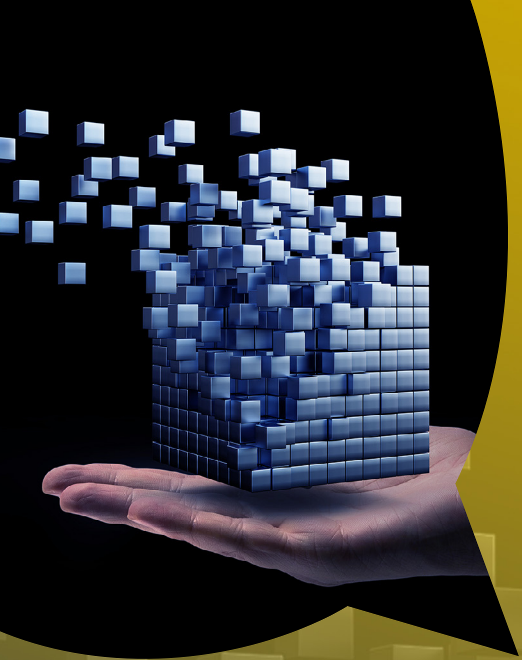

Illegal Acts:

The External Auditor's Responsibilities

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CAQ

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Recent global corporate fraud scandals such as those related to Wirecard in Germany and Carillion in the United Kingdom have driven a focus by capital market participants on the auditor's role in identifying and detecting fraud. Certain audit regulators, including the International Auditing and Assurance Standards Board (IAASB) and the Public Company Accounting Oversight Board (PCAOB) have taken action with respect to fraud. For example, the IAASB issued a discussion paper[1] this past fall and held a series of roundtables in order to seek input from various stakeholders as to the auditor's responsibilities pertaining to fraud within its' auditing standards. Separately, in April 2021, the PCAOB released a Spotlight document[2] that highlighted the PCAOB Staff's outlook for 2021 and noted that fraud procedures would be an area of emphasis for its' 2021 audit inspections.

Fraud can be inter-related to non-compliance with laws and regulations; however, the auditor's responsibilities under PCAOB auditing standards to identify and detect a potential material financial statement misstatement due to fraud can differ from the auditor's responsibilities related to illegal acts such as those resulting from non-compliance with laws and regulations. This publication provides an overview of the external auditor's responsibilities with respect to illegal acts under PCAOB auditing standards[3] and how, depending on the facts and circumstances, they can differ from the auditor's responsibility to assess whether an entity's financial statements are free of material misstatements due to fraud.

This resource is intended as general information and should not be relied upon as being definitive or all-inclusive, or as a substitute for the applicable accounting and auditing standards, requirements, guidance, or other laws and regulations.

1 https://www.ifac.org/system/files/publications/files/IAASB-Discussion-Paper-Fraud-Going-Concern.pdf
2 https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/staff-outlook-2021-inspections-spotlight.pdf?sfvrsn=6b415087_6
3 In addition to PCAOB standards, it is important to note that various ethical standards also apply to and may very well prohibit, disclosure of confidential information discovered during the course of the audit, to anyone other than those who engaged the auditor.

OVERVIEW OF THE EXTERNAL AUDITOR'S RESPONSIBILITIES WITH RESPECT TO FRAUD

The PCAOB auditing standards define fraud as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit."[4] Fraud detection is a shared responsibility among participants in the financial reporting ecosystem which includes public company management, internal and external auditors, audit committees, and regulators. Management is responsible for adopting sound accounting policies and for establishing and maintaining effective internal control over financial reporting. Management, along with those charged with governance, are responsible for assessing whether the company has the appropriate controls in place to prevent, deter, and detect fraud.

PCAOB Auditing Standard (AS) 1001, *Responsibilities and Functions of the Independent Auditor,* requires the auditor to, among other things, plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. PCAOB AS 2401 (AS 2401), *Consideration of Fraud in a Financial Statement Audit*, further establishes requirements and provides direction to auditors to fulfill that responsibility, as it relates to fraud, in an audit of financial statements. Among other requirements included in AS 2401, the auditor is required to design an audit that considers the risk of a material misstatement in the financial statements due to fraud. The auditor is also required to exercise professional skepticism and perform audit procedures to respond to identified fraud risks to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud.

An auditor's procedures to identify and respond to risks of material misstatement due to fraud can vary from entity to entity depending on the facts and circumstances. An auditor will perform various procedures over the course of the audit, notably including risk assessment procedures designed to identify and assess the risk of fraud. One example of a possible risk of material misstatement due to fraud that could be identified by an auditor is the risk that an entity records a material amount of fictitious revenue in its financial statements through the use of inappropriate or unauthorized journal entries. If revenue is a metric that is closely monitored by a company's stakeholders, and potentially also tied to executive compensation, there could be incentive for management to fictitiously overstate revenue. If a company's internal control structure provides the opportunity for management to manipulate revenue, this could be a potential fraud risk identified by an auditor. If such a fraud risk is identified by the auditor, the auditor would then be required to perform audit procedures to respond to this fraud risk and obtain reasonable assurance that the company's revenue reported in its financial statements is not materially misstated due to the overstatement of fictitious revenue prior to opining on the entity's financial statements.

