



Agenda Item 1

NOCLAR

Objective of Agenda Item

To consider comment letters received on the exposure draft of the proposed SAS, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations* and review NOCLAR Task Force suggested changes to the proposed revisions to AU-C section 210, *Terms of Engagement* and provide feedback to the Task Force.

Absent any significant concerns raised by the ASB, the Task Force anticipates presenting a draft of the proposed standard to the Board at its meeting in October 2021. That draft will be considered “close to final.” The vote to issue as a final standard will be held after the Professional Ethics Executive Committee (PEEC) finalizes proposed revisions to the Code of Professional Conduct regarding responding to NOCLAR. The PEEC currently anticipates finalizing the proposed Code revisions at its meeting in November 2021. The final SAS would be issued in conjunction with final revisions to the Code of Professional Conduct as approved by the PEEC.

NOCLAR Task Force

Harry Cohen – Task Force Chair and current ASB Member

Dan Dustin – National Association of State Boards of Accountancy (NASBA)

Lawrence Gill – Former ASB Member

Gaylen Hansen – Former ASB Member

Bill Mann – Immediate past member of the PEEC and General Counsel and National Director of Independence at Mayer Hoffman McCann, PC

The Task Force is staffed by Mike Glynn.

Background

At its meeting in January 2021, the ASB voted to expose for public comment proposed revisions to AU-C section 210 to require a prospective successor auditor, once management authorizes the predecessor auditor to respond to inquiries from the prospective successor auditor, to inquire of the predecessor auditor regarding identified or suspected fraud or noncompliance with laws or regulation (NOCLAR). One ASB member dissented to the exposure of the proposed standard.

The exposure draft was issued in February 2021 and the comment period ended on June 30, 2021.¹ The exposure draft was issued in conjunction with the corresponding exposure draft issued by the PEEC.

Summary of Comment Letters Received

24 comment letters were received on the proposed SAS. A list of the respondents as well as a comprehensive summary of the comments received is included as agenda item 3B.

Discussion of Issues with the ASB

Two commenters – the PCPS Technical Issues Committee (comment letter #08) and Grant Thornton (comment letter #13) questioned the need for revisions to AU-C section 210. The Task Force does not believe that the proposed revision will have a substantial impact on practice as the revision is primarily an elevation of application guidance to a requirement. Further, the Task Force believes that the issue has been thoroughly considered and concluded upon by the ASB.

Issue #1 – Retention of Requirement for Management Authorization

The ASB included the following specific request for comment in the explanatory material accompanying the exposure draft:

Request for Specific Comment #1 - Does the respondent agree with the ASB's determination that it is appropriate to retain the requirement for the auditor, prior to accepting an initial audit, including a reaudit engagement, to request management to authorize the predecessor auditor to respond fully to the auditor's inquiries? If not, why not, and how would the respondent revise the requirement (for example, by making the procurement of management's agreement a precondition for the auditor to accept the engagement or requiring the auditor to communicate with the predecessor auditor without management's authorization)?

23 of the 24 respondents were supportive of the retention of the requirement. National Association of State Boards of Accountancy (NASBA), in their comment letter (comment letter #06), stated:

NASBA firmly believes that it is in the public interest to allow the predecessor auditor to freely discuss matters involving NOCLAR with the successor auditor.

The majority of the Task Force believes that retention of the requirement to request management to authorize the predecessor to respond fully to the prospective successor auditor's inquiries remains appropriate. However, Task Force member Gaylen Hansen does not support the retention of the requirement. Mr. Hansen's concerns are as follows:

I have previously expressed strong views and they haven't changed. I fundamentally don't support an audit standard that depends on management consent to communicate actual or suspected illegal acts to a successor auditor. It has been adequately demonstrated that

¹ The exposure draft is available at <https://www.aicpa.org/content/dam/aicpa/research/exposedrafts/accountingandauditing/downloadabledocuments/20210225a/20210225a-noclar-ed.pdf>

compliance with professional standards do not conflict with state board confidentiality regs. Further, the consent requirement is not consistent with the approach taken by IESBA and IAASB...

Finally, much has been said about a “red flag” scenario. GAAS is better if it doesn’t endorse red flag “protections”. Far better to be fully transparent with all stakeholders in an audit.

