UNDERSTANDING NOCLAR: A MULTIFACETED CONCEPT

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Introduction:

The revised Code of Ethics for professional accountants has a game-changer: Non-Compliance with Laws and Regulations (NOCLAR). This new emphasis places ethical responsibility squarely on the shoulders of professionals, empowering them to identify and address potential legal and regulatory infractions within their organizations. But what does NOCLAR entail, and how can professionals navigate this complex ethical landscape? Let's explore.

Applicability:

The 12th edition of the Code of Ethics (Code of Ethics, 2019) introduced requirements relating to NOCLAR for both members in service as well as in practice (professional accountants), coming into effect from 1 July 2020. However, the applicability was deferred due to COVID-19 pandemic. ICAI, vide an announcement dated 29 September 2022 made the NOCLAR requirements applicable with effect from 1 October 2022.

What is NOCLAR?

NOCLAR – NON COMPLIANCE WITH LAWS AND REGLATIONS

In the course of providing a professional service to a client or carrying out professional activities for an employer, a professional accountant may come across an instance of Non compliance with laws and Regulations or suspected NOCLAR committed or about to be committed by the client or the employer… And these are those laws and reguations that are not under the scope of professional accountants work still PAs are not supposed to turn a blind eye to such situation.

Non Compliances by Whom?

It applies to non-compliance committed by:

- The professional accountant's employing organization itself
- Those charged with governance (TCWG), such as the board of directors or similar oversight bodies
- Management within the organization
- Any individuals working for or under the direction of the employing organization

Scope of Laws and Regulations :

This passage outlines the types of laws and regulations that fall under the purview of NOCLAR for professional accountants (PAs). Here's a breakdown with additional insights:

1. Nexus to Professional Training and Expertise:

   NOCLAR applies to laws and regulations directly related to a PA's professional knowledge and skills. This includes accounting and auditing standards, tax laws, corporate governance regulations, and laws relating to professional ethics and conduct. PAs are expected to possess a strong understanding of these relevant laws and regulations and identify potential non-compliance based on their expertise.

2. Direct Effect on Material Amounts and Disclosures:

   NOCLAR also encompasses laws and regulations that directly impact the financial statements, specifically concerning the determination of material amounts and disclosures.

   This includes laws pertaining to revenue recognition, expense accounting, asset valuation, and debt classification, among others.

   PAs have a responsibility to ensure these laws are considered when preparing financial statements and address any potential misstatements arising from non-compliance.

3. Fundamental to Entity's Business and Operations:

   NOCLAR extends beyond financial reporting to include laws and regulations crucial to the entity's overall operations. This involves areas like:

- Environmental regulations
- Health and safety regulations
- Labor laws
- Data privacy regulations
- Competition laws etc

Non-compliance with these regulations can have severe consequences for the entity, including fines, penalties, reputational damage, and even business shutdowns.

4. Material Penalties and Public Interest:

   The scope of NOCLAR includes laws and regulations where non-compliance could result in significant financial penalties or harm the public interest. This can include:

- Fraudulent activities like embezzlement or asset misappropriation
- Corruption and bribery schemes
- Money laundering and terrorist financing
- Insider trading and market manipulation

Some Important facts about NOCLAR are given below :

- During course of providing service : NOCLAR will be applicable if a professional accountant encounters, or is made aware of, non-compliance or suspected non-compliance in the course of providing a professional service to client. He is not required to investigate, nor responsible for ensuring complete compliance.

- Expertise of law not required : A Professional accountant is expected to apply knowledge and expertise, and exercise professional judgment. However, he is not expected to have a level of knowledge of laws and regulations greater than that which is required to undertake the engagement. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

- Certain matters expressly out of purview : Matters that are clearly inconsequential, or relating to personal misconduct pertaining to business activities of the client not covered.

- Disclosure, which is contrary to law not required : As per ISEBA code, disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation.

Some Examples :

As per IESBA, following examples would be covered in NOCLAR :

Fraud, Corruption and Bribery	Money Laundering, Terrorist financing and Proceeds of crime	Securities Markets and Trading
Data Protection	Environmental Protection	Public health and safety etc

Objectives of the PA in relation to NOCLAR :

1. Act in the Public Interest:

- This is the overarching principle guiding the PA's response to non-compliance. It means prioritizing the well-being of stakeholders beyond just the entity itself. This might involve reporting the issue to regulators, even if it's detrimental to the entity's short-term interests.

- Public interest considerations include protecting investors, safeguarding financial markets, and upholding ethical business practices.

