



## Agenda Item 3

### NOCLAR

#### Objective of Agenda Item

To present potential alternatives and request ASB feedback and direction on potential revisions to GAAS to require communication to successor auditors if the predecessor auditor withdraws from an engagement or decides not to stand for reappointment and noncompliance with laws or regulation (NOCLAR) has been identified or is suspected.

Note that it is intended that the scope of this project is narrow and does not include other potential changes that may be considered as part of a future project specific to convergence with ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

#### Background

The International Ethics Standards Board for Accountants (IESBA) Code of Ethics for the Professional Accountant (IESBA Code) was revised in July 2016 to require, in the absence of any law prohibiting disclosure of confidential information to an outside party, the disclosure of identified or suspected NOCLAR to an appropriate authority even if not required by law where necessary in the public interest.

In 2016, the IAASB revised ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, to reflect the changes in the IESBA Code of Ethics.

In March 2017, the AICPA's Professional Ethics Executive Committee (PEEC) issued an exposure draft with proposals for two new interpretations entitled "Responding to Non-Compliance with Laws and Regulations." The intent was to conform to NOCLAR standards promulgated by IESBA. While similar to the IESBA's interpretation, the PEEC's proposal departed from the international standard because most state accountancy boards and the AICPA Code of Professional Conduct do not permit a CPA to disclose NOCLAR without client or employer consent.

In response to the exposure draft, the National Association of State Boards of Accountancy (NASBA) submitted a comment letter expressing concerns that the proposed language would discourage CPAs from acting in the public interest even after the CPA demonstrated compliance with all relevant professional standards and may also be construed as either limiting or prohibiting a NOCLAR disclosure without written client consent.

Based on NASBA's response and other concerns, the PEEC did not adopt the proposed interpretations. As an option to further address NOCLAR, the PEEC requests that the ASB

consider revisions to GAAS to require communication to successor auditors of a former client when NOCLAR has been identified or is suspected by the predecessor auditor. Until further PEEC deliberations with regard to the interaction with state law and potential changes to the Code of Conduct are proposed, the PEEC is not requesting that the ASB consider revisions to GAAS that would require auditors to report NOCLAR to other outside parties, such as the appropriate authorities.

In consideration of PEEC's request, a project proposal was developed and presented to the Audit Issues Task Force (AITF) in November 2019. That project proposal is included as Agenda item 3A. The AITF approved the project proposal as presented and a Task Force is in the process of being established. That Task Force will be staffed by Mike Glynn.

Please note that due to it not being established until after the AITF approved the project plan in late November, that Task Force has not considered this discussion memorandum. This discussion memorandum was developed by staff.

## Issues for Discussion with the ASB

### Issue 1 – Interaction with the AICPA Code of Professional Conduct

The PEEC's request for the ASB to consider revisions to GAAS to require communication to successor auditors of a former client when NOCLAR has been identified or is suspected by the predecessor auditor is because of the following section of the Code of Professional Conduct (*emphasis* added):

#### 1.700.001 Confidential Client Information Rule

.01 A member in public practice shall not disclose any confidential client information without the specific consent of the client.

.02 This rule shall not be construed *(1) to relieve a member of his or her professional obligations of the "Compliance With Standards Rule" [1.310.001] or the "Accounting Principles Rule" [1.320.001],...*

It is PEEC's position that if Professional Standards (in this case, GAAS) requires a practitioner to disclose information to a third party, that the preclusion in paragraph .01 in the preceding does not apply.

We are not aware of any issues with respect to state board regulations or state laws that would preclude a predecessor auditor from communicating identified or suspected NOCLAR to a successor auditor with specific client consent. To address any potential issues, the wording "in the absence of any law prohibiting disclosure of confidential information to an outside party" can be included in any requirement for the predecessor to discuss identified or suspected NOCLAR to a successor auditor.

### Issue 2 – Operationalizing a requirement for a processor auditor to disclose identified or suspected NOCLAR to a successor auditor

Staff has identified two alternatives with respect to operationalizing the communications with respect to NOCLAR.

