17, 2017. Available at: https://www.marketwatch.com/story/where-was-wells-fargos-auditor-kpmg-while-the-funny-business-was-going-on-2017-08-17

[3] See: https://www.warren.senate.gov/files/documents/2016_11_28_KPMG_Response.pdf?_ga=2.129379724.1802620313.1502978510-1739014247.1502978510

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> internal controls over financial reporting. From the facts developed to date, including those set out in the CFPB settlement, the misconduct described did not implicate any key control over financial reporting and the amounts reportedly involved did not significantly impact the bank's financial statements."

This PCAOB leadership team has been proposing and approving several standards that confirm, emphasize and, in some cases, simply clarify obligations that auditors already have but have, over and over, failed to fulfill.

For example, *The Auditor's Use of Confirmation, and Other Amendments to PCAOB Standards*, a new standard[4] adopted in September, is intended "to strengthen and modernize the requirements for the auditor's use of confirmation – the process that involves verifying information about one or more financial statement assertions with a third party."

But what's really new here?

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[4] *The Auditor's Use of Confirmation, and Other Amendments to PCAOB Standards*, PCAOB Release No. 2023-008, September 28, 2023. PCAOB Rulemaking Docket Matter No. 028. Available at: https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket_028/2023-008_confirmation-adopting-release.pdf?sfvrsn=e18cef74_2

A press release says that the new confirmation standard "reflects changes in technology, communications, and business practices since the interim standard was first adopted by the PCAOB in 2003 after being issued by the AICPA in 1991." The emphasis is to protect investors "by strengthening procedures that enhance an auditor's ability to identify fraud in certain circumstances and improving overall audit quality."

But there is actually only one new requirement in the confirmation standard update. Auditors must now confirm cash and cash equivalents held by third-parties or otherwise obtain relevant and reliable audit evidence by directly accessing information maintained by a knowledgeable external source. It's a shame that requirement, a common sense one, had to be made explicit. There have been so many frauds where bank confirms were either not done at all or done poorly and the auditors "duped" by management or other criminal actors.

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Parmalat[5], Satyam[6], Wirecard[7], many of the Chinese reverse merger frauds like Longtop[8], PFG Best[9], and now FTX[10] are all instances where auditors, including Big 4 auditors, either did not confirm bank balances at all or were fooled by fakes and fraudsters including at the banks.

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[5] "Parmalat forged accounts, says bank," *The Guardian*, December 23, 2003. Available at: https://www.theguardian.com/world/2003/dec/23/italy.business

[6] "Price Waterhouse India settles with regulators but Satyam saga not over," *Forbe*s, Francine McKenna April 6, 2011. Available at: https://www.forbes.com/sites/francinemckenna/2011/04/06/price-waterhouse-india-settles-with-regulators-but-satyam-saga-not-over/?sh=7782c0702794

[7] "EY and Wirecard: Anatomy of a Flawed Audit," *Financial Times*, Olaf Storbeck, October 25, 2021. Available at: https://www.ft.com/content/bcadbdcb-5cd7-487e-afdd-1e926831e9b7

[8] "The Audacity of Chinese Frauds*," The New York Times,* Floyd Norris, May 26, 2011. Available at: https://www.nytimes.com/2011/05/27/business/27norris.html

[9] "When Big 4 audit firms need an audit they choose cheap," *Medium.com*, Francine McKenna, October 14, 2014.

