IESBA Exposure Draft:

"Responding to Non-Compliance with Laws and Regulations ('NOCLAR')

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Dear Mr Siong,

Response to Exposure Draft by the Group A and APA firms

This response is joint between the Group A and the members of the Association of Practising Accountants (we have appended a list of all of the firms which have ascribed to the response[1]), namely the medium sized firms that are active in the mid-tier market, including SMEs[2].

Introductory remarks and key submissions

It is recognised that instances of NOCLAR, or instances where a potential exists that NOCLAR has occurred, has long been a fraught subject for the profession to content with: on the one hand, the duty of confidence is one of the 'fundamental principles' by which a professional accountant is bound, yet, on the other hand, there may be a broader, public, interest in knowledge the professional accountant comes into possession of being known to a public authority.

The resultant tension is very difficult for professional accountants to address: his or her training has, after all, been heavily predicated on the fact that the fundamental principles constitute absolute standards of behaviour from which there are no derogations: the duty of integrity, for example, is not subject to any *caveat*.

Though the duty of confidentiality *is* subject to derogations (there is an 'entitled or obliged by law' override - which begs the question whether it is properly termed a fundamental principle anyway), it surely must be the case that confidential information about a client or employer should only ever be breached where the degree of compunction, objectively viewed, is substantial.

Of course, whenever the test for a professional obligation is qualitative, invoking a public interest threshold, the sorts of interpretational difficulties that the consultation points up become inevitable. This is the point at which we suggest caution: it is a difficult enough task to make a public interest test comprehensible at national level (we in the UK have

[1] **Group A** - Baker Tilly, Crowe Clark Whitehill, Haines Watts, Kingston Smith, Mazars, Moore Stephens, Saffery Champness, and Smith & Williamson; **APA** – Armstrong Watson, BHP, Blick Rothenberg, Brebners, Buzzacott, Dixon Wilson, Duncan & Toplis, James Cowper Kreston, Kreston Reeves, Mercer & Hole, Price Bailey, Roffe Swayne, and Shipleys.

[2] In total, we have annual revenues of £1.1bn+, with 12,600 partners and staff in 230+ offices around the United Kingdom.

experienced this recently, in professional disciplinary circumstances[3]), but when it needs to be a common test, applied uniformly across all of the jurisdictions whose professional bodies make up the membership of IFAC, the problem is multiplied.

The additional reporting obligations that the proposed new Sections in the IESBA Code seek to impose will bear heaviest on professional accountants who are auditors. The justification is said to be that the public interest is greatest in that professional service. The consultation paper also concedes that extant obligations on auditors in the sort of circumstances the paper refers to are already extensive[4] and we counsel against the need or desirability of making them broader and more onerous still.

Our concern is based on the vagueness that attends any instance where the public interest is invoked as the justification. What tends to follow (and the consultation paper concedes the point[5]) is an unsureness on the part of the auditor as to the proper application of the law and a resort to legal advice.

Taking a recent practical example in the UK context, the sale of military aircraft to a Middle Eastern country by a British manufacturer was said to have involved the making of illicit payments to third parties. Those professional accountants (whether in practice as auditors or employed by the seller) will have been subject to the UK's statutory secrecy laws. The consultation paper suggests that they may have been under a professional obligation, which superseded the law, to test the extent of their professional duty against their legal one by taking legal advice. The answer from lawyers to the question would almost certainly have been equivocal, leaving the professional accountants concerned no better placed than they were before asking the question.

It would not be a defence for those professional accountants to a charge of professional misconduct to plead in answer that they took advice, the import of which was that the law *may* permit them to disclose NOCLAR. This example is, frankly, not untypical, and it extends not merely to situations of clear criminality to but to practical situations often encountered by auditors: when they feel obliged to resign from audit appointments, a situation which lays professional and legal obligations on them.

The professional obligation (to intimate the circumstances giving rise to the decision to their successor) is very difficult as directors may threaten to sue for defamation, and the legal obligation (to make a public report on those reasons) is subject to a very narrow and arguably equivocal extent of public interest right. The result is that the decision to resign is very often publicly announced in a very nuanced way and the information the incumbent auditor feels able to give to the incoming one is also nuanced and limited, for the same reason.

[3] Executive Counsel to the (UK) Financial Reporting Council against Deloitte & Touche, and another (30 January 2015)
[4] ISA 250, for example.
[5] Para 130 says there will inevitably be incremental costs of applying the Code, since taking legal advice will be virtually always necessary.