**Alternative 1 - Potential revisions to AU-C section 210, Terms of the Engagement**

Paragraphs .10-.12 (and related application guidance) of AU-C section 210 could be revised as follows:

**Agreement on Audit Engagement Terms**

- .09** The auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: par. A20-.A21)
- .10** The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of written agreement and should include the following: (Ref: par. A22-.A26)
- a. The objective and scope of the audit of the financial statements
  - b. The responsibilities of the auditor
  - c. The responsibilities of management
  - d. A statement that because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAAS
  - e. Identification of the applicable financial reporting framework for the preparation of the financial statements
  - f. Reference to the expected form and content of any reports to be issued by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content
  - g. *A statement that, if the relationship is terminated for any reason, management consents to the auditor communicating any instances of known or suspected fraud or noncompliance with laws and regulations to a successor auditor upon the successor auditor's inquiry.*

**Initial Audits, Including Reaudit Engagements**

- .11** Before accepting an engagement for an initial audit, including a reaudit engagement, the auditor should request management to authorize the predecessor auditor to respond fully to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement. If management refuses to authorize the predecessor auditor to respond, or limits the response, the auditor should inquire about the reasons and consider the implications of that refusal in deciding whether to accept the engagement. (*Ref: par. .A27*)

- .12 The auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement. The auditor should specifically inquire whether the predecessor auditor identified any instances of actual or suspected fraud or noncompliance with laws or regulations by the entity. (Ref: par. A28 - .A29)*
- .13 The predecessor auditor should respond to the auditor's inquiries promptly and, in the absence of unusual circumstances or any law prohibiting disclosure of confidential information to an outside party, fully on the basis of known facts. (Ref: par. .A30-.A31)*
- ~~.12.14~~ The auditor should evaluate the predecessor auditor's response, or consider the implications if the predecessor auditor provides no response or a limited response, in determining whether to accept the engagement. (Ref: par. ~~.A27-~~ .A32)

**Initial Audits, Including Reaudit Engagements (Ref: par. ~~.11-~~.12/4)**

- ~~.A27~~ An auditor may make a proposal for an audit engagement before being granted permission to make inquiries of a predecessor auditor. The auditor may advise management in the proposal or otherwise that the auditor's acceptance of the engagement cannot be final until the inquiries have been made and the responses of the predecessor auditor have been evaluated.
- ~~.A29~~A28 Relevant ethical and professional requirements guide the auditor's communications with the predecessor auditor and management, as well as the predecessor auditor's response. Such requirements provide that, except as permitted by the rules of the AICPA Code of Professional Conduct, *except in limited circumstances*, an auditor is precluded from disclosing confidential information obtained in the course of an engagement unless management specifically consents. ~~Such~~ *Relevant ethical and professional* requirements also provide that both the auditor and the predecessor auditor hold in confidence information obtained from each other. This obligation applies regardless of whether the auditor accepts the engagement.
- ~~.A31~~A29 The communication with the predecessor auditor may be either written or oral. *In addition to the required inquiry regarding whether the predecessor auditor identified any instances of actual or suspected fraud or noncompliance with laws or regulations by the entity*, ~~the~~ matters subject to the auditor's inquiry of the predecessor auditor may include the following:
- Information that might bear on the integrity of management
  - Disagreements with management about accounting policies, auditing procedures, or other similarly significant matters
  - Communications to those charged with governance regarding fraud and noncompliance with laws or regulations by the entity

- Communications to management and those charged with governance regarding significant deficiencies and material weaknesses in internal control
- The predecessor auditor's understanding about the reasons for the change of auditors

~~A30~~A30 In accordance with the AICPA Code of Professional Conduct, which states that members have a responsibility to cooperate with each other, *where not otherwise required*, the predecessor auditor is expected to respond to the auditor's inquiries promptly and, in the absence of unusual circumstances, fully, on the basis of known facts. If, due to unusual circumstances, such as pending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, the predecessor auditor decides not to respond fully to the inquiries, the predecessor auditor is expected to clearly state that the response is limited.

