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INT/IESBA/874

- please always indicate -

Exposure Draft: Responding to Non-Compliance with Laws and Regulations (NOCLAR)

Dear Ken
Dear Ladies and Gentlemen

The WPK is pleased to take this opportunity to comment on the above mentioned Exposure Draft (hereinafter referred to as "ED"). We would like to address some general issues first and provide you with our responses to the questions of the ED subsequently. As the German profession does not include professional accountants in business, we would like to limit our comments to those elements of the ED that effect auditors and professional accountants (PAs) in public practice.

General Comments

The WPK appreciates the various efforts undertaken by IESBA and its consultations with stakeholders carried out to address the substantive concerns which had been expressed by many stakeholders in connection with IESBA´s 2012 ED on Responding to an Illegal Act.

Overall, we note that the current ED is a considerable improvement over the 2012 ED. In particular, we appreciate the conceptual change taken in withdrawing the proposal to override confidentiality by requiring an auditor to disclose identified or suspected NOCLAR to an appropriate authority. However, we still have serious concerns where, unlike the Explanatory Memorandum

is apparently suggesting, the Code of Ethics (hereinafter referred to as the “Code”) in our view still provides a (de facto) requirement to disclose a suspected or identified NOCLAR to an appropriate authority in 225.24 and 225.27 because such disclosure would only be precluded “if it would be contrary to law or regulation”. At least, these requirements may bring about a distinct lack of legal certainty for auditors and other PAs where there is no legal system that provides for a clear understanding of what needs to be reported outside of the client and for complementary measures, such as liability and whistleblower protection. We have similar concerns with respect to the provisions applicable for those PAs who are providing non-audit services, particularly where the disclosure is to others than the contracting party of the PA (225.40 addressing disclosure to a network member firm; 225.43 addressing disclosure to an appropriate authority).

We do view very positively the further alignment of the new concept with ISA 250 and appreciate the corresponding efforts undertaken by the joint IESBA/IAASB Working Group. We do have, however, some reservations in respect to the documentation requirements (see question 9).

Although we consider the present ED to be an overall improvement over the 2012 ED, we are still of the opinion that the question as to when and how PAs should report suspected or identified NOCLAR to an external authority or person, respectively, should be exclusively governed by the legislator of the jurisdiction concerned, but not by IESBA, in order to provide PAs with legal certainty. In this sense the EU legislator recently adopted a provision in Art. 7 of its Regulation (EU) No 537/2014 which stipulates a possible reporting towards an external authority and takes effect in the 31 countries of the European Economic Area.

Another issue which we would like to already address within our general remarks pertains to the drafting of the new provisions of the Code. We recognize that many provisions of the ED probably originate from the desire to provide comprehensive guidance. However, one of the main achievements of the Code so far has been its principles-based approach. We have to note with increasing concern that the Code appears to get incrementally detailed and runs the risk of moving gradually towards a rules-based approach, even though we have experienced that IESBA is basically committed to a principles-based approach. On the other hand, the present ED does not cover important cross-border issues (see question 2).

Specific Comments - Responses to the Questions of the ED

Request for Specific Comments

General Matters

1. *Where law or regulation requires the reporting of identified or suspected NOCLAR to an appropriate authority, do respondents believe the guidance in the proposals would support the implementation and application of the legal or regulatory requirement?*

   The objective of providing guidance to PAs on how to react in instances of suspected or identified NOCLAR is well intended. We question whether it is the responsibility of the IESBA Code to set provisions at an international level that may conflict with applicable local laws or regulatory requirements. Therefore, we welcome that IESBA included a reference in the ED that "disclosure would be precluded if it would be contrary to law or national regulation". However, we would suggest giving this provision more prominence (see our response to question 7 d).

   Irrespective of this point, we consider the proposals in the ED to present an ambiguous picture (see question 2).

2. *Where there is no legal or regulatory requirement to report identified or suspected NOCLAR to an appropriate authority, do respondents believe the proposals would be helpful in guiding PAs in fulfilling their responsibility to act in the public interest in the circumstances?*

   As explained above, IESBA in our view is not the appropriate institution to set up provisions for regulating the disclosure of a suspected or identified NOCLAR to an external authority.

   In addition, the guidance and requirements proposed are on the one hand very detailed and to some extent overly complex. They may lead to such a density which would hardly be manageable by the profession in practice. Moreover, the precise meaning of some terms remain unclear and will depend upon the individual interpretation of the PAs concerned. Hence the process of determining the right action runs the risk of becoming a subjective one resulting in a considerable lack of legal certainty. This lack of certainty is even reinforced by the fact that in many jurisdictions there is not (yet) a system in place that provides whistle-blowing protection.

