ALM | LAW.COM

New York Law Journal

Public Company Accounting Oversight Board Proposes Role-Altering Audit Standards

By William F. Johnson
July 5, 2023

The Public Company Accounting Oversight Board—the SOX-established audit regulator—recently proposed a set of new and revised auditing standards addressing a public company auditor's responsibility for considering the company's "noncompliance with laws and regulations, including fraud."

Among other things, the proposal would require auditors to proactively identify laws and regulations that, if violated, could have a material effect on the company's financial statements, without regard to whether the impact is direct or indirect, and to determine whether noncompliance has or may have occurred. [*See generally* Pub. Co. Acct. Oversight Bd. Proposing Release: Amends. to PCAOB Auditing Standards Related to a Co.'s Noncompliance with Laws & Reguls. & Other Related Amends., Release No. 2023-003 (June 6, 2023) ("Proposing Release")].

The PCAOB's stated reason for proposing the new standards is that companies' noncompliance with laws and regulations has consequences that impact the financial statements in the form of sanctions, fines, and settlements, which are relevant to investors. [Proposing Release at 4].

However, the new proposal is so extreme that both of the CPA members of the Board refused to support it, with one describing it as a "breathtaking expansion of the auditors' responsibilities." [Christina Ho, Stmt. on Proposed Amends. to PCAOB Auditing Standards Related to a Co.'s Noncompliance with Laws & Reguls. ("Ho Dissent") at 2].

In rare dissenting statements from the issuance of the proposal, these Board members made clear that they believe the new standards would fundamentally change the auditor's role.

Credit: EtiAmmos/Shutterstock.com

Until now, at least, that role has been to obtain reasonable assurance that the company's financial statements are free of material misstatement, whether due to fraud or error. [AU Section 110.02]. It has been management's responsibility to "adopt[] sound accounting policies and…establish[] and maintain[] [a system of] internal control that will…initiate, record, process and report transactions[, events, and conditions], consistent with management's assertions embodied in the financial statements."[AU Section 110.03].

The PCAOB's proposal seems to blur the auditor's role with that of management, and dramatically expand auditors' responsibilities to encompass and integrate legal identification and analysis into risk assessment and audit procedures to identify whether noncompliance has or may have occurred.

Current Role of Auditors and Related Standards

Under existing standards, auditors perform the audit to obtain reasonable assurance that the company's financial

statements are free of material misstatement, whether due to fraud or error. [Proposing Release at 4; Duane DesParte, Stmt. on Proposed Amends. to PCAOB Auditing Standards Related to a Co.'s Noncompliance with Laws & Reguls. ("DesParte Dissent") at 1].

Auditors typically perform this function by collecting, reviewing, and verifying management's information and the procedures management has performed. Auditors rely on and substantiate management's information to determine whether reported financial statement figures are an accurate representation of the company's financial position, assess whether financial statement disclosures are accurate, and assess the adequacy of the company's internal control environment.

Given this background, it is consistent with the auditor's role in performing the financial statement audit to plan and perform procedures to address risks of material misstatement from noncompliance, regardless of whether the impact on the financial statements is direct or indirect. [DesParte Dissent at 2].

In fact, the standards currently require auditors to understand clients' regulatory environments, including the applicable legal framework, as part of their risk assessment and audit procedures. [Proposing Release at 6; *see also* Pub. Co. Acct. Oversight Bd. Release: Auditing Standards Related to the Auditor's Assessment of and Response to Risk & Related Amends. to PCAOB Standards, Release No. 2010-004 (Aug. 5, 2010) at A5–3].

AS 2405, the existing audit standard covering "illegal acts by clients," requires auditors to perform procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on a company's financial statements. [15 U.S.C. §78j-1(a)(1)].

Proposed Enhancements

The PCAOB's proposal seeks to replace AS 2405 entirely with a new standard for the auditor to inquire regarding a company's "noncompliance with laws and regulations."

This new standard would require the auditor to identify all laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, to incorporate potential noncompliance with laws and regulations into the auditor's risk assessment, and to identify whether noncompliance has or may have occurred.

These additional obligations include planning and performing procedures to identify whether there is information available that may indicate noncompliance. [Proposing Release at 5; *see also* DesParte Dissent at 2].

In addition to the substantial burdens this proposal would impose at the planning and risk assessment phases of the audit, it would also require auditors to take additional steps in instances when an auditor identifies actual or potential noncompliance.

