

September 4, 2015

IFAC Small and Medium Practices (SMP) Committee Response to the International Ethics Standards Board for Accountants (IESBA) Exposure Draft: Responding to Non-Compliance with Laws and Regulations

INTRODUCTION

The SMP Committee (SMPC) is pleased to respond to the IESBA (the Board) 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 world¹.

We have closely followed the development of this project and have provided comments on past IESBA Agenda Items and the 2012 Exposure Draft: Responding to a Suspected Illegal Act². The SMPC Chair, Giancarlo Attolini attended the 2014 roundtable in Brussels and previous SMPC Ethics Task Force (ETF) Chair, Albert Au and current ETF Chair, Raymond Cheng attended the 2014 roundtable in Hong Kong.

GENERAL COMMENTS

The SMPC acknowledges this is a sensitive and complex topic and commends the Board on the substantial amount of work and outreach that has been undertaken in moving this project forward. We generally consider that the revised framework has significantly improved. We fully support the Board's decision that it is not appropriate to carry forward the original ED proposal for the IESBA *Code of Ethics for Professional Accountants* (the Code) to require auditors to disclose identified or suspected NOCLAR to an appropriate authority in the relevant circumstances. We also note that several of the changes made address some of our previous concerns and especially welcome the efforts to closer align the Code with ISA 250³. However, we have significant concerns with the proposals that go beyond the scope of ISA 250 in respect of audits.

We are concerned that the criteria are unclear and subjective as to when and what a Professional Accountant (PA) might disclose externally, which may create significant uncertainty. In addition, the potential unintended consequences from how the proposals may in certain circumstances create an indirect requirement, which could result in the PA determining that it is necessary to breach client confidentiality and disclose an identified or suspected NOCLAR to an appropriate authority (notwithstanding when there is no legal or regulatory requirement to do so) is also a concern. This is

¹ 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.

² See <http://www.ifac.org/publications-resources/smp-committee-response-iesba-exposure-draft-responding-suspected-illegal-act>

³ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*



following the interaction of the factors listed in paragraph 225.21-24, combined with the third party test in paragraph 225.25 and the fact that paragraph 225.24 proposes only two further actions.

We appreciate the disclosure is not a requirement or an expectation and the determination should be judged following an assessment of factors, such as those listed in paragraphs 225.21-24 and 225.27. It is also noted that paragraph 225.27 states that disclosure would be precluded if it would be contrary to law or regulation and paragraph 225.29 maintains that such disclosure will not be considered a breach of the duty of confidentiality under Section 140 of the Code. However, we are concerned this may not address the substance of what might occur in practice and will not afford legal protection to the PA if they are subject to any subsequent legal action by a client following such disclosure. We believe that the Code should not go beyond ISA 250 and therefore 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 public interest is best served by a strong economy driven by SMEs having access to the best business advice available to grow their business. SMEs will only seek advice from PAs where they can be assured of a trusted advisor relationship in which they are free to share information with their advisor and can trust them to maintain confidentiality in their dealings. We are concerned that in continuing to view the auditor as a 'regulatory internal policing mechanism', this project risks being detrimental to the fundamental way in which an audit works and as such would be contrary to the public interest. Client confidentiality is generally accepted as essential to quality work. 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. It may also drive clients to seek the services of accountants or other professionals who are not subject to the Code, which would not be in the public interest.

SPECIFIC COMMENTS

We have outlined our responses to each question in the ED below.

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?

We believe that where law or regulation requires the reporting of an identified or suspected NOCLAR to an appropriate authority, the guidance may support the implementation and application of the legal requirement. However, it is not within IESBA's mandate to provide guidance to supplement the wide variety of different national laws and regulations.

The proposed paragraphs 225.10, 225.33 and 360.10 highlight that the PA should obtain an understanding of the legal and regulatory provisions in their country. The Board could consider whether it should be made clearer in these paragraphs that the national legal or regulatory provisions should prevail over the Code.



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?

In certain jurisdictions legislation prohibits the PA in practice from disclosing information acquired in the course of their professional engagement to any person other than their client without their consent or otherwise than as required by specific provisions in law. Therefore, disclosure must only be made in these specific circumstances. We are concerned that in seeking to “allow”, the proposals may, in some circumstances, effectively “require” breaches of client confidentiality and the IESBA is not the appropriate party to either “require” or “allow” such a breach. In our opinion, this remains a matter for legislators, who, in contrast to the IESBA, can ensure an appropriate legal environment. In addition, even if the law in a particular jurisdiction is silent on client confidentiality, there may be contractual obligations to confidentiality for individual engagements. The Code cannot override such obligations and we are concerned that this is not clear within the proposals, including in paragraph 225.29. Ultimately the issue of “allowing” breaches of confidentiality is problematical and unlikely to be workable in practice.

