NOCLAR—Issues and Task Force Proposals

I. Background

1. At the October 2014 meeting, the Board considered the main feedback received from the three global roundtables held in Hong Kong, Brussels and Washington DC in May, June and July 2014, respectively. The Board also considered a proposed revised framework to guide professional accountants (PAs) in public practice and those in business (PAIBs) in how to respond to identified or suspected non-compliance with laws and regulations (NOCLAR). In addition, the Board was briefed on recent outreach on the project, including discussion with the IESBA Consultative Advisory Group (CAG) in September 2014.

2. The Board broadly supported the direction of the Task Force's proposals as reflected in the revised framework. It was noted in particular that the revised framework reflected a more holistic and balanced approach, focusing on the achievement of key overarching objectives in the public interest in responding to NOCLAR or suspected NOCLAR, and not singularly on whether or not there should be disclosure to an appropriate authority.

3. Among other matters, the Board supported the following elements of the revised framework:

   - The proposed objectives for all categories of PAs, i.e.:
     - To comply with the fundamental principles of integrity and professional behavior;
     - Through alerting management or, where appropriate, those charged with governance (TCWG), to seek to:
       - Have the consequences of suspected NOCLAR rectified, remediated or mitigated by the entity where they have occurred; or
       - Deter the suspected NOCLARs from being committed where they may be about to occur; and
     - To take further action that may be appropriate to serve the public interest.
   - A scope that is aligned with that of ISA 250.[1]
   - Distinguishing the approach to responding to NOCLAR or suspected NOCLAR among four different categories of PAs, namely auditors, senior PAIBs, PAs in public practice other than auditors, and other PAIBs.
   - A threshold of "substantial harm," and credible evidence that this threshold has been reached, with respect to the requirement:
     - For auditors to prompt management and TCWG to take appropriate actions, and for senior PAIBs to take such actions, to address the NOCLAR or suspected NOCLAR; and
     - For them to determine if further action is needed to achieve the objectives under the proposed standards and to serve the public interest (including whether to disclose the matter to an appropriate authority).

[1] ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

4. Based on the Board discussion, the Task Force has fine-tuned the framework as shown in Agenda Item 5-E. The Task Force has also made consequential and other refinements to the draft text as shown in Agenda Item 5-C. The significant and other matters the Task Force wishes to bring to the Board's attention are set out below. These are outlined in relation to proposed Section 225;[2] corresponding changes have been made to proposed Section 360.[3]

II. Significant Matters

A. Scope of Proposed Section 225

5. At the September 2014 CAG meeting, some CAG Representatives wondered whether the proposed scope would be sufficiently broad to capture NOCLARs that do not directly impact the financial statements, particularly in the case of PAs in public practice other than auditors and PAIBs. It was also noted that care should be taken in that transposing elements from another category of standards (i.e., in this case aligning the scope with that in ISA 250) may have an unintended consequence of missing out coverage of certain matters that should be addressed.

6. In the light of these comments, the Task Force has reconsidered the description of the scope in Section 225. The Task Force believes that the two categories of laws and regulations covered by ISA 250 continue to be appropriate for purposes of the section, i.e.:

   (a) Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the client's financial statements; and

   (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the client's financial statements, but compliance with which may be fundamental to the operating aspects of the client's business, to its ability to continue its business, or to avoid material penalties.

7. The Task Force, however, proposes the following changes to the text to more clearly explain the nature of the NOCLARs envisaged to be covered by the section, and how its scope articulates with that of ISA 250:

   - Deleting the examples of laws and regulations attached to the description of each category of laws and regulations, which were carried over from ISA 250 (see paragraph 225.4). The Task Force felt that these examples might convey the impression that the scope is much narrower than intended.
   - Fine-tuning the examples of non-compliance introduced at the very beginning of the section, which are intended to help set out the context for, and highlight the focus of, the section. As previously drafted, they might also convey the impression that the scope is much narrower than intended. (See paragraph 225.1.)
   - Adding guidance to more clearly explain the nature of laws and regulations covered in the second category, including more specific examples of such laws and regulations (see paragraph 225.5).
   - Explaining that while non-compliance with the two categories of laws and regulations may result in fines, litigation or other consequences for the client that may have a material effect on

[2] Proposed Section 225, *Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations*

[3] Proposed Section 360, *Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations*

its financial statements (i.e. the focus of ISA 250), it may, importantly, have wider public interest implications in terms of potentially substantial harm to the client and stakeholders (which is where the Code needs to go beyond ISA 250). (See paragraph 225.5.)

