

NOCLAR—Comments from IFAC SMP Committee

#	Comments	Task Force Responses
1.	<p>GENERAL COMMENTS</p> <p>The SMPC recognizes that it is not possible for the IESBA <i>Code of Ethics for Professional Accountants</i> (the Code) to address all the developments, complexities and practicalities in each jurisdiction and the IESBA (the Board) should focus on setting standards with an appropriate balance at the global level. It is therefore essential that the Code is sufficiently principles-based to allow it to work in conjunction with national requirements.</p> <p>We have closely followed the development of this project and have provided comments on past IESBA Agenda Items and the Exposure Draft <i>Responding to a Suspected Illegal Act</i>¹. The SMPC Chair, Giancarlo Attolini and previous Ethics Task Force Chair, Albert Au also attended the recent roundtables in Brussels and Hong Kong, respectively.</p> <p>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. In particular, we note that several of the changes address some of our previous concerns. For example, we support the proposed alignment to ISA 250² and welcome the clarification and greater guidance included on what is meant by non-compliance or suspected non-compliance with laws and regulations.</p> <p>We have a number of general observations on proposed Sections 225 and 360, which are followed by our detailed comments in response to the questions raised in Agenda Item 5-A.</p>	
2.	SME/ SMP Perspective	Paragraph 225.37 (now renumbered 225.40-41) was addressing non-

¹ <http://www.ifac.org/publications-resources/smp-committee-response-iesba-exposure-draft-responding-suspected-illegal-act>

² ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

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	<p>We are concerned that some of the proposals as drafted may not be written from an SME/SMP perspective and could be difficult for some SMPs to implement.</p> <p>As the Board will be aware, the proportion of SMPs undertaking audits of SMEs in many jurisdictions has reduced in recent years, partly as a result of the introduction of, or increase to, audit thresholds. Many SMPs provide professional services including non-audit assurance services and business advisory services to clients who do not require an audit. In these cases paragraph 225.37 (consider whether to inform the engagement partner for the audit about the matter) will not be applicable and the only course of action foreseen is resigning (225.38) or disclosing the matter externally (225.40).</p>	<p>assurance services performed for an audit client of the firm or a network firm, so the consideration of whether to inform the audit engagement partner would apply in those situations.</p> <p>However, the Task Force has amended the first bullet of 225.44 to recognize that not every entity will have an auditor.</p>
3.	<p>It is likely in the SME environment that some instances of NOCLAR will result from either ignorance or a lack of understanding of prevailing laws and regulations rather than from intentional disregard and non-compliance. We question why the spirit of the requirement of 225.19 (consideration of whether the client understands their legal or regulatory responsibilities with respect to the matter) is limited to the Section <i>Professional Accountants Performing Audits of Financial Statements</i>.</p>	<p>Point not accepted. As the provision applicable to auditors is a requirement to consider whether management and TCWG understand their level or regulatory responsibilities, the Task Force believes that introducing this requirement for non-auditors will further increase the degree of prescription and burden for those PAs. In addition, the latter do not generally have as much access to TCWG as the former.</p>
4.	<p>The requirement in paragraph 225.15 that the professional accountant “shall” discuss a matter of management non-compliance with those charged with governance is likely to be difficult in some SME environments. For example, in many small businesses those charged with governance are not separate from management. The Task Force may wish to consider the wording used in ISA 260³, paragraph 13 for these situations.</p>	<p>Point accepted. The Task Force is proposing a consequential amendment to the subsection <i>Communicating with Those Charged with Governance</i> in Section 100 to recognize this point at the broader level of the Code as it will apply also in other areas of the Code. See paragraph 100.26.</p>

