

Non-Compliance with Laws and Regulations - Significant Requirement under the Revised Code of Ethics

“Whether or not your values are operational is crucially determined by whether or not there are consequences for non-compliance.” David Maister

Responding to Non-Compliance with Laws and Regulations (NOCLAR) is an integral aspect covered in the Revised Code of Ethics. While tendering professional service to a client or performing professional activities for an employer, a professional accountant may face an instance of NOCLAR or suspected NOCLAR committed or about to be committed by the client or the employer, or by those charged with governance, management or employees of the client or employer.

Identifying such a situation can often be a complex and challenging one for the professional accountant, the onus lies on the professional accountant to respond to such a situation, the International Ethics Standards Board for Accountants (IESBA) has, accordingly, incorporated the feature of NOCLAR to guide the professional accountant in tackling the situation and deciding how best to serve the public interest in these circumstances.

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Non-compliance with laws and regulations (“non-compliance”) comprises of acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by:

- a client/professional accountant’s employing organisation;
- those charged with governance of a client or employing organisation;
- management of a client/ employing organisation; or
- other individuals working for or under the direction of a client/ employing organisation.



However, NOCLAR under Revised Code of Ethics (hereinafter referred as The Revised Code) does not address the personal misconduct unrelated to the business activities of the client/ employing organisation and non-compliance by parties other than listed out in the definition of NOCLAR.

The Revised Code has incorporated NOCLAR and

* Contributed with guidance from CA. Vandana Nagpal, member of the Institute.

most importantly covered guidance for the members as to how to deal with the non-compliances. The existing Code of Ethics is silent with respect to guidance for the members on NOCLAR.

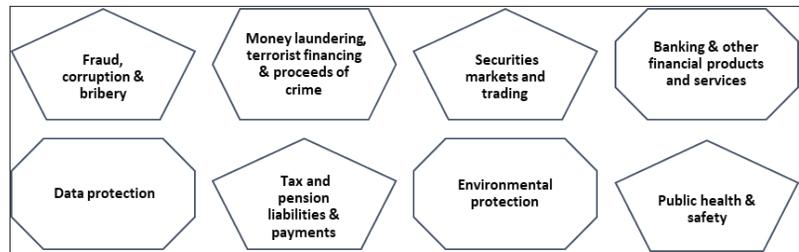
The Revised Code has discussed, in depth the manner, in which the professional accountant will address the NOCLAR, alert the client about the NOCLAR and take further steps to respond to NOCLAR.

The Revised Code has put thrust on Public Interest in the fundamental principles and NOCLAR as well. Professional accountants whether in service or in practice, are required to act in the public interest and are also required to comply with relevant laws and regulations. Moreover, members are required to follow the principles of integrity and confidentiality. However, complying with the principle of confidentiality would not be in the public interest when an accountant's client or employer is involved in significant illegal activities.

The Revised Code ensures that the professional accountant responds to NOCLAR in a timely manner so that adverse



Examples of laws and regulations which section 260/360 addresses include those that deal with:



consequences of the same on stakeholders and the general public are rectified, remediated or mitigated to the extent possible. In other words, measures specified in the Revised Code are preventive in nature.

Revised Code contains two detailed sections on NOCLAR for professional accountants in service and in practice for listed entities.

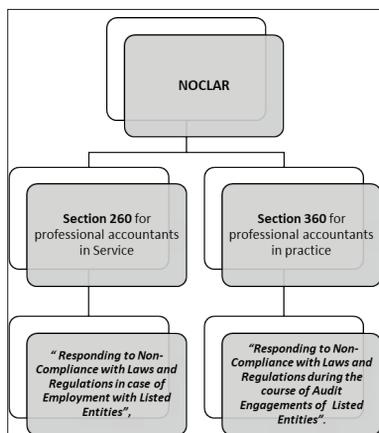
Professional accountants while providing services to a client or carrying out professional activities for an employer in listed entities, come across various acts or suspected acts of non-compliance with laws and regulations (NOCLAR).

Such non-compliances may result in levying of fines, giving rise to litigation or imposition of other penalties /outcomes for the clients or employing organization which may potentially materially affect its financial statements. These non-compliances can also potentially lead to substantial harm to stakeholders such as investors, creditors, employees or the general public. Such substantial harm can result in serious adverse consequences to the parties concerned in financial or non-financial.