8. The Task Force believes these changes present the scope of the section more clearly and coherently, and are responsive to the advice received from the CAG.

Matter for Consideration

1. Do IESBA members agree with the Task Force's proposals?

B. **"Clearly Inconsequential" Threshold**

9. The Task Force had proposed to require that if the PA becomes aware of information concerning suspected NOCLAR and the matter is other than clearly inconsequential, the PA seek to obtain an understanding of the matter. At the October 2014 meeting, a few Board members questioned how that threshold would articulate with the scope of ISA 250. It was noted that the thresholds implicit in the description of the two categories of laws and regulation within the latter (i.e., "material amounts and disclosures" and "fundamental to the operating aspects of the business") appeared to already be significantly higher than clearly inconsequential. In addition, it was felt that the threshold of clearly inconsequential was too low and that tied to the very first requirement in the process, it could prompt the PA to seek legal advice in almost every case.

10. The Task Force has reflected on these comments and believes that the perception about the threshold being very low may have arisen because it was directly linked to the requirement to seek to obtain an understanding of the matter, particularly as that requirement included obtaining an understanding of the potential consequences to the client and stakeholders. Rather, the Task Force believes that at the point of coming across information concerning an instance of non-compliance or suspected non-compliance, the PA would not be in a position to assess the potential consequences of the matter without *first* having obtained an understanding of it. Accordingly, other than when the matter is *clearly* inconsequential, the PA ought to seek to obtain that understanding to be able to make an assessment of those consequences.

11. Therefore, to make this clearer and to address the concerns at the Board (which echoed similar concerns at the roundtables), the Task Force proposes the following changes:

- Removing the threshold from the requirement to seek to obtain an understanding of the matter and deleting the reference to obtaining an understanding of the potential consequences to the client and stakeholders (see paragraph 225.10);
- Adding a reference to obtaining an understanding of the nature of the act and the circumstances in which it has been committed or may be about to be committed (see paragraph 225.10); and
- Scoping out matters that are clearly inconsequential from the section and including guidance to explain when a matter would be considered clearly inconsequential (see paragraph 225.7(a)).

12. As a result of these changes, the articulation of the requirement to seek to obtain an understanding of the matter is now largely consistent with how the corresponding requirement in ISA 250 is worded. The PA's understanding and assessment of the potential consequences would then be developed

through the ensuing discussion with management, assuming the PA suspects that non-compliance has occurred or may be about to occur (see paragraphs 225.11-12).

13. With regard to the question raised at the Board as to how the threshold of clearly inconsequential would articulate with the thresholds implicit in the scope of ISA 250, the Task Force noted that the latter are linked more to the nature of the laws and regulations themselves than the actual instances of NOCLAR. Accordingly, the Task Force does not believe there is an inconsistency between the two.

Matter for Consideration

2. Do IESBA members agree with the Task Force's proposals?

C. **Third Party Test**

14. The Task Force had proposed to require the PA to apply a third party test to objectively determine the nature and extent of further action required to achieve the PA's objectives under the section and to serve the public interest (see paragraph 225.29). At the October 2014 meeting, a few Board members questioned whether it would be appropriate to position the test at the end of the process, believing that it would be better placed much earlier in the process. In particular, it was felt that if positioned late in the process, the test could be used by regulators in some jurisdictions to enforce against it. It was suggested that the test would be more appropriate if it were pitched at the overarching level, i.e., with respect to the application of judgment in considering process matters such as scope and threshold. There was also a question as to whether the combination of the "substantial harm" threshold and the third party test could nevertheless create a regulatory expectation that the PA should disclose the suspected NOCLAR to an appropriate authority.

15. The Task Force has further reflected on these comments and reaffirms that the test is not about whether the matter should be disclosed to an appropriate authority but about the *need for and extent of any further action*. Whether such further action would include disclosure to an appropriate authority would depend on an objective assessment of the facts and circumstances at the time, and not in hindsight. Accordingly, the Task Force does not share the concerns about second guessing. The Task Force believes that the test is important to ensure that there is rigorous consideration of the nature and extent of any further action needed to serve the public interest, given the context of credible evidence of substantial harm to stakeholders. Whether disclosure would be an appropriate further action would depend on consideration of a number of relevant factors (see paragraph 225.27).

