Responding to Non-Compliance with Laws and Regulations—Issues Paper

I. Background

1. At the September 2013 meeting, the Board considered a revised straw man of an alternative to the approach set out in the exposure draft, *Responding to a Suspected Illegal Act*, (the ED) regarding a professional accountant's (PA's) responsibilities when encountering a suspected illegal act (SIA). Among other matters, the Board tentatively agreed the following:

   - The terminology used in the straw man should be aligned with that in the ISAs by replacing the term "illegal act" with the term "non-compliance with laws and regulations" (NOCLAR).
   - The concept of a rebuttable presumption that disclosure of a SIA will be made to an appropriate authority in the appropriate circumstances in the case of an audit of a public interest entity (PIE) should be reconsidered in terms of whether it can be operationalized in the context of what can be reasonably expected of a PA bound by the Code.
   - The need for a materiality filter early on in the process should be considered as the straw man appears to direct the PA to pursue every matter that is other than clearly inconsequential through to the end of the process.
   - Guidance should be provided to highlight that if documentation is prepared, this should be done carefully and thoughtfully as documentation can be subject to legal discovery.
   - Consideration should be given to how best to facilitate communication between successor and predecessor auditors within the context of the legal framework and subject to client consent.

2. Previously, at the June 2013 meeting, the Board had also tentatively agreed the following:

   - The Code should explicitly permit for PAs to override the duty of confidentiality under the Code and disclose a SIA to an appropriate authority in the appropriate circumstances when it is judged to be in the public interest.
   - Sections 225[1] and 360[2] should provide more general guidance to support PAs in public practice and PAs in business (PAIBs), respectively, in responding to a SIA.
   - The types of SIA that should be subject to disclosure should not be limited to those falling within the PA's expertise.
   - The proposed thresholds for actions, including the public interest test for disclosure to an appropriate authority, are generally appropriate in the context of voluntary disclosure.
   - Documentation should not be mandated but encouraged. In addition, guidance should be provided to explain why documentation can be helpful to PAs in those circumstances.
   - The general approach with respect to PAIBs in the proposed section 360 appears appropriate.

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

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

3. The Task Force has developed the proposed changes to the Code shown in Agenda Item 5-B (NOCLAR draft) based on the revised straw man and the Board discussions. The key matters the Task Force wishes to bring to the Board's attention are discussed below (Issues A-D are focused on the proposed Section 225 and Section 210;[3] Issue E on the proposed Section 360 and partly Section 225).

II. Significant Issues

A. Disclosure of Non-Compliance with Laws and Regulations to an Appropriate Authority

4. At the September 2013 meeting, the Board considered the option of a rebuttable presumption where the client is a PIE audit client and the PA has determined that disclosure would in principle be in the public interest. Under this approach, the presumption would be that the PA would disclose the matter to an appropriate authority when certain conditions are met, including the availability of protection under law or regulation that is sufficiently established to protect the PA from civil or criminal liability. The Task Force noted the concerns of several IESBA members regarding the operability of such an approach in a global Code, even under the defined limited circumstances. Among those concerns were views that a rebuttable presumption would amount to a de facto requirement in practical terms (a view also expressed at the CAG), and that whether this approach would be workable would depend on the existence of a fair and trusted legal process and one that was accustomed to dealing with the concept of rebuttable presumption.

5. Having further reflected on the matter, the Task Force agreed that the real issue is not about whether disclosure to an appropriate authority would be justified if doing so would be in the public interest, but about *compelling* the PA to do so. The Task Force believes that establishing a presumption or requirement in the Code would presuppose the existence of a legal framework and process accustomed to dealing with a rebuttable presumption or requirement of disclosure, and not merely the availability of sufficiently established legal protection from civil or criminal liability. Given the wide variation in legal frameworks around the world and in the degree to which they are developed, the Task Force felt that it would be inappropriate and unreasonable for a Code for global application to establish a presumption or requirement of disclosure based on such presupposition, nor to compel the PA to take a leap of faith that the legal process will be sufficiently robust to deal with any adverse consequences for the PA or indeed make the PA whole given the potential costs of disclosure.