[10] "'A Complete Failure of Corporate Controls': What Investors and Accountants Missed in FTX's Audits," *CoinDesk*, Francine McKenna, November 18, 2022. Available at: https://www.coindesk.com/layer2/2022/11/18/a-complete-failure-of-corporate-controls-what-investors-and-accountants-missed-in-ftxs-audits/

Let's look at what the PCAOB said to PwC India firms[11] in 2011, 13 years ago, about their seriously deficient work in not following standards when confirming the Satyam bank balances:

> "In auditing Satyam's financial statements, PW Bangalore and Lovelock used a procedure to test Satyam's cash balance that did not comply with the PCAOB auditing standard governing the confirmation process. Contrary to their own audit plan and PCAOB standards, PW Bangalore and Lovelock relied on Satyam management to send confirmation requests to Satyam's banks, and relied on Satyam management to return purported confirmation responses from the banks to the auditors.
>
> The Board found that deficient cash confirmation procedures contributed to the failure of the firms to detect that Satyam's cash balance was materially

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[11] PCAOB Announces Settled Disciplinary Order Against PricewaterhouseCoopers International Firms in India for Audit Violations Related to Satyam, PCAOB, Washington, D.C., Apr. 5, 2011. Available at: https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-announces-settled-disciplinary-order-against-pricewaterhousecoopers-international-firms-in-india-for-audit-violations-related-to-satyam_331

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> overstated. Satyam management used these bank confirmations as part of a cover up of its scheme to inflate the company's reported cash balance by approximately $1 billion."

It's incredible to me that Grant Thornton and Deloitte were faked out by Parmalat more than twenty years ago, and then that PwC didn't independently check up on Satyam's bank balances fifteen years ago. I incredulous that auditor EY skipped this basic step in 2020 when non-existent billions allegedly led to the bankruptcy of Wirecard. More recently Armanino and Prager Metis were allegedly fooled by FTX.

The confirmation standard also makes it clear that the use of negative confirmation requests alone does not provide sufficient appropriate audit evidence. What is a negative confirmation request? That's when the auditors' confirmation request says, "Tell us if this financial statement cash balance is wrong." Fraudsters can dodge this by saying no or not answering at all. Auditors apparently are still using this ineffective approach and aren't following-up.

Why was it necessary for the PCAOB to propose and adopt a new confirmation standard? Because auditors keep screwing up a fundamental lesson they should have learned in accounting school: cash is king and fraud is often

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accomplished by faking it. Students should learn about the importance of convincingly confirming cash early in their accounting career because cash is likely material to the company's assets and can be faked 100 ways to Sunday. But auditors, including the largest global firms, keep failing this test.

It's the same with the PCAOB's midterm standard setting project[12] to consider "how AS 2401, *Consideration of Fraud in a Financial Statement Audit*, should be revised to better align an auditor's responsibilities for addressing intentional acts that result in material misstatements in financial statements with the auditor's risk assessment, including addressing matters that may arise from developments in the use of technology."

There is again, sadly, a need to reiterate and emphasize, more forcefully, the auditors' obligation to plan and perform the audit to detect material misstatements whether due to error ***or fraud***.

This was always the case.

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[12] Standard-Setting, Research, and Rulemaking Projects, PCAOB. Available at: https://pcaobus.org/oversight/standards/standard-setting-research-projects

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In November 2013 the PCAOB published a very useful, and at the time very brave Appendix to a discussion document distributed at a PCAOB Standing Advisory Group meeting[13]. The agenda item for the meeting was, "Consideration of Outreach and Research Regarding the Auditor's Approach to Detecting Fraud". The appendix provides a detailed overview of auditors' obligations under existing PCAOB standards to design and perform the audit to detect fraud — from engagement acceptance and continuance to reasons to resign an audit and covers Section 10A of the Securities and Exchange Act of 1934. Section 10A of the Securities and Exchange Act of 1934 requires auditors to report to the SEC when, during the course of a financial audit, an auditor detects likely illegal acts that have a material impact on the financial statements and appropriate remedial action is not being taken by management or the board of directors.