16. The Task Force has nevertheless made a couple of editorial refinements to the wording of the test (see paragraph 225.29).

Matter for Consideration

3. Do IESBA members agree with the Task Force?

III. Other Matters

D. Professional Accountants in Public Practice Providing Services Other than Audits of Financial Statements

17. The Task Force proposed that if a PA performing a non-audit service for an audit client of the firm or a network firm suspects that non-compliance has occurred or may be about to occur, the PA consider informing the engagement partner for the audit about the matter. The Task Force reflected on the need for further guidance in relation to when such communication would be appropriate. The Task Force noted that there should generally be no impediments to reporting within a firm (unless there are specific engagement terms preventing such disclosure). The situation may, however, be more complex and nuanced when it comes to reporting to another firm in the network. For example, there may be local laws or regulations that prevent disclosure outside the jurisdiction; the nature of the engagement itself may limit disclosure, such as in the case of forensic services or in an ongoing investigation into the matter by a prosecutor; and materiality considerations may come into play (e.g. the matter may be immaterial to the audit of the group).

18. The Task Force felt that addressing all the potential complexities of reporting to another network firm would lead to the guidance becoming unbalanced and skewed towards this particular aspect of the proposals, detracting from the broader principles the Board is seeking to establish. The Task Force believes that network firms will generally be able to judge the appropriate course of action with respect to reporting out to another network firm, taking into account the circumstances of the matter and the local jurisdictional context. Accordingly, the Task Force has not expanded further on the guidance in paragraph 225.37 but made it slightly more open (i.e., considering whether to inform vs. considering informing) to better provide for the exercise of appropriate judgment.

19. More generally, the Task Force has added some guidance on factors to consider regarding whether information can be disclosed outside the entity (see paragraph 225.42).

Matter for Consideration

4. Do IESBA members agree with the Task Force's proposals?

E. Other Changes to the Text

20. In addition to editorial refinements, the Task Force would like to highlight the following other enhancements to the proposed Section 225:

- Referring to non-compliance or suspected non-compliance with laws and regulations in the title of the section and throughout the section where appropriate, consistent with ISA 250. This recognizes that the evidence may be beyond doubt that non-compliance has occurred, notwithstanding that it would be up to a court of law to ultimately determine whether the act constitutes actual non-compliance.
- More clearly setting out upfront the purpose of the section, i.e., to *guide* PAs in how to respond to non-compliance they may come across in the course of providing a professional service to a client (see paragraph 225.1).
- Alignment of the wording of the third part of the objectives to be consistent with the requirement to determine whether further action is needed to achieve the PA's objectives and to serve the public interest (see paragraph 225.2(c)).

- Guidance as to the meaning of the concepts of "substantial harm" and "credible evidence" (see paragraphs 225.6 and 225.18).
- A requirement for the PA to *understand* the provisions of laws and regulations governing how NOCLAR or suspected NOCLAR should be addressed, and not merely to comply with them (see paragraph 225.9).
- Making it clear that the concept of the public interest is not capable of general definition and that each situation will need to be considered individually (drawing from similar guidance in ISA 250 (UK & Ireland)). Consideration of each situation will need to have regard to the facts and circumstances of the NOCLAR or suspected NOCLAR, and the nature and extent of the consequences or potential consequences to stakeholders (see paragraph 225.23).
- Fine-tuning of the factors to consider in determining the nature and extent of further action needed to achieve the PA's objectives under the section and to serve the public interest (also drawing from some guidance in ISA 250 (UK & Ireland)). (See paragraphs 225.24-26.)
- Recognizing that in some jurisdictions there may be limitations as to the further actions available to the PA and withdrawal may be the only available course of action (see paragraph 225.30).

21. The Task Force is also proposing a change to the last sentence of paragraph 3 of Section 270[4] concerning situations where the PA provides custody of client assets and the PA becomes aware that they were derived from illegal activities such as money laundering. The Task Force believes that the current guidance, which suggests that the PA may consider seeking legal advice in these situations, is rather weak and proposes instead that the PA be required to comply with the provisions of Section 225.

