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Sent by email:  
[comments@pcaobus.org](mailto:comments@pcaobus.org)

Brussels, 28 July 2023

**Subject: Accountancy Europe's comments on the proposed amendments to PCAOB Auditing Standards related to a company's noncompliance with laws and regulations**

Dear Sir or Madam,

Accountancy Europe is pleased to provide you with its comments on the amendments to PCAOB Auditing Standards related to a company's noncompliance with laws and regulations. We have chosen to restrict our response to address global aspects with a public interest lens focusing on quality.

#### **ECOSYSTEM APPROACH FOR MITIGATING NON-COMPLIANCE RISK**

Non-compliance with laws and regulations and fraud are serious issues that can cause irreversible harm to companies, people and to the economy. Hence, it is in the public interest to protect investors by mitigating risks of fraud and non-compliance.

Auditors can play a crucial role in tackling fraud and non-compliance with laws and regulations. We are aware that stakeholders expect auditors to be doing more or better in this area. For this to happen, all parties' roles in the corporate reporting ecosystem and the interactions amongst them need to evolve coherently, as the auditor is a part of this ecosystem. In this regard, it will be the most cost-effective way to first align the responsibilities of management with stakeholder expectations.

It is primarily the responsibility of management, with the oversight of those charged with governance, to ensure that the company's operations are conducted in accordance with applicable laws and regulations. Audit and/or risk committees and compliance departments play an important role in this regard. While planning an audit engagement, the auditor obtains an understanding of how the company manages non-compliance risk and of internal control relevant to non-compliance and fraud.

We believe that auditors should continue focusing on noncompliance that could materially impact the financial statements, such as material penalties or loss contingencies and any new audit requirement should be risk-based considering the role of the company's compliance management system.

## **ADDRESSING NONCOMPLIANCE THROUGH DIFFERENT MECHANISMS**

Auditors or other assurance service providers may perform separate or integrated compliance engagements that involve a more focused approach on non-compliance risks. These could be required by laws and regulations or provided upon request from the company and often have a clearly defined scope. The extent and nature of the procedures performed in such engagements are different than those in a financial statements audit.

In the European Union (EU), the EU Audit Regulation of Public Interest Entities (PIEs)<sup>1</sup> requires auditors to inform the audited company and invite its management to investigate and take appropriate measures when the auditor suspects that irregularities (i.e., non-compliance), including fraud, regarding the financial statements may have occurred. If management does not investigate the matter, the auditor has to inform the authorities responsible for investigating such irregularities.

In the case of the US, an audit of internal control over financial reporting, as required by the Sarbanes-Oxley Act, is integrated with an audit of financial statements. Accordingly, auditors already perform additional procedures addressing the risk of non-compliance, including to identify and test relevant entity-level controls.

## **LINK BETWEEN NON-COMPLIANCE AND FRAUD**

We agree that fraud is a subset of non-compliance with laws and regulations, since committing fraud also requires laws or regulations to be breached. However, the nature of fraud, i.e. its intentional character and the concealment pursued by perpetrators, makes fraud more challenging to detect. It is therefore paramount from a public expectations perspective that this standard recognizes these differences, and that it is cognizant of the limitations that auditors face in detecting fraud, which are higher than for detecting non-compliance.

The inclusion of requirements relating to fraud within the scope of AS 2405, in addition to those that already exist in AS 2401 and AS 1215 increases the complexity of the standards and makes it difficult for stakeholders to understand the scope of the auditor's work on fraud.

## **NEED FOR CLARITY ON THE SCOPE OF THE AUDITOR'S WORK**

We are concerned that the broadening of the scope of which laws and regulations are relevant (changing from only those with a direct and material effect on the financial statements) has expectation implications. There will be an expectation that auditors are responsible for detecting noncompliance with far more wide-ranging subject matters than may presently be the case. As written, it implies laws and regulations, except those for which noncompliance is penalty-free in terms of fines or restitution expense for noncompliant companies. There may also be other instances where reputational damage results in lack of trust and deterioration of business rather than specific impact on the financial statements.

According to paragraph 12 of the proposed standard, when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred, the auditor must communicate the matter to the appropriate level of management and to the audit committee. This is a requirement even when the noncompliance is not perceived to have a material effect on the financial statements. The standard states that communication to audit committee is not required if the matter is clearly inconsequential. We believe that the same threshold should apply to matters that need to be communication to management.

This proposed "broadening" will also extend the scope of, and work effort associated with, the audit beyond the financial statements because paragraph 09 b specifically refers to "other information containing a material misstatement of fact". If this is the intent to change the scope of an audit of financial statements performed under its standards, the PCAOB should be clearer.

