PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SPOTLIGHT

Auditor Responsibilities for Detecting, Evaluating, and Making Communications About Illegal Acts

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OVERVIEW

PCAOB staff periodically provides reminders to auditors on applying specific auditing requirements, including relevant examples. Staff outreach performed in connection with the Board's proposal on the auditor's responsibility with respect to a company's noncompliance with laws and regulations indicated that an overview of existing audit requirements regarding detecting, evaluating, and making communications about illegal acts[1] by a company in an audit of financial statements may be beneficial.

Under federal securities laws,[2] auditors have a longstanding responsibility to (1) detect illegal acts; (2) evaluate information indicating that an illegal act has or may have occurred; (3) determine whether it is likely that an illegal act has occurred, and, if so, to consider the possible effect of the illegal act on the financial statements of the company; and (4) make appropriate communications about illegal acts, unless "clearly inconsequential," to management, the audit committee, and possibly the United States Securities and Exchange Commission (SEC). PCAOB standards include similar requirements.[3] These responsibilities also inform the auditor's obligation to plan and perform the audit to obtain reasonable assurance that the company's financial statements are free of material misstatement, whether due to error or fraud.

This staff publication focuses auditors on relevant considerations when performing procedures to detect, evaluate, and make communications about illegal acts by a company under audit.

DETECTING ILLEGAL ACTS

Companies are subject to a variety of legal and regulatory requirements depending on a number of factors, including, among others, geographic location, the product or services provided, and the particular industry. Violations, by act or omission, of laws and regulations that a company is subject to (i.e., illegal acts) can materially affect the financial statements and harm investors. As such, auditors' procedures related to identifying possible illegal acts are an important part of planning and performing an audit.[4]

Federal securities laws prescribe the auditor's responsibilities for considering the possibility of illegal acts by a company and responding when a possible illegal act is detected. Audits are required to include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."[5]

Under PCAOB standards, for direct illegal acts (those that have a direct effect on the determination of financial statement amounts such as, for example, violations

[1] See paragraph .02 of AS 2405, *Illegal Acts by Clients*, which describes illegal acts as "violations of laws or governmental regulations." Section 10A of the Securities Exchange Act of 1934 ("Section 10A"), 15 U.S.C. § 78j-1, which applies to audits of issuers, defines the term illegal act as "an act or omission that violates any law, or any rule or regulation having the force of law." See Section 10A(f).

[2] Section 10A was passed as part of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, § 301 (Dec. 22, 1995). Subsections (a), (b), and (f) of the originally enacted statute have undergone minor terminology changes, but the substantive obligations for auditors remain the same.

[3] See AS 2405.

[4] See e.g., Paul Munter, Chief Accountant, SEC, *The Auditor's Responsibility for Fraud Detection* (Oct. 11, 2022).

[5] See Section 10A(a)(1).

of tax and pension laws), the auditor's responsibility to detect and report misstatements from illegal acts is the same as that for misstatements caused by error or fraud.[6] In addition, the auditor is required to be aware of the possibility that illegal acts with an indirect effect (violations that relate more to a company's operations than its financial reporting) may have occurred.[7] If specific information comes to the auditor's attention about possible illegal acts that could have a material indirect effect on the financial statements, the auditor is required to perform procedures specifically directed to ascertaining whether an illegal act has occurred.[8]

The auditor's procedures for detecting potential illegal acts are aligned with existing requirements for identifying and assessing risks of material misstatement. For example, as part of performing risk assessment procedures, PCAOB standards require the auditor to understand the company and its environment.[9] Obtaining this understanding includes understanding the relevant industry, regulatory, and other external factors, which encompasses, among other things, the company's legal environment.[10] Based on observations from PCAOB oversight activities, to obtain this understanding, auditors often make inquiries of management, the audit committee, internal or external legal counsel, internal audit, and various others within and outside of the company. In addition to performing inquiries, observations from PCAOB oversight activities have indicated that many auditors read SEC or other regulatory filings, press releases, and other reports or filings (including prior enforcement actions by the government or regulator, if any), conduct online research, and read news articles and alerts, industry publications, or analyst and similar reports.

The auditor is also required to inquire of management and the audit committee whether they have received, or are aware of, tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's and the audit committee's responses to such tips and complaints.[11] Additionally, the auditor is required to inquire whether the company has entered into any significant unusual transactions[12] and make inquiries about relationships and transactions with related parties.[13] Such procedures may help the auditor to identify, among other things, possible illegal acts, including fraud. Other procedures that are performed as part of the audit may bring illegal acts (or information indicating illegal acts) to the auditor's attention. For example, while reviewing board minutes, minutes of committees, correspondence from regulators, letters from legal counsel and legal expenses,[14] and matters arising through the company's

[6] See AS 2405.05.

[7] See AS 2405.07.

[8] See AS 2405.07.

[9] See paragraph .07 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

[10] See AS 2110.07, .09.

[11] See AS 2110.56.

[12] Id.

[13] See paragraphs .05-.07 of AS 2410, *Related Parties*.