Matter for Consideration

5. Do IESBA members agree with the Task Force's proposals?

F. Other Comments from the Board

22. In addition to the significant comments from the October 2014 Board meeting as noted above, the Task Force has considered other matters raised at the Board meeting as follows:

#	Matters Raised	Task Force Response
1.	Whether the wording of the second part of the objectives could be reconsidered, particularly with respect to the use of the passive voice, as how this was worded could be perceived as leading auditors to assume management responsibility.	Point accepted. See paragraph 225.2.
2.	Whether it would be acceptable for the PA not to report suspected NOCLAR if there was a risk of	A high bar is needed for the determination of any further action needed to serve the public interest, including whether to

[4] Section 270, *Custody of Client Assets*

#	Matters Raised	Task Force Response
	harm, as opposed to substantial harm, to stakeholders.	override confidentiality under the Code to disclose NOCLAR or suspected NOCLAR to an appropriate authority. Also, "harm" could be interpreted as being quite a low threshold.
3.	With regard to the reference to the independence of TCWG from management in the list of factors to consider in determining the nature and extent of further action, whether a term other than "independent" could be used to avoid confusion with auditor independence.	The Task Force does not believe that this would be misunderstood given that the concept of independent directors is generally well recognized and understood.
4.	The need to acknowledge that certain roles for PAs may involve higher confidentiality expectations (e.g., client privilege roles such as forensics and litigation support) and that difficult dilemmas could arise for the PA if the client has not appropriately responded to suspected NOCLAR.	The Task Force does not intend those types of engagements to be scoped in. The Task Force has proposed guidance to make this clear (see paragraph 225.42).
5.	How the PA should deal with a suspected NOCLAR identified in a due diligence engagement if the transaction falls through, and also if the transaction is successful.	This type of engagement would be scoped out as proposed Section 225 only deals with identified or suspected NOCLAR by the client or committed by those within the client. The section does not address NOCLAR identified or suspected at a third party. The Task Force believes that the guidance in the section may nevertheless be helpful to the PA in considering how to respond in such situations. The Task Force has proposed guidance to that effect in paragraph 225.7(c).
6.	Whether it would be effective to inform the parent entity of the suspected NOCLAR in the case of a component within a group. In particular, it is unclear what the parent entity should do with the report and whether it could address the matter, especially if it occurred in a component in a foreign jurisdiction. Also, even if the matter was material for the component, it might not be so for the parent entity.	The aim is to flag the matter to the attention of the parent entity management, as one of a number of possible further actions for the PA. It would be the responsibility of the parent entity management to determine how it should respond to the matter.
7.	With respect to PAIBs, whether the degree of seniority within the organization should be	The Task Force believes that making such a distinction could unnecessarily render the

#	Matters Raised	Task Force Response
	recognized, i.e., the more senior PAIBs are, the higher their responsibilities.	proposals complex. In particular, levels of seniority may vary among senior PAIBs and also among PAIBs who are not senior PAIBs. In any event, the Task Force notes that paragraph 300.5 in the recently issued Part C exposure draft already states: "The more senior the position of the professional accountant, the greater will be the ability and opportunity to influence policies and decision-making."
8.	In relation to the description of a senior PAIB, whether there should be reference to proximity to the matter and the individual's ability to act.	Point partially accepted – see paragraph 360.11. Proximity to the matter is implicit in the concept of "significant influence".
9.	Also in relation to the description of a senior PAIB, whether there should be reference to "senior" employees as opposed to merely employees.	Point accepted – see paragraph 360.11.
10.	With respect to consideration of the level of seniority of the PA, whether there should be a distinction between a junior auditor and an audit engagement partner.	The TF believes that addressing reporting within the audit engagement team would be an unnecessary complication. In any event, this would be covered by the ISAs.
11.	Whether it is sufficiently clear that PAIBs other than senior PAIBs are free to report suspected NOCLAR to an appropriate authority without breaching the Code.	The Task Force believes that this would be unnecessary as the permission to override confidentiality is already granted in paragraph 140.10(d). The Task Force believes that it should be clear in Section 360 what PAIBs who are not senior PAIBs are required to do, i.e., escalating the matter to the PAIB's superior or raising the matter through an internal ethics policy.

G. **Responses to Roundtable Case Studies**

23. At the October 2014 Board meeting, there was a question as to whether, in relation to the two case studies that were discussed at the three global roundtables, specific stakeholders could be identified who were in favor of reporting suspected NOCLAR to an appropriate authority, and whether it would be possible to see how those views changed during the course of the discussions.