6. The Task Force believes that it is, and should be, within the proper authority, purview and power of national legislators or regulators to establish a disclosure obligation for PAs, as in fact is the case in a number of jurisdictions around the world that already mandate disclosure by PAs in the context of audits of financial statements. Further, in the context of the responses to the ED and further discussions with regulators and audit oversight bodies, the regulatory community as a whole has not argued, nor made a case, that the Code must impose a disclosure obligation on PAs in the circumstances envisaged.

7. The Task Force therefore came to the view that it would not be appropriate to pursue the options of a rebuttable presumption or a requirement. Instead, the Task Force proposes the following approach:

[3] Section 210, *Professional Appointment*

- With respect to terminology in the proposed changes to the Code, referring to *reporting* of non-compliance to an appropriate authority as opposed to *disclosure* of non-compliance in order to more precisely describe what is intended.
- With respect to the reporting process, first recognizing that if there already are legal or regulatory provisions in place governing the reporting of non-compliance, the PA must comply with those provisions (see paragraph 225.19).
- Where there are no such legal or regulatory provisions, requiring the PA to make a determination as to whether reporting would nevertheless be in the public interest provided, of course, that such reporting would not be contrary to law or regulation (see paragraph 225.20). Such determination will require an evaluation of the gravity of the matter in terms of consequences (financial and non-financial) to those potentially affected by the matter. As an illustration of what is intended, the Task Force proposes guidance to explain that an auditor of a listed entity would take into account whether the matter might cause substantial harm to investors (see paragraph 225.21). (With respect to the public interest threshold, see also Issue E below.)
- Making it clear that if the PA then decides to voluntarily report in such a situation, "this would not be a breach of the duty of confidentiality under the Code" (see paragraph 225.20). The Task Force believes that this wording sends a stronger and more positive message than what was previously suggested in the straw man, i.e., that the PA "is permitted to override the duty of confidentiality under the Code."
- To assist the PA in deciding whether to report in the circumstances, providing guidance regarding the need to consider the degree to which relevant information is known and substantiated, and whether there is an appropriate authority to receive the information. In this regard, the Task Force proposes a refinement to the description of an appropriate authority, i.e., that it is one that has acknowledged that it can receive the information and cause the matter to be investigated (see paragraph 225.22).
- Recognizing further that the existence of whistle-blowing protection from civil or criminal liability may be a factor to consider in deciding whether to report (see paragraph 225.22). However, the Task Force did reflect on whether it would be better to delete protective mechanisms as a factor to consider altogether so as to avoid the impression that absence of such mechanisms would inappropriately deter the PA from reporting.

8. The Task Force believes that this approach is a practicable way forward and, together with the proposal that the Code mandate communication between successor and predecessor auditors in the case of audits of financial statements (see Issue C below), would raise the bar significantly relative to where the Code stands today. The Task Force believes that it behooves legislators and regulators, as the principal guardians of the public interest, to take action to put in place the necessary legal and regulatory framework and process at the national level to support the reporting by PAs of non-compliance to an appropriate authority. In this regard, the Task Force suggests that the Board, and IFAC more generally, should encourage the regulatory community to take steps in that direction through stimulating broader policy debates on this issue internationally.

Matters for Consideration

1. IESBA members are asked:

   (a) Whether they support the Task Force's proposals above and the related changes to the straw man; and

   (b) To consider whether it is appropriate that whistle-blowing protection be a factor for the PA to consider in evaluating whether to report non-compliance to an appropriate authority.