³ ISA 260, *Communication with those Charged with Governance*

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5.	<p>Expectations Gap</p> <p>As the Board will be aware, it is important that changes to the Code are not made without consideration of any unintended consequences i.e. the potential for new provisions to lead clients away from professional accountants who are subject to the Code.</p>	<p>Point noted.</p>
6.	<p>Whilst we appreciate the clarification in the last sentence of 225.3 “Whether an act constitutes actual non-compliance is ultimately a matter for legal determination by a court of law.”, we remain concerned that the underlying issues that could lead to unrealistic expectations on the part of the public or to serious practical difficulties for accountants in practice, have not been satisfactorily addressed and therefore we suspect will not lead to the Code having the desired impact. For example, the fact remains that in some circumstances accountants do not possess the qualifications (e.g. as lawyers) that would enable them to verify non-compliance. It could be argued that professional accountants can only ever suspect non-compliance, whereas a legal process by a court of law is needed to confirm a party’s guilt or otherwise. Therefore compliance with section 225 of the Code could lead to accusations of libel and slander by clients who believe they were wrongly accused by their auditor, particularly when following a disclosure outside the entity the matter was either not pursued by authorities or there was an acquittal by a court.</p>	<p>Point considered. Paragraphs 225.14, 225.38, 360.15 and 360.32 already make clear that PAs are expected to apply knowledge, judgment and expertise but are not expected to have detailed knowledge of laws and regulations beyond that necessary for their work.</p>
7.	<p>The flowchart in Agenda item 5-H is helpful. However, some aspects differ from the proposed wording of the Code. For example, by asking in box 13 of the flowchart whether all the conditions supporting such disclosure were met, it confirms that all factors need to be present, although 225. 42 does not actually cite the existence of legal protection as a factor.</p>	<p>Point to be taken into account in reviewing the flow chart for incorporation into the explanatory memorandum.</p> <p>With respect to paragraph 225.42, the level of expectation on non-auditors in the framework is lower than on auditors in that it is only a requirement to consider the need for further action vs a requirement to determine the need for such action. There is also no requirement to apply a third party test. Adding legal protection as a factor to</p>

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		consider may convey an expectation of disclosure with respect to non-auditors, which is not the framework’s intention.
8.	There appears to be contradiction between the title of the section on ‘Non-Compliance or Suspected Non-Compliance’ and paragraph 225.34. Accountants are asked to respond to non-compliance when the final sentence of para 225.34 states that whether an act constitutes actual non-compliance is ultimately a matter of legal determination by a court of law.	The Task Force does not believe that there is necessarily a contradiction. An act of non-compliance may obviously have occurred. The legal determination would be for the court to make.
9.	<p>Structure</p> <p>We recommend that the sections on the <i>Responsibilities of the Client, Its Management and Those Charged with Governance (225.8)</i> and <i>Responsibilities of the Employing Organization and Its Management and Those Charged with Governance (360.8)</i> should be moved earlier in their respective sections and closer to the requirements on “alerting management” in paragraphs 225.2 (b) and 360.2 (b).</p>	Point not accepted. The Task Force believes that doing so would disturb the flow as the opening paragraphs are about the objectives and scope.
10.	<p>Wording Considerations</p> <p>We are concerned that some of the draft wording makes certain requirements in proposed section 225 unclear. For example, the use of “shall seek to” in paragraphs 225.10 and 225.17 is unhelpful in English and may be even less clear following translation.</p>	Point accepted. This has now been deleted from 225.17.
11.	It is also ambiguous whether the “shall” requirement in paragraph 225.11 should take precedence over the one used in paragraph 225.9. We recommend that the Task Force consider how it can make clearer that the requirement in 225.9 is an all-time override.	Point not accepted. The Task Force does not believe that it should be a matter of debate that PAs must comply with applicable laws and regulations, regardless of what the Code specifies.
12.	Paragraph 225.21 requires the professional accountant to determine if further action is needed. Many of the subsequent paragraphs appear to provide guidance on how this determination is to be made, however, in some cases the use of passive voice makes what	Point accepted. Paragraph 225.23 (now renumbered 225.4) has been reworded.