These steps include performing procedures to understand the nature of the matter and to evaluate whether noncompliance has occurred. The proposal requires auditors to take significant steps even if it is unlikely that noncompliance will have a material effect on the financial statements, or if it is unclear whether noncompliance has occurred.

The proposal broadens auditors' responsibilities even further by enhancing required communications between the auditor, management, and the audit committee.

Even where an instance of potential or actual noncompliance is "clearly inconsequential," the auditors must communicate with management and document how they concluded that the potential noncompliance is "clearly inconsequential."

If the auditors determine that the potential noncompliance is not "clearly inconsequential," they must communicate with both management and the audit committee in two stages.

First, the proposal requires that the auditor, upon learning of the potential noncompliance, communicate that fact to management and the audit committee.

It seems unnecessary and inefficient to require such preliminary disclosure to the audit committee before the auditor has evaluated whether noncompliance has occurred and whether any potential impact has resulted.

This new requirement runs the risk of unnecessarily burdening both the auditors and the audit committee during the audit.

Second, after the auditor has conducted an evaluation of the matter to determine whether noncompliance has occurred and whether there is a related impact on the financial statements, the auditor must communicate again with management and the audit committee. [Proposing Release at 48–49].

Practical Impact of the Proposal

Role of the Auditor. As recognized by Christina Ho, one of the PCAOB's two CPA Board members, the proposed changes "introduce[] ambiguities regarding auditor obligations to investors, by transforming the auditor's role from one of providing reasonable assurance to one of performing a management function." [Ho Dissent at 3].

It does seem that the PCAOB's proposal, if adopted, would fundamentally alter the traditional role of the auditors by superimposing a management or investigative role on them.

To begin with, identifying all laws and regulations that could reasonably impact a company's financial statements falls squarely within management's expertise.

The proposal attempts to downplay just how much this requirement will strain audit teams across all engagements by performatively speculating that "[t]hese 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." [Proposing Release at 22, 29].

The proposal does not provide guidance for how auditors should discern which laws and regulations fall on either side of that line. In a real sense, however, for an auditor to determine which laws and regulations will be relevant to the company or its operations, the auditor must first scope out the entire universe of laws that may be applicable. This is a near impossible task without specialized legal knowledge and developed subject-matter expertise.

The auditor's traditional role has been to review management's processes and representations. In this regard, the proposal states that although "the auditor would be able to benefit from management's process to identify [relevant] laws and regulations," that identification "would not be limited to those laws and regulations identified by management." [*Id.* at 29].

Yet, management is in the best position to know how its operations fit within the relevant legal framework, how the law applies to its business, and how to enforce compliance and respond to noncompliance. It has never been within the auditor's role or core competency to identify the entire legal framework applicable to a company.

The dissenting views of the only two CPA Board members speak volumes as to how the proposal's burden-shifting mechanisms would change the auditing industry with respect to identifying and addressing noncompliance risks.

Paradoxically, although the proposal is more rigorous than current standards governing the auditor's role in identifying and responding to noncompliance risks, it is also vague in that it fails to provide much guidance to auditors on the threshold of which laws and regulations "could reasonably have a material effect on the financial statements."

For example, although the proposal states that auditors will not be responsible for identifying "every law or regulation to which the company is subject," it does little to articulate the scope of what will be expected of auditors. Does this requirement cover any law or regulation that could tangentially impact the financial statements? Or is the scope limited to just those that more closely affect a business's operations? The proposal does not provide much guidance on this issue.

The proposal recognizes that its enhanced responsibilities will require auditors to more substantially rely on experts and lawyers to comply. The PCAOB anticipates that, under the new standards, auditors may need to engage legal counsel to assist in several ways: understanding laws and regulations, assessing and responding to the risk of material misstatement of the financial statements due to noncompliance, evaluating the likelihood that noncompliance has occurred, developing more rigorous inquiries of management and others to understand the circumstances surrounding noncompliance, and identifying other transactions following the same patterns as the ones being evaluated for noncompliance. [*Id*. at 43].

These processes can be very complicated for large, complex companies with multiple businesses or operational segments around the globe. They require lawyers and experts in a wide variety of subject matter areas, depending on the nature of the potential noncompliance.

