

NOCLAR

I. Objective of Agenda Item

To consider the draft proposed SAS, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations* and discuss any remaining significant issues with respect to the proposed SAS.

The proposed SAS has been revised pursuant to comment letters received in response to the exposure draft of the proposed SAS and feedback provided by the ASB at its meeting in September 2021.

The ASB will be asked to vote to issue the proposed SAS at a meeting after the Professional Ethics Executive Committee (PEEC) votes to approve proposed revisions to the Code of Professional Conduct regarding responding to noncompliance with laws and regulations (NOCLAR). The PEEC currently anticipates finalizing the proposed Code revisions at its meeting in February 2022. A final SAS, if approved, would be issued in conjunction with final revisions to the Code of Professional Conduct.

II. 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 – Past member of the PEEC; current member of the PEEC's NOCLAR Task Force; and General Counsel and National Director of Independence at Mayer Hoffman McCann, PC

The Task Force is staffed by Mike Glynn.

III. Issues Discussed at the September 2021 ASB Meeting

At the September ASB 2021 meeting:

- The Task Force presented its consideration of the comment letters received on the exposure draft of the proposed SAS and suggested changes to the proposed revisions to AU-C section 210, *Terms of Engagement*.
- The ASB members provided feedback to the Task Force. As part of the discussion, certain ASB members expressed fundamental concerns and objections to the proposed revisions to AU-C section 210. Those concerns and objections can be described as follows:
 - 1) **Issue #1:** Preference for a requirement to require predecessor auditors to seek out successor auditors, regardless of management authorization, when:
 - a. the predecessor auditor has identified or suspected fraud or matters involving NOCLAR or suspected NOCLAR came to the predecessor's attention during their audit, and
 - b. the successor auditor has not initiated contact with the predecessor.
 - 2) **Issue #2:** Objection to the introduction of requirements for predecessor auditors in generally accepted auditing standards (GAAS).
 - 3) **Issue #3:** Objection to any revision to GAAS regarding communication of confidential client information.

Each of these issues are discussed below.

Issue #1 – Preference for a requirement to require predecessor auditors to seek out successor auditors, regardless of management authorization, when a) the predecessor auditor has identified or suspected fraud or matters involving NOCLAR or suspected NOCLAR came to the predecessor's attention during their audit and b) the successor auditor has not initiated contact with the predecessor.

The ASB discussed the issue at length. The stated concern is summarized as follows:

- The knowledge transfer between the predecessor and successor auditor was dependent on the successor auditor requesting management to authorize the predecessor to respond to the successor's inquiries.
- There may be instances in which a predecessor has identified or suspects fraud or matters involving NOCLAR or suspected NOCLAR came to the predecessor's attention during their audit and the predecessor was not contacted by the successor and, therefore, was not provided an opportunity to communicate the matters to the successor.

In cases where a predecessor is not contacted, one of the following would have to occur:

- 1) **First scenario:** Management refuses to provide the successor auditor with the authorization for the predecessor to respond to the successor's inquiries or
- 2) **Second scenario:** The successor failed to comply with extant paragraph .11 of AU-C section 210 by not requesting management to authorize the predecessor to respond to the successor's inquiries

In the first scenario, the Task Force believes that the absence of authorization by management for the successor to make inquiries of a predecessor should alert the successor to carefully consider engagement acceptance, irrespective of the basis for the lack of authorization. Many of the ASB members stated that it would be unlikely that their firm would accept an engagement in such a scenario.

However, when management refuses to authorize the predecessor to respond to the successor's inquiries and the successor determines to accept the engagement anyway:

- A) The predecessor would be precluded from disclosing confidential client information to the successor.
 - a. The task force believes this is appropriate for the following reasons:
 - i. While a knowledge transfer is in the public interest, client confidentiality is equally in the public interest and it is an invaluable component of an effective audit.
 1. If a client was hesitant to share information with their auditor for fear that the auditor would eventually share such information with an outside party, the auditor may not obtain the most complete and relevant information thereby impacting the effectiveness of the audit – which is most definitely not in the public interest.
 - ii. If the ASB were to facilitate (via a change in auditing standards) a communication between predecessor and successor auditors absent management authorization within the auditing standards, the standards would have to require the predecessor to seek out and communicate with the successor.
 1. Such a requirement would be very difficult to operationalize in the nonissuer environment as it would place the predecessor in the impractical position of identifying the successor auditor prior to the issuance of the successor auditor's report.

