

October 21, 2015

## **Small and Medium Practices (SMP) Committee Response to the Exposure Draft: *Proposed Amendments to the IAASB's International Standards – Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations***

### **INTRODUCTION**

The SMP Committee (SMPC) is pleased to respond to the IAASB on this Exposure Draft (ED).

The SMPC is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small-and medium-sized entities (SMEs). The constituents of the SMP Committee are small-and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members and Technical Advisers serving the SMPC are drawn from IFAC member bodies representing 22 countries from all regions of the world<sup>1</sup>.

We have closely followed the development of the IESBA project on Non-Compliance with Laws and Regulations (NOCLAR) and submitted a [comment letter](#) in response to its recent Exposure Draft: *Responding to Non-Compliance with Laws and Regulations* (the IESBA ED).

### **GENERAL COMMENTS**

We support the IAASB and IESBA working together to consider amendments to International Standards<sup>2</sup> in response to the IESBA project on NOCLAR. We agree that it would be appropriate and helpful for the respective Boards to ensure there is an alignment of the work efforts required by the IESBA *Code of Ethics for Professional Accountants* (the Code), the ISAs, and all the other IAASB standards.

We are, however, concerned with the timing of the IAASB ED as the IESBA proposals will not be finalized until after its closure, and many in the profession believe certain proposals remain contentious. It could also be argued that the IAASB Explanatory Memorandum indicates support, or a “seal of approval”, for the IESBA proposals, which may have resulted in some commentators not according the IESBA proposals the necessary degree of critical reading. In addition, we believe that the potential impact of the IESBA NOCLAR proposals on audit quality should be fully explored by the IAASB (the Board).

In principle, we do not support alignment of ISA 250<sup>3</sup> with the IESBA NOCLAR proposals, since these have not been finalised and, in our opinion, cannot be considered entirely uncontentious. We have raised a number of concerns with the proposed changes to the Code, which are explained in our comment letter response to the IESBA ED.

---

<sup>1</sup> Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Italy, Kenya, Malawi, Malta, Nigeria, South Africa, Spain, Sweden, Turkey, Tunisia, Uganda, United Kingdom, United States.

<sup>2</sup> The IAASB's International Standards comprise the International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs), International Standards on Assurance Engagements (ISAEs), International Standards on Related Services (ISRSs), and International Standards on Quality Control (ISQCs).

<sup>3</sup> ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*



In our view, some of the changes proposed to the Code have been addressed in the IAASB drafting proposed changes to the ISAs. However, in other cases, the areas included in the 'Invitation for Additional Input' relate to matters discussed in the IESBA proposals, but no changes to the standards seem to have been proposed. For example, it could be questioned that if the Code was changed to require instances of NOCLAR that a professional accountant (PA) believes may be about to occur with management (proposed paragraph 225.12 of the Code), would the IAASB follow suit and change the ISAs as appropriate, given the implications as to client integrity.

The standards of the standards setting boards (IAASB, IESBA, IAESB) have always been written in the public interest such that there is a presumption that when the PA has met the standard (objectives and requirements), the PA has acted in the public interest. The IESBA is now proposing to change this by introducing a public interest test that is either not actionable or enforceable, and may lead to audit oversight authorities second-guessing auditors as to what is in the public interest. This issue is exacerbated by the "reasonable informed third party" test. The IAASB's silence on this aspect of the IESBA's proposals appears to imply acceptance of this change in approach.

We believe that the determination of any action that may be needed in the public interest in any particular circumstance is highly subjective. There needs to be some recognition (by IAASB and IESBA) that there are varying degrees of public interest and it is not the same for all audits. For example, it could be argued that the voluntary audit of a small unlisted entity has significantly fewer public interest implications, compared to the statutory audit of a listed entity, or a large financial institution.

## **Issues not (yet) discussed by the IAASB or the IESBA**

### **Auditor Reporting**

We believe that both the IAASB and the IESBA should give consideration to the impact of the new and revised Auditor Reporting Standards and, in particular, the requirements in the new ISA 701<sup>4</sup> when NOCLAR constitutes a Key Audit Matter (KAM). For example, it may need to be clear in ISA 701 what impact NOCLAR would have, or not have, on the auditor's report. In our view, the auditor's report is on the financial statements only and reporting by the auditor on the true and fair opinion would not extend to NOCLAR beyond this. However, it is unclear whether the IAASB supports the proposed extension of the auditor's duty in this context as well. Clarification from the IAASB might be helpful in guiding public expectations in this relatively new area.