Although well intended, my hope is the ASB will see that the proposal will not meaningfully modify current practice and choose to withdraw the proposal, leaving it to the PEEC to deal with the issue more holistically within the Code. If the ASB moves forward with the proposal it may not hurt anything, but it will risk sending a message that the overriding priority of GAAS is to auditees and their auditors. I don’t see anything in the proposal that will help with enforcement nor public protection.

Task Force member Bill Mann expresses a similar concern in that it is his position that the predecessor auditor should be free to discuss NOCLAR with the successor auditor even absent management consent.

In addition, although expressing support, the U.S. Government Accountability Office (GAO), in their comment letter (comment letter #03) stated:

To improve the clarity with respect to governmental audit organizations, we suggest that the ASB consider clarifying that in the governmental environment, auditors may find it is necessary to obtain authorization from parties in addition to management for inquiries to predecessor auditors about suspected fraud and noncompliance with laws and regulations (NOCLAR). Such parties may include, for example, those charged with governance or those contracting for or requesting the audit. We suggest that the ASB add to the application guidance a paragraph explaining this distinction, followed by some examples.

To address the concern expressed by the GAO, the Task Force proposes to add the following application paragraph, which would hang off the requirement for the auditor, prior to accepting an initial audit, including a reaudit engagement, to request management to authorize the predecessor auditor to respond fully to the auditor’s inquiries (proposed revised paragraph .11):

Considerations Specific to Governmental Entities

.A37 In the governmental environment auditors may find it is necessary to obtain authorization from parties in addition to management for inquiries to predecessor auditors about suspected fraud and noncompliance with laws and regulations. Such parties may include those charged with governance or those contracting for or requesting the audit.

ASB Consideration

ASB is asked whether it continues to support a) the retention of the requirement to request management to authorize the predecessor to respond fully to the prospective successor auditor’s inquiries; and b) the addition of the application paragraph addressing considerations specific to

governmental entities. The ASB is further asked whether there are any additional revisions or considerations that the Task Force should consider.

Issue #2 – Appropriateness and Completeness of Proposed Requirements

The ASB included the following specific request for comment in the explanatory material accompanying the exposure draft:

Request for Specific Comment #2 - Are the proposed requirements appropriate and complete, including whether it is appropriate to continue to provide an exception that permits the predecessor auditor to decline to respond to the auditor's inquiries due to impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances? If not, please suggest specific revisions to the proposals.

21 of the 24 respondents were supportive of the retention of the requirement. NASBA, Grant Thornton LLP, and Moss Adams LLP were not supportive. The concerns expressed by the non-supportive respondents were with the requirement for the predecessor auditor to respond to the successor auditor's inquiries. Such concerns are discussed later in this discussion paper.

First, with respect to paragraph .12 of the proposed revisions to AU-C section 210, the Task Force considered the overall objective of the proposed requirements. Such objective is to facilitate a knowledge transfer between the predecessor auditor and the prospective successor auditor so that the predecessor auditor's knowledge of issues regarding fraud and NOCLAR is, at least, on the level of those charged with governance or at the level that would have been communicated to those charged with governance if termination/withdrawal occurred prior to such communication. The Task Force concluded that, while utilizing the language from AU-C sections 240 and 250 would result in a transfer of knowledge related to fraud and NOCLAR *during* the audit, there may have been knowledge obtained outside of the audit (for example with respect to subsequent discovery of facts or subsequent events) that would have been required to be communicated to those charged with governance (in this case, in accordance with AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*). As a result, to capture all issues related to fraud and NOCLAR that was communicated to those charged with governance, the Task Force proposes the following revision to proposed paragraph .12 (highlighted):

- .12 If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement, the auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including (Ref: par. .A30-.A32)***
- a. identified or suspected fraud involving***
 - i. management,***
 - ii. employees who have significant roles in internal control, or***

iii. others, when the fraud resulted in a material misstatement in the financial statements.

b. matters involving noncompliance or suspected noncompliance with laws and regulations that came to the predecessor auditor's attention during the audit, other than when matters are clearly inconsequential.

c. Other communications to those charged with governance with respect to fraud or NOCLAR during or subsequent to the audit.

ASB Consideration

ASB is asked to consider whether it supports the addition of the proposed "catch-all" that would result in the prospective successor auditor inquiring of the predecessor about all items that was communicated to those charged with governance.