The auditor's expanded use of lawyers and experts will be time-consuming and expensive for auditors and issuers, and, ultimately, expensive for investors, who are supposed to be the intended beneficiary of the proposal.

Scoping the universe of applicable laws and regulations is not the only management and investigative function the proposal seeks to impose on auditors. The proposal also requires auditors to read all publicly available information about the company disclosed by the company's executive officers, including information disseminated through a continuum of mediums such as websites, social media accounts, and media and analyst reports. [*Id.* at 37]. This onerous requirement is another substantial expansion of the traditional role of the auditor.

Privilege. The proposal's requirements necessarily raise a host of privilege issues that are beyond the scope of this article—including privilege concerning increased communications between the auditor and the issuer, as well as the auditor's own work product.

Certain of proposal's provisions requiring auditors to determine whether there is a risk of noncompliance essentially amount to a requirement that auditors conduct investigations on their own by speaking with company employees and third parties.

It is not clear whether such investigations, something auditors have never done before, including presumably auditor interviews to gather facts, would be covered by any privilege. This requirement raises questions about whether the information obtained would be subject to production in government investigations, civil litigation discovery, and other legal process, and what the consequences for the company's privileged communications would be.

Costs. As noted earlier, the proposal will unduly burden auditors and issuers by imposing excessive costs and unnecessarily creating audit inefficiencies.

Board member Christina Ho notes that "the proposal takes a one-size-fits-all approach and does not take into account differences between large auditing firms on the one hand, and mid-sized and smaller firms on the other hand. Auditors are CPAs, not legal experts."

As discussed above, to comply with the proposal's new requirements, auditors will have to increasingly rely on lawyers and subject matter experts. Expanding the auditor's use of experts will lead to a substantial increase in audit fees for companies and may also lead auditors to over-engage legal experts to avoid potential professional liability stemming from more rigorous requirements under the new standards.

Along the same lines, issuers will bear the brunt of the costs that will come with significant increases in required interaction between issuers and auditors throughout the audit. [Ho Dissent at 3; Proposing Release at 78, 86].

Increased issuer costs can adversely affect investors. Smaller companies with fewer resources may not be able to absorb such exponential increases in audit fees. Similarly, not all audit firms have the capacity and resources to undertake the work the proposal seeks to require, which could result in a disproportionate impact of the new requirements on medium- and smaller-sized audit firms.

The proposal will also increase fixed costs for auditors because they will need to update their audit methodologies and tools and to prepare training materials and to train staff on new procedures. Similarly, variable costs for auditors will increase.

As noted earlier, auditors will need to invest more time and resources to identify laws and regulations applicable to a company and to perform more rigorous risk assessment audit procedures related to identifying and addressing noncompliance risks. [Proposing Release at 76–77, 85, 87].

On top of economic costs, the proposal's new requirements could cause auditors to devote such increased time and resources to risk assessment and identifying potential noncompliance with applicable laws and regulations that other audit areas may suffer. Issuers may be resistant to enhanced audit procedures solely because of the increased cost, which could result in less information in the auditors' hands.

Similarly, there is a risk that issuers will conclude that if auditors spend more time and effort to address noncompliance risks based on the new audit standards, management can get away with spending less of its time on that task, thus flipping the traditional roles between management and auditors in this area. [*Id.* at 76–77, 85, 87].

Although the proposal recognizes these costs, it downplays them by predicting that the costs of compliance with the new standards are "unlikely to be disproportionate to the benefits." [*Id.* at 93]. Whether this is true is yet to be seen, but the proposal surely has captured the attention of the auditing community and issuers.

Conclusion

We expect that many audit firms, industry groups, and other interested stakeholders will submit comment letters on the proposal, which the Board is accepting until Aug. 7, 2023.

Time will tell what final rules emerge from this process, but one thing is clear: if the proposal is adopted in current form, it will dramatically transform the role of auditors from one of assurance to one of investigation and management, a line the industry historically has avoided crossing.

William F. Johnson i*s a partner in the special matters and government investigations practice group at King & Spalding. Counsel* **Kevin J. O'Brien** and summer associate **Victoria Panettiere** *assisted in the preparation of this article.*

Reprinted with permission from the July 5, 2023 edition of the NEW YORK LAW JOURNAL © 2023 ALM Global Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 877-256-2472 or asset-and-logo-licensing@alm.com. # NYLJ-7112023-45102