Example of such non-

compliances are given below:

- A listed company incurs huge significant financial losses due to perpetration of fraud in the company.
- Hazard to the health of the employees or public due to non-compliance with environmental laws and regulations, for example, in chemical / textile industry.
- Management of listed entity indulging in money laundering looks for avenues with weak banking controls for converting illegal money into the banking system. Any excess credit in the bank accounts that does not belong to the customer or is parked for a temporary period should raise suspicion of such activities. Such listed entity indulging in money laundering activity looks for avenues to enter into 'benami' (could be called 'proxy' name lending) transactions. Companies with extensive cash handling and inadequate identification process of source of money or about the remitter are susceptible to money laundering activities.
- Non establishment of vigil mechanism as required



under regulations 22, 46 and Part C of Schedule V of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

- Non deposition of statutory dues such as PF/Gratuity/Advanced Tax/GST, etc.

While encountering such non-compliances or suspected non-compliances, the accountant shall obtain an understanding of legal or regulatory provisions governing such non-compliances or suspected non-compliances, and comply with them, including:

- (a) Any requirement to report the matter to an appropriate authority; and
- (b) Any prohibition on alerting the client.

Let us take an example of ABC Listed entity, which has submitted the financial statements for the year ended 31-3-2020 for audit. The audit assistant observes the same and brings to the notice of the Professional Accountant that the company's records show the following:

The Company has material uncertain position related to the regulated matters and direct and indirect tax matters under dispute.

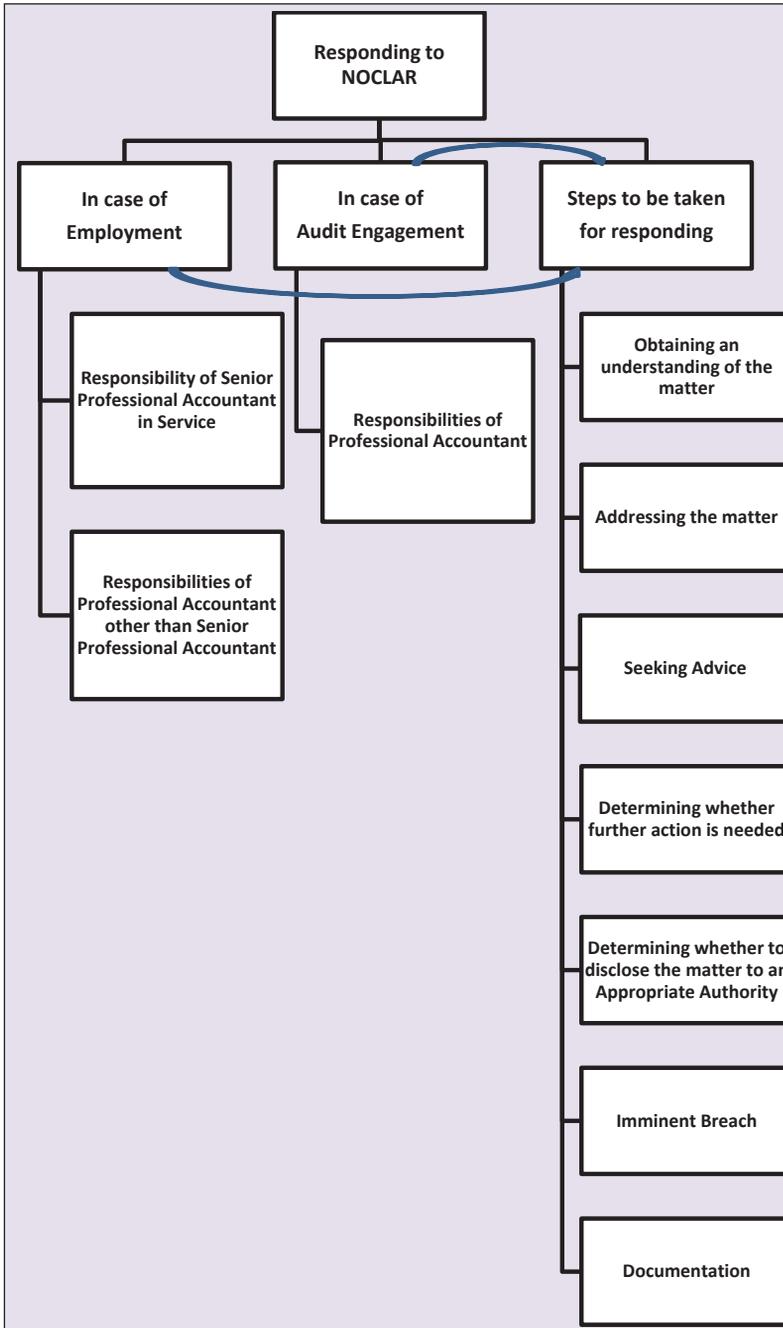
-Customs duty rupees 105 lakhs - Demand notice received on 17-8-18 but no action has been taken to pay or appeal.