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	<p>is actually required of the accountant unclear. For example, the phrase “each situation needs to be considered individually taking into account: ... the wider public” in 225.23 is unclear as to whether accountants are or are not required to perform this particular consideration in every case to establish whether there is or is not a public interest perspective in the determination required by 225.21. In contrast, paragraph 225.29 clearly requires a third party test in relation to the determination if further action is needed in the public interest.</p>	
13.	<p>In the second sentence of paragraph 225.19 the only action proposed is for the accountant to recommend the client obtains legal advice. In our opinion, it might also be preferable they are able to suggest a range of options to rectify any lack of understanding. For instance, depending on the nature of the matter, it might be equally effective for the accountant to explain the basic issue and legal requirements to the client or direct them to appropriate sources. Only suggesting the client take legal advice may prove ineffective in some cases, particularly if there is a perception by the client that this would involve high costs. The result may therefore be less likely to achieve the accountant’s (and the Codes) objectives.</p>	Point accepted – see paragraph 225.19.
14.	<p>Public Interest</p> <p>Paragraph 225.23 states that the concept of the public interest is not capable of general definition. However, the Code also states that “In acting in the public interest, a professional accountant shall observe and comply with this Code” (100.1). Therefore, when an accountant complies with the Code he/she acts in the public interest. The inclusion of paragraph 225.23 could be considered confusing as it may appear that the proposed Section 225 has a different understanding of public interest than the rest of Code. This also raises the issue of the Code stating that the concept of public interest is not capable of general definition; however it is asking accountants to do just that.</p>	Point accepted – paragraph 225.23 (renumbered 225.4) has been reworded.
15.	<p>Some of proposed amendments referring to public interest do not appear consistently. For example, paragraphs 225.2 and 360.2 both refer to the accountant “acting” in the public interest, whereas other references are “serving” the public interest (e.g. 225.21, 29, 30, 40 and 360.16, 24, 25). In our opinion, if the Code is going to shift from acting in the public</p>	Point accepted and editorial changes made.

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	interest, to serving the public interest, it should be adopted as the overall approach throughout.	
16.	<p>SPECIFIC COMMENTS</p> <p><i>Scope of Proposed Section 225</i></p> <p>Overall, we support the Task Force's view that the two categories of laws and regulations covered by ISA 250 continue to be appropriate for the purposes of the section. We agree with the fine-tuning of the examples of non-compliance introduced in paragraph 225.1.</p>	Support noted.
17.	<p>However, we are concerned that the decision to change the scope of what non-compliance is from that envisaged in ISA 250 (final bullet point in paragraph 7, Agenda Item 5-A) may not have the desired impact in practice. The requirements for a professional accountant performing an audit are based on information which the auditor becomes aware during the course of the audit (para.225.10 Agenda Item 5-C), which remains under ISA 250. If the Board wants to extend the scope it would need to introduce additional requirements for the auditor.</p>	<p>Point not accepted. There is no difference in scope with ISA 250 with respect to the two categories of laws and regulations. There is a difference, however, with respect to consideration of the consequences or potential consequences of the NOCLAR or suspected NOCLAR given the different objectives of the Code and the ISAs.</p>
18.	<p>Alternatively, the Code needs to be clear that an auditor will have different chances of coming across non-compliance issues depending on whether the particular instance of non-compliance is with a law or regulation in category 225.4 (a) or (b).</p>	<p>Point not accepted. Unlike ISA 250, the objectives of the framework are not about identifying instances of NOCLAR. Therefore, it would not be appropriate for the Code to make a statement regarding the probability of identifying particular instances of NOCLAR. If any such statement were to be made, it should be in the ISAs. The overriding objective of framework is to require an appropriate</p>

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		ethical response when the PA comes across NOCLAR or suspected NOCLAR.
19.	We consider that the examples provided in para. 225.4 (a) and (b) aid the understandability and implementation of the paragraph and therefore do not support the proposed deletion. It may be more useful to add a phrase like “The examples provided are only illustrative”.	Point not accepted. The Task Force believes that the examples attached to the description of the two categories may convey the impression that the framework is only focused on a consideration of the impact of NOCLAR/suspected NOCLAR on the financial statements, which would be appropriate for the ISAs. Paragraph 225.6, however, appropriately presents those examples in the more balanced context of those types of laws and regulations which the framework addresses.
20.	In our opinion, paragraph 225.4 (b) should be extended in line with ISA 250.6(b) to explain that non-compliance with the second type of laws and regulations also potentially has some impact on audit of the financial statement: <i>“non-compliance with such laws and regulations may therefore have a material effect on the financial statements”</i> ISA 250.6(b).	Point not accepted. The Task Force believes that this phrase overly focuses the consideration of the implications of the NOCLAR/suspected NOCLAR on the financial statements.
21.	In this context, it is also misleading to state as drafted in the second sentence of paragraph 225.5 that “Other laws or regulations.....do not have a direct effect on the financial statements”. Without appropriate clarification the reader may understand that the second type law or regulations have nothing or little to do with the financial statements (and therefore would not be in the remit of the audit and thus not be “found” by the auditor), which is also not correct.	Point not accepted. This is already in ISA 250.