2. Comply with the Principles of Integrity and Professional Behavior:

- These principles, enshrined in professional codes of ethics, require PAs to be honest, objective, and diligent in their work. In the context of non-compliance, this translates to:

- Accurate and complete reporting: PAs cannot conceal or misrepresent information about non-compliance.

- Professional judgment: PAs must exercise sound judgment in assessing the severity of the issue and determining the appropriate course of action.

- Confidentiality: PAs must maintain confidentiality of client information while still fulfilling their duty to report serious non-compliance.

3. Alert Management or, where appropriate, TCWG:

   Early communication is crucial in addressing non-compliance.

- Management: PAs should first inform management of the identified or suspected non-compliance, allowing them to investigate and take corrective action.
- TCWG: For serious or systemic issues, PAs may need to escalate the matter to the Technical Consultative Working Group (TCWG) or other relevant governance bodies within the entity.

4. Rectify, Remediate, or Mitigate the Consequences:

   The goal is to minimize the harm caused by the non-compliance. This might involve:

- Working with management to implement corrective actions: This could involve revising financial statements, implementing new controls, or addressing legal repercussions.
- Reporting to external parties: In certain cases, reporting to regulators or legal authorities may be necessary to mitigate the consequences.

5. Deter Non-Compliance where it has not yet occurred:

   PAs should play a proactive role in preventing non-compliance. This involves:

- Performing risk assessments: Identifying areas where non-compliance is more likely to occur.
- Providing guidance and advice: Educating management and employees on relevant laws and regulations, and promoting a culture of ethical conduct.
- Implementing strong internal controls: Helping the entity establish robust systems and procedures to prevent and detect non-compliance.

6. Take Such Further Action as Appropriate in Public Interest:

   This ultimate objective allows for flexibility depending on the specific circumstances. In rare cases, it might involve:

- Resigning from the engagement: If the entity refuses to address the non-compliance adequately.
- Publicly disclosing the issue: As a last resort, if public safety or financial markets are at significant risk.

It's important to remember that these objectives are interrelated and should be considered holistically. The PA's role is to navigate complex situations with integrity, professional judgment, and a firm commitment to the public interest.

A. Responding to NOCLAR in case of Employment Of Listed Companies (section 260):

1. Responsibilities of senior professional accountant in service :

Senior professional accountants in service are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and tangible resources.

2. **Obtaining understanding of Matter :**

(a) Nature and Circumstances:

- This involves identifying the specific type of non-compliance and the context in which it occurred or might potentially occur. Understanding the specific act or omission violating laws and regulations is crucial.
- Additionally, understanding the context helps assess the level of intent, knowledge, or negligence involved.

(b) Application of Laws and Regulations:

- This requires analyzing the relevant laws and regulations applicable to the identified non-compliance. This might involve legal expertise or seeking external guidance to ensure an accurate interpretation of the rules.
- Understanding the specific legal framework helps determine the severity of the non-compliance and potential consequences.

(c) Potential Consequences:

- This involves assessing the impact of the non-compliance on various stakeholders. This includes the potential harm to the employing organization, investors, creditors, employees, and even the wider public.
- Evaluating the potential financial, legal, reputational, and operational consequences guides the next steps in addressing the issue.

3. **Addressing the Matter :**

Discuss the matter with the accountant's immediate superior, if any. If the accountant's immediate superior appears to be involved in the matter, the accountant shall discuss the matter with the next higher level of authority within the employing organization.

The senior professional accountant shall also take appropriate steps to:

- Have the matter communicated to those charged with governance;
- 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;
- Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;
- Reduce the risk of re-occurrence; and
- Seek to deter the commission of the non-compliance if it has not yet occurred.

Determine if disclosure to external auditor needed or not.

4. **Responsibility of the senior professional accountants in service relating to NOCLAR :**

- Depending on the nature and significance of the matter, a senior professional accountant might take appropriate steps to investigate the matter internally.

- **Seeking Advice :**
  - As assessment of the matter might involve complex analysis and judgments, the senior 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.
- Discuss with Immediate superiors: A senior professional accountant should discuss the matter with his/her immediate superior(s). If the immediate superior(s) appear to be involved in the matter, the matter should be discussed with the next higher level of authority within the employing organization.
- Basis the response of the senior professional accountant's superiors and TCWG, the accountant should determine if further action is needed in the public interest.
- Additionally, it must also be determined if there is a need to disclose the matter to the employing organization's external auditor
- Further action that the senior professional accountant might take includes:
  - Informing the management of the parent entity of the matter, if the employing organization is a member of a group.
  - Disclosing the matter to an appropriate authority as specified under respective law, or
  - Resigning from the employing organization

5. Responsibilities of Professional Accountants Other than Senior Professional Accountants :

If, in the course of carrying out professional activities, a professional accountant becomes aware of information concerning non-compliance or suspected non-compliance:

- Obtain an understanding of the matter
- Apply knowledge and expertise, and exercise professional judgment.
- Not expected to have a level of understanding of laws and regulations greater than that which is required for the accountant's role within the employing organization.
- Consult on a confidential basis with others within the employing organization or the Institute, or with legal counsel
- Inform an immediate superior to enable the superior to take appropriate action. If the accountant's immediate superior appears to be involved in the matter, the accountant shall inform the next higher level of authority within the employing organization.
- In exceptional circumstances, the professional accountant may determine that disclosure of the matter to an appropriate authority is an appropriate course of action

B. Responding to NOCLAR during the course of audit engagement of listed entities (section 360) :

1. Applicability :

- Audit engagement of entities the shares of which are listed on recognized stock exchange(s) in India **and**
- Have net worth of 250 crores of rupees or more

This section guides the accountant in assessing the implications of the matter and the possible courses of action when responding to non-compliance or suspected non-compliance with:

- Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the client's financial statements; and
- Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the client's financial statements, but compliance with which might be fundamental to the operating aspects of the client's business, to its ability to continue its business, or to avoid material penalties.

2. Responsibility of the professional accountants in public practice relating to NOCLAR

- The matter so identified should be discussed with the appropriate level of management and, where appropriate, TCWG. The purpose of the discussion is to clarify the professional accountant's understanding of the facts and circumstances relevant to the matter and its potential consequences. The discussion might also prompt management or TCWG to investigate the matter.
- The professional accountant should discuss the non-compliance or suspected non-compliance with management/TCWG to take appropriate and timely actions. Basis the communication the management/TCWG should communicate the matter to appropriate authorities.
- Assess the appropriateness of the response
  - Whether the response is timely.
  - The non-compliance or suspected non-compliance has been adequately investigated.
  - Action has been, or is being, taken to rectify, remediate or mitigate the consequences of any non-compliance.
  - Action has been, or is being, taken to deter the commission of any non-compliance where it has not yet occurred.
  - Appropriate steps have been, or are being, taken to reduce the risk of re-occurrence, for example, additional controls or training.
  - The non-compliance or suspected non-compliance has been disclosed to an appropriate authority where appropriate and, if so, whether the disclosure appears adequate.
  - In light of the response determine if further action is needed in the public interest.
- In case of audit of consolidated financial statements, the professional accountant should communicate the matter to the group engagement partner and the group partner should consider whether the matter would be relevant to one or more components and communicate to components engagement teams.

- Additionally, it should be determined if there is a need to discuss the matter with the internal auditors, where applicable.
- Further action that a professional accountant might take includes:

Disclosing the matter to an appropriate authority as specified under respective law, or

Withdrawing from the engagement and the professional relationship where permitted by law or regulation.

  - *Withdrawing from the engagement and the professional relationship is not a substitute for taking other actions*
  - *However, there might be limitations as to the further actions available to the accountant. In such circumstances, withdrawal might be the only available course of action.*

3. <u>Documentation :</u>

The professional accountant shall document:

- How management and, where applicable, those charged with governance have responded to the matter.
- The courses 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 accountant has fulfilled the responsibility set out

  This documentation is in addition to complying with the documentation requirements under applicable auditing standards
- Prepare documentation sufficient to enable an understanding of significant matters arising during the audit, the conclusions reached, and significant professional judgments made in reaching those conclusions;
- Document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place; and
- Document identified or suspected non-compliance, and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity

A. <u>CASE STUDY : Let us discuss a scenario with the help of case study</u> :

CASE: You are an audit partner of a firm auditing a group subsidiary. During the audit you have identified that the subsidiary company won two substantial overseas contracts. During fieldwork your audit team has been unable to identify a clear timeline relating to the offering and bidding process in relation to those contracts. At the same time, it is discovered that large unidentified payments were made during this time which are later traced to individuals linked to overseas government departments. Payables testing procedures have revealed purchase orders were raised at the instruction of the finance director which cannot be cross-referenced to an approved supplier list, but which were included within the payable ledger. The subsidiary company has also paid significant penalties for the breach of environmental laws and regulations due to exceeding levels of carbon emissions and breaching industrial waste disposal regulations. The directors failed to take appropriate steps to stop this happening repeatedly during the audited period. To hide this fact from the auditors, the finance director asked the staff of the subsidiary company to post the penalty charges to the cost of sales. You have been auditing the group companies for the last three years and have never come across this behaviour in the past.

Facts of the Case in Detail:

Company: A subsidiary company within a larger group.