   The complexity and the lack of applicability becomes particularly clear with respect to the use of the term "public interest", the definition of which has been an issue of a wider debate over the last years not only within IFAC but also within the profession itself. In paragraph 50 on-

wards of the ED IESBA itself rightly acknowledges that he concept of “public interest” is “too broad and vague” as a threshold. Nonetheless, the ED is suggesting a determination of what constitutes the public interest in section 225.4, and requires the PA in section 225.25 to use the “public interest” as a benchmark for his or her judgement in connection with the “third-party test” which in itself is already a proxy. On this basis, we believe that due to cultural differences and the given room for individual interpretation, it is unavoidable that the Code will be inconsistently applied, should this approach be maintained.

On the other hand we note the existence of loopholes and the lack of guidance within the ED with respect to cross-border situations, including group audits as well as international non-audit engagements. For example, there are situations where a component audit takes place in a jurisdiction with a strict legal duty to preserve confidentiality, like in Germany, whereas the group audit is conducted in another country where an override of confidentiality would not be in conflict with the local laws in that country. Such types of situations become even more problematic where jurisdictions are involved the legislation of which has an extraterritorial outreach (e. g. the US FCPA and the UK Bribery Act).

We would also favour a clearer wording in Paragraph 225.13 Sentence 2 in order to underpin the intended purpose of the process stipulated. It would be conducive to substitute the word “may” by “is intended to” (prompt management) or the like.

Last but not least, we would like to draw IESBA´s attention to Paragraph 225.17 which could be misunderstood that further actions from the auditor would only be required if management or those charged with governance agree that non-compliance has taken or may take place.

3. *The Board invites comments from preparers (including TCWG), users of financial statements (including regulators and investors) and other respondents on the practical aspects of the proposals, particularly their impact on the relationships between:*

   a) *Auditors and audited entities;*

      When discussing a possible override of confidentiality and justifying it with the public interest, one should bear in mind that confidentiality is a core principle that is also in the public interest since it enables the extensive disclosure of facts and circumstances within the relationship of the audited entity and its auditor and therefore contributes to improving the quality of the auditor´s work from which the stakeholders and the public benefit. In contrast, overriding confidentiality may run the risk of creating inappropriate disincentives for the audited entity for the disclosure of certain information and circumstances resulting in a decrease of information provided. In other words, the relationship of the auditor and

the audited entity might be affected negatively, also against the background of the aforementioned lack of legal certainty for the auditor.

b) *Other PAs in public practice and their clients; and*

The considerations under a) also apply to other PAs in public practice and their clients. In addition, with reference to the provision of non-audit services which can be provided by PAs or other professionals, the ED may bring about a competitive disadvantage for PAs as potential clients may wish to engage those other professionals who are not bound by the Code in a preferential way.

c) *PAIBs and their employing organizations.*

N/A (cf. introductory remark).

Specific Matters

4. *Do respondents agree with the proposed objectives for all categories of PAs?*

We agree with the objectives of Paragraphs 225.3 (a) and (b). However, the objective of 225.3 (c) is, as already explained above, problematic since and as far as it pertains to overriding confidentiality to an external authority or person. In addition, the precise meaning and scope of the term “public interest” (Paragraph 225.3 (c)) have become an issue of wider debate over the last years not only within IFAC but also within the profession itself. The concept itself is undefined and only little guidance had been provided in the past.

5. *Do respondents agree with the scope of laws and regulations covered by the proposed Sections 225 and 360?*

We are supportive of the scope of laws and regulations to the extent that they reflect ISA 250. However, where the Code extends the scope beyond the auditor´s mandate as expressed in 225.7 to wider public interest implications in terms of potentially substantial harm to the wider public, including investors, creditors or employees, we still believe that this would not only bring about a high level of uncertainty on what actually falls in the scope but would also contribute to an increase in the public expectations of what kind of NOCLAR an auditor apparently should be able to detect, i.e. widen the expectation gap, which may then have unintended adverse consequences for the profession as a whole. In fact, for other PAs the approach taken by the ED bears the risk of creating an expectation gap where no such gap has existed so far.

6. *Do respondents agree with the differential approach among the four categories of PAs regarding responding to identified or suspected NOCLAR?*

   We agree that with regard to the distinction of auditors and those PAs in public practice that provide non-audit services a different approach is necessary. However, as stated above, for PAs providing non-audit services in their entirety the current proposals of “encouraging disclosures” to others outside the client as well as to the scope of laws and regulations are either too unclear or going too far in that they bear liability and legal risks for the individual PA, may create an expectation gap that currently does not yet exist, and thus may contribute to a discredit to the profession together with bringing about a competitive advantage for those other professions that are entitled to provide the same type of services without being subject to the Code.

7. *With respect to auditors and senior PAIBs:*

   a) *Do respondents agree with the factors to consider in determining the need for, and the nature and extent of, further action, including the threshold of credible evidence of substantial harm as one of those factors?*

      As already indicated under question 2, the factors to consider are to some extent overly complex and the precise meaning of some terms remain unclear (e. g. “appropriateness of the response”, “urgency of the matter”). On the other hand the proposals do not contain, as explained above (question 2), any guidance concerning cross-border issues. Hence the process of determining the need for further action runs the risk of becoming a subjective one resulting in a considerable lack of legal certainty for the profession.