B. **Materiality Filter**

9. One of the preconditions for the presumption of disclosure that the Board considered at the September 2013 meeting was that the matter has a material impact on the financial statements and those financial statements have not been adjusted to reflect that impact. Notwithstanding Board concerns regarding the appropriateness of establishing materiality as a precondition in this context, it was noted that this test of materiality comes late in the process and it should rather come earlier to avoid the PA having to put every matter that is other than clearly inconsequential through the process of investigation and resolution.

10. The Task Force first agreed that as a matter of *ethical principle*, every identified or suspected non-compliance should be a matter of concern for the PA regardless of the significance or potential impact of the non-compliance. The Task Force, however, recognized that the Code is a body of standards for practical application and it would not serve the public interest if the Code were impracticable for PAs to apply. Accordingly, the Task Force agreed that it would be appropriate to introduce a materiality filter at the front end of the process, albeit that this would not necessarily be intended to indicate that any identified or suspected non-compliance that passes this filter will be material to the financial statements.

11. The Task Force proposes that this be done at the following two stages:

- At the point when the PA becomes aware of information concerning potential non-compliance, the PA should seek to obtain an understanding of such a matter as long as it is *other than clearly inconsequential* (see paragraph 225.5). At this point in the process, the PA will generally have only a limited amount of information concerning the matter and it is only appropriate that the scope be fairly wide in terms of seeking an understanding of the nature and implications of such matters. Nothing in the Code of course will preclude the PA from pursuing matters that are clearly inconsequential should the PA choose to do so.

- At the point of understanding what actions the client, its management or those charged with governance (TCWG) plan to take to address the matter and then evaluating their response, the Task Force felt that these efforts should more narrowly focus on matters that could have *significant consequences for the client or others* (see paragraphs 225.9(b) and 225.14). At that stage of the process, after having discussed the matter with the client to confirm the PA's understanding of the facts and circumstances and the potential consequences, the PA should have an appreciation of whether or not the matter could have significant consequences for the client or others. It will be a matter of the PA's professional judgment as to whether a particular matter could have significant consequences in this regard. Again, nothing in the

Code will preclude the PA from pursuing matters that would not likely have significant consequences should the PA choose to do so.

12. Thereafter in the process through to consideration of whether to report to an appropriate authority, the PA's efforts will focus only on matters that could have significant consequences for the client or others. The Task Force believes this approach gives due regard to proportionality of work effort and costs of implementation.

Matter for Consideration

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

C. Communication Between Successor and Predecessor Auditors

13. Under extant paragraph 210.11, the Code currently suggests as a safeguard that when considering taking up a new appointment with a prospective client, a PA ask the existing PA to provide known information on any facts or circumstances that, in the existing PA's opinion, the proposed PA needs to be aware of before deciding whether to accept the engagement.

14. At the September 2013 meeting, several IESBA members emphasized the importance of communication between the successor and predecessor auditors in the case of audits of financial statements. It was recognized that it would not be in the public interest if a matter of non-compliance were to be simply dropped as a result of the withdrawal of the existing auditor from the client relationship without a potential successor being alerted to it. It was noted that this issue was flagged for the Board's consideration at the September 2013 CAG meeting. In addition, in its response to the ED, the International Organization of Securities Commissions (IOSCO) had recommended that the Board consider requiring the predecessor auditor to notify a successor auditor of the non-compliance, prior to the latter's final acceptance of the engagement, so that the successor auditor understands the risk of accepting the engagement. Further, a recommendation arising from the International Auditing and Assurance Standards Board's (IAASB's) Audit Quality project is for the IESBA to consider improving information sharing between audit firms when one firm decides to resign from, or is not reappointed to, an audit engagement.

