



Agenda Item 1B

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

INQUIRIES OF THE PREDECESSOR AUDITOR REGARDING FRAUD AND NONCOMPLIANCE WITH LAWS AND REGULATIONS

(Amends Statement on Auditing Standards [SAS] No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended, section 210, Terms of Engagement [AICPA, Professional Standards, AU-C sec. 210])

January XX, 2021

Comments are requested by April 16, 2021

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be submitted in Word format and sent to CommentLetters@aicpa-cima.com.

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Explanatory Memorandum

Introduction

This memorandum provides background to the proposed Statement on Auditing Standards (SAS) *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations* 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). If issued as final, the proposed SAS will amend SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 210, *Terms of Engagement* (AICPA, *Professional Standards*, AU-C sec. 210).¹

Background

The International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants (IESBA code) requires a predecessor auditor to “provide all relevant facts and other information concerning the identified or suspected non-compliance (with laws and regulations) to the proposed accountant. The predecessor accountant shall do so even... where the client fails or refuses to grant the predecessor accountant permission to discuss the client’s affairs with the proposed accountant, unless prohibited by law or regulation.”²

In 2016, the International Auditing and Assurance Standards Board (IAASB) revised ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, to reflect certain relevant changes as adopted in the IESBA code. For example, ISA 250 (revised) includes a conforming change to paragraph .A9 of ISA 220 (Revised), *Quality Control for an Audit of Financial Statements* which states, in part, “where the predecessor auditor has withdrawn from the engagement as a result of identified or suspected non-compliance with laws and regulations, the IESBA Code requires that the predecessor auditor, on request by a proposed successor auditor, provides all such facts and other information concerning such non-compliance that, in the predecessor auditor’s opinion, the proposed successor auditor needs to be aware of before deciding whether to accept the audit appointment.” As the AICPA Code of Professional Conduct (AICPA code) has not been similarly revised, the ASB has not revised AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. AU-C section 250 was last revised in October 2011 with the issuance of SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*.

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.” Although similar to the IESBA code, the exposure draft explained that certain differences were necessary to enhance the clarity of the proposed interpretations and make them relevant to AICPA members in the United States. Most notably, certain provisions were not

¹ All AU-C sections can be found in AICPA *Professional Standards*.

² Paragraph R360.22 of the IESBA Code.

included in the AICPA proposals because they were believed to be incompatible with most state laws and regulations on client and employer confidentiality. The AICPA code does not permit a CPA to disclose confidential client information without client or employer consent unless required by professional standards. The following is the applicable excerpt from the AICPA code:

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]

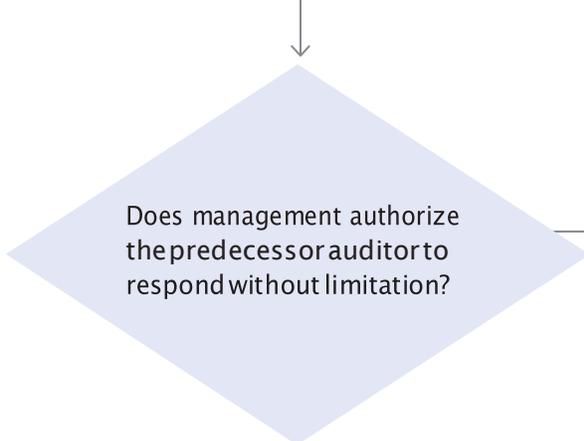
In response to the PEEC exposure draft, comments were received expressing concern that the proposed language would discourage CPAs from acting in the public interest even after the CPA demonstrated compliance with all relevant professional standards.

The Auditing Standards Board (ASB) is not proposing a revision to the requirement that the successor auditor request management to authorize the predecessor auditor to respond fully to the successor auditor’s inquiries regarding matters that will assist the successor auditor in determining whether to accept the engagement. However as an option to address identified or suspected fraud and matters involving NOCLAR, the ASB is considering narrow revisions to auditing standards generally accepted in the United States of America (GAAS) to require a successor auditor, once management authorizes the predecessor auditor to respond to inquiries from the successor auditor, to inquire of the predecessor auditor regarding identified or suspected fraud and matters involving NOCLAR. The ASB believes this approach is similar to the approach included in the Public Company Auditing Oversight Board’s AS 2610, *Initial Audits – Communications Between Predecessor and Successor Auditors* (PCAOB AS 2610) that directs the successor auditor to make more specific inquiries of the predecessor auditor after requesting permission from the prospective client to make an inquiry of the predecessor auditor. Furthermore, the absence of authorization for a potential successor auditor to make inquiries of a predecessor auditor should give rise to sufficient questions from the prospective successor auditor with respect to engagement acceptance irrespective of the basis for the lack of authorization. Until further PEEC deliberations regarding the interaction with state law and potential changes to the AICPA code take place, the ASB is not considering revisions to GAAS that would require auditors to report fraud or NOCLAR to other outside parties, such as the appropriate authorities.

The following flowchart illustrates the proposed narrow revisions. The procedures in black are currently required by GAAS. The proposed additional procedures are in red.

