

**Illustrative Example—Application of NOCLAR Standard****Case Particulars**

Noren Inc. is an integrated utility company based in Ruritania with electricity, exploration, transmission and energy trading businesses. It holds a commanding place in Ruritania's energy industry as one of its largest energy dealers, specializing in gas and electricity futures contracts and commodity trading. Recently, its market value on the Ruritanian stock exchange topped CU 60 billion.<sup>1</sup>

As part of its business, Noren holds financial relationships with numerous partner companies (known as special purpose entities, or SPEs) to help it raise cash and manage debt, among other matters. Under Ruritanian generally accepted accounting principles (GAAP), with which all companies are required by law to comply, Noren does not have to consolidate the profits and losses and the assets and liabilities of the SPEs if the SPEs are independently owned. For each one of these partner entities to be classified as a legitimate SPE under GAAP, it must meet three criteria:

- At least 3 percent of the entity's shares should not be held by Noren;
- Noren should not control the entity; and
- Noren should not be responsible for any loans or losses of the entity.

In the second quarter of 20X5, Noren changed auditor from TKL LLP to CGVR LLP pursuant to the requirement under the Ruritanian Corporations Act for listed entities to rotate their auditors every 15 years.

During the audit of Noren's consolidated financial statements for the year ended December 31, 20X5, the following events occurred:

1. While carrying out certain audit procedures, CGVR senior audit manager Alexandra Modigliani came across information that seemed to indicate the following:
  - Bertrand Pavlov, Noren's Chief Operating Officer, appeared to have signed a number of large loan agreements with Noren on behalf of an entity called Topaz 56 Ltd. Topaz 56, which is incorporated in the Cayman Islands, is one of Noren's largest SPEs.
  - Calvin Nekil, Noren's Chief Marketing Officer, appeared to have signed a number of large derivative contracts with Noren on behalf of an entity called Jade 38 Ltd, a company incorporated in the British Virgin Islands. Jade 38 is also one of Noren's largest SPEs.
2. While auditing Noren's investments, the audit engagement team pieced together the following in what appeared to be effective ownership by Noren in the following large SPEs:
  - A 97.7% ownership in Opal 97 Ltd, a company incorporated in the Cayman Islands.
  - A 98% ownership in Aquamarine 81 Ltd, a company also incorporated in the Cayman Islands.
  - A 97.5% ownership in Zircon 26 Ltd, a company incorporated in Bermuda.

The shares were all held through various networks of intermediary vehicles.

3. Through further inquiries and investigation, the audit engagement team managed to find out that these arrangements had been in place during the last five to six years when the company was

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<sup>1</sup> CU: Ruritanian currency unit

reporting rapidly increasing profitability and its market value was growing exponentially. The team also gathered sufficient information suggesting that Eli Spark and Fred Sataire, CFO and CEO of Noren respectively, were both likely involved in planning these arrangements. External data sources on insider trades indicated that both Eli and Fred had benefited substantially from unloading portions of their equity interests in Noren to the market recently.

4. Having reviewed and discussed the findings with the audit team, Dale Leopold, the audit engagement partner, instructed his team to estimate the potential impact on Noren's balance sheet and income statement of consolidating all these SPEs. Altogether, it appeared that Noren would have to add about CU 2.8 billion of debt to its balance sheet. It would also need to take a charge on its income statement in excess of CU 1 billion, which would wipe about 20% of its earnings over the past five years.
5. Dale conferred with Greg Jobie, the engagement quality control reviewer on the audit. They both shared the view that the facts seemed to point to significant management fraud at Noren. In the circumstances, they agreed that Dale should raise the matter directly with Noren's audit committee.
6. In a confidential meeting without Eli and Fred present, Dale, accompanied by key members of his audit team, presented the audit team's findings before the audit committee. The audit committee resolved to fully investigate the matter internally.
7. As part of its investigation, the audit committee confronted Eli and Fred. The CFO and CEO both eventually admitted that they had concealed the fraud from the board of directors and Noren's previous auditor for a number of years using a variety of accounting practices and with the collusion of a couple of other members of the management team.
8. The audit committee reported the findings of its investigation to Dale. Given the potential material impact of restating Noren's financial statements, the audit committee recognized that disclosing the suspected fraud publicly would likely cause a severe adverse market reaction, most likely crystallizing substantial losses for investors. The audit committee also recognized the potential for significant litigation against the board of directors.
9. Dale raised the matter with his firm's national office, which agreed that Noren's financial statements for the previous five years should be restated. The national office and the firm's legal counsel also concurred that the most appropriate action for Noren's board of directors should be to inform the Ruritania Securities and Exchange Commission (SEC) about the fraud immediately to prevent further investor losses.

**Situation 1 – Disclosure of the Matter by Noren's Board of Directors to the SEC**

10. After consulting with internal legal counsel, Noren's board of directors agreed with the firm that it must disclose the matter to the SEC to fulfill its responsibilities. Shortly afterwards, it did so.

Situations 2 and 3

11. Despite prompting from Dale, the audit committee hesitated in doing so, seeking to bide time for the board to explore options for addressing the issue in the least damaging way.
12. Dale reported the audit committee's response to his national office and the firm's legal counsel. Both agreed with Dale that given the circumstances, the audit committee's response was not appropriate. Legal counsel confirmed that in Ruritania, there is no legal or regulatory requirement governing the

reporting of suspected fraud to an appropriate authority. National office, however, concurred that the firm's audit opinion on the group financial statements for the year ended December 20X5 would need modification due to the fraud. It also concurred that the matter would need to be disclosed in the auditor's report as a key audit matter in accordance with ISAs.

### **Situation 2 – Disclosure to an Appropriate Authority**

13. After further internal consultation, including consideration of the firm's ethical responsibilities under the IESBA Code, the firm determined that the right thing for it to do would be to disclose the suspected fraud to an appropriate authority. The firm based its assessment of further action on an objective analysis of the facts and circumstances, and credible evidence of substantial harm to investors. The firm determined that time was of the essence and that it should make the disclosure without waiting for Noren's board of directors to complete exploring its next steps.
14. Legal counsel advised, among other matters, that the SEC would be an appropriate authority in the circumstances, that disclosure would not be prohibited by law or regulation, and that there is robust and adequate protection available under broad Ruritania whistle-blowing legislation that would cover such a disclosure.
15. Dale informed Noren's audit committee about the firm's decision to disclose the matter to the SEC to fulfill its responsibilities under the Code. Shortly afterwards, the firm disclosed the facts to the Commission.

### **Situation 3 – Withdrawal from the Engagement and Client Relationship**

13. After further internal consultation, including consideration of the firm's ethical responsibilities under the IESBA Code, the firm determined that the right thing for it to do would be to disclose the suspected fraud to the SEC. Legal counsel, however, advised that strict confidentiality laws in Ruritania would preclude such a disclosure.
14. In the circumstances, and based on an objective analysis of the facts and circumstances, the firm determined that the most appropriate further course of action would be to resign from the engagement and the client relationship.
15. Dale informed Noren's board of directors about the firm's decision.

### **Caveats**

- The following flow chart is only intended to illustrate certain possible pathways to responding to suspected NOCLAR through application of the proposed standard.
- It does not purport to be comprehensive. Depending on the circumstances, application of the standard may lead the PA to take other actions.
- While actions in the flow chart are shown in a certain sequence, they may not need to be taken in the same order in practice.

- No flow chart can fully capture all the complexities of a significant suspected NOCLAR in practice or reflect the dynamism of the interactions among all the relevant players in that situation.

### Possible Pathways to Responding to Suspected Fraud