[14] AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* requires auditors to perform procedures to identify litigation, claims, and assessments, including unasserted claims and assessments that management considers to be probable of assertion and as to which a lawyer has been engaged.

internal compliance function (e.g., performing testing related to an issuer's compliance with regulations such as capital requirements), the auditor may detect possible illegal acts. Auditors may also become aware of information indicating that an illegal act has or may have occurred when conducting a review of interim financial information.[15] PCAOB standards further require the auditor to obtain various representations from management, including, for example, specific representations relating to violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.[16]

For those companies subject to an audit of internal control over financial reporting (ICFR), the auditor is also required to evaluate whether matters affecting the industry in which the company operates, such as laws and regulations, are important to the company's financial statements and the effectiveness of its ICFR.[17]

EVALUATING ILLEGAL ACTS

Once the auditor becomes aware of a possible illegal act (e.g., through audit procedures or publicly available information), under PCAOB standards, the auditor is required to obtain an understanding of the nature of the act and the circumstances in which it occurred, and to evaluate the effect on the financial statements.[18] In performing these steps, the auditor is required to make inquiries of management at a level above that of the individuals involved, if possible.[19] Similarly, under Section 10A, if in the course of conducting an audit the auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred," the auditor is required "to determine whether it is likely that an illegal act has occurred."[20] It is important to note that the auditor is required to evaluate any violations of laws and regulations (irrespective of whether such violations have a direct or indirect effect on the financial statements) that have or may have occurred that have come to the auditor's attention.[21] This statutory requirement applies *regardless* of the nature of the law or regulation at issue and irrespective of whether the violation is perceived to be material.

As observed through PCAOB oversight activities, examining relevant documents including invoices, contracts, cancelled checks, support for electronic payments, and regulatory correspondence can assist the auditor in understanding the nature of the possible illegal act. Examples of other procedures the auditor may perform after becoming aware of any instances of possible illegal acts include obtaining an understanding of the matter from management or others,

[15] See paragraph .32 of AS 4105, *Reviews of Interim Financial Information.*

[16] See AS 2805, *Management Representations*.

[17] See paragraph .09 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

[18] See AS 2405.10.

[19] Id. See also Section 10A(b)(1)(A)(ii).

[20] See Section 10A(b)(1); See also *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, SEC Rel. No. 34-64545 (May 25, 2011) (noting that "if an auditor discovers or detects an illegal act during either a quarterly review or annual audit, it is required to comply with Section 10A.")

[21] See Section 10A(b)(1)(A). See also AS 2405.06.

consulting senior firm personnel, discussing the matter with the audit committee and legal counsel, obtaining audit inquiry letters from legal counsel, reviewing government reports, reviewing relevant regulatory correspondence, and considering using the work of specialists.

Under PCAOB standards, if management does not provide satisfactory information that there has been no illegal act, the auditor is required to (1) consult the company's counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements and (2) apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.[22] The auditor uses this information and, if necessary, consults with legal counsel to conclude whether an illegal act has likely occurred and, if so, considers the effect on the financial statements as well as the implications for other aspects of the audit.[23]

If the auditor concludes that an illegal act has or is likely to have occurred, the auditor is required to consider the effect on the amounts in the financial statements as well as the adequacy of the disclosure in the financial statements of the potential effects of the illegal act on the company's operations.[24] PCAOB standards also require the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.[25]

In considering the financial statement effect of illegal acts, the auditor is required to evaluate the materiality of the act, considering both quantitative and qualitative factors; consider the effect on the amounts in the financial statements, including contingent monetary effects, such as fines, penalties, and damages; and evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations.[26] Similarly, the auditor's assessment of the materiality of any effects on the financial statements, including disclosures, also involves a consideration of both quantitative and qualitative factors. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.[27] As another example, illegal acts involving senior management may call into question other information provided by the company during the course of the audit. The auditor is required to consider the implications of the illegal act in relation to other aspects of the audit, including the reliability of management representations[28] and on the effectiveness of ICFR.[29]

MAKING COMMUNICATIONS ABOUT ILLEGAL ACTS

Under existing requirements, the auditor is required to communicate information about possible or actual illegal acts to management, the audit committee, and, in some cases, the board of directors. With respect to illegal acts that come to the auditor's attention, the auditor is required to inform the appropriate level of management and assure themselves that the audit committee is adequately informed of the illegal act as soon as practicable and prior to the issuance of the auditor's report, unless

[22] See AS 2405.10.

[23] See AS 2405.12.

[24] See AS 2405.13-.15.

[25] See paragraph .30 of AS 2810, *Evaluating Audit Results.*

[26] See AS 2405.13-.15.

[27] See AS 2405.13.

[28] See AS 2405.12, .16.

[29] See AS 2201.B8.

the illegal act is "clearly inconsequential" (e.g., considered significantly less than materiality).[30] The communication to the audit committee is required to describe the illegal act, the circumstances of its occurrence, and the effect on the financial statements.[31] Under Section 10A, the auditor is required to communicate directly to the board of directors, as soon as practicable, if the auditor concludes the illegal act has a material effect on the financial statements; senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement.[32] The auditor is also required to notify the SEC of the illegal act if the auditor has made the communication to the board of directors just described and the company fails to comply with certain provisions in Section 10A within the specified timelines.[33]

If the auditor concludes that an illegal act has a material effect on the financial statements and has not been properly accounted for or disclosed, PCAOB standards require the auditor to express a qualified or adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.[34] If the auditor is precluded by the company under audit from obtaining sufficient appropriate audit evidence to evaluate whether an illegal act that could be material to the financial statements has, or is likely to have, occurred, the auditor generally should disclaim an opinion on the financial statements.[35] Furthermore, the auditor may conclude that withdrawal is necessary when remedial action that the auditor considers necessary in the circumstances is not taken, even when the illegal act is not material to the financial statements.[36] In some circumstances, such as responding to inquiries of a successor auditor or a subpoena, the auditor may have a duty to notify parties other than the company under audit of the illegal act.[37]

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[30] See AS 2405.17 and Section 10A(b)(1)(B).

[31] See AS 2405.17.

[32] See Section 10A(b)(2).

[33] See Section 10A(b)(3)(B) and (4).

[34] See AS 2405.18.

[35] See AS 2405.19.

[36] See AS 2405.22.

[37] See AS 2405.23.