Proposed paragraph .13, as exposed for public comment, is as follows:

.13 If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement, the predecessor auditor should respond to the auditor's inquiries on a timely basis and, on the basis of known facts, unless prohibited by applicable law. However, when the predecessor auditor decides, due to impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to fully respond to the auditor's inquiries, the predecessor auditor should clearly state that the response is limited. Such circumstances are expected to be rare. (Ref: par. .A33-.A35)

NASBA (comment letter #06) expressed:

The exception that allows a predecessor auditor to not respond to the successor's inquiries due to "potential litigation" and "other unusual circumstances" leaves endless opportunities for an unprincipled and/or risk-averse auditor to avoid his or her professional responsibilities under the AICPA Auditing Standards Board June 21, 2021 proposed SAS. We suggest that when the predecessor auditor chooses this option, in addition to stating that the response is limited, he or she should provide information sufficient to allow the successor to determine the general nature for the lack of response, for example, by disclosing whether the limitation is self-imposed or imposed by the former client.

The qualification in paragraph .13 that "such circumstances are expected to be rare" lacks specificity and imposes no specific requirement on the auditor to limit his or her exercise of the exception. Therefore, we believe it is highly unlikely that it would compel a predecessor auditor to cooperate with a successor. The lack of a specific requirement means State Boards will be unable to enforce this provision.

The Task Force considered the concerns expressed in NASBA's comment letter and the majority of the Task Force concluded not to propose revisions to proposed paragraph .13. The members of the Task Force who concluded not to propose revisions to the proposed paragraph .13 believe that "unprincipled and/or risk adverse" auditors would not be swayed by any requirements or guidance included in the standards. Those Task Force members agree with Grant Thornton LLP (comment letter #13) who stated the following in support of retaining the proposed "exceptions":

If the Board decides to move forward with its proposal, however, we believe it is essential to retain the exception permitting the predecessor auditor to decline to respond to the successor's inquiries under certain circumstances. This language exists in US GAAS and is consistent with the standards of the PCAOB. We are unaware of audit quality issues indicating that predecessor auditors are inappropriately using this exception; rather, it appears that this exception is used judiciously by auditors when deemed necessary. Therefore, we believe it is most appropriate to retain the proposed exception if the Board moves forward and to further clarify the predecessor auditor's responsibilities in the AICPA Code.

Mr. Hansen disagreed with the other members of the Task Force stating:

I do not support the exception if there is actual or threatened litigation because that effectively neuters everything in the proposal.

The preceding support aside, Grant Thornton LLP's concern (comment letter# 13) is as follows:

We do not believe the proposed predecessor auditor requirements are appropriate. The predecessor auditor's responsibilities related to the audit end with the issuance of the auditor's report or the auditor's dismissal, unless subsequent events or discoveries of fact necessitate reissuing the report or the auditor is otherwise involved with a report reissuance. Further, we believe that ongoing predecessor auditor responsibilities related to communicating or cooperating with successor auditors are ethical responsibilities guided by the AICPA Code and not by US GAAS.

Moss Adams LLP (comment letter #23) expressed a similar concern:

We support the efforts of the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) to enhance the role of CPAs in protecting the public interest, however we take considerable exception to the extension of presumptively mandatory communications by the predecessor auditor in proposed paragraph .13 to AU-C section 210, *Terms of Engagement*.

We do not believe it is necessary to modify generally accepted auditing standards (GAAS) to achieve the desired outcome of information exchange between a predecessor and successor auditor, even in the areas of fraud and noncompliance with laws or regulations (NOCLAR). The proposed SAS materials cite the ASB's observation that it is unaware of significant practice issues involving predecessor auditors inappropriately limiting their response while following the extant professional standards, and its belief that the statement in the AICPA Code of Professional Conduct (Code) that members are expected to

cooperate with each other helps protect against the potential of a predecessor auditor inappropriately limiting the response to the auditor's inquiries. We agree entirely with these observations. The Code clearly states that members are expected to cooperate with each other, which we believe is well understood and followed, including in the realm of responding to successor auditor inquiries. Introducing a presumptively mandatory requirement for the predecessor auditor to respond to successor auditor inquiries (except for rare instances) attempts to address a nonexistent practice issue. In turn, the establishment of this requirement introduces numerous questions and interpretations as to what knowledge would be subject to response (further discussed in "Request for Specific Comment #2") and potential negative impacts to clients. Thus, we strongly recommend eliminating paragraph .13 of the proposed SAS.