2. Further, the Task Force discussed the fact that the predecessor is not engaged as the auditor any longer and subjecting the predecessor to requirements under AU-C section 210 is inconsistent with the intent and applicability of the auditing standards.
 - iii. Any revisions to auditing standards regarding predecessor communications that were structured as “the predecessor should/may consider...” or “the predecessor may but is not required to...” would not result in the predecessor being able to communicate confidential client information to a successor auditor absent management authorization, because of the Code of Professional Conduct, which is not under the remit of the ASB.
 1. An introduction of a requirement for the predecessor to seek out the successor would also add to the concerns expressed by certain ASB members described in issue #2.
- B. There are other actions the predecessor can take if the predecessor is concerned that professional standards have not been met or that laws or regulations have been broken. See second scenario below.

In the second scenario, if the predecessor believes that the successor has failed to comply with AU-C section 210, there are actions that the predecessor can take including, but not limited to, initiating a complaint with the applicable state board of accountancy, applicable state CPA society, or the AICPA Professional Ethics Division. In this way, the predecessor would not violate section 1.700.001, *Confidential Client Information Rule* of the Code of Professional Conduct.¹

Issue #2 - Objection to the introduction of requirements for predecessor auditors in GAAS.

Extant AU-C section 210 includes application guidance stating that, in accordance with the Code of Professional Conduct, members have a responsibility to cooperate with each other², the predecessor is expected to respond to the auditor’s inquiries promptly and, in the absence of unusual circumstances, fully. However, extant GAAS is structured to provide auditor requirements from the commencement of an audit engagement (including acceptance/continuance of the engagement) through report issuance (and any subsequent issues that may impact the issued report). Certain ASB members believe that the introduction of requirements that run to a predecessor auditor’s responsibilities is an inappropriate extension of GAAS.

The proposed standard has been structured so that it is not introducing any new requirements on the processor auditor. The Task Force believes that the proposed standard, as drafted, will result in more robust communication between predecessor and successor auditors and is, therefore, in the public interest.

Issue #3 - Objection to any revision to GAAS regarding communication of confidential client information.

Certain ASB members believe that, while the ASB may be well intended, any change in requirements with respect to communication of confidential client information should be provided via revisions to section 1.700.001, *Confidential Client Information Rule* of the Code of Professional Conduct.

The ASB Task Force believes that the proposed revisions to AU-C section 210 amount to clarification of existing explicit and implied requirements for the successor auditor. The Task Force is not proposing any revisions to GAAS that would require predecessor auditors to report fraud or NOCLAR to other outside parties, such as the appropriate authorities. However, such options exist (i.e., a predecessor auditor can report concerns to various whistleblower hotlines without violating the Code of Professional Conduct.)

¹ Section 1.700 of the Code of Professional Conduct is presented in the Exhibit to this discussion memorandum.

² See 0.300.020.02 of the Code of Professional Conduct.

IV. Task Force Views

The majority of the Task Force believes, depending upon the final changes approved by PEEC to the Code of Professional Conduct, at a meeting after PEEC approval, the ASB should consider issuing the changes as presented in Agenda item 3A (marked) and 3B (clean) as a final SAS.

V. Agenda Items Presented:

Agenda item 3A Draft proposed revisions to AU-C section 210, *Terms of Engagement* - redline to show changes to the draft presented at the September ASB meeting

Agenda item 3B Draft proposed revisions to AU-C section 210, *Terms of Engagement* - clean

Mr. Cohen will use Agenda item 3A in leading the discussion.

Excerpts of the Code of Professional Conduct included as an Exhibit for convenience.

Exhibit – Excerpts of the AICPA Code of Professional Conduct

1.700 Confidential Information

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], (2) to affect in any way the member’s obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member’s compliance with applicable laws and government regulations, (3) to prohibit review of a member’s professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy. Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member’s confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members’ exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above. [Prior reference: paragraph .01 of ET section 301]

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1.310 Compliance With Standards

1.310.001 Compliance With Standards Rule

.01 A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

.02 See Appendix A “Council Resolution Designating Bodies to Promulgate Technical Standards.” [Prior reference: paragraph .01 of ET section 202]

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Appendix A

Council Resolution Designating Bodies to Promulgate Technical Standards

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Auditing Standards Board

RESOLVED: That, with respect to standards relating to the preparation and issuance of audit reports not included within the resolution on the Public Company Accounting Oversight Board, the AICPA auditing standards board is hereby designated as the body authorized under the “General Standards Rule” (AICPA, Professional Standards, ET sec. 1.300.001) and the “Compliance With Standards Rule” (AICPA, Professional Standards, ET sec. 1.310.001) of the Code of Professional Conduct to promulgate auditing, attestation, and quality control standards and procedures.

RESOLVED: That the auditing standards board shall establish under statements on auditing standards, the responsibilities of members with respect to standards for disclosure of financial information outside of the financial statements in published financial reports containing financial statements.