### **ISA 200 requirements**

We note that the IESBA has not (yet) chosen to discuss the general issue of how national ethical regimes might be measured against the Code in terms of their respective restrictiveness going forward, but believe that this is an issue that will need to be considered in conjunction with the IAASB. The proposals

---

<sup>4</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*



in the IESBA NOCLAR ED, if adopted, would increase the stringency of the extant Code in regard to instances of NOCLAR of which a PA may become aware. In addition, while the Code recognizes that it cannot override law or regulation, national laws or regulations may indeed prohibit the PA from complying with specific provisions of the Code.

These factors impact compliance with ISAs, in regard to whether national ethical requirements need to be at least as stringent as the Code, since an auditor is required by ISA 200.14 to: “comply with the relevant ethical requirements...”. In addition, ISA 200.A14 explains: “relevant ethical requirements ordinarily comprise Parts A and B of the IESBA Code of Ethics for Professional Accountants..., together with national requirements that are more restrictive”. As the Code becomes increasingly stringent or divergent from national “equivalents” in isolated respects, this issue will need to be addressed i.e., what can “ordinarily” be deemed to mean in this context.

In some jurisdictions there may be little or no law or regulation to address the role of a PA, or an auditor, encountering any form of NOCLAR. In many of the more developed jurisdictions there will be laws and regulations dealing with distinct issues e.g., money laundering and corruption etc. Legislation in the EU contains further requirements for auditors of public interest entities. As the ED potentially extends the scope to certain instances of NOCLAR including and beyond these issues, we suggest there is a need for the IESBA and the IAASB to explore how national requirements can be assessed. For example, when would they be deemed as either less, equally, or not as, restrictive as the Code in the context of this project – or should they be assessed as a whole, rather than in relation to isolated aspects of the Code? In particular, the two Boards may need to consider the consequences for auditors and the compliance with the ISAs in the event that national requirements are deemed less restrictive than the Code. We recognize that this issue is not limited to the proposals on NOCLAR, and we accept that this may need to be addressed “as a whole” rather in respect of isolated projects.

### **Alignment of the approach**

The IESBA NOCLAR proposals cover both audit and non-audit services, but do not adequately convey the fact that the ability of the PA to identify NOCLAR differs according to the type of service provided. For example, the sufficiency and appropriateness of evidence with which a PA would be satisfied as to whether initial indications of NOCLAR support, or do not support, the identification of NOCLAR for a limited assurance engagement is considerably less than for a reasonable assurance engagement. Likewise, the information that a PA might obtain to satisfy themselves with respect to issues identified as part of a compilation engagement would have significantly less evidential value than in an assurance engagement. There is a risk that the public may have unrealistic expectations unless the IAASB and IESBA can work together to address this issue.



## **SPECIFIC COMMENTS**

### **Proposal to change the auditors existing responsibilities within the requirements of ISA 250**

We believe that the proposal to replace “responsibility” with “legal or ethical duty or right” in ISA 250.28 could introduce a significant degree of uncertainty, which may have unintended consequences impacting the trust in the relationship between the client and the auditor, ultimately to the detriment of audit quality. In the SMPC comment letter in response to the IESBA ED, we raised the concern that the uncertainty over if, when, and how, an auditor might break client confidentiality could have the unintended result that management may cease to be as forthcoming to the auditor’s inquiries.

We only foresee auditors breaking client confidentiality where this is already provided for within the applicable laws and regulations of their jurisdiction. In our opinion, the IAASB proposal does not provide a balanced view since it emphasizes a “duty or right” to report, when in many jurisdictions there may be legal prohibitions on reporting. These should be equally prominent.

The IESBA proposals for the Code include potentially mitigating factors, which are not addressed in the IAASB’s ED. This includes external factors such as whether there exists robust and credible protection from civil, criminal or professional liability or retaliation afforded by legislation or regulation or where there are actual or potential threats to physical safety (see IESBA ED para. 225.27). The paragraphs in the IAASB standards where there is potentially a lack of balance between “duty or right” on one hand and “prohibition or other risks” on the other are ISA 250.28, A15, A19; ISA 240.A65<sup>5</sup>; ISQC 1 A56<sup>6</sup>; and ISAE 3402.A53<sup>7</sup>.