Before engagement acceptance

Successor auditor required to request management to authorize predecessor auditor to respond fully to successor auditor's inquiries



NO

New requirement
Successor auditor required to inquire of predecessor regarding identified or suspected fraud and matters involving NOCLAR

New requirement
Predecessor auditor required to respond fully and timely* and to indicate if the response is limited

Evaluate the predecessor auditor's response/consider implications if no or limited response in determining whether to accept engagement

*Stated as application guidance in extant based on Code of Professional Conduct statement that members have a responsibility to cooperate with each other.

Effective Date

If issued as final, the proposed amendment to AU-C section 210 will be effective for audits of financial statements for periods ending on or after December 15, 2022.

Explanation of Proposed Changes

Management authorization of communication between successor and predecessor auditors

The ASB determined to retain the requirement in paragraph .11 of extant AU-C section 210 for the successor auditor, prior to accepting an initial or a reaudit engagement, to request management to authorize the predecessor auditor to respond fully to the successor auditor's inquiries. The ASB did consider a requirement for the successor auditor to obtain the client's explicit consent as either a precondition for the audit or as a required element of the terms of the engagement. The ASB is concerned that such a requirement or precondition may result in a potential client being unable to engage an auditor and concluded that that was not in the public interest, nor was it necessary as the requirement would now be in the auditor's professional standards, which the client would be broadly acknowledging. The ASB also considered an approach where the successor auditor would be required to communicate with the predecessor auditor but would not be required to request management to authorize the predecessor auditor to respond fully to the successor auditor's inquiries. The ASB concluded that such an approach is not practical with respect to the financial statements of a non-public entity as the successor auditor may not be aware of the identity of the predecessor auditor and the predecessor auditor would have no basis to conclude that the management is considering engaging the purported successor auditor.

Further, the ASB believes that the requirement for the successor auditor to inquire about the reasons for a refusal to authorize the predecessor auditor to respond fully to the successor auditor's inquiries and to consider the implications of that refusal or limitation in deciding whether to accept the engagement results in sufficiently drawing attention to potential issues prior to engagement acceptance.

The requirement is consistent with the requirements in PCAOB AS 2610 for audits of financial statements of issuers.

Request for Specific Comment #1

Does the respondent agree with the ASB's determination that it is in the public interest to retain the requirement for the successor auditor, prior to accepting an initial or a reaudit engagement, to request management to authorize the predecessor auditor to respond fully to the successor auditor's inquiries? If not, why not and how would the respondent revise the requirement (for example, make the client providing consent a precondition for the successor auditor to accept the engagement or requiring the successor auditor to communicate with the predecessor auditor without the client's authorization)?

Knowledge transfer from predecessor auditor to successor auditor

The ASB believes that it is in the public interest for a knowledge transfer from the predecessor auditor to the successor auditor with respect to identified or suspected fraud and matters involving NOCLAR. To effect such knowledge transfer with respect to the audit of the financial statements of a non-public entity, the ASB proposes that a requirement be added to AU-C section 210 whereby, if management authorizes the predecessor auditor to respond to the successor auditor without limitation, the successor auditor makes specific inquiries regarding identified or suspected fraud and matters involving noncompliance with laws and regulations:

.12 If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond fully to the successor auditor’s inquiries regarding matters that will assist the successor auditor in determining whether to accept the engagement, the successor auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including, but not limited to: (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 the matters are clearly inconsequential.

The proposed additional required inquiries are consistent with matters that the predecessor auditor is required to communicate to those charged with governance by paragraph .40 of extant AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, and paragraph .21 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

If management does not authorize the predecessor auditor to respond or limits the predecessor’s response, the requirement in extant AU-C section 210 for the successor auditor to inquire about the reasons and consider the implications of that refusal or limitation in deciding whether to accept the engagement is not changed.

Further, while the AICPA code states that members have a responsibility to cooperate with each other and paragraph .A32 of extant AU-C section 210 states that, “therefore, 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,” the proposed revision would also include the following new requirement:

- .13 If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond fully to the successor auditor’s inquiries regarding matters that will assist the successor auditor in determining whether to accept the engagement, the predecessor auditor should respond to the successor auditor’s inquiries on a timely basis and, on the basis of known facts, fully, 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 successor auditor’s inquiries, the predecessor auditor should clearly state that the response is limited. (Ref: par. .A33–.A35)*

The final sentence in proposed paragraph .13 is intended to make clear that the predecessor auditor is expected to respond fully to the successor auditor’s inquiries while acknowledging that there are circumstances that make that expectation unrealistic. The language from that sentence is taken from paragraph .A30 of extant AU-C section 210. The statement in the AICPA code that members are expected to cooperate with each other is not impacted.

The intent of the proposed required inquiries and response is to facilitate a knowledge transfer of identified or suspected fraud and matters involving NOCLAR between a predecessor to a successor auditor. The knowledge transfer would limit the ability of a client to avoid the consequences of such matters by simply changing auditors.

Request for Specific Comment #2

Are the proposed requirements appropriate and complete, including whether it is appropriate to provide and retain the predecessor auditor’s ability to not respond fully to the successor auditor’s inquiries due to impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances? If not, please suggest specific revisions.