15. The Task Force recognizes the potential benefits that may flow from the Code mandating communication between successor and predecessor auditors. In particular, this could more effectively lead to desired outcomes in the public interest in terms of prompting appropriate actions by management or TCWG to respond to non-compliance, or deterring the commission of non-compliance, than what might otherwise be achieved in the Code. The Task Force also has considered existing practice in Canada and the UK where the national ethical requirements in this area are more demanding. Canada, in particular, already has a requirement with respect to communication between successor and predecessor auditors and a further related requirement regarding sharing by a predecessor auditor of information concerning suspected fraud or other illegal activity with a possible successor auditor.[4]

[4] **Canadian Rule of Professional Conduct 302, *Communication with Predecessor***

.1 A member shall not accept an engagement with respect to the practice of public accounting or the public practice of a function not inconsistent with public accounting, where the member is replacing another member or public accountant,

16. In the light of the above, the Task Force has reconsidered its previous reservations about establishing a communication requirement between successor and predecessor auditors in the Code. The Task Force thus proposes that Section 210 be amended as follows:

    - Requiring in the case of an audit of financial statements that a proposed PA request the existing PA to provide known information regarding any facts or circumstances that, in the existing PA's opinion, the proposed PA needs to be aware of before deciding whether to accept the engagement (see paragraph 210.11).
    - If the client fails or refuses to grant the existing PA permission to discuss the client's affairs with the proposed PA, requiring the existing PA to report this fact to the proposed PA; and requiring the proposed PA to then carefully consider the reason for such failure or refusal when determining whether or not to accept the appointment (see paragraph 210.11).
    - Making a consequential change to paragraph 210.9 to delete the indication in the current Code that depending on the nature of the engagement, direct communication with the existing PA may be required to establish the facts and circumstances regarding the proposed change of appointment.

17. These proposed requirements will, importantly, need to operate within the constraints of client consent and the specific requirements of the legal, regulatory and ethical framework in the particular jurisdiction. Accordingly, the Task Force proposes retaining the current provisions in paragraphs 210.12-13 to the effect that whether the existing PA is able to discuss the client's affairs with the proposed PA is subject to client consent and the prevailing national legal, regulatory or ethical requirements regarding such communication and disclosure.

18. A concern was expressed during the September 2013 Board discussion that the most significant obstacle to introducing a communication requirement in the Code would be whether legal protection exists given that the information conveyed by the existing PA could include an allegation of wrongdoing. The Task Force did not share the view that the absence of legal protection should be an impediment to the existing PA communicating with the proposed PA given that the communication would be made confidentially and subject to the client's consent to enable the proposed PA to determine whether or not to accept the appointment. Further, the proposed PA would be bound by the overriding duty of confidentiality under the Code.

19. With respect to the scope of the proposed communication requirement, the Task Force felt that it would be appropriate to limit the requirement to audits of financial statements given the greater public interest role of auditors. Therefore, in all other cases, the Task Force proposes that communication with an existing PA continue to be a possible safeguard, subject to the relevant facts and circumstances (see paragraph 210.9).

20. Finally, notwithstanding the fact that Section 210 would be a natural home for the communication requirement, the Task Force considered whether the requirement would be better placed in auditing

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without first communicating with such person and inquiring whether there are any circumstances the member should take into account which might influence the member's decision whether or not to accept the engagement.

.2 The incumbent member shall respond promptly to the communication referred to in Rule 302.1.

.3 A member responding to a communication pursuant to Rule 302.2 shall inform the possible successor if suspected fraud or other illegal activity by the client was a factor in the member's resignation or if, in the member's view, fraud or other illegal activity by the client may have been a factor in the client's decision to appoint a successor.

standards given that it would apply only in relation to audits of financial statements. The Task Force believes that to drive the appropriate ethical conduct by auditors, which would serve to enhance audit quality, the requirement should be in the Code. Further, by complementing the provisions in the proposed Section 225, the requirement would serve to raise the bar in the Code in a practicable way for auditors in responding to non-compliance by clients. In the Task Force's view and subject to consultation with the IAASB, this approach also would complement the ISAs given that ISA 300 already requires a successor auditor to communicate with a predecessor auditor in compliance with relevant ethical requirements.[5]

Matter for Consideration

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

D. Documentation

21. As directed by the Board, the Task Force has added guidance to highlight the importance of careful and thoughtful documentation given that any documentation the PA prepares can be subject to legal discovery (see paragraphs 225.27 and 360.24).