The proposal in the consultation does nothing to improve the situation that obtains presently. Actually, it makes it worse, as auditors may feel compelled to take legal advice purely as a defensive or self-protective measure against allegation that they have failed to fulfil the terms of the new provisions, even though a common sense view is that it is not necessary: the only tempering wording in the new provisions is where there is no 'substantial harm' results with an instance of NOCLAR. The reality is that auditors are going to feel compelled to take legal advice on what the presence/absence of 'substantial harm' means in the particular circumstances they are facing.

We comment too on the assumption in the Exposure Draft[6] that professional accountants carrying out *non*-audit work should (be deemed to) have the same extent of knowledge of law and regulation affecting a particular client as its *auditor* would. We do not accept that proposition: the extent of 'deemed knowledge' should be tempered by the nature of the engagement – a professional accountant engaged to prepare the accounts of a client should not be deemed to know the client-context to the same degree as its auditor should: an auditor is obliged by standards to have a knowledge of the laws and regulations to which an audited entity is subject, whereas there is no such requirement for many non-audit services (indeed, it would be entirely possible to advise a company on a given matter without needing to have knowledge of laws and regulations which, though fundamental to its activities, nevertheless do not impact on the matter on which the advice is provided.

We therefore disagree with the last three sentences of para 22, that,

"The Board further believes that those two categories should also represent an appropriate scope of laws and regulations covered for all other categories of PA. This is because it would be reasonable to expect them, by virtue of their professional training and expertise, and their knowledge of and experience with the entity (either through the provision of non-audit services to the entity or through an employment relationship), to recognize an act of NOCLAR or suspected NOCLAR in those two categories of laws and regulations if they came across it. This expectation would hold regardless of these other PAs' roles and levels of seniority."

Para 73 appears to accept that non-auditors should not have the same extent of *reporting obligation* as auditors,

"For these PAs [PAs in public practice providing services other than audits], the Board believes that the extent of the required response should be less compared with that for auditors. This is consistent with the former's generally narrower mandates and the lower level of public reliance on the services they provide."

but we believe that it is not correct for them to have imputed to them the same degree of *knowledge* of the client-context as an auditor: simply cutting down the extent of his or her reporting duty is not the distinguishing feature that the Board should be concentrating on.

Key additional points

In relation to the objectives of 'Sections 225 and 360 and Interaction with Applicable Legal Requirements', whereas we are supportive of IESBA's objective to improve the clarity of the Code of Ethics for Professional Accountants and believe that it is right to have the current

[6] Paragraphs 21 and 22.

debate, and that in some respects, the guidance now offered to professional accountants helps in that respect, we do not believe that the new provisions and the accompanying guidance are yet workable.

Our fear is one that the consultation paper itself refers to – of unintended consequences: there is still considerable work still to be done.

Whereas we note IESBA's objectives for the new sections,

(i) To ensure that PAs do not turn a blind eye to identified or suspected NOCLAR and that they do not, through their actions or inaction, bring the profession into disrepute;
(ii) By alerting management or, where appropriate TCWG, to seek to:
(a) Enable them to rectify, remediate or mitigate the consequences of the NOCLAR or suspected NOCLAR; or
(b) Deter the commission of the NOCLAR where it has not yet occurred; and
(iii) For PAs to take such further action as may be needed in the public interest.

and are supportive of them, we think that (ii) may have a unintended consequence in terms of the 'tipping off' offences that apply in FATF countries.

Whereas we understand too that the following wording has been introduced in paragraph 225.10 to deal with the tipping-off point,

"In some jurisdictions, there are legal or regulatory provisions governing how professional accountants should address non-compliance or suspected non-compliance with laws and regulations. The professional accountant shall obtain an understanding of those provisions and comply with them, including any prohibitions on alerting ("tipping-off") the client prior to making any disclosure, for example, pursuant to anti-money laundering legislation."

we believe there is a risk that users could still regard it as qualified by paragraph 225.12,

"If the professional accountant suspects that non-compliance with laws and regulations has occurred or may occur, the professional accountant shall discuss the matter with the appropriate level of management and, where appropriate, those charged with governance."

We therefore believe that the qualification in paragraph 225.12 should be reflected in 225.10, and in other paragraphs where the same qualification applies.

Paragraph 225.30 deals with the point we made above (about obligations on incumbent auditors who are resigning), saying that,

"Where the professional accountant determines that withdrawing from the engagement and the professional relationship would be appropriate, doing so would not be a substitute for taking other actions that may be needed to achieve the professional accountant's objectives under this section. In some jurisdictions, however, there may be limitations as to the further actions available to the professional accountant and withdrawal may be the only available course of action. When withdrawing from the professional relationship, the professional accountant shall comply with the requirements of section 210."

We believe that this important provision needs to take cognisance of the fact that the boundaries of legal discretion given to auditors is as best opaque, and that sound ethical conduct in circumstance such as these may not go beyond what the law allows: in other

words, there are many situations in which *ethical* obligations are coextensive with *legal* ones.

