

Responding to Non-Compliance or Suspected Non-Compliance with Laws or Regulations — Issues and IAASB Task Force Recommendations

Objective of the IAASB Discussion

The objective of this Agenda Item is to discuss two specific matters relating to the IAASB's project on *Responding to Non-Compliance or Suspected Non-Compliance with Laws or Regulations* (NOCLAR), namely the requirement and related guidance addressing the auditor's responsibilities with respect to reporting NOCLAR, and the definition of non-compliance, and provide feedback on the Task Force's recommendations in this regard. This Agenda Item also addresses the proposed Effective Date for the proposed revisions to the International Standards.

At its June 2016 meeting, the IAASB will be asked to consider the remaining issues, as well as other detailed comments from two respondents to the IAASB's NOCLAR Exposure Draft (ED) not previously considered, and will be asked to approve the final changes to the International Standards addressing NOCLAR.

Introduction

1. At its March 2016 meeting, the IAASB considered the significant issues raised by respondents to the IAASB NOCLAR ED and the Task Force's recommendations thereon, as well as a revised draft of proposed ISA 250¹ and the related conforming amendments. The most significant matters discussed related to the definition of non-compliance in paragraph 11 of ISA 250 and the articulation of the auditor's responsibility to consider reporting NOCLAR to an appropriate authority in paragraph 28 and the related application material.
2. Subsequent to the finalization of the March 2016 agenda materials, two additional comment letters were identified – the International Organization of Securities Commissions (IOSCO) and KPMG. Accordingly, the views of these respondents had not been considered in the preparation of the issues paper presented to the Board. Relevant comments from these two respondents in relation to the matters for discussion during the teleconference have been included in this paper; the remaining feedback from IOSCO and KPMG will be considered in the June 2016 agenda material.
3. For the purposes of this paper, and when considered necessary to provide context to the magnitude of responses, the following descriptive terms have been used:
 - Some respondents = 4-6; and
 - Many respondents = 12-21.

¹ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

Matters for IAASB Discussion

A. The Responsibility to Report NOCLAR to an Appropriate Authority

Background and IAASB Comments

4. As noted in paragraphs 22–26 of Agenda Item 7-A of the March 2016 agenda material, respondents to the ED had reservations with the use of the term “legal or ethical duty or right” to report NOCLAR to an appropriate authority. At the March 2016 meeting, the Task Force proposed enhancements to the language in paragraph 28 of ISA 250, which were intended to provide further clarity and ensure that all of the possible scenarios under law or regulation or relevant ethical requirements were considered in ISA 250.
5. Neither the IAASB nor the Consultative Advisory Group (CAG) supported paragraph 28 and the related conforming amendments to the other ISAs as redrafted, as the wording was considered to be confusing. In particular, IAASB members were confused by the wording “or may otherwise report” and also questioned whether “without breaching the duty of confidentiality” could be viewed as imposing an additional matter for the auditor to consider. Further comments noted that the words “duty”, “requirement” and “responsibility” are used interchangeably throughout ISA 250 and the conforming amendments, which was seen to be confusing.
6. Concern was also expressed about the sequence and clarity of the related application material, including the examples in relation to reporting NOCLAR in respect of banks and financial institutions and reporting misstatements to an appropriate authority.
7. The Task Force was asked to consider how to simplify paragraph 28 of ISA 250 and address the other comments received on this paragraph and the related application material.

Feedback from IOSCO and KPMG Not Included in the March 2016 Agenda Material

8. KPMG did not agree with the proposed drafting of paragraph 28 in the ED, as they believed it was too broad and was not helpful without context as to how an ethical duty or right might arise.
9. IOSCO recommended that paragraph 28 of ISA 250 include a reference to the *Code of Ethics for Professional Accountants* issued by the International Ethics Standards Board for Accountants (IESBA Code) in a footnote to point those auditors who are subject to the IESBA Code to its additional requirements. In addition, KPMG commented that the IESBA Code should be included as an example in the application material in paragraph A19, rather than being referenced as a footnote to paragraph A19.

Task Force Recommendations

10. The Task Force has revisited paragraph 28 of ISA 250, and acknowledges that it is challenging to fully address the variety of possible circumstances in law or regulation or relevant ethical requirements regarding the reporting of NOCLAR to an appropriate authority, without making the requirement complex. The suggested revisions are included in paragraph 28 of **Agenda Item 1-B**.