22. The Task Force proposes that this new guidance be retained in the proposed Sections 225 and 360 for the time being together with the existing documentation guidance pertaining to those sections. The Task Force believes that there would be an opportunity under the Structure of the Code initiative to consider generally in due course the placement of the documentation provisions in the Code.

Matter for Consideration

4. IESBA members are asked whether they agree with the proposed new documentation guidance.

E. Proposed Section 360 – PAIBs

23. Except for the issue highlighted below, the Task Force has generally conformed Section 360 to the changes proposed in Section 225 but with a greater emphasis on providing guidance to the PAIB. Accordingly, there is a lesser degree of prescription with respect to specific actions the PAIB should take or consider in responding to non-compliance.

The Public Interest Threshold

24. In contrast to the approach in Section 225, the Task Force proposes that the PAIB's consideration of whether to report non-compliance to an appropriate authority *not* be made subject to the public interest threshold. Having further reflected on the different circumstances and responsibilities of a PA in public practice and a PAIB, the Task Force believes that it would be unreasonable for the

[5] ISA 300, *Planning an Audit of Financial Statements*, paragraph 13, states the following:

> The auditor shall undertake the following activities prior to starting an initial audit:
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> (a) Performing procedures required by ISA 220 regarding the acceptance of the client relationship and the specific audit engagement; and
>
> (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.

Code to demand that an individual PAIB make a public interest determination with respect to reporting of the non-compliance to an appropriate authority, and expect that the PAIB would be able to make such a determination on his or her own. The Task Force believes it would be more appropriate in the case of a PAIB for a public prosecutor or regulator to make the determination as to whether reporting of the matter to an appropriate authority would have been in the public interest.

25. Accordingly, paragraph 360.18 requires the PAIB to consider the gravity of the matter and whether it should nevertheless be reported to an appropriate authority, provided that such reporting would not be contrary to law or regulation. Paragraph 360.19 then provides guidance to assist the PAIB in judging the gravity of the matter and in considering whether report.

26. Having taken this approach for PAIBs, the Task Force also reflected on the alternative, with respect to Section 225, of not applying a public interest threshold regarding reporting of non-compliance to an appropriate authority. If this alternative were to be adopted, the relevant provisions in Section 225 could possibly read as follows:

> 225.20 Where there are no legal or regulatory provisions governing the reporting of non-compliance, the professional accountant shall consider the gravity of the matter and determine whether the matter should nevertheless be reported to an appropriate authority, provided that such reporting would not be contrary to law or regulation. If the professional accountant decides to report the non-compliance to an appropriate authority in such a situation, this would not be a breach of the duty of confidentiality under this Code.
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> 225.21 Whether reporting would be justified depends on the gravity of the matter, such as the consequences to those potentially affected by the matter in both financial and non-financial terms, including the nature and extent of any damage to the wider public. For example, a professional accountant acting as an auditor of a listed entity would take into account whether substantial harm to investors might be caused by the matter.

27. The Task Force noted that this alternative approach might be perceived as addressing concerns expressed by a number of respondents to the ED regarding how PAs in public practice would interpret the meaning of the public interest, although the Task Force believes this is less of an issue if reporting is not mandated in the Code. In addition, this alternative could be seen as being more responsive to concerns that IOSCO had raised regarding whether auditors would be able to make a determination as to whether a matter is in the public interest in the same way as a regulator. The Task Force noted, however, that the public interest threshold has been a significant consideration throughout the project, especially with respect to auditors. The Task Force therefore agreed not to finalize its views on this issue pending further reactions from, and discussion with, the Board.

Matters for Consideration

5. Do IESBA members agree with the proposed changes to Section 360?
6. What are IESBA members' views as to whether the public interest threshold should be retained in Section 225 with respect to reporting of non-compliance to an appropriate authority?