



DOCKET 051: AMENDMENTS TO PCAOB AUDITING STANDARDS RELATED TO A COMPANY'S NONCOMPLIANCE WITH LAWS AND REGULATIONS

Issued 18 March 2024

ICAEW welcomes the opportunity to comment on Docket 051: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations, published by the PCAOB on 26 February 2024, a copy of which is available from this [link](#).

For questions on this submission please contact the Audit and Assurance Faculty at tdaf@icaew.com quoting REP 29/24.

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KEY POINTS

1. We applaud the PCAOB's decision to open for public comment questions arising from the 6 March Roundtable discussion of proposed amendments to auditing standards related to NOCLAR. This decision reflects the exceptionally significant concerns raised by a wide range of stakeholders.
2. We believe that re-exposure of the proposals is warranted because substantial changes are likely to be necessary. Re-exposure would also facilitate a more robust cost benefit analysis.
3. We agree with the focus of the Roundtable discussion on the identification of NOCLAR. There is less disagreement over auditor responsibilities to evaluate potential NOCLAR than there is over auditor responsibilities in relation to detection. To prevent both under- and over-auditing, criteria are needed to provide greater clarity regarding the extent of auditor procedures required to identify whether an act has occurred, that might reasonably be expected to have a material effect.
4. Many of the concerns expressed by respondents would be diminished if auditors were explicitly permitted to use the entity's process for identifying noncompliance as a starting point for their assessment, acknowledging that:
 - auditors should obtain an understanding of that process and test relevant controls;
 - where the process is deficient, additional auditor procedures will be required, including procedures relating to the wider population of laws and regulations to be considered.
5. We noted in our response to the UK's recent Financial Reporting Council (FRC) consultation on the same subject that while auditors should not approach the audit through the lens of management, management's approach is nevertheless critical to auditors' understanding of noncompliance.
6. While we expressed our support for the abolition of the distinction between direct and indirect laws and regulations in our comment letter on the PCAOB's June 2023 proposals, we did not express our support for the proposals as a whole. We noted in our response to the recent FRC consultation on the same subject that it was suggested to us by some stakeholders that enhancing and strengthening the identification of risk of fraud might be better achieved by raising the bar for both direct and indirect laws and regulations. In particular, a more thorough assessment of which laws and regulations are classified as indirect might be required, as might a more robust approach and greater specificity regarding the procedures performed thereon. Given the potential problems associated with the proposals as they stand, we believe that further consideration of this as an alternative to abolishing the distinction altogether is merited by both the FRC and the PCAOB.

ANSWERS TO SPECIFIC QUESTIONS

IDENTIFICATION

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

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?

7. We do not disagree with the proposed threshold. However, 'could reasonably have a material effect' would be less burdensome and more effective for both companies and auditors to apply, and less likely to result in disproportionate additional cost, if auditors were explicitly permitted to use the work of management in identifying laws and regulations and the risk of noncompliance therewith, as part of their risk assessment. Criteria are needed to provide greater clarity regarding the extent of auditor procedures required to identify whether an act has occurred, that might reasonably be expected to have a material effect.

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?

8. A risk-based audit approach requires auditors to develop proportionate, appropriate responses to different categories of assessed risk. The proposed abolition of the distinction between direct and indirect laws and regulations seems likely to result in a more nuanced spectrum of risk assessments. Procedures should correspond to the assessed risk.
9. Auditors should be able to consider the work of management in identifying noncompliance with laws and regulations. Auditors should not approach the audit through the lens of management, but management's approach to different categories of laws and regulations is critical to auditors' understanding of noncompliance, and of the population of laws and regulation to consider. Auditors should obtain an understanding of management's process and test relevant controls. If management's process is found to be deficient, as it will be in some cases, auditors will need to perform additional procedures, including procedures relating to the wider population of laws and regulations to be considered.

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)?

10. Factors facilitating auditor identification of laws and regulations include auditors' assessment of management's processes and controls. Factors facilitating identification also include company correspondence with regulators, regulatory thematic reports and other indicators such as information about noncompliance claims against competitors in the public domain, including information relating to overseas jurisdictions in which the company operates.
11. In some cases, this will result in an assessment of populations of laws and regulations that management has not identified.

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

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?

12. While we expressed our support for the abolition of this distinction in our comment letter, we did not express our support for the proposals as a whole. We noted in our response to the UK's FRC on the same subject that it was suggested to us by some stakeholders that enhancing and strengthening the identification of risk in this area might be better achieved by raising the bar for both direct and indirect laws and regulations. In particular, a more thorough assessment of which laws and regulations are classified as indirect might be required, as might a more robust approach and greater specificity regarding the procedures performed thereon. Given the potential problems associated with the proposals as they stand, we believe that further consideration of this as an alternative to abolishing the distinction altogether is merited by both the FRC and the PCAOB.

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?

13. The direct or indirect nature of a law violated is not relevant to the assessment of the violation when it results in a misstated contingent liability. Nor is it relevant to the response to that assessment. The direct or indirect nature of the law is only relevant to the how the risk is identified. It is important to note that the assessment of contingent liabilities involves understanding the range of potential outcomes, as well as the law potentially violated. This is a more important and harder assessment to make determining the direct or indirect nature of the relevant law.

CONSIDERATIONS FOR AN AUDITOR'S ASSESSMENT OF NONCOMPLIANCE AND OTHER LEGAL CONSIDERATIONS

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

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?

14. Procedures employed to determine whether it is likely that an illegal act has occurred depend on the nature of the illegal act, including the extent to which such acts might have a material effect on the financial statements. Procedures also include auditor evaluation of the appropriateness of management's response, such as investigation by an independent external specialist where appropriate, and follow-through with the risk committee, audit committee, board or regulator where appropriate. Procedures employed in relation to illegal acts that could reasonably have a material effect on the financial statements are more extensive than those illegal acts that are less likely to do so.

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?

15. As noted in paragraph 13, above, the direct or indirect nature of a law violated is not relevant to the assessment of the violation or the response thereto. When auditors detect or otherwise become aware that an illegal act may have occurred, direct or indirect, they evaluate whether the violation could reasonably result in a material misstatement in all cases.

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 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?

16. Firms follow defined processes once potential illegal acts are identified, including interaction with those engaged by the company to investigate. This includes engagement with investigators, which involves an assessment of the sufficiency of the scope of their work and an evaluation of the results of that work.

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

17. Specific procedures to assess such laws and regulations include understanding management's approach, inquiry of the company's legal counsel, consideration of reported noncompliance of competitors, and in the wider industry, including outcomes thereof, and consideration of regulatory thematic reports.

(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)?

18. Reading relevant minutes, inquiring of compliance personnel, examining whistleblower hotline records and reading regulatory correspondence are all relevant to the related risk assessment.

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

19. We do not comment of question related to Topic (2): Concerns Regarding Potential Waiver of Attorney-Client Privilege.

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?

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?

ECONOMIC IMPACTS

Topic: Benefits and Costs of Proposal

20. We do not comment on the Topic: Benefits and Costs of Proposal, except to note that we remain of the view that the expected cost of the proposals as they stand are likely to be wholly disproportionate to any benefits in the form of the identification of fraud or enhanced corporate reporting.

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.**