11. The Task Force discussed possible alternatives that would reflect the possibility that there may be a requirement to report, or a requirement to consider whether to report (such as in the IESBA NOCLAR pronouncement), or an overarching right to report, and agreed the following:
 - (a) The description of the auditor's responsibility should refer to "a responsibility ... in relation to reporting identified or suspected non-compliance to an appropriate authority outside the entity", since the ED language "a legal or ethical duty or right to report identified or suspected non-compliance to an appropriate authority outside the entity" may imply a more definitive requirement to report and may overlook the possibility that, in some cases, reporting to an appropriate authority is a potential action and not an absolute requirement. The use of the term "responsibility", which is consistent with extant ISA 250, appropriately addresses both a requirement to report and a responsibility to consider whether to report.
 - (b) The reference to a "legal" responsibility would be more clearly explained as a "responsibility under law or regulation."
 - (c) Adding a reference to a "responsibility under ... relevant ethical requirements" would achieve the necessary linkage to the IESBA Code and similar ethical requirements that establish broader responsibilities, under which reporting to an appropriate authority may be a potential action rather than a definitive responsibility.
12. In light of comments from some respondents² regarding a possible preclusion under law or regulation from reporting to an appropriate authority outside the entity, the Task Force believed that some emphasis is needed regarding the relationship between reporting to an appropriate authority and the duty of confidentiality. The Task Force was of the view that it is important to explain the two scenarios regarding the duty of confidentiality: namely, that there may be a preclusion on reporting under law, regulation or relevant ethical requirements, or alternatively an override of the duty of confidentiality under law, regulation or relevant ethical requirements. The Task Force has proposed wording to explain these two possible circumstances in paragraph 28 of **Agenda Item 1-B** and has also proposed amendments to the application material in paragraphs A19a–A19d, to give more prominence in paragraph A19a on the legal preclusion on reporting.
13. The Task Force also considered the sequence and clarity of paragraphs A19-A19b and has proposed distinguishing the various scenarios into separate paragraphs, to help auditors better understand the range of possible responsibilities of an auditor in relation to reporting to an appropriate authority (see paragraphs A19b, A19c and A19d of **Agenda Item 1-B**).
14. In addition, the Task Force recognized that a preclusion from reporting arising from a duty of confidentiality under law or regulation or relevant ethical requirements would be pervasive to all of the scenarios explained in paragraphs A19b-A19d, and accordingly propose relocating this language before these paragraphs (see paragraph A19a of

² *National Auditing Standard Setters: IDW; Member Bodies and Other Professional Organizations: FEE, FSR, ICAS, SMPC*

Agenda Item 1-B). This placement addresses the comment from a Board member that paragraph A19a, as presented to the Board at the March 2016 meeting, was somewhat confusing as it appeared to conflict with some of the later scenarios.

15. The Task Force also revisited the guidance explaining the responsibility to report to an appropriate authority under relevant ethical requirements. In addition to providing an enhanced description of these circumstances, the Task Force believed that making a direct reference to the IESBA Code would be clearer and more understandable (see paragraph A19d of **Agenda Item 1-B**). Direct references to the IESBA Code exist in other parts of the ISAs in application material, for example paragraph A31 of ISA 260³ and A14 of ISA 610.⁴ The Task Force did not believe a footnote reference to the IESBA Code within paragraph 28 would be appropriate in light of the IAASB's drafting conventions, but noted that the reference in paragraph A19d as well as the new requirement in paragraph 8a of ISA 250 discussed at the March 2016 meeting would be responsive to IOSCO's comment to give more prominence to the additional requirements in the IESBA Code.
16. Paragraph A19b has also been updated to address concerns that the requirement to report NOCLAR in respect of financial institutions needs to be stronger. With respect to the reporting of misstatements, the Task Force investigated this further and identified that there are jurisdictions where the reporting of misstatements to authorities is required in certain circumstances.⁵ Accordingly, the Task Force propose retaining this example in paragraph A19b of **Agenda Item 1-B**, with a better linkage to NOCLAR.

Matter for IAASB Consideration

1. The IAASB is asked whether:
 - (a) The proposed revisions to paragraph 28 and related application material are understandable and appropriately encapsulate the various scenarios with respect to reporting NOCLAR to an appropriate authority.
 - (b) The reference to the duty of confidentiality in paragraphs 28 and A19a is appropriate and balanced, in particular whether the last sentence of paragraph 28 is necessary in light of the revisions to the application material in paragraphs A19a–A19d, which clarify all of the possible scenarios, including a legal preclusion on reporting to an appropriate authority.