24. For information, the Task Force has compiled the statistics regarding the responses to the case studies, as shown in Agenda Item 5-G. The Task Force notes that the case studies were only aimed at:

    (a) Setting the context for the discussion of the key issues with the roundtable participants;

    (b) Stimulating their immediate reactions as a means to promote wide and active engagement in the discussions; and

    (c) Promoting greater appreciation among participants regarding the complex issues involved in this project and the diversity of views that exist on them.

25. The amount of information contained in the case studies was deliberately limited, as was the time allocated to participants in responding to them, in order to avoid participants over-analyzing them, thereby undermining the aims of the case studies. Many participants responded to the case studies with the context of their national legal and regulatory frameworks in mind and made various assumptions based on the limited information provided. The roundtables were not designed to track the orientation of each participant's views on the issues as the discussions progressed through the day. Accordingly, it would not be possible to see how those views changed during the course of the discussions, nor indeed would it be reasonable to expect the roundtables to be able to demonstrate this given the breadth and complexity of the issues, and the large number of participants across the three roundtables.

26. For information, the two case studies are set out in the Appendix.

APPENDIX

Case Study 1

Duraglass Corp. is a company listed on the stock exchange of Ruritania. Its main business is the production and supply of a type of glass used in the manufacture of smartphones around the world. Recently, the business has been under significant threat as the company has been losing its major customers to a competitor that has developed another type of glass with bendable and scratch-resistant properties at a lower cost. In June 20X1, Duraglass Corp. declared an interim dividend of CU[5] 150 million which was paid in August 20X1. The audit of the company's financial statements for the year ended December 31, 20X1 was completed in April 20X2.

Given the trajectory of the business, Duraglass Corp. should have taken an impairment charge on its production assets in its 20X1 financial statements, which would have eliminated its distributable reserves and precluded payment of the interim dividend. It is illegal in Ruritania for companies to pay dividends out of non-distributable reserves.

Action Requested

Putting yourself in the role of the professional accountant in each of the following scenarios, please indicate on the wall chart (using the post-it notes provided to you) what you would do in the above situation upon finding out about the need to take the impairment:

(a) Eugene, the audit partner in charge of the audit of Duraglass' financial statements for the year ended December 31, 20X1, who identified during the audit in February 20X2 the need to write down Duraglass' production assets.

(b) Marisol, a partner in the Corporate Finance department of another accounting firm, who is carrying out a valuation engagement in November 20X1 regarding Duraglass' assets for purposes of identifying capital raising options for Duraglass and has a copy of Duraglass' quarterly financial statements for the nine months ended September 30, 20X1.

(c) Tatyana, the CFO of Duraglass, who is finalizing the draft 20X1 financial statements in preparation for the annual audit.

(d) Oleg, the Financial Accountant of Duraglass who participates in the preparation of Duraglass' 20X1 financial statements.

[5] CU: Currency Unit

Case Study 2

Terralyne Ltd is a specialty manufacturer of rubber products used in industrial applications. It is based in Europe. Among its various product lines, it markets TerraCap rings at 50 cents each. The rings are manufactured from a proprietary rubber formula that gives them a high tolerance to heat and cold as well as certain chemicals, which means they can be useful in nuclear applications.

In each of the circumstances below, it was found that Terralyne Ltd had recently shipped 100 TerraCap rings to an Iranian firm along with an order for other Terralyne products. Export of the rings from Europe to Iran has been banned since 2010.

Action Requested

Putting yourself in the role of the professional accountant in each of the following scenarios, please indicate on the wall chart (using the post-it notes provided to you) what you would do in the above situation:

(a) Georgia, the audit partner from Terralyne's external audit firm, who was made aware of the matter by her audit manager after he had come across the information when carrying out certain audit procedures.

The value of the TerraCap rings transaction was immaterial for the audit and the transaction itself was not selected for audit testing.

(b) Leo, a partner from the IT consulting division in another accounting firm, who was briefed on the matter by one of his staff after she had stumbled upon the information while undertaking an internal control engagement related to Terralyne's IT systems.

(c) Victor, the Chief Financial Officer of Terralyne, who found out that the rings had been inadvertently shipped to the Iranian firm when trying to resolve a complaint from a Kuwaiti firm that had actually ordered the rings.

(d) Mango, the Finance Manager at Terralyne, who, on a coffee break in the company cafeteria, overheard two staff members from the shipping department discussing the shipment of the rings to the Iranian firm.