More recently a federal judge made the auditors' duty to perform and audit according to standards which require the consideration of fraud in the planning and performance of

[13] Standing Advisory Group meeting consideration of outreach and research regarding the auditor's approach to detecting fraud, November 15-16, 2012. Available at: https://assets.pcaobus.org/pcaob-dev/docs/default-source/news/events/documents/11152012_sagmeeting/2012_11_15_-sag_bp_-fraud.pdf?sfvrsn=e979a5fb_0

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the audit plain in her 2018 decision against PwC for the 2009 failure of Colonial Bank. On July 2, 2018, Judge Barbara Jacobs Rothstein of the United States District Court for the Middle District of Alabama wrote[14] that the FDIC was "entitled to recover all reasonably foreseeable losses Colonial incurred from its ongoing fraudulent relationship with TBW," and "[t]here can be no real dispute (indeed PwC does not raise one) that it was foreseeable that because PwC failed to detect the fraud, Colonial would continue to fund TBW-originated mortgages, both legitimate and fake."

Judge Rothstein found on December 28, 2017 that PwC had breached its professional duty to exercise reasonable care in performing its audits by failing to plan and perform its audits to detect fraud and failing to obtain sufficient audit evidence that would have led to discovery of the Colonial Bank-TBW fraud.

Judge Rothstein ordered PwC, the former auditor for now-defunct Colonial Bank, to pay the Federal Deposit Insurance Corp. $625 million in damages arising out of PwC's failure

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[14] See Federal Deposit Insurance Corporation v. PricewaterhouseCoopers LLP et al, No. 2:2012cv00957 (M.D. Ala. 2013).

to detect the "massive fraud" perpetrated by employees of Colonial Bank and Taylor, Bean & Whitaker Mortgage Corporation from 2002-2009, which ultimately led to Colonial Bank's failure.

It was the largest ever damages award for auditor liability.[15] The two sides eventually settled for $335 million.

Judge Rothstein's decision in *FDIC v. PwC*, the 2013 PCAOB document, and the SEC's ongoing emphasis on the auditors' public duty should have been the last words on whether the auditor has an obligation under law to plan and perform the audit to detect fraud and illegal acts at its audit clients. The auditors may have stopped saying "the audit is not designed to detect fraud" to journalists, at least in the US and UK, since it sounds ridiculous as well as being wrong. However, it is possible they continue to say it in court where the media and the public often can't hear them given the penchant for everyone to agree to seal depositions and other exhibits for expediency.

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[15] "FDIC win against PwC could finally force auditors to look for fraud," MarketWatch, Francine McKenna, Jan. 5, 2018. Available at: https://www.marketwatch.com/story/fdic-win-against-pwc-could-finally-force-auditors-to-look-for-fraud-2018-01-04 and https://www.fdic.gov/foia/plsa/al-colonialbankpwc.pdf.

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And so the myth dies hard...

The SEC Chief Accountant Paul Munter[16] had to remind them recently:

> "Auditors are **gatekeepers** and therefore the importance of their responsibilities with respect to the identification of risks of material misstatement due to fraud ("fraud risks") and the detection of material misstatements in the financial statements due to fraud should not be underestimated. This is particularly true because any changes to the macroeconomic and geopolitical environment in which companies operate may result in new pressures, opportunities, or rationalizations for fraud. Areas that have historically been a focus for auditors—**the tone at the top of a company and the effectiveness of internal controls**—appear to be key factors in either exacerbating or mitigating such pressures, opportunities, or rationalizations for fraud.

[16] "The Auditor's Responsibility for Fraud Detection," Statement of Paul Munter, SEC Chief Accountant, Oct. 11, 2022. Available at: https://www.sec.gov/news/statement/munter-statement-fraud-detection-101122

> **Auditors must plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error *or* fraud.** The PCAOB auditing standards further require auditors to exercise **due professional care**, which requires the auditor to exercise **appropriate levels of professional skepticism** throughout the audit."

And, so, like the "update" to the confirmations standard and the project to update the standard that outlines the duty to "plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error *or* fraud," it is unfortunately necessary for the PCAOB to propose the new NOCLAR standard. That's because it is unfortunately necessary to remind auditors that they have always had an obligation to know the laws and regulations that are applicable to the audit client's environment and the impact of violations of those laws on the financial statements.