The Task Force discussed the concerns and concluded that, while the proposal elevates application guidance from extant AU-C section 210 to a requirement, those Task Force members who support the requirement believe that it appropriately standardizes a responsibility that the predecessor auditor is expected to adhere to.

Further, in addition to Grant Thornton LLP, Michigan Office of the Auditor General (comment letter #02) recommended that the requirement include an explanation of "unusual circumstances" that resulted in the predecessor auditor deciding to not fully respond to the potential successor auditor's inquiries.

The Task Force determined that a requirement to "explain" would introduce issues as to the "extent of the explanation" and may cause further issues with respect to confidentiality. The Task Force also felt that an explanation to the potential successor auditor may put the predecessor auditor in a position of disclosing litigation concerns to the former client.

With respect to application paragraph .A35, KPMG LLP (comment letter #01) commented:

Paragraph A35 provides conditions before the predecessor auditor may be available to respond to inquiries. These conditions include (a) the auditor being selected by the entity and (b) the auditor planning to accept the engagement, subject to inquiries with the predecessor auditor.

We propose revisions to paragraph A35 because it is unlikely that a predecessor auditor knows the status of the potential successor auditor's engagement acceptance process, or that the only barrier to acceptance is the results of these inquiries. Specially, we recommend the following (deleted text is noted in strikethrough):

.A35 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 plans to accepted the engagement, subject to the evaluation of the communications with the predecessor auditor as provided in paragraph 14.~~

The Task Force proposed to revise paragraph .A35 as recommended by KPMG LLP.

ASB Consideration

ASB is asked to consider whether it supports the Task Force conclusion that no substantive revisions should be made to proposed paragraph .13. In addition, the ASB is asked whether it agrees with the proposed revisions to paragraph .A35.

Issue #3 – Documentation Requirement

The ASB included the following specific request for comment in the explanatory material accompanying the exposure draft:

Request for Specific Comment #3 – Is the proposed (documentation) requirement appropriate and complete? If not, please suggest specific revisions.

22 of the 24 respondents were supportive of the retention of the requirement. Crowe LLP (comment letter #12) did not respond to the request for comment. Grant Thornton LLP was not supportive. Grant Thornton LLP's concern is as follows:

We found the proposed documentation requirement to be potentially duplicative and unnecessary. We believe AU-C Section 230, Audit Documentation, sufficiently addresses the successor auditor's responsibilities to appropriately document the results of inquiries made of the predecessor auditor.

Further, the Board may need to reconsider the predecessor auditor's documentation responsibilities considering the new US GAAS requirements that would be imposed on the predecessor auditor by the Proposed SAS. If US GAAS requires the predecessor auditor to respond to the successor auditor's inquiries and the successor auditor documents the results of these inquiries, we would expect that the predecessor auditor would also need to retain documentation of their responses to the successor auditor's inquiries.

The Task Force considered Grant Thornton's concern but concluded that the proposed documentation requirement is appropriate and consistent with the ASB's consideration prior to public exposure.

While supportive of the documentation requirement, KPMG LLP (comment letter #01), requested that the requirement be clarified:

We believe that clarification of the documentation requirement, as described in paragraph 15 is needed to allow for an auditor to comply. Specifically, it is not clear whether the auditor is required to document and retain the results of its inquiries only if the engagement is ultimately accepted, or if the proposed change would require that documentation even if the engagement is declined. There is no existing guidance on maintaining documentation for a proposal that does not become an engagement, and we believe that is outside the scope of the auditing standards. As such, we recommend limiting this requirement to retaining documentation of the inquiries and results in scenarios where the auditor accepts the engagement. Specifically, we recommend the following (edits are noted in bold underline):

.15 The auditor should document its inquiries and the results of those inquiries with the predecessor auditor **and include as part of the audit documentation if the engagement is accepted.**

Moss Adams LLP (comment letter #23) made a similar comment. The Task Force proposes to revise the proposed documentation requirement as suggested by KPMG LLP.

ASB Consideration

ASB is asked to consider whether it supports the Task Force's proposal to revise proposed paragraph .15 as indicated in KPMG LLP's comment letter.

Agenda Items Presented:

- Agenda item 1A Draft proposed revisions to AU-C section 210, *Terms of Engagement* - redline to show changes to address comments received on the exposure draft
- Agenda item 1B Summary of comment letters received on the exposure draft of the proposed SAS, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*