-Non-current assets in respect of withholding tax and other includes CENVAT recoverable amounting to rupees 209 lakhs which are pending adjudication.

Rupees 23 lakhs of employee contribution and rupees 19.50 lakhs of employer contribution towards employee state insurance contribution have been accounted in the books of accounts in respective heads. Whereas, it was found that rupees 14 lakhs only has been deposited with ESIC department during the year ended 31st March, 2019.

It has also come to the notice that child labour is employed by the company.

Being an auditor of ABC Listed Entity, the onus lies on the Professional Accountant to take



timely steps (NOCLAR in case of Audit Engagement is covered in section 360 of Revised Code). While taking timely steps, the accountant shall take into account the nature of the matter and assess the potential harm to the interests of the entity, investors, creditors, employees or the general public.

Steps to be taken by the Professional Accountant are:

I. Obtaining an Understanding of the Matter:

After gaining knowledge about the non-compliance or suspected non-compliance, the foremost responsibility which vests on the statutory auditor of ABC Listed entity is to obtain an understanding of the matter and circumstances.

In such circumstances, the statutory auditor is expected to apply his knowledge and expertise and exercise professional judgement.

After assessing the nature and significance of matter, the auditor might consult with others within the firm, a network firm or the Institute or with legal counsel on a confidential basis.

The professional accountant shall **discuss the matter with the appropriate level of management and, where appropriate, those charged with governance** so as to reach to an understanding of the facts and circumstances with respect to the matters and its consequences. Discussion may lead to investigation of the matter by management or those charged with governance.

It is pertinent at this juncture to decide about appropriate level to

be approached. Appropriate level of management with whom to discuss the matter is a question of professional judgement. Generally, **appropriate level of management is at least one level above the individual or individuals involved or potentially involved in the matter**. However, **in case of group**, appropriate level might be **management at an entity that controls the client**.

The professional accountant may decide to discuss the matter with internal auditor in accordance with the circumstances.

In case the professional accountant has reason to believe that management is involved in the NOCLAR, in that situation he shall discuss the matter with those charged with governance.

The statutory auditor in aforesaid example has to follow the steps as mentioned above requiring to obtain an understanding of the matter and circumstances like:

- For tax disputes, to obtain details of completed tax assessments, orders passed, demands raised and to check whether any appeal has been filed challenging the order from the management.
- Involvement of internal experts to challenge the management's underlying assumptions in estimating the tax provisions and the possible outcome of the disputes.
- Consideration of legal precedence and other rulings in evaluating management's position on uncertain tax status.
- For child labour, to seek details from HR and legal department

of ABC Entity about such employment.

- To enquire from the management about non-deposit of full amount of employee state insurance contribution to ESIC Department, evaluate the management's valuation method used and accuracy.

Further, the auditor is required to discuss the nature and circumstances of the matter regarding such non-compliances, assess likelihood of collusion and potential consequences of the matter with management/ appropriate authority to investigate the matter and take appropriate action.

An act constitutes non-compliance or not is ultimately a matter to be determined by a court or other appropriate adjudicative body.

II. Addressing the Matter:

While discussing with management/those charged with governance about NOCLAR, next important step is to ensure that appropriate and timely action has been taken to rectify, remediate or mitigate the consequences of NOCLAR.

The professional accountant shall also see whether management and those charged with governance understand their legal or regulatory responsibilities with respect to the non-compliance or suspected non-compliance. In case, they do not understand their legal or regulatory responsibilities, the professional accountant might suggest appropriate sources of information or recommend that they obtain legal advice.