B. Definition of Non-Compliance

Background and IAASB Comments

17. The IAASB did not propose changes to the definition of non-compliance included in paragraph 11 of ISA 250 in the ED. However, at the March 2016 Board meeting, the Task Force recommended alignment of the definition to paragraphs 225.2 and 225.9 of the

³ ISA 260 (Revised), *Communication with Those Charged with Governance*

⁴ ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

⁵ See, for example, Section 10A of the United States Securities Exchange Act of 1934.

IESBA NOCLAR pronouncement in response to comments received on the ED. The proposed amendments were as follows:

11. For the purposes of this ISA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission ~~by the entity~~, either intentional or unintentional, ~~which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, committed by the entity, or by those charged with governance, by management or employees by other individuals working for, or under the direction of the entity, which are contrary to the prevailing law or regulation.~~ Non-compliance does not include:

- (a) Personal misconduct unrelated to the business activities of the entity by those charged with governance, by management, or employees by other individuals working for, or under the direction of the entity.
- (b) Non-compliance by persons other than the entity or those charged with governance, by management or by other individuals working for, or under the direction of, the entity.

18. The Board agreed that to the extent possible, the terminology in the ISAs and the IESBA Code should be aligned, deviating where necessary for the purposes of the ISAs and having a sufficient basis for such deviations.
19. Despite this principle, a member was concerned with the proposed revisions to paragraph 11 of ISA 250, viewing the change as having the potential to broaden the scope beyond what is required to perform a financial statement audit. In particular, concern was raised with the removal of the words “transactions entered into by, or in the name of, the entity, or on its behalf”. Another member was of the view that the proposed changes did not broaden the scope of ISA 250 and that personal misconduct related to the business activities of the entity has always been included.
20. There was also a discussion regarding the reference to “contrary to the prevailing law or regulation”, with the Public Interest Oversight Board (PIOB) observer questioning the need for the use of the word “prevailing”. Further, it was pointed out that an entity is not a person and, accordingly, the phrase “non-compliance by persons other than the entity” was an incorrect reference from a legal viewpoint.
21. One member recommended that the following example set out in paragraph 225.9(b) of the IESBA NOCLAR pronouncement, that references to a third party, be included in the definition in paragraph 11 of ISA 250 to illustrate the limitation envisaged by paragraph 11(b):

This includes, for example, circumstances where a professional accountant has been engaged by a client to perform a due diligence assignment on a third party entity and the identified or suspected non-compliance has been committed by that third party.

22. It was agreed that the Task Force would investigate the history of the definition of “non-compliance” in paragraph 11 and the impact, if any, of the proposed changes.

Feedback from IOSCO and KPMG Not Included in the March 2016 Agenda Material

23. IOSCO did not raise any comments on the definition of non-compliance. However, in their response to the question regarding a more fulsome review of ISA 250, KPMG signaled their belief that personal misconduct is not within the scope of ISA 250, noting that this is a subtle difference from the IESBA Code, and that such a difference is appropriate due to the different objectives of the ISAs and the IESBA Code. However, KPMG recommended that as part of a more fulsome review, the ISA should explicitly acknowledge that any instances of personal misconduct, related or unrelated to the business activities, which come to the attention of the auditor may provide information that is relevant to the audit, since it may have a bearing on the integrity of management, those charged with governance, employees of the entity or parties associated with the entity, including contractors.

Task Force Recommendations

24. The Task Force investigated the history of the definition of non-compliance contained in ISA 250, noting that it has existed for many years, and was traced back to pre-2001, thus providing little insight into the basis for the definition, such as the meaning of the sentence “Such acts include transactions entered into by, or in the name of, the entity, or on its behalf.”
25. In the Task Force’s view, this phrase is merely an example of an act of non-compliance in the context of a financial statement audit; the Task Force did not believe it was intended to limit the application of the definition only to transactions. The Task Force therefore believe that there is no impact on ISA 250 arising from the removal of this wording.
26. The Task Force is also of the view that personal misconduct related to the business activities of the entity was always included within the scope of ISA 250, since the extant definition explicitly scopes out personal misconduct *unrelated* to the business activities of the entity (i.e., as this is explicitly scoped out, by default, personal misconduct *related* to the business activities is scoped in).
27. In further researching the background to the IESBA NOCLAR project and discussion with the IESBA Staff, it was identified that the intention of the IESBA in terms of defining non-compliance was always to ensure alignment with the meaning of non-compliance in ISA 250. The addition of “those charged with governance, management or other individuals working for or under the direction of the entity” was added by IESBA to ensure that it is clear that actions by such individuals, if they relate to the business activities of the entity, would be included within the scope of the IESBA NOCLAR pronouncement.
28. In summary, the Task Force believes that the additional wording to clarify the meaning of non-compliance, as added by IESBA and echoed in ISA 250, does not inappropriately broaden the scope of ISA 250. Nor does the deletion of the reference to transactions described in paragraphs 24–25 of this paper. However, as this example was intended to illustrate a type of non-compliance that would be relevant in the context of a financial statement audit, the Task Force proposes including the example as application material (see paragraph A6a of **Agenda Item 1-B**). Doing so enables the definition to be consistent

with what is in the IESBA pronouncement, while further elaborating on the definition in the context of the ISAs.