As in the cash confirmation standard and the fraud project, there is little new in the NOCLAR standard itself. You see the words "enhance" and "clarify" used a lot to imply that the auditors needed the PCAOB, and SEC, to hit them over

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head with the equivalent of a baseball bat to get them to perform their public duty.

There are only a few new things in the NOCLAR proposal.

- Replace the term "illegal acts" with "noncompliance with laws and regulations" and expressly include fraud, as defined by PCAOB standards, within the definition of noncompliance with laws and regulations. *(This, in my opinion, is the PCAOB afraid to talk plainly and sadly feeling the necessity of speaking to the auditors as if they were babies.)*
- Expand the auditor's obligation to plan and perform audit procedures to (1) identify 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 such noncompliance with those laws and regulations has or may have occurred.

There is also a small piece to cover the impact of the standard on interim reviews by amending AS 4105, *Reviews of Interim Financial Information*. Otherwise, it is all "enhance" and "clarify". The auditors' obligations to understand the

legal and regulatory environment that their audit clients are operating in, and how legal and regulatory issues may affect the financial statements, are outlined in more than one auditing standard.

I wrote in a newsletter found at my site *The Dig*[17] of KPMG's obligation to understand what banking regulators were saying about its clients Silicon Valley Bank, First Republic Bank, and Signature Bank. How would KPMG have known what the Fed and California DFPI were telling SVB about weaknesses in its risk management and internal audit functions, among many other operational and management weaknesses? I explained how almost ten years to the day of the most recent banking crisis, on March 13, 2013, when I wrote for Forbes about this issue with regard to the JPM "Whale" trades debacle.[18]

> "Between July and December 2012, the OCC issued six Supervisory Letters covering the problems

[17] "Part 1: Where was KPMG while Silicon Valley Bank, and the rest, were teetering?" The Dig, Francine McKenna, May 13 2023. Available at: https://thedig.substack.com/p/where-was-kpmg-while-silicon-valley

[18] "No Accounting For Auditor PwC At Levin's Whale Hearing," *Forbes,* Francine McKenna, March 13, 2013. Available at: https://www.forbes.com/sites/francinemckenna/2013/03/18/no-accounting-for-auditor-pwc-at-levins-whale-hearing/?sh=22bc99de6ff9

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> detected as a result of the "Whale" trade losses. The Supervisory Letters include 20 *Matters Requiring Attention* (MRAs) which the bank must address with corrective action.
>
> The Federal Deposit Insurance Act Section 36(h) requires each bank and savings institution to provide its independent auditor with copies of the institution's most recent call report and examination report. Banks “must also provide the auditors with any MOU or other written agreement between the institution and any federal (or state) banking agency, and any report of any action initiated or taken by any federal (or state) banking agency.”
>
> PwC should have received all OCC reports on the bank and been fully aware of all of the OCC’s concerns about JPMorgan, not just related to the “Whale” trades, and especially during 2012."

Auditing Standard 2101, *Planning*, includes the following requirements for the auditor to evaluate to determine if they have an impact on the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's tests and procedures:

- 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;
- Legal or regulatory matters of which the company is aware;
- The relative complexity of the company's operations.

One of the big objections to the NOCLAR proposal is that it might jeopardize attorney-client privilege. That's just throwing spaghetti against the wall to see if it sticks. It allows me to remind the reader of one of the most common illegal acts that audits never seem to flag for investors: violations of the Foreign Corrupt Practices Act.