This practical example tends to illustrate the difficulties of prescribing new ethical obligations: what a professional accountant may wish to do and what he might feel is the right thing to do is constrained by the extent of his entitlement.

Neither the new guidance under Sections 225 and 360 nor the Explanatory Memorandum make this point explicitly enough. There needs to be explicit 'legal professional privilege': even a cursory examination of LPP in the Member States of the EU shows a wide difference in its availability – professional accountants in industry have it but not their equivalents in public practice. The new guidance, should it fail to refer to LPP and build it into the new provisions, will be seriously undermined in practical implementation terms.

Section 140 on Confidentiality should make explicit reference to the issue we have pointed up as the intended revisions to it do not address it.

The difficulty with tying professional behaviour to a 'public interest' test

Section 225.4 does nothing to clarify what the term means,

"What constitutes the public interest will depend on:

(a) The facts and circumstances of the non-compliance or suspected non-compliance; and
(b) The nature and extent of the immediate or ongoing consequences to the client, investors, creditors, employees or the wider public."

There is widespread debate in a number of jurisdictions currently about the value of a public interest test in seeking to define professional obligations and we caution against taking decisions in the NOCLAR context while that debate is ongoing: it is not self-defining and is often used in lazily juridical way – it does not become clearer through the mere fact of repetition.

We agree with the Explanatory Memorandum that issues like definition of the public interest and the obligations of professional accountants need to be tackled at intergovernmental level and with the authority of truly supranational bodies with the authority to bind nations, not simply a class of person: to place all of the onus on the professional accountant is a disproportionate and unfair policy.

We agree too that there should be no differentiation between PIEs and Non-PIES for NOCLAR purposes.

We note too that, in instances where the auditor has reported the NOCLAR circumstances to 'those charged with governance', he has to consider further whether he has to make wider disclosure. We have concerns about the wording of the **Threshold for the Determination of Further Action** in proposed paras 225.20 – 225.29 as this is the watershed test for what the professional accountant should do. Whereas we agree with 'clearly inconsequential matters' being scoped out *per* para 33 of the Explanatory Memorandum, we are concerned about the Third Party Test in para 54 of the EM,

"To ensure an objective and rigorous assessment of the need for, and nature and extent of, further action, the Board is proposing that the framework require the application of a third party test. Under this test, auditors would be required to take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available at the time, would be likely to conclude that they have acted appropriately in the public interest (see paragraph 225.25)."

The tying-back to the public interest suffers from the same criticism we made above – the opaqueness of 'public interest'.

The threshold test introduces a term new to ethical guidance – 'substantial harm'.

"225.21 Whether further action is needed, and the nature and extent of it, will depend on various factors, including:
• The legal and regulatory framework.
• The appropriateness and timeliness of the response of management and, where applicable, those charged with governance.
• The urgency of the matter.
• The pervasiveness of the matter throughout the client.
• Whether the professional accountant continues to have confidence in the integrity of management and, where applicable, those charged with governance.
• Whether the non-compliance or suspected non-compliance is likely to recur.
• Whether there is credible evidence of actual or potential substantial harm to the interests of the entity, investors, creditors, employees or the wider public. An act that causes substantial harm is one that results in serious adverse consequences to any of these parties in financial or non-financial terms."

It is odd that a term that implies such gravity is only one of seven, individual not cumulative criteria set out in the paragraph, and constitutes an obligation wider than ISA 250. A new conceptual term such as this is bound to become the focus for those trying to interpret Section 220.21 and deserves deeper discussion, and consultation with the regulatory bodies and their members who will have to live with it.

An undue level of emphasis on the auditor

The stratification of responsibility proposed for the revised Code seems to us to place a degree of emphasis on the auditor that is unwarranted, certainly much higher than other categories of professional accountant. The duty of care owed by the auditor in the UK and most other mature civil and common law jurisdictions is limited to the shareholders of the audited entity.

We submit that the increased emphasis on the auditor is not justified.

Responses to the 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?

We referred above to circumstances which we believe ought to be covered by the new provisions – circumstances where the extent of legal obligation is unclear or subject to unclear derogations. We strongly counsel that further work needs to be done in these important respects.

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 instances where there is *no* legal or regulatory requirement to report identified NOCLAR to an appropriate authority, the guidance may be helpful only where the absence of such will not militate against the professional accountant: as the consultation itself makes clear, the laws in some jurisdictions are silent on such requirements but be quite draconian so far as breach of confidence is concerned.

The practicalities of implementing the Code may be particularly difficult for the professional accountant in such an environment. The absence of LPP or a safe harbour is a severely limiting factor.