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22.	<p>Clarification along the lines of the last sentence of ISA 250.5 “<i>Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize the non-compliance</i>” would also be useful to counter any unrealistic expectations.</p>	<p>Point not accepted. This guidance is overly focused on the audit of the financial statements, which is not the purpose of the Code.</p>
23.	<p>“Clearly Inconsequential” Threshold</p> <p>We support the changes proposed by the Task Force and the result that the requirement to seek to obtain an understanding of the matter is largely consistent with how the corresponding requirement in ISA 250 is worded. In particular, the guidance as to the threshold for substantial harm (paragraph 225.1(b)), together with the proposed clarification in paragraph 225.7 (a) is very useful. It may well be clear from the outset that a particular matter of which a professional accountant becomes aware is unlikely to be consequential in terms of meeting the substantial harm threshold.</p>	<p>Support noted.</p>
24.	<p>In our view, it would also be helpful if para. 225.7 (c) could be clarified. It is not clear why this clause is necessary given the section is about responding to non-compliance by the client, or by those charged with governance, management or employees of the client.</p>	<p>Paragraph 225.7(c) (now 225.8(c)) has been provided for the avoidance of doubt, given questions raised by other stakeholders. This will be explained in the Explanatory Memorandum.</p>
25.	<p>Third Party Test</p> <p>We accept that significant improvements have been made compared to the previously exposed material.</p> <p>However, we remain concerned that aspects of the proposals go beyond the aim of ensuring ethical behavior of individual professional accountants, and in particular, at the addition of further action needed to serve the public interest to the objectives in para. 225.2. As the Code points out (para. 225.23) there is no general definition of the concept of public interest. Adding the third party test as drafted in para. 225.29 may further complicate the determination of how to act in the public interest and could also give rise to differing expectations by various parties.</p>	<p>The Task Force has added “credible evidence of substantial harm” to the list of factors in 225.22 rather than in the third party test.</p>

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	<p>We note that the explanation in paragraph 15 of Agenda Item 5-A refers to the test being performed in the context of credible evidence of substantial harm to stakeholders and suggest that, as a minimum, this clarification be made in 225.29. We agree that this test ought to only come into consideration in extreme circumstances.</p>	
26.	<p>Other Matters</p> <p>We agree with the changes made in paragraph 225.37 to make it slightly more open and allow for the accountant to exercise professional judgment. It may also be helpful to have the reasoning behind the Task Force’s proposals (paragraph 18 Agenda Item 5-A) reflected in guidance as to factors that should feature in the consideration required.</p>	<p>Point considered. The Task Force believes that there is a risk of making Section 225 unbalanced by providing detailed explanations regarding the consideration of communication across a network. However, these explanations will be provided in the Explanatory Memorandum.</p>
27.	<p>We support the guidance added in paragraph 225.42 regarding whether information can be disclosed outside the entity as it should assist the professional accountant in their decision making process.</p>	<p>Support noted.</p>
28.	<p>Other Changes to the Text</p> <p>In general we support the other wording changes to the proposed section 225 highlighted in paragraph 20 (Agenda Item 5-A), but have a couple of observations:</p> <ul style="list-style-type: none"> • As part (c) of the objectives in paragraph 225.2 already refers to the public interest it is covered in 225.21 (a) and therefore does not need to be duplicated by adding it in 225.21 (b). 	<p>Point accepted.</p>
29.	<ul style="list-style-type: none"> • We are not convinced that the text on credible evidence (225.18) will be helpful or well understood for practical application, given the fact remains that in some circumstances accountants do not possess the qualifications (e.g. as lawyers) that would enable them to assess non-compliance appropriately. The question as to what “reasonable” is in this context remains unanswered. We also believe this concept should be introduced earlier 	<p>Point accepted – the proposed guidance has now been deleted.</p> <p>However, the Task Force does not believe that the “credible evidence” threshold can be introduced any earlier than paragraph</p>

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	than paragraph 225.17 as without credible evidence it would be inappropriate to require professional accountants to follow all the requirements of the Code.	225.17. In practice, the process is unlikely to be linear.
30.	The Task Force's proposal to amend the last sentence of paragraph 3 of Section 270 <i>Custody of Client Assets</i> seems reasonable. However, we believe it would be more helpful if the exact requirements are clarified rather than stating the professional accountant is required to comply with the provisions of Section 225.	Point not accepted. The Task Force believes that doing so could convey the impression that Section 270 is being substantively revised, which would be beyond the scope of this project.