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<sup>1</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02014R0537-20140616> (see Article 7 and 12)

In this context, we also believe that the phrase “could reasonably have a material effect on the financial statements” is not an enforceable test. While there are laws and regulations for which such identification is simple, there are many laws and regulations for which such identification is very difficult or subject to considerable subjective judgment. We believe that “could reasonably have a material effect” invites third parties, including regulators, investors and others, to call into question the judgments of management and of the auditors after the fact with hindsight bias. For this reason, it would be helpful to clarify the role of both significance of the non-compliance matter or issue and the magnitude of a potential impact of an instance of non-compliance determined as not likely.

Auditors may encounter indications that point to a possible instance of non-compliance that relates to a significant matter or that carries huge financial implications. If the determination of whether or not non-compliance is likely to have occurred falls below the threshold of “likely”, the proposals would require no further action by the auditor under paragraphs 09 and 10, since these deal with the financial statement impact. We therefore question whether significance or magnitude ought to be considered relevant factors triggering action in these paragraphs, e.g., in cases of close calls in determining a likely non-compliance.

### **INHERENT LIMITATIONS OF AN AUDIT**

There is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed. This is due to the inherent limitations of an audit and is why audits are reasonable, and not absolute, assurance engagements. Recognition of this in the auditing standards is imperative to manage stakeholders’ expectations of audit and avoiding misunderstandings between what auditors can reasonably be expected to achieve and what users of the financial statements believe should be possible.

We are concerned at the removal of language around the inherent limitations of an audit in these proposals and urge the PCAOB to reconsider this matter, as it risks widening yet further the expectation gap between what auditors (can) do and what stakeholders believe they should do.

There are specific inherent limitations related to the identification of laws and regulations as proposed by the PCAOB and these limitations do not always apply in relation to fraud and vice versa. We note that as a general rule fraud involves intentional acts whereas noncompliance with laws or regulations can be inadvertent and whether inadvertent noncompliance has occurred can be subject to a greater lack of clarity.

Ultimately, whether or not such instances of noncompliance are identified will primarily depend upon the appropriate design (including granularity) and operating effectiveness of management’s risk management and compliance management systems related to compliance with laws and regulations. It is unlikely that management in most registrants have established such systems with the same degree of granularity as for internal control over financial reporting as currently defined.

### **LEGAL IMPEDIMENTS TO COMPLIANCE WITH CERTAIN PROPOSED REQUIREMENTS**

The Standard does not recognise that there may be legal impediments applicable to some auditors in certain circumstances that could force the auditor to depart from one or more of the proposed requirements. For example, if management is suspected of involvement in a specific illegal action or inaction, the auditor may be subject to legislative provisions that preclude the auditor from “tipping off” a potential perpetrator. We suggest the PCAOB acknowledge this aspect.

## **MATERIALITY AND COST-EFFECTIVENESS OF THE AUDIT**

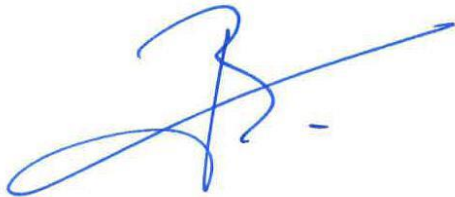
We acknowledge that the distinction between laws and regulations that have a direct or an indirect effect on financial statements is not always clear for all stakeholders. Hence, we support PCAOB's decision that the objective of the proposed standard does not refer to this distinction.

Auditors should still focus on the laws and regulations with a clear potential to have a material effect on the financial statements, acknowledging that this may not be limited to a "direct effect" and soon on sustainability (i.e., environmental, social and governance - ESG) reporting. This is the only way to ensure that audits are delivered in a cost-effective and timely manner. As noted above, for certain companies it may be in the public interest to require or request specific assurance engagements on compliance.

We are concerned that the proposals require the auditor to perform procedures to respond to any noncompliance they are aware of, regardless of materiality. These procedures may add significant additional cost to an audit for little benefit in responding to non-material risks of misstatement. The lack of clarity in some of the proposals may lead to other unintended consequences such as reducing the attractiveness of the US audit market to accounting firms.

For further information on this Accountancy Europe letter, please contact Harun Saki on +32 (0) 28 93 33 85 or via email at [harun@accountancyeurope.eu](mailto:harun@accountancyeurope.eu).

Sincerely,



Olivier Boutellis-Taft

Chief Executive

## **ABOUT ACCOUNTANCY EUROPE**

Accountancy Europe unites 50 professional organisations from 35 countries that represent close to **1 million** professional accountants, auditors and advisors. They make numbers work for people. Accountancy Europe translates their daily experience to inform the public policy debate in Europe and beyond.

Accountancy Europe is in the EU Transparency Register (No 4713568401-18).