The uniform application of the Code, particularly as international networks develop, will depend not only on commonly accepted standards but a substantially common regulatory environment in which they can be implemented meaningfully.

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 employing organizations.

We have set out our concerns, particularly with regard to the increased onus on auditors, and our criticism of paras 21 and 22 in relation to professional accountants carrying out non-audit work, above.

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

We do not agree with the disproportionately heavier emphasis placed on the auditor. We understand that regulators may support it but IFAC should be aware of the increasing accountability that regulators (certainly in the UK) are subject to by government, to be proportionate in their actings and to promote only new regulation that is proportionate in its terms and consequence. We believe that the new provisions might fail either test, if viewed from a UK perspective.

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

It follows from the key points we have made above that we support the equiparation with the scope of ISA 250 as the basis for these revised proposals.

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

Though we can understand agree with the four classifications, we do not accept that the auditor should have greater public interest responsibilities than those of the other categories of professional accountant.

The conceptual approach should not place a heavy degree of emphasis on the audit engagement partner.

We also note the guidance in Paragraph 74 of the Explanatory Memorandum in relation to requiring non-audit practitioners thus:

"If the client is also an audit client of the firm, communicate the matter within the firm so as to enable the engagement partner for the audit to be appropriately informed about it and for the latter to determine how it should be addressed in accordance with proposed Section 225 (see paragraph 225.39)".

We counsel against this sort of provision which presents firms with a compliance obligation that may be difficult to implement in practical terms.

Decisions of these kinds might better be left with the Ethics Partner of the firm[7] in consultation with the engagement partner.

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 have set out above our criticisms of 'substantial harm': it may be a useful concept but as it is American in derivation and usage and has no parallel elsewhere, it will need further deliberation with the stakeholders likely to be most closely affected by it, before implementation.

(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?

[7] Admittedly a UK creation but may serve the purposes of the new provisions better. (Audit firms with more than three Responsible Individuals need to have a separate Ethics Partner.) It is appropriate for the engagement partner to determine how the matter should be addressed but firms that do have an Ethics Partner to include that person in deciding the appropriate action. Indeed there may also be others, such as the MLRO.

Whereas we agree with the implementation of the test, whereby auditors would be required to take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available at the time, would be likely to conclude that they have acted appropriately in the public interest (paragraph 225.25), we have residual concerns over its association with the public interest.

(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?

We agree with the proposals, subject to our significant concerns over the law of confidentiality, and the presence or absence in a given jurisdiction of Legal Professional Privilege.

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

We are generally supportive of the approach set out in paragraphs 57 and 58 of the Explanatory Memorandum: we agree that whether disclosure to an appropriate authority would be a proper course of further action will depend on the nature and extent of the actual or potential harm from the matter to the wider public, including investors, creditors or employees.

We further agree that the determination of whether to disclose a matter to an appropriate authority should also take into account of considerations such as whether or not there is an appropriate authority, whether there exists robust and credible legal protection, and whether there are threats to the physical safety of the auditor or others.

We observe that if the auditor determines that disclosure to an appropriate authority would be appropriate in the circumstances, even though not required by law or regulation, the Code would allow him to do it under Section 1408 (professional accountants' right to disclose confidential information to comply with ethical standards).

We specifically support para 59: we are supportive of the general proposition that the Code does not override local laws and regulation.

We are also supportive of IESBA's revised position as set out in paragraph 60 of the explanatory memorandum not to establish a disclosure requirement.[8]

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 question whether it would be correct and permissible for professional accountants in public practice providing services other than audits, to ask them to consider whether to communicate the matter to the network firm so as to enable the engagement partner for

[8] "The Board believes that it is not appropriate to carry forward the original ED proposal for the Code to require auditors to disclose identified or suspected NOCLAR to an appropriate authority in the relevant circumstances.".

the audit to be informed about the existence of the service: if it is being suggested that if a firm providing non-audit services becomes aware of NOCLAR, it should inform its network firm which is the auditor, how could that obligation be consistent with client confidentiality? Networks tend to have 'independent' members, and in that circumstance, it is hard to see how a right to pass client confidential information, without the express permission of the client, could be implemented.

It would seem permissible fora PA performing a non-audit service for an audit client of the firm to communicate the matter within the firm, so that the engagement partner is informed.

However, identification of the person responsible for deciding whether further action is needed presents more difficulty. It does not appear reasonable that a professional accountant in public practice can relinquish all responsibility once he has informed the audit engagement partner, and the network firm, likely being in a different jurisdiction, adds another layer of complexity.

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

The keeping of adequate documentation is always advisable but the real question is whether the keeping of such records should be mandatory, breach of which obligation meads to professional censure.

We therefore think that the proposed wording, encouraging the keeping of documentation is the correct balance to strike.

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