~~A28~~A31 When more than one auditor is considering accepting an engagement, the predecessor auditor is not expected to be available to respond to inquiries until an auditor has been selected by the entity and has accepted the engagement, subject to the evaluation of the communications with the predecessor auditor as provided in paragraph ~~.42~~13.

#### *Considerations Specific to Governmental Entities*

~~A32~~ When the auditor is required by law or regulation to audit a governmental entity, inquiries of the predecessor auditor for the purpose of obtaining information about whether to accept the engagement may not be relevant. However, inquiries of the predecessor auditor may still be relevant for the purpose of obtaining information that is used by the auditor in planning and performing the audit.

Advantages to this proposal include:

- The proposed addition of paragraph. 10.g above builds of extant paragraph. 10.b as a specific aspect of the auditor's responsibilities.
- The auditor (future predecessor auditor) would have specific written consent from management to communicate any instances of known or suspected fraud or noncompliance with laws and regulations to a successor auditor upon the successor auditor's inquiry.
- The requirement for the successor auditor to *request* management to authorize the predecessor auditor to respond to the successor auditor's inquiries can be retained. The authorization would apply to inquiries other than those involving known or suspected fraud or noncompliance with laws and regulations.
- New requirements can be included:

- A requirement that the successor auditor specifically inquire about whether the predecessor auditor identified any instances of actual or suspected fraud or noncompliance with laws or regulations by the entity.
- A requirement that the predecessor auditor respond to the successor's inquiries promptly and, in the absence of unusual circumstances, fully on the basis of facts known.

The potential drawbacks to this proposal include:

- The proposal would include a requirement on the predecessor auditor. Currently all requirements in AU-C section 210 are on the successor. The current "hook" on the predecessor auditor is in the Code of Conduct, which states that members have a responsibility to cooperate with each other and the predecessor auditor is expected to respond to the auditor's inquiries promptly and, in the absence of unusual circumstances, fully, on the basis of known facts.

#### Alternative 2

Alternatively, AU-C section 210 can be revised to make the management's authorization for the predecessor auditor to respond to the successor auditor's inquiries a precondition of the successor auditor's acceptance of the initial audit. Such revision may read as follows:

#### **Preconditions for an Audit**

- .06** In order to establish whether the preconditions for an audit are present, the auditor should
- a. determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable and (Ref: par. A2-.A8)
  - b. obtain the agreement of management that it acknowledges and understands its responsibility (Ref: par. .A9-.A12 and .A17)
    - i. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; (Ref: par. A13)
    - ii. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: par. A14-.A16)
    - iii. to provide the auditor with
      - (1) access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;

- (2) additional information that the auditor may request from management for the purpose of the audit; ~~and~~
- (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence;
- (4) *Written consent that, if the relationship is terminated for any reason, the auditor is permitted to communicate any instances of known or suspected fraud or noncompliance with laws and regulations to a successor auditor upon the successor auditor's inquiry.*

With respect to AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph .27 reads as follows:

.27 If the auditor has identified or suspects noncompliance with laws and regulations, the auditor should determine whether the auditor has a responsibility to report the identified or suspected noncompliance to parties outside the entity. (Ref: par. .A28 - .A29)

Any proposed standard would include an additional application paragraph that would refer the auditor to the appropriate paragraphs in proposed revised AU-C section 210.

#### **Action Requested of ASB**

The ASB is asked to provide feedback to staff with respect to the alternatives proposed for potential revisions to operationalize a requirement for a predecessor auditor to disclose identified or suspected NOCLAR to a successor auditor. The ASB's feedback will inform the Task Force as it prepares a draft standard for ASB consideration.

#### **Proposed Timeline:**

- January 2020 – Present proposed standard to ASB for consideration and vote to expose for public comment
- May 2020 – consideration of comments received on public exposure and vote to finalize revisions to GAAS

#### **Agenda Items Presented:**

Agenda Item 3A      November 2019 Project Proposal as presented to the AITF