

Meeting Location: InterContinental Eros, Nehru Place, New Delhi

Meeting Date: February 6-8, 2011

Responding a Suspected Fraud or Illegal Act

Objectives

1. To consider the Task Force proposals and to provide input on the proposed draft wording.

Background

Confidentiality is one of the fundamental principles with which the professional accountant is required to comply, Section 140 identifies three circumstances where a professional accountant is required, or may be required, to disclose confidential information:

- Disclosure is permitted by law and is authorized by the client or the employer;
- Disclosure is required by law; and
- There is a professional duty or right to disclose when not prohibited by law.

While the Code recognizes that a professional accountant may have a professional duty or right to disclose confidential information it does not provide examples or guidance to the accountant on how to respond in such situations. At its November 2010 meeting, the IESBA approved a project proposal to develop guidance for a professional accountant on how to respond when encountering a suspected fraud or illegal act.

The Task Force¹ met on December 20-21, 2010 and January 20-21, 2011 to consider the issues outlined in the project proposal and to develop proposed wording. The Task Force has developed draft wording for a section to address professional accountants in public practice (new section 225) and professional accountants in business (new section 360). The sections follow the same approach with the guidance and requirements being broadly similar. The Task Force recognizes that conforming amendments will need to be made to

¹ Bob Franchini (Chair), Caroline Gardner, Isabelle Sapet, Kate Spargo and Brian Walsh (Aiko Sekine was a member of the Task Force in 2010).

Section 140 Confidentiality, and will develop these amendments after receiving the IESBA's input on the proposed new sections.

Discussion

Nature of Items to be Addressed

The project proposal calls for a consideration of the nature of the items to be addressed and indicates that the Task Force should be mindful of *ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and *ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements*.

ISA 240 defines a fraud as “an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.” The Task Force considered this and felt that it was an appropriate descriptor for the scope of the Code guidance.

ISA 250 refers to non-compliance with laws and regulations. The ISA defines non-compliance as “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, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.” The Task Force considered the ISA 250 definition and felt that it was an appropriate descriptor for the scope of the Code guidance.

The Task Force felt that the Code should address those frauds and illegal acts that could have a direct or indirect effect on the financial reporting of the client or employing entity. The Task Force felt that this was appropriate because an accountant's expertise is linked to financial reporting.

The project proposal calls for the Task Force to consider whether the scope of the project should be wider and address, for example personal misconduct and matters that are “unethical or improper”. The Task Force considered this matter and was of the view that the sections should address suspected frauds and illegal acts and should not be wider to address personal misconduct or matters that could be considered to be “unethical or improper”. Whether a matter would be considered to be “unethical” or “improper” is a subjective judgment and the Task Force was of the view that a possible requirement to breach confidentiality and disclose a matter outside of the client or employing organization should be focused on suspected fraud or illegal acts which could have a direct or indirect effect on the financial reporting. In addition, paragraphs 210.1 and 300.15 of the Code already provide some guidance in this area.

Action requested

IESBA members are asked to consider the proposed nature of items to be addressed.

Process for Responding

In considering the thought process that the professional accountant would use in determining how to respond to a suspected fraud or illegal act, the Task Force developed the following sequential approach for disclosing within the client or employing organization before considering whether the matter should be disclosed outside:

- A professional accountant in public practice discloses the matter as follows:
 - To management at an appropriate level;
 - If management's response is not appropriate, to a higher level of management or to those charged with governance as appropriate;
- A professional accountant in business discloses the matter as follows:
 - Within the reporting lines of the organization, to a superior.
 - If the matter is not satisfactorily addressed, to a higher level of authority within the organization, such as those charged with governance, or to the entity's external auditor;

The Task Force has also developed guidance on the factors that the accountant would consider to determine whether the matter has been satisfactorily addressed.

- Whether the matter was appropriately investigated;
- Whether appropriate available remedial action has been taken to address the matter;
- Whether steps have been taken to reduce the risk of re-occurrence, such as for example, additional controls or training; and
- Whether the entity has disclosed the matter to an appropriate authority, or intends to do so within a reasonable period of time.

Action requested

IESBA members are asked to consider the sequential nature of the proposed process for responding.

Actions to be Taken after Disclosing within the Organization

The Task Force considered what action, if any, the accountant should be required to take after the matter has been escalated within the client or employing organization. The Task Force considered two separate matters:

- Steps to be taken if the matter is not satisfactorily addressed; and
- Whether there should be an obligation/expectation/encouragement for the accountant to disclose the matter outside of the organization and, if so, under what conditions.

Part B addresses the reputation of a client. For example 210.1:

“Before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behavior may be created from, for example, questionable issues associated with the client (its owners, management or activities).

Part C addresses actions taken by an employing organization – for example 300.15:

“In circumstances where a professional accountant in business believes that unethical behavior or actions by others will continue to occur within the employing organization, the professional accountant in business may consider obtaining legal advice. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, a professional accountant in business may conclude that it is appropriate to resign from the employing organization.”

If a client or employing organization does not satisfactorily address a suspected fraud or illegal act, its integrity may be called into question – for example, if it does not take appropriate steps to prevent a recurrence of the matter. The guidance developed by the Task Force, therefore, requires a professional accountant to determine an appropriate course of action if, in the accountant’s judgment, the matter has not been satisfactorily addressed – for example whether to resign from the client or employing organization. The determination of whether the matter has been satisfactorily addressed depends upon factors which include whether disclosure has been made to an appropriate authority.

In considering whether to disclose the matter outside the client or employing organization, if disclosure has not already been made, the Task Force considered the following possible differing levels of obligation for the professional accountant:

- The accountant shall determine whether to disclose;
- The accountant is encouraged or expected to disclose;
- The accountant is required to disclose if disclosure is in the public interest except when the nature of the outcome would be disproportionate to the matter (as might be the case when there was no authority to take action, or where disclosure carries the risk of physical harm); and
- The accountant is required to disclose if disclosure is in the public interest.

The Task Force is of the view that the appropriate threshold is a requirement to disclose if such disclosure would be in the public interest (fourth bullet). Such a requirement is consistent with the fundamental underpinning of the Code as stated in the first sentence of the Code:

“A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest.”

The Task Force recognizes that such a requirement may be particularly onerous for a professional accountant in business and, accordingly, recommends that a new obligation be included in the SMOs of member bodies to provide support of a financial and legal nature to those accountants that so require such support as a result of complying with this requirement.

The Task Force has considered what guidance can be given on “public interest”. There is no generally accepted definition of public interest and, therefore, only guidance can be given. The Task Force has identified the following factors that would be considered in determining whether disclosure would be in the public interest:

- The significance to the entity’s financial reporting;
- The extent to which external parties are likely to be affected; and
- The likelihood of recurrence.

Action requested

IESBA members are asked to consider the obligation to disclose if disclosure would be in the public interest and whether that obligation might be different depending on the role of the professional accountant (i.e. auditor, other accountant in professional practice, or accountant in business).

IESBA members are asked to consider the factors that would be considered to determine whether disclosure would be in the public interest.

Material Presented

Agenda Paper 5	This Agenda Paper
Agenda Paper 5-A	Project Proposal
Agenda Paper 5-B	Proposed Wording

Action Requested

1. IESBA members are asked to consider the questions raised in the paper