Documentation

The proposed SAS includes the following requirement:

- .15 The successor auditor should include in the audit documentation the communications with the predecessor auditor.*

Request for Specific Comment #3

Is the proposed requirement appropriate and complete? If not, please suggest specific revisions.

Proposed effective date

If issued as final, the ASB proposes that the revisions to AU-C section 210 be effective for audits of financial statements for periods ending on or after December 15, 2022. Practically, any auditor

changes during the calendar year 2022 and thereafter would be subject to the proposed revisions to AU-C section 210.³ Early implementation would be permitted.

Request for Specific Comment #4

Are respondents supportive of the proposed effective date? If you are not supportive, please provide reasons for your response.

Guide for Respondents

Respondents are asked to comment on the proposed changes to AU-C section 210.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, when appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view, as well.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA for one year, beginning April 16, 2021. Responses should be submitted in Word format, sent to commentletters@aicpa-cima.com, and received by April 16, 2021. Respondents may also submit a PDF version of their response for posting to the AICPA website.

Comment Period

The comment period for this exposure draft ends April 16, 2021.

³ This proposed effective date is provisional but will not be earlier than December 15, 2022.

**Auditing Standards Board
(2020–2021)**

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Proposed Amendment to SAS No. 122, as amended, section 210, *Terms of Engagement* (AICPA, *Professional Standards*, AU-C sec. 210)

1. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2022.

(***Boldface italics*** denotes new language. Deleted text is shown in ~~strikethrough~~.)

[No proposed amendment to paragraphs .01–.03.]

Definitions

.04 For purposes of generally accepted auditing standards (GAAS), the following terms have the meanings attributed as follows:

...

Successor auditor. An auditor who is considering accepting an engagement to audit financial statements but has not communicated with the predecessor auditor as provided in paragraphs .11 through .14, as well as an auditor who has accepted such an engagement.

[No proposed amendment to paragraphs .05–.10.]

Initial Audits, Including Reaudit Engagements – *Communications Between Predecessor and Successor Auditors*

- .11 Before accepting an engagement for an initial audit, including a reaudit engagement, the ***successor*** auditor should, ***if a predecessor auditor exists***, request management to authorize the predecessor auditor to respond fully to the ***successor*** auditor’s inquiries regarding matters that will assist the ***successor*** auditor in determining whether to accept the engagement ***and: . (Ref: par. .A29)***

- ***If management authorizes the predecessor auditor to respond fully to the successor auditor’s inquiries, the requirements in paragraphs .12-.13 apply; or***
- If management refuses to authorize the predecessor auditor to respond, or limits the response, the ***successor*** auditor should inquire about the reasons and consider the implications of that refusal ***or limitation*** in deciding whether to accept the engagement

- .12 ***If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond fully to the successor auditor’s inquiries regarding matters that will assist***

the successor auditor in determining whether to accept the engagement, the successor auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including, but not limited to: (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.

.13 If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond fully to the successor auditor’s inquiries regarding matters that will assist the successor auditor in determining whether to accept the engagement. the predecessor auditor should respond to the successor auditor’s inquiries on a timely basis and, on the basis of known facts, fully, 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 successor auditor’s inquiries, the predecessor auditor should clearly state that the response is limited. (Ref: par. .A33–.A35)

.12.14 The successor 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. ~~.A29–.A34.~~A36)

.15 The successor auditor should document its communications with the predecessor auditor in the audit documentation.

[Former paragraphs .13–.18 are renumbered as paragraphs .16–.21. The content is unchanged.]

Application and Other Explanatory Material

[No amendment to paragraphs .A1–.A29. .]

Initial Audits, Including Reaudit Engagements – Communications Between Predecessor and Successor Auditors (Ref: par. .11–.14)

~~.A31~~A30 Relevant ethical and professional requirements guide the **successor** 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 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 *successor* 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 The inquiries specified in paragraph .12a-b are consistent with the requirements to communicate with those charged with governance as required by paragraph .40 of AU-C section 240, Consideration of Fraud in a Financial Statement Audit, and paragraph .21 of AU-C section 250, Consideration of Laws and Regulations in an Audit of Financial Statements, respectively.

~~.A33~~ *.A32* The communication with the predecessor auditor may be either written or oral. ***In addition to the inquiries specified in paragraph .12a-b, matters*** subject to the *successor* 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

~~.A33~~ ~~In accordance with~~ ~~the AICPA Code of Professional Conduct,~~ ~~which states that members have a responsibility to cooperate with each other,~~ ~~the predecessor auditor, is expected to respond to the auditor's inquiries promptly 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.~~

.A34 Before responding to the successor auditor's inquiries made pursuant to paragraph .12, the predecessor auditor may consider it appropriate to obtain legal advice to determine whether any professional or legal requirements restrict the predecessor auditor's ability to respond.

~~.A30~~.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 ~~has~~ *plans to* ~~accepted~~ the engagement, subject to the evaluation of the communications with the predecessor auditor as provided in paragraph ~~.A21~~.A214.

[Former paragraphs .A34–.A44 are renumbered to paragraphs .A36–.A46. The content is unchanged. No further amendment to AU-C section 210.]