Professional accountant shall comply with applicable:

- laws and regulations including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority; and
- requirements under auditing standards, including those relating to
 - ❖ identifying and responding to non-compliance, including fraud,
 - ❖ communicating with those charged with governance
 - ❖ considering the implications of the non-compliance or suspected non-compliance for the auditor's report.

Some laws and regulations might stipulate a period within which reports of non-compliance or suspected non-compliance are to be made to an appropriate authority.

For example, reporting of fraud under section 143 (12) of the Companies Act, 2013. As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In the aforesaid example, the auditor of ABC Listed entity after obtaining understanding of the matter and circumstances, is required to ensure that whether ABC Listed entity has taken appropriate step to rectify/ remediate the disputes regarding statutory dues or non- deposit of full amount of ESIC and mitigate the violation of the Child Labour (Prohibition and Regulation) Act, 1986.

In case the management does not take appropriate action the auditor should determine the need for further action.

IV Determining Whether Further Action Is Needed

The next step to be taken by professional accountant is to assess the appropriateness of the response of management/ those charged with governance. Thereafter, in the light of the response received from the management, the professional accountant is also required to decide whether there is need for **further action to be taken in public interest.**

While determining the need for further action, in the given example of ABC Listed entity, the professional accountant will take into account the following factors:

- applicable legal and regulatory framework.
- pervasiveness of the matter throughout the client.
- After discussing with management or those charged with governance, whether the professional accountant continues to have confidence in the integrity of management /those charged with governance.
- Whether there is credible evidence of actual or potential substantial harm to the interests of the entity, investors, creditors, employees or the general public.

- Whether a reasonable informed third party would be likely to conclude that accountant has acted appropriately in the public interest.

Assuming that management of ABC Listed Entity was aware of such non-compliances causing the professional accountant to have no longer confidence in the integrity of management/ those charged with governance, statutory auditor should exercise professional judgement in deciding the need for further action.

The professional accountant might take further actions, namely:

- ❖ **Disclosing the matter to an appropriate authority as specified under respective law.**
- ❖ **Withdrawing from the engagement and the professional relationship where permitted by law or regulation.**

The facts and other information to be provided are those that, in the predecessor accountant's opinion, the proposed accountant needs to be aware of before deciding whether to accept the audit appointment.

Seeking Advice: As assessment of the matter might involve complex analysis and judgements, the professional accountant might consider:

- Consulting internally.
- Obtaining legal advice to understand the accountant's options and the professional or legal implications of taking any particular course of action.
- Consulting on a confidential basis with the Institute.

For example, the auditor is required to report certain matters of non-compliance to

the Reserve Bank of India as per the requirements of Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

V Determining Whether to Disclose the Matter to an Appropriate Authority

After obtaining an understanding of the matter, addressing the matter and determination of need for further action in public interest, the professional accountant is to determine whether to disclose the matter to an appropriate authority or not. The purpose of disclosure to appropriate authority is to enable them to cause the matter to be investigated and determine the action to be taken in public interest. However, disclosure of the matter to an appropriate authority if precluded would be contrary to law or regulation.

Example of situation where the professional accountant might determine that disclosure of the matter to an appropriate authority is an appropriate course of action if:

- The entity is engaged in bribery (for example, of local or foreign government officials for purpose of securing large contracts).
- The entity is listed on a securities exchange and the matter might result in adverse consequences to the fair and orderly market in the entity's securities or

pose a systemic risk to the financial markets.

- It is likely that the entity would sell products that are harmful to public health or safety.

Disclosing the matter to an appropriate authority as specified under respective law. **For example, Ministry of Labour and Employment in case of a breach of the Child Labour (Prohibition and Regulation) Act, 1986; Further,** the appropriate authority would be the **Institute in case of complaint of professional misconduct** against a professional accountant, whether in public practice or in service, **Securities and Exchange Board of India (SEBI) in the case of fraudulent financial reporting** or an **environmental protection agency** e.g. Environment Pollution (Prevention & Control) Authority for National Capital Region of **Delhi in the case of a breach of environmental laws and regulations.**

In the aforesaid example, the professional accountant decided to disclose the violation and non-compliances in ABC Listed entity in his audit report to

an appropriate authority, that disclosure is permitted pursuant to confidentiality fundamental principle of the Code. However, the accountant is required to act in good faith and exercise caution when making statements and assertions while disclosing the matter.