The concept of acting appropriately in the public interest has different meanings worldwide and the Code is not sufficiently clear what this may involve and how it should be applied. The Board may wish to consider providing examples of PAs fulfilling their responsibility to act in the public interest as a guide for practitioners to better understand the concept and avoid the nature of mandatory requirements.

As the Board will be aware, the Code is intended for global application and does not recognize the fact that many countries may be less developed than others. One area which may cause problems is over the determination of an “appropriate authority” in certain countries. This is despite the guidance included in paragraph 225.27.

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;**
- (b) Other PAs in public practice and their clients; and**
- (c) PAIBs and their employment organizations.**

The responsibilities of management of the audited entity and auditors for compliance with laws and regulations are described in ISA 250 (para. 3 – 8). It is important to note that an auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor follows audit procedures, which includes sampling, and may also be engaged after events have occurred. Therefore, the level of responsibility of an auditor is different from the responsibility of the entity for NOCLAR identification.

We are concerned about the impact on all auditors and audit costs due to the different requirements in ISA 250 and the Code immediately before the auditor is required to discuss NOCLAR matters with the audit client’s management. If the auditor becomes aware of information concerning an instance of noncompliance or suspected non-compliance with laws and regulations under ISA 250.18, the auditor is required to obtain “an understanding of the nature of the act and the circumstances in which it has



occurred” and obtain “further information to evaluate the possible effect on the financial statements”. The 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. In addition, ISA 250.19 puts the onus firmly on the entity’s management and, where appropriate, those charged with governance to investigate suspected instances of non-compliance and provide to the auditor sufficient information to dispel such suspicion.

Paragraph 225.11 of the Code proposes extending the PAs understanding of the matter to include both the nature and the circumstances which has occurred or may occur, and specifically include the application of the relevant laws and regulations to the circumstances. In our opinion, obtaining an understanding of the legal position pertaining to the individual matter (which is not required under ISA 250 at this stage) will, in practice, often involve recourse to legal advice, as firms will seek to be sure of their facts if required to possess such an understanding (also regulators would expect diligent documentation), which would certainly add to the costs of the audit. Therefore, we do not consider that the differences between ISA 250 and proposals for the Code are justified at this stage of the auditor’s considerations.

We do not fully agree with the statements in the proposals that disclosure of the matter to an appropriate authority will not be considered a breach of the duty of confidentiality under Section 140 of the Code (para. 225.29 and 225.45), and are concerned about the potential adverse consequences, including those highlighted in the legal advice referred to in the ED.

The auditor’s legal responsibilities vary by jurisdiction. In certain circumstances the duty of confidentiality may be overridden by legislation, but in some countries the references would be against local law definitions. We note this is included in paragraph 225.27 and support the Board’s revised position not to require auditors to disclose identified or suspected NOCLAR to an appropriate authority in the relevant circumstances. However, we believe that the potential unintended consequences described in the ED (para. 60) still remain with the revised proposals because of the uncertainty they could create. In particular, we believe a key risk is that the proposals may potentially impede the flow of information between the client and the auditor, which could be damaging to audit quality.

We also wonder whether the preclusion statement proposed in para. 225.27 “disclosure would be precluded if it would be contrary to law or regulation” should be afforded greater prominence. This is particularly important as the Board moves towards an electronic version of the Code and given human nature to only read as far as necessary in order to obtain an understanding, which may result in such a critical statement being overlooked.

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

We agree with the proposed objectives (a) and (b) in paragraph 225.3. In principle, we also agree with the intention of (c), but are concerned about how subjective the term “in the public interest” is and how wide it may be interpreted as there is no definitive understanding of what “public interest” entails. What “action as may be needed in the public interest” in any particular circumstance is highly subjective.



We support the proposals to scope out personal misconduct unrelated to the business activities of the client (para 225.8 (b)) and that they are not intended to apply to due diligence engagements. In our opinion, if despite our concerns detailed above, the IESBA retains its stance, this scope out should as a minimum extend to practitioners engaged to undertake forensic engagements, where legal privilege does not apply. We are concerned that clients may not hire PAs for such services if they are unable to confirm total confidentiality.