Auditor's Findings:

- Suspicious Contracts: The subsidiary won two significant overseas contracts, but the audit team couldn't find a clear timeline for the bidding and offering process.
- Unidentified Payments: Large payments were made during the contract negotiation period, and later traced to individuals linked to overseas government departments.
- Unauthorized Purchases: Purchase orders were created at the finance director's instruction, without reference to an approved supplier list, and subsequently included in the payable ledger.
- Environmental Violations: The company paid significant penalties for exceeding carbon emission levels and breaching industrial waste disposal regulations. These violations occurred repeatedly during the audited period.
- Accounting Irregularities: To hide the environmental penalties from the auditors, the finance director instructed staff to post them to the cost of sales.

Additional Context:

- The auditor has been working with the group companies for three years and never encountered similar behavior before.
- The subsidiary appears to have a close relationship with the parent company, raising concerns about potential knowledge or involvement from higher management.

Potential Issues:

- Corruption: The unidentified payments and connections to government officials suggest potential bribery or kickbacks related to the contracts.
- Fraud: The unauthorized purchases and accounting irregularities might indicate attempts to misrepresent the company's financial performance.
- Environmental Negligence: Repeated violations of environmental regulations raise concerns about the company's commitment to sustainability and potential harm to the environment.

Ethical Dilemmas for the Auditor:

- Maintaining Integrity: Ignoring the client's potential illegal activities could compromise the auditor's professional integrity.

- Objectivity vs. Familiarity: The long-standing relationship with the client may make it difficult to remain objective while assessing the situation.
- Confidentiality vs. Legal Obligations: Client confidentiality needs to be balanced with the legal duty to report potential wrongdoing to relevant authorities.

Possible Courses of Action:

1. Gather Evidence and Understand the Scope:

- Deepen Investigation: Conduct additional procedures to solidify understanding of the suspicious activities. This might involve interviewing relevant personnel, reviewing additional documentation, and seeking expert advice if needed.
- Identify Applicable Laws and Regulations: Research regulations governing anti-bribery, anti-corruption, environmental protection, and financial reporting in both the subsidiary's and the contracts' jurisdictions.
- Document Findings: Maintain meticulous records of all evidence gathered, observations made, and actions taken throughout the process.

2. Internal Communication and Escalation:

- Discuss with Management: Schedule a meeting with the subsidiary's management, including the finance director, to express concerns and gather their explanation for the identified irregularities. Emphasize the seriousness of the potential issues and the need for transparency.
- Inform Those Charged with Governance: Depending on the company's structure and internal reporting lines, escalate the concerns to the board of directors, audit committee, or other relevant personnel within the parent company. This ensures wider awareness and potential involvement of higher management.
- Consider Internal Whistleblowing Mechanisms: If internal communication channels seem ineffective or raise concerns about potential retaliation, utilize the company's whistleblower hotline or relevant reporting procedures to raise the alarm internally.

3. External Reporting and Legal Considerations:

- Consult Legal Counsel: Seek guidance from a qualified legal professional specializing in corporate law, anti-corruption, and environmental regulations. This helps navigate the legal complexities and determine potential reporting obligations.
- Report to Regulatory Authorities: Depending on the nature and severity of the suspected wrongdoing, consider reporting the identified irregularities to relevant authorities, such as anti-corruption agencies, environmental protection agencies, or financial regulators.
- Public Disclosure: In exceptional circumstances, where public interest and potential harm outweigh confidentiality concerns, consider public disclosure of the identified issues. This should be a carefully considered last resort after exhausting all internal and legal avenues.

4. Resignation and Professional Detachment:

- Consider Resignation: If management fails to take adequate corrective action or attempts to obstruct the investigation, resigning from the engagement might be necessary to uphold professional integrity and avoid association with potential wrongdoing.

- Inform Successor Auditor: In case of resignation, share pertinent information with the successor auditor while adhering to legal and confidentiality restrictions. This ensures continuity of the audit process and potential follow-up on identified issues.

- Maintain Professional Conduct: Throughout the process, adhere to professional ethics and standards, prioritizing objectivity, integrity, and transparency in all communications and actions.

Overall, the facts of the case present a complex situation with serious ethical implications for the auditor. Carefully considering all the details and applying relevant professional standards is crucial for reaching a responsible and ethical resolution.

Conclusion: NOCLAR empowers professional accountants to be ethical guardians within their organizations. By understanding their responsibilities, navigating challenges, and adopting best practices, accountants can effectively address potential wrongdoing, promote transparency, and uphold the highest ethical standards in the profession. Remember, acting with integrity and safeguarding the public interest are paramount in today's dynamic business environment.

By embracing NOCLAR, professional accountants can contribute significantly to building a more ethical and sustainable business world.