VI Imminent Breach

In exceptional circumstances, where the professional accountant consider that such breach would cause considerable harm to investors, creditors, employees or the general public, in such circumstances, the professional accountant should consider the appropriateness of discussing the matter with management / those charged with governance. The professional accountant is required to exercise professional judgement and decide to disclose the matter in order to prevent or mitigate the consequences of such imminent breach to an appropriate authority.

VII Documentation

Standards on Auditing 230, Audit Documentation require a professional accountant performing an audit of financial statements to:

<p>Prepare documentation sufficient to enable an understanding of significant matters:</p> <ul style="list-style-type: none"> ♦ arising during the audit, ♦ the conclusions reached, and ♦ significant professional judgments made in reaching those conclusions; 	<p>Document discussions of significant matters including the nature of the significant matters discussed:</p> <ul style="list-style-type: none"> • with management, • those charged with governance, and • others, and when and with whom the discussions took place; and 	<p>Document identified or suspected non-compliance, and the results of discussion with:</p> <ul style="list-style-type: none"> • management and, • where applicable, those charged with governance and • other parties outside the entity.
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The Revised Code over and above require the professional accountant to follow the additional documents requirements as under:

- How management / those charged with governance have responded to the matter.
- The course of action the accountant considered, the judgments made and the decisions that were taken, having regard to the reasonable and informed third party test.
- How the accountant is satisfied that the responsibility of public interest has been fulfilled.

Responsibility of Professional Accountant in case of Employment:

In the same example assume that the professional accountant working in the same listed entity as employee and considering the **ABC Listed entity as employing organization, responsibility of professional accountant will be different.**

In such a situation, the professional accountant has to consider as to whether there are established protocols and procedures regarding how to raise non-compliance or suspected non-compliance internally. These protocols and procedures include, **for example, an ethics policy or internal whistle-blowing mechanism.** Such protocols and procedures might allow matters to be reported anonymously through designated channels.

The responsibilities of professional accountant is further divided in two categories:



A Professional accountant while employment has to follow certain steps:

- **Obtaining an understanding of the matter**
- **Addressing the matter**
- **Determining whether further action is needed**
- **Seeking Advice**
- **Determining whether to disclose the matter to an Appropriate Authority**
- **Imminent Breach**
- **Documentation**

Senior professional accountants in service (“senior professional accountants”) are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organisation’s human, financial, technological, physical and intangible resources.

Conclusion:

Unique feature of the accountancy profession is acceptance of its responsibility towards the public interest. Ethics are as old as human civilisation and the foundation stone of the Chartered Accountancy Profession. It is nothing but the laws or rules of acceptable behaviour. Therefore, professional accountants whether in service or in practice are required to comply with Ethical standards. This denotes that adhering to Ethics must step up

and that resources must be guided into standards’ implementation.

The revised code besides having flawless language, new vibrant structure and guide for the professional accountant, comprises of significant developments, such as more robust framework for addressing a breach of the requirements of the Code, enhanced description of inducements with a view to respond to continuing concerns about bribery and corruption, stronger independence provisions concerning long association of personnel (including partner rotation) with audit clients, detailed independence requirements included for assurance engagements, auditor rotation requirements included under various local regulations and **responding to NOCLAR**, etc.

Towards the end it is reiterated that a Professional Accountant’s responsibility is not exclusively to satisfy the needs of an individual client or employer but also to protect and promote the public interest, stimulate greater accountability within organisation, proceed with strengthening reputation of the profession by ensuring the compliance with Revised Code including while responding to NOCLAR and stand-in the public interest.

Dr. Stavros Thomadakis, Chairman of the International Ethics Standards Board for Accountants (IESBA) has very aptly stated as under:

“Again, the accountant has to exercise judgement. But imagine the reverse situation where an accountant turns a blind eye and does nothing about NOCLAR. He or she will live with the risk of consequences down the road. And there have been many cases where in big corporate scandals, the authorities, courts or investors have gone against not only the management when NOCLAR takes place, but also the auditors and accountants.” ■