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

Scope

We agree with the Board's revised position that the types of NOCLAR PAs should be concerned with should be within the scope of their professional training and expertise. We agree that aligning the scope of laws and regulations covered by the revised proposals with those established in ISA 250 is appropriate for the purposes of the Code.

However, we are concerned with the proposals (para. 225.7) that go beyond ISA 250 and call for auditors and other PAs to have regard to the wider public interest implications of the matter in terms of potentially substantial harm to stakeholders, whether in financial or non-financial terms. We believe that this aspect introduces uncertainty as to the scope of NOCLAR and could create unrealistic expectations in respect to the responsibility of the auditor.

We believe that there should be a clear distinction between those matters an auditor is expected to identify which directly affect the determination of material amounts and disclosures in the financial statements (ISA 250 para. 6(a)), the matters the auditor may generally be expected to identify – those that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business (ISA 250 para. 6(b)) and those that may be less likely to be identified, but that the auditor should remain alert to by maintaining professional skepticism throughout the audit (ISA 250 para. 8). Such a distinction makes clear the inherent limitations of the auditor detecting NOCLAR and we believe is required to not create uncertainty and an expectation gap.

Clearly Inconsequential Matters

We recognize that paragraphs 225.8(a) now clarifies the exclusion of clearly inconsequential matters and support the Board's proposal to remove the threshold from the requirement to seek to obtain an understanding of the matter. However, we remain concerned that while the ISAs follow a risk-based approach and focus on material matters, the proposals for the Code still do not recognize a risk-based approach in terms of the required work effort similar to "materiality" and risk response under the ISAs.



Reporting

As stated above we also disagree with the disclosure to an appropriate authority not being considered a breach of the duty of confidentiality (para. 225.29 and 225.45). We believe that local legislation should govern this and the requirements and application material in ISA 250 are sufficient that the auditor may consider obtaining appropriate legal advice to determine the appropriate course of action when reporting identified or suspected non-compliance with laws and regulations. In other professions, such as lawyers, it is common for client confidentiality to remain in force even in the case of NOCLAR.

We believe that the approach to reporting NOCLAR outlined in the extant ISA 250 (paragraphs 25-27) is sufficient. In our opinion, additional “ethical responsibilities” beyond ISA 250 can only constitute two elements. Firstly, the PAs consideration as to whether the specific circumstances encountered have a public interest dimension beyond accounting implications. For example, an instance of NOCLAR may result in a fine for an entity, so the financial statements impact would be addressed under ISA 250 in a relatively straightforward manner. The public interest impact might be quite different in terms of its significance e.g. pollution or disregard for building safety regulations putting employees at risk. Secondly, the termination of the PAs in practice relationship with the client, unless expressly precluded by law and regulation.

There can be instances where the auditor has facts significant enough to inform those charged with governance, but not as significant to disclose to external authorities. We believe that paragraph 225.27 could be clearer that an additional consideration of the significance and impact of the facts should be made when determining whether to disclose the matter to an appropriate authority.

Auditor Reporting

In addition, we believe that both the IESBA and the IAASB should give consideration to the impact of the new and revised Auditor Reporting Standards and in particular the requirements in the new ISA 701⁴ when NOCLAR constitutes a Key Audit Matter (KAM) and should be reported. This discussion may require the involvement of the relevant task forces from each Board.

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

We accept that the differential approach among the categories of PAs is necessary. We also agree that the scope of laws and regulations for PAs should not go beyond ISA 250. However, we are concerned about the alignment of ISA 250 for PAs and auditors may create unrealistic expectations on the role of PAs and their ability to identify NOCLAR, which may vary considerably depending on the particular service provided. In ISA 250 it is clear the auditor cannot be expected to detect non-compliance with all laws and regulations because of the inherent limitations of an audit (para. 4), but they are required to perform specified audit procedures to help identify instances of NOCLAR. The Code should clarify in some way that for other PAs the ability to identify NOCLAR is significantly less because it is directly related to the nature and type of the service provided.

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



We also note that paragraph 225.34 et seq. is silent as to how the PA could be expected to satisfy him- or herself with respect to initial suspicions regarding NOCLAR. This contrasts with the relevant IAASB's standards where the sufficiency and appropriateness of evidence with which a PA would be satisfied is considerably less for a limited assurance engagement than for a reasonable assurance engagement. Likewise, the information that a PA might obtain to satisfy him- or herself with respect to issues identified as part of a compilation engagement would have significantly less evidential value than in an assurance engagement. The Code does not recognize that the work effort required of the PA by paragraphs 225.34 et seq. may vary significantly depending upon the nature of the engagement and this could also give rise to unrealistic expectations.