### **Lack of alignment in terms of the work effort**

When the auditor becomes aware of information concerning an instance of non-compliance, ISA 250.18 requires the auditor to obtain an understanding of the nature of the act and the circumstances in which it has occurred. Related application guidance in ISA 250.A13 provides examples of the types of information that may be relevant in this context, indicating that the auditor’s understanding would be expected to be of a relatively general nature at this initial stage. Following on from this, ISA 250.19 puts the onus firmly on the entity’s management, and where appropriate, those charged with governance (TCWG), to investigate suspected instances of non-compliance and provide to the auditor sufficient information to dispel such suspicion.

In contrast, paragraph 225.11 of the ED IESBA, includes proposed changes to the Code for the auditor to be required to obtain a more comprehensive understanding of the matter – extending the term “matter” to include both acts that have occurred, as well as those that may yet occur, and extending the understanding to specifically include the application of the relevant laws and regulations to the

---

<sup>5</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>6</sup> International Standard on Quality Control (ISQC 1), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

<sup>7</sup> ISAE 3402, *Assurance Reports on Controls at a Service Organization*



circumstances. Therefore, before any discussion with the entity's officers, the proposed changes to the Code exceed extant ISA 250 and would specifically require the auditor to look into the matter more thoroughly than is required under the ISAs.

We believe this proposed "difference" between ISA 250 and the Code is inappropriate for two reasons. Firstly, in practice the auditor's required "understanding" under the Code would lead them to "firm up on" facts as a prerequisite to obtaining an understanding of the legal position, as (in contrast to ISA 250) it appears that the Code is dealing with relatively well founded suspicions at this stage. Indeed, obtaining an understanding of the legal position pertaining to the individual matter (which is not required under ISA 250 at this stage) will often involve recourse to legal advice, which would certainly add costs to audits. For instance, regulators would expect diligent documentation. Secondly, in placing the onus on the auditor at this initial stage, instead of on management, it may also potentially leave the auditor open to claims, should the auditors "probing" be perceived as a false accusation, deformation of character or similar. For example, in the worst case scenario it may lead to a formal legal investigation that could subsequently dispel the original suspicion. In addition, a perception of excessive probing by the auditor prior to a discussion of the matter with the entity's officers beyond "normal" audit procedures could be detrimental to the auditor's relationship with the client.

In our view, the approaches of both the IESBA and IAASB differ in terms of the risk-based approach under the ISAs. Whilst we recognize that proposed paragraph 225.8(a) of the Code clarifies the exclusion of clearly inconsequential matters, the proposals still do not recognize a risk-based approach in terms of the required work effort. We suggest that the IESBA and IAASB align the required work effort more closely to ISA 250, and other of the IAASB's standards, as applicable.

### **Proposed limited amendments**

The proposals for ISA 250.8a and ISA 240.8a both use the term "may", which, in practice following the NOCLAR ethical requirements would mean either the auditor does, or does not, have additional ethical responsibilities. We believe that the IAASB should consider whether in the absence of "additional responsibilities" the auditor currently does sufficient work under the ISAs regarding the evaluation of the integrity of management or TCWG. It could be helpful to look into whether there have been cases where inspection findings indicate deficiencies in this area and also consider how this links in with the project on professional skepticism.

We are concerned that the IAASB is proposing to add the same examples of laws and regulations (ISA 250.A5a) as proposed by IESBA, without fully considering all the possible implications. In our opinion, there is a risk that public expectations will be increased beyond what auditors are able to do. We also note that the example of securities markets and trading was added by the IESBA in response to regulatory stakeholders, despite the IESBA ED Explanatory Memorandum acknowledging that insider trading is generally extremely difficult to prove in practice. In addition, paragraph 6 (b) already includes examples, which seem to duplicate the new list in paragraph A5a. We recommend just including the examples in the explanatory material.



In ISA 250.A5a the words “one or the other, or both” could be inserted between the words “in” and “categories” (after deleting the word “the” prior to categories), since it is not clear that these laws and regulations cannot be categorized between the two categories on an exclusive basis.

In our response to the IESBA ED, we raised significant concerns with the proposals that go beyond the scope of the extant ISA 250 in respect to reporting non-compliance to an external authority. We therefore do not support the proposed changes to paragraphs ISA 250.28 and A19 to align ISA 250 to this aspect of the proposed Code, changes to ISQC 1.A56, ISA 240.43 and A65, ISRE 2400.A92<sup>8</sup> and ISAE 3402.A53.