29. The Task Force further notes that any non-compliance would still need to qualify under the scope of laws and regulations set out in paragraph 6 of ISA 250, i.e. those laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements and other laws and regulations 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, to an entity's ability to continue its business, or to avoid material penalties.
30. The comments raised regarding the use of "prevailing" laws or regulations were highlighted to the IESBA staff, who noted that this concept has existed in the ISAs for many years with no apparent or reported confusion in practice. Furthermore, no concerns have been expressed by respondents to the IESBA or IAASB EDs in this regard. In light of this, the Task Force agreed that ISA 250 should continue to be aligned to the IESBA NOCLAR pronouncement in this respect.
31. The Task Force agreed with the point that an entity is not a person from a legal viewpoint, as is currently implied in the definition. The IESBA NOCLAR pronouncement makes reference to "client" in place of "entity" and accordingly the reference to "client" in the context of a person is appropriate in the IESBA NOCLAR pronouncement. The Task Force believed that it is not possible to refer to "client" in place of "entity" in ISA 250, as "entity" is used consistently throughout the ISAs. Instead, the Task Force has proposed the deletion of the reference to "entity", recognizing that, while this is a deviation from the definition of non-compliance in the IESBA NOCLAR pronouncement, the removal of this reference has no bearing on non-compliance that would be within the scope of ISA 250.
32. The Task Force also considered the recommendation to include a reference to a third party within the definition in paragraph 11(b), as included in section 225.9(b) of the IESBA NOCLAR pronouncement. However, the scenario provided in the IESBA NOCLAR pronouncement relates to a specific situation that does not exist in an audit engagement, and including a more general reference to third-party relationships could be problematic. Accordingly, the Task Force did not support making reference to third parties in the definition.

Matter for IAASB Consideration

2. Does the IAASB agree with the further changes to align the definition of non-compliance in paragraph 11 of ISA 250 to the IESBA Code, as well as excluding the example contained in section 225.9(c) of the IESBA NOCLAR pronouncement from the definition?

C. Proposed Effective Date of the Amendments to the IAASB's International Standards

Background and IAASB Comments

33. The IAASB ED contained a specific question to respondents on whether or not they supported the alignment of the effective date of the amendments to the International Standards with the IESBA NOCLAR pronouncement. The IAASB ED noted that the IESBA

was aiming to approve the restructured Code by Q4 2016, with the effective date to be determined in due course.

34. Many respondents⁶ to the IAASB ED supported the alignment of the effective date of the amendments to the International Standards with the IESBA NOCLAR pronouncement. However, subsequent to the issuing of the IAASB ED, the IESBA determined that its NOCLAR pronouncement should be issued when finalized, instead of waiting for the final restructuring of the IESBA Code, thus moving the timeline for the effective date of the IESBA NOCLAR pronouncement forward.
35. The IESBA has provisionally set July 15, 2017 as the effective date for its final NOCLAR pronouncement, subject to PIOB approval of due process, with final approval of the effective date at the IESBA's April 25 teleconference. The IESBA's effective date is a "triggering" effective date (i.e., the pronouncement will apply to instances of non-compliance that come to the professional accountant's attention on or after July 15, 2017).

Task Force Recommendations

36. The Task Force considered various alternatives in terms of the most appropriate effective date, taking into consideration the practicalities in implementing revisions to the standards and how the effective date was established for other ISAs. In particular, the Task Force noted the following:
 - The due process related to the IESBA NOCLAR pronouncement will be considered by the PIOB at the June 2016 PIOB meeting, while the changes to ISA 250 and conforming amendments to other IAASB International Standards will only be considered by the PIOB at the September 2016 meeting.
 - The approach used most recently for the effective date of revisions to the ISAs is for periods ending on or after December 15 (of a specified year), for example 2016 in the case of the auditor reporting standards, the revisions arising from the Disclosures project and ISA 720 (Revised).⁷ The clarified ISAs were made effective for periods *beginning* on or after December 15 (2009), so that all audits commencing at a point in time (regardless of whether they were for annual period or longer/shorter) would incorporate the improvements. In addition, the IAASB has not previously referred to months other than December in setting effective dates.
 - The time taken to translate and approve new or amended ISAs by affected jurisdictions can vary from a couple of months to more than a year, depending on