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?**

We do not agree with the factors listed in paragraph 225.21 to consider when determining whether further action is needed. In our opinion, the factors are too ambiguous and subjective, which will make the determination difficult. For example, it may not be easily apparent the extent of the “urgency of the matter” that would result in further action. In addition, the threshold for actual or potential substantial harm of “serious adverse consequences” is not sufficiently clear. We believe the list of factors requires further explanation and concrete details and examples to be workable in practice, including detail on how they could be interrelated. For instance, one factor alone may lead to a determination of no further action.

The determination of the nature and extent of further action needed is based on the auditor’s professional judgment (para. 225.25). We believe that due to the nature of the likely sensitive issues these require legal certainty and should be dealt with by legislation, not in the Code.

- 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?**

We do not agree with the imposition of the third party test relative to the determination of the need for, and nature and extent of, further action. We remain concerned that the proposals for a “third party test” (para. 225.25) may further complicate the determination of how to act in the public interest and could also give rise to differing expectations by various parties. As highlighted by paragraph 225.4 there is no general definition of the concept of public interest. We recognize that the concept of “a reasonable and informed third party” is already included in the Code, but are concerned about its application in practice in relation to NOCLAR given the differences in each circumstance, size of clients and in separate jurisdictions.

The inclusion of the “third party test” is one of the factors that, in certain circumstances, may essentially force an auditor to disclose to an authority, despite there being no legal or regulatory requirement to do so.



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?

There are only two mutually exclusive further actions included in the proposals in paragraph 225.24. If the area of NOCLAR was simple, the Board would have proposed a variety of possible courses for further action, which could include that taking no action may be deemed appropriate. As outlined above, we do not believe the Code should deal with breaking client confidentiality.

In determining whether further action is needed for PAs in public practice providing professional services other than audits of financial statements, paragraph 225.43 could include withdrawing from the engagement and the professional relationship. Reference to this option could also be included in considering whether to remain associated with the client (para. 225.47).

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

Please see our response in (a).

We are concerned about the inclusion of the example of a client being listed on a securities exchange since the disclosure in certain countries would strictly only be made with express permission of legislation. Indeed, we note that the IESBA discussed whether to limit its proposals to listed entities, but decided against this approach.

The proposals do not adequately recognize that there may be varying degrees of public interest. For example, in differentiating only between “audits of financial statements” and “non-audit services” in section 225, the implication is that IESBA believes that all audits carry the same level of public interest. It could be argued that the voluntary audit of a small unlisted entity, have significantly fewer public interest implications compared to, say, the statutory audit of a listed entity of a large financial institution. The Board may wish to acknowledge the special public interest connotations applicable to the audit of financial statements of PIEs as opposed to other audits and other services performed by PAs. In this way the provisions would lend themselves to being capable of application in a manner proportional to the size and public interest of the client.

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 agree with a PA considering whether to communicate the matter to the network firm engagement partner when the client is also an audit client of the network firm (para. 225.40) as the matter can affect the whole network and its reputation. However, communication with network firms might give rise to a potential breach of confidentiality as network firms in separate jurisdictions can be subject to different national laws, which have distinct consequential legal implications.

We note that depending on the type of service provided, the PA may not have access to enough information to conclude definitively on the NOCLAR and should not therefore be considered responsible



for determining whether an act constitutes non-compliance and disclosing the matter to the external auditor if the client is not an audit client of the firm (para.225.43).

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

We agree with the Board's approach to differentiate documentation in terms of the level of obligation imposed for auditors as requirements (under ISA 250) and for encouragement to other PAs. A PA may be accused of not taking the appropriate action, so documentation can prevent undesirable consequences.

However, we are concerned about the proposals in paragraph 225.32 which place additional documentation requirements on auditors with respect to identified or suspected NOCLAR they have concluded as a significant matter. We do not support the Code going beyond the ISAs in making additional requirements and are also concerned that the proposals place a disproportionate requirement on auditors when compared to PAIBs. We believe that the documentation requirements for auditors should not go beyond what is required under ISA 230, *Audit Documentation*.

CONCLUDING COMMENTS

We hope the IESBA finds this letter helpful in moving forward with the NOCLAR project. 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, appearing to read 'Giancarlo Attolini', with a horizontal line above it.

Giancarlo Attolini
Chair, SMP Committee