As noted above, we are particularly concerned with the proposal in ISA 250.28 to amend “responsibility” to “legal or ethical duty or right” as this is a major change to the extant ISA, which only deals with legal responsibilities. The proposed change implies that an ethical duty must be followed and a right may, or may not, be exercised. The proposed accompanying guidance in ISA 250.A19-A20 does not expand on this aspect (it repeats “the auditor may have the right to disclose...”). The change may lead to considerable uncertainty, especially when read in conjunction with the relevant provisions of the proposed IESBA Code. The result also has the potential to cause unintended consequences and impact audit quality. Our letter to the IESBA discussed this issue in more detail and we refer to that letter in this context also.

In addition, the proposal that obtaining legal advice in the context of disclosure to an external party (ISA 250.A19) could be helpful in making the required determination, does not seem logical. Legal advice can identify the relevant provisions in law, but not the ethical issues extending beyond the law. It will also likely add to the costs of an audit, as auditors seek to ensure they have considered all the relevant legal aspects.

### **Jurisdictions that have not adopted or do not plan to adopt the Code**

We are concerned that the inclusion of paragraph A12a in ISA 250 could invite unrealistic expectations, especially where the auditor does not use the Code, or has similar requirements elsewhere. There is also a risk it could be interpreted as meaning additional audit effort is required by the Code, which does not seem appropriate as the audit procedures included within the ISAs are considered to be comprehensive. If the paragraph remains, it could be argued that similar guidance might be required for ISRE 2410<sup>9</sup>, ISAE 3000<sup>10</sup>, ISAE 3400<sup>11</sup>, ISAE 3410<sup>12</sup>, ISAE 3420<sup>13</sup>, ISRS 4400<sup>14</sup> and ISRS 4410<sup>15</sup>.

---

<sup>8</sup> ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*

<sup>9</sup> ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*

<sup>10</sup> ISAE 3000, *Assurance Engagements Other than Audits or Reviews or Historical Financial Information*

<sup>11</sup> ISAE 3400, *The Examination of Prospective Financial Information*

<sup>12</sup> ISAE 3410, *Assurance Engagements on Greenhouse Gas Statements*

<sup>13</sup> ISAE 3420, *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*

<sup>14</sup> ISRS 4400, *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*

<sup>15</sup> ISRS 4410 (Revised), *Compilation Engagements*



## **Additional Input**

We have received feedback that the use of the word “shall” in the extant ISA 250 paragraphs 19 and 20 may be contrary to the tipping off provisions of certain Anti Money Laundering (AML) Regulations in some jurisdictions, and note that the IAASB proposes to address this within application material of ISA 240 and ISA 250; but not within the requirements section of these standards. In our view, this is an appropriate time for the IAASB to address this issue within the requirement paragraph 19, and include a preclusion statement similar to that in the Code (proposed para. 225.27 of the IESBA ED).

Furthermore, ISA 250.A15 cross refers to paragraph 19 which first requires a discussion with management and, where appropriate also with TCWG. However, A15 is silent on management and only refers to TCWG, thus it is not implied that any tipping off regulation may potentially apply to communication with management. We believe that it should be clear that the same tipping off carve out applies also to management and that this is of such importance as to warrant inclusion in the requirements section.

This issue applies equally to ISA 240: We note that the mandatory “shall” is included in ISA 240.40, with no recognition of the fact that the required communication could contravene national legislation in certain circumstances. We suggest that paragraph 40 be cross referenced to the new application and explanatory material (A59a) and also recommend that paragraph 40 be amended to state “where permitted by law or regulation, the auditor may...” or changed in line with ISA 450.8<sup>16</sup> “The auditor shall communicate....unless prohibited by law or regulation”.

Similarly, the revised application material paragraph A92 in ISRE 2400 (Revised) is focused on external issues. We believe that the IAASB should consider including detail on the internal matters as raised in the cross reference para 52(a). Again, the Board may wish to consider revisiting the inclusion of “shall” in section (a) of this particular paragraph.

The new paragraph A8a in ISQC 1 does not seem to include recognition that such communication between the auditor and predecessor audit may not be able to take place without a client waiver of confidentiality in certain jurisdictions.

## **CONCLUDING COMMENTS**

Overall, we are concerned that the proposed changes to the ISAs are not appropriately balanced as they do not acknowledge the possibility that national law and regulation may preclude the professional accountant from acting on such ethical aspects.

---

<sup>16</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*



We hope the IAASB finds this letter helpful. We are committed to helping the Board in whatever way we can to build upon the results of this ED.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

A handwritten signature in black ink, which appears to read 'Giancarlo Attolini'. The signature is written in a cursive style and is positioned below a short horizontal line.

Giancarlo Attolini  
Chair, SMP Committee