⁶ *Regulators and Oversight Bodies:* IRBA; *National Auditing Standard Setters:* AUASB, CAASB, NBA, NZAuASB; *Accounting Firms:* EYG; *Member Bodies and Other Professional Organizations:* CPAA, FEE, ICAS, ICAZ, ICPAK, SAICA, WPK; *Academics:* HC

⁷ The effective date of *periods ending on or after December 15, 2016* for the new and revised standards in respect of auditor reporting was established to achieve consistency of auditors' reports issued in the market on or after this date. The effective dates for the revised standards arising from the Disclosures project and ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, were aligned to the effective date for auditor reporting to achieve consistent effective dates in respect of changes to the ISAs that were coming into effect at a similar time.

the extent of changes to the underlying ISAs and the availability of resources to prepare the translations. Further, the translation process for some languages can be complex due to the necessary process of reviewing and approving the translations. Accordingly, a lead time of less than a year between the issue date and effective date is unlikely to allow sufficient time for translations of the IAASB amendments in many jurisdictions.

- Certain jurisdictions that use the ISAs (either as the standards or as the basis for their standards) may also need to conduct their own due process (e.g., where the standards are included in law or regulation). This process, and the length of time needed for it, varies by jurisdiction.
 - Some firms will prefer to incorporate the changes to their methodologies arising from the IAASB's International Standards and the IESBA Code concurrently. For this to be done efficiently, relevant implementation guidance will need to be available shortly after the release of the respective final IESBA NOCLAR pronouncement.
37. As highlighted above, the IESBA effective date is a “triggering” date, whereas the ISAs relate to a financial period. Furthermore, the Task Force noted that there would be some complexities in interpreting the effective date, for example whether the effective date would apply to when the NOCLAR took place or when the professional accountant became aware of the NOCLAR. Accordingly, the Task Force recognized that it is not possible to achieve perfect alignment of the effective dates.
 38. The Task Force is of the view that the auditor's response to the NOCLAR would not differ between extant and revised ISA 250, since the auditor would still have an obligation to consider the appropriate action be taken in accordance with the relevant ethical requirements, for example the IESBA Code when this constitutes the relevant ethical requirements.
 39. The effective date that would achieve the closest alignment to the IESBA NOCLAR pronouncement would be an effective date of *periods beginning on or after July 15, 2017*; however this effective date is unlikely to allow sufficient time for translations and implementation as it would only allow a nine-month lead time, assuming the changes to the IAASB's standards are approved by the Board at the June 2016 meeting and the PIOB considers and concurs with the due process applied at their September 2016 meeting.
 40. Using an effective date of *periods ending on or after December 15, 2017 or 2018* would be consistent with the approach used in the most recent revisions to the ISAs. As already highlighted, however, an effective date of *periods ending on or after December 15, 2017* would not allow sufficient time for the implementation of the changes to the ISAs, as it would effectively apply to audits of financial statements that commence December 16, 2016 or later and would predate the effective date of the changes to the IESBA Code. While an effective date of *periods ending on or after December 15, 2018* is consistent with the approach used in the most recent revisions to the ISAs and allows for a sufficient period for translations, adoptions and other implementation activities, it is disconnected from the effective date of the IESBA NOCLAR pronouncement.

41. Accordingly, the Task Force believes that the most appropriate effective date is for audits of financial statements for *periods beginning on or after December 15, 2017*, with early adoption permitted, as this would allow for a sufficient time period for the implementation activities (approximately fifteen months), and is more consistent with the basis of the effective date of the IESBA NOCLAR pronouncement (in that it would apply as of a commencement date rather than an ending date). Firms wishing to implement the changes to the ISAs concurrently with the IESBA changes could choose to early adopt.
42. The Task Force agreed that further clarification in the IAASB's Basis for Conclusions would be helpful in explaining the relationship between the IESBA NOCLAR pronouncement and the revisions to ISA 250 (i.e. that the changes to ISA 250 are merely to make it clearer how the ISAs interact with the IESBA NOCLAR pronouncement, but do not change the auditor's work effort).

Matter for IAASB Consideration

3. Does the IAASB agree with the proposed effective date of audits of financial statements for *periods beginning on or after December 15, 2017*, assuming the standard is approved by the Board at the June 2016 meeting and the PIOB approves the due process at their September 2016 meeting?