      This might also lead to an increased exposure to litigation for the profession. It is questionable if these additional liability risks are covered by the current professional indemnity insurance. Yet, according to German law, the maintenance of a professional indemnity insurance covering financial damages arising out of the indemnity risks of exercising the profession, is a prerequisite for being authorized to practice as a public accountant (Section 54 Public Accountant Act, WPO). Although new insurance might be offered for the new risks in the future since the insurance industry might react correspondingly, the insurance premiums will certainly rise. This would not be easy to cope with by the profession, particularly for SMPs who already face quite high insurance premiums (also cf. question 9 regarding liability risks).

b) *Do respondents agree with the imposition of the third party test relative to the determination of the need for, and nature and extent of, further action?*

The WPK is opposed to the public interest as a reference for the third party test. As already stated in our response to question 2, we note that apparently IESBA itself is opting against the concept of public interest in Paragraphs 50 et seq. of its Explanatory Memorandum, while then introducing this concept as the reference for the third party test in Paragraph 225.25. As explained above, the concept of public interest itself is undefined and there exists only little guidance in this respect.

To mention one more point only in passing, we are confident that the Task Force Safeguards will do a great job in providing more guidance for the third party test.

c) *Do respondents agree with the examples of possible courses of further action? Are there other possible courses of further action respondents believe should be specified?*

The WPK is, as explained above, opposed to the IESBA concept of disclosing the matter to an appropriate authority (Paragraph 225.24 first bullet point). Such a disclosure would also often be precluded since it would be contrary to laws and regulations. Withdrawing from the engagement (Paragraph 225.24 second bullet point), which we would deem a reasonable course of action, would also often be not permitted by law or regulation either. Therefore there might be situations for which the Code does not provide guidance and it would be unclear to the profession what kind of action to take under the Code. This would also be particularly true for the above mentioned cross-border issues.

d) *Do respondents support the list of factors to consider in determining whether to disclose the matter to an appropriate authority?*

From our point of view, these factors do predominantly not ensure adequate legal certainty due to their vagueness and subjective nature. This lack of certainty would also be detrimental to the enforceability of the Code and its global acceptance.

In addition, it may remain unclear in particular cases which institution could be regarded as the appropriate authority. In our view the authority shall be a public one since the public interest is concerned and it should be established by the legislator of the jurisdiction concerned to be legitimate and enforceable.

As regards the provision that the disclosure would be precluded if it would be contrary to laws and regulations, we are, as described above, unrestrictedly in favour of this caveat.

However, we would suggest giving this provision more prominence by highlighting or re-positioning it.

8. *For PAs in public practice providing services other than audits, do respondents agree with the proposed level of obligation with respect to communicating the matter to a network firm where the client is also an audit client of the network firm?*

   We are, as explained above, against this provision and do think that the issue of overriding confidentiality towards an external authority or person should be addressed by the respective jurisdictions themselves and not IESBA.

9. *Do respondents agree with the approach to documentation with respect to the four categories of PAs?*

   We are concerned that, should the provisions in the ED be adopted, PAs will have to meet documentation requirements of two different standards. It would be preferable for the sake of user-friendliness and -practicability to reunite the documentation requirements in the auditing standards only.

   Irrespective of that, we are not supportive of documentation requirements (Paragraph 225.32) and encouragements (Paragraph 225.48) which exceed those stipulated in ISA 250. The current proposals comprise a mechanism by means of which a corresponding de facto requirement could easily be created as already explained above in a slightly different context. Furthermore, such a documentation system that may also be inspected by the audit regulator could lead to a serious increase of risks for the PA making it hard for him/her to strike the right balance of documentation. The PAs would end up in situations where a) the regulator may question an insufficient documentation (reputation risks) and b) an extensive documentation might be used directly against the PAs in a subsequent claim for compensation (liability risks).

   Finally we would like to point out that it would also be conducive to specify the term “significant matter” (Paragraphs 225.32, 225.48) and provide guidance, respectively, since its meaning remains unclear.

Request for General Comments

a) *PAIBs working in the public sector*— Recognizing that many PAIBs work in the public sector, the Board invites respondents from this constituency to comment on the revised proposals and, in particular, on their applicability in a public sector environment.

N/A.

b) *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the Code, the Board invites respondents from these nations to comment on the proposals, and in particular, on any foreseeable difficulties in applying them in their environment.

N/A.

c) *Translations*—Recognizing that many respondents may intend to translate the final pronouncement for adoption in their environments, the Board welcomes comment on potential translation issues respondents may note in reviewing the revised proposals.

In light of the high importance of the Code and its worldwide (de facto) binding effect on the profession, it might be worthwhile, as already stated in previous comment letters of WPK, considering a translation of the Code and the present changes into the respective language of important jurisdictions by IFAC itself. This could also lead to greater acceptance and use of the Code.

We hope that our remarks will be taken into consideration in the subsequent course of the proceedings, and we would be delighted to answer any questions you may have.

Kind regards

Dr. Reiner Veidt
Executive Director

RA Peter Maxl
Executive Director