OVERVIEW OF THE EXTERNAL AUDITOR'S RESPONSIBILITIES WITH RESPECT TO ILLEGAL ACTS

Entities may be affected by many laws or regulations, including but not limited to those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust matters. Often, these laws and regulations impact an entity's operations broadly rather than pertaining directly to its financial reporting. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including those that determine the reported amounts and disclosures in an entity's financial statements. PCAOB auditing standards define illegal acts as *"…violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."*[5]

4 PCAOB AS 2401.05, *Consideration of Fraud in a Financial Statement Audit*
5 PCAOB AS 2405.02, *Illegal Acts by Clients*

The determination as to whether a particular act is illegal is generally based on the advice of an informed expert qualified to practice law and is normally beyond the auditor's professional competence.[6]

PCAOB auditing standards state that *"Normally, an audit in accordance with PCAOB auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention."*[7] Examples of such audit procedures that may bring a possible illegal act to the auditor's attention include, but are not limited to, reading board minutes, inquiring of management's legal counsel concerning litigation and performing testing of financial statement account balances. Absent specific information concerning possible illegal acts that the auditor becomes aware of, the auditor is not required to perform further audit procedures related to possible illegal acts under PCAOB auditing standards.[8] However, if the auditor becomes aware of information concerning a possible illegal act, the auditor is required to obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements, if any. The auditor's assessment of the potential impact of the illegal act(s) on the financial statements affects the procedures the auditor may need to perform related to the possible illegal act. Often the potential impact of the possible illegal act on the financial statements will fall into one of the following categories:

+ *The possible illegal act is not directly material to the financial statements and is not likely to have an indirect material impact on the financial statements.*

  In this scenario the auditor would be required to consider the implications of the possible illegal act in relation to other aspects of the audit, particularly the reliability of representations of management as well as the relationship of the possible illegal act to internal controls over financial reporting and associated audit procedures. If the auditor concludes that the possible illegal act is more than inconsequential, the auditor also should determine that the audit committee is aware of the matter.

  While the facts and circumstances are critical to this assessment, consider an example of a possible illegal act that could fall into this fact pattern:

  An individual in a key management position, in a personal capacity, has accepted a bribe of $50,000 from a supplier of the entity and in return secures the appointment of the supplier to provide services to the entity. If either individual is a foreign government official, or the payment is knowingly passed to a foreign official, this could trigger a possible violation of the Foreign Corrupt Practices Act (FCPA), among other violations. In this example it can be assumed the $50,000 bribe, the possible penalty for the FCPA violation, the related legal fees and the supplier contract obtained through the bribe are immaterial individually and in aggregate to the entity's financial statements when taken as a whole. Also assume that management and the auditor have concluded there are no other potential indirect material impacts to the financial statements related to the matter. In making a conclusion, the auditor likely would need to assess whether there is any evidence to suggest that the entity's business could be susceptible to similar risks on other supplier contracts or whether this was an isolated incident. Further, the auditor likely also would consider any implications to the entity's internal controls and whether the matter is potentially indicative of a broader tone at the top within the organization that lacks an appropriate ethical culture that extends throughout the organization, or some portion of it. In addition, the auditor would want to consider whether the individual who accepted the bribe had other responsibilities within the organization that could potentially create other audit risks in light of the demonstrated lack of integrity.

6 PCAOB AS 2405.03, *Illegal Acts by Clients*
7 PCAOB AS 2405.08, *Illegal Acts by Clients*
8 PCAOB AS 2405.08, *Illegal Acts by Clients*

+ *The possible illegal act is not directly material to the financial statements, but that it could have a material indirect impact on the financial statements.*

  In this situation, the auditor is required to perform the same procedures as described in the category above, however, the auditor also should consider whether the entity has adequately accounted for and disclosed the matter in its financial statements, as applicable.

  Consider the same example above related to the $50,000 bribe, but for this example assume the potential penalty if the possible illegal act is determined to be an FCPA violation could be material to the entity's financial statements. In addition to the procedures outlined in the scenario above, the auditor also should consider whether entity management's assessment as to the treatment of the loss contingency was appropriate.

+ *The possible illegal act has a direct material impact on the financial statements*

  The auditor's responsibility to detect direct material misstatements to the financial statements is the same regardless of whether the material misstatement results from error, illegal acts, or fraud.[9]

CONCLUSION

While the term fraud is often used in different contexts to broadly describe all of the examples of possible illegal acts described herein, the auditor's responsibilities for each of them may vary depending on the facts and circumstances. External financial statement audits of public companies are designed to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. Normally external audits are not required to and do not include audit procedures specifically designed to detect illegal acts.

9 PCAOB AS 2405.05, *Illegal Acts by Clients*

Endnotes

1 https://www.ifac.org/system/files/publications/files/IAASB-Discussion-Paper-Fraud-Going-Concern.pdf

2 https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/staff-outlook-2021-inspections-spotlight.pdf?sfvrsn=6b415087_6

3 In addition to PCAOB standards, it is important to note that various ethical standards also apply to and may very well prohibit, disclosure of confidential information discovered during the course of the audit, to anyone other than those who engaged the auditor.

4 PCAOB AS 2401.05, *Consideration of Fraud in a Financial Statement Audit*

5 PCAOB AS 2405.02, *Illegal Acts by Clients*

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