I wrote about this at *The Dig* in the context of surprise litigation settlements, most of which are, surprisingly these days, fully accrued for when announced. However, the

accrued amount is not disclosed earlier in connection with the settled litigation.[19]

> What happened to 3M's share price after all this bad news about unreserved multibillion dollar liabilities for litigation and an SEC enforcement action for FCPA violations at its China subsidiary was revealed on June 22, August 25, and August 29? It went up.
>
> That's possible because as each announcement is made, earnings information is spun positively via the use of non-GAAP adjustments that erase the impact of no reserves for these huge hits, as if each time in an ongoing onslaught of legal judgments is the last time, and that every time they happen, they are an anomaly.
>
> What did the auditor, in this case Maura Elizabeth DePrisco at PwC, know about the status of the 3M legal risks and contingencies every time a 10-Q or 10-K was filed? (Incidentally, DePrisco was also the engagement partner for Medtronic when it was hit by

[19] "Ready or not litigation settlements continue to surprise investors," The Dig, Francine McKenna, September 1, 2023. Available at: https://thedig.substack.com/p/ready-or-not-litigation-settlements

a number of litigation issues, including FCPA violations.)

That's an interesting question that touches on an issue that has come up now in discussions about the U.S. audit regulator's, the PCAOB's, proposal to update AS 2405, *Illegal Acts by Clients*, with a new AS 2405, *A Company's Noncompliance with Laws and Regulations*, or NOCLAR for short. Critics of the proposal have mentioned that the proposal would weaken attorney-client privilege protections.

Tom Quaadman commenting for the U.S. Chamber of Commerce: "Furthermore, the Proposal would potentially require information to be provided to auditors in such a way to violate attorney-client privilege protections thus opening the company to additional wide-ranging litigation and discovery risks."

This issue of attorney-client privilege is often thrown out to explain why auditors are unable to second-guess the adequacy of accruals and disclosures for litigation contingencies. That is, auditors can't judge what they don't know because lawyers say they are not allowed to tell them.

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Attorney-client privilege is a red herring. If auditors can't be brought into the "circle of trust"[20] to know how pending litigation and regulatory actions for illegal acts might materially impacts on the financial statements, the opinions on financial statements of most issuers, especially banks, oil companies, pharmaceuticals, and every other frequently sued company are worthless.

Note also the example I described of a PwC partner that has presided over two material FCPA violations at companies where she signed the audit. It's not hard to find many more repeat occurrences of auditors being duped and/or complicit in hiding the inevitable as KPMG did for Wells Fargo.

Those that resist the NOCLAR proposal have not read what SEC Chief Accountant Paul Munter and the PCAOB have said and written about the auditor's obligation to plan and perform an audit to detect fraud and to warn investors of the consequences for the financial statements of clients' fraud and illegal acts.

[20] The term "circle of trust" is how the KPMG partners who were in on the scheme to get the PCAOB inspection lists early and use this info to clean up the audits in anticipation of the inspections referred to themselves. See https://www.justice.gov/usao-sdny/pr/former-kpmg-executive-and-former-pcaob-employee-convicted-wire-fraud-scheme-steal-and

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It's the title of Munter's statement in October 2022, *The Auditor's Responsibility for Fraud Detection*.

> Through OCA's discussions with stakeholders we have heard particularly troubling feedback that **auditors many times frame the discussion of their responsibilities related to fraud by describing what is beyond the auditor's responsibilities and what auditors are not required to do.**
>
> We find this attitude of focusing on the limits of the auditor's responsibilities at the outset as opposed to the affirmative requirements with respect to the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud, **deeply concerning**, as it could impact an auditor's mindset[20] or their degree of professional skepticism, and may thereby reduce the likelihood of fraud detection and potentially result in **dereliction of professional responsibilities to the public trust.**

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Approving the NOCLAR means maybe regulators, and not just private plaintiffs[21], can start holding auditors accountable for not raising their hands when illegal acts such as Wells Fargo and FCPA violations occur.

[21] "Deal with PwC brings Petrobras investors recovery to $3 billion," Reuters, Brendon Pierson, February 3, 2018. https://www.reuters.com/article/us-petrobras-classaction/deal-with-pwc-brings-petrobras-investors-recovery-to-3-billion-idUSKBN1FM26P