



Meeting Location: Sofitel, Warsaw, Poland

Meeting Date: June 15-17, 2011

Responding to a Suspected 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 IESBA considered Task Force proposals at its February 2011 meeting and provided feedback to the Task Force. The proposals were also discussed by the CAG at its March 2011 meeting and by the IESBA-National Standards Setters (IESBA-NSS) at its April meeting.

The Task Force¹ met on April 19-20, 2011 and May 16-17, 2011 to carefully consider the input received and revised the proposed wording for a section to address professional accountants in public practice (new section 225) and professional accountants in business (new section 360).

¹ Bob Franchini (Chair), Caroline Gardner, Felicitas Irungu, Isabelle Sapet, Kate Spargo and Brian Walsh.

Discussion

Nature of Items to be Addressed

The project proposal called for a consideration of the nature of the items to be addressed and indicated 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*.

At the February meeting, the Task Force proposed that the guidance focus on frauds and illegal acts that have a direct or indirect effect on the financial reporting of the client or employing organization. The IESBA considered this proposal and felt that restricting the scope of the guidance in this manner might be too limiting. It was also noted that a discussion of the nature of the items to be addressed can be more difficult if one pre-determines the actions to be taken. It would be preferable to first scope the nature of the matters to be addressed broadly. The next step would be to stratify the items with potentially differing courses of action depending upon the severity of the matter.

The Task Force considered this matter and agreed with the approach. In considering the difference between a fraud and an illegal act, the Task Force recognized that a fraud is an illegal act. The Task Force determined, therefore, that the section address suspected illegal acts. Paragraphs 225.2 and 360.2 contain examples of illegal acts and the first two examples address fraud.

The previous Task Force proposals also addressed unethical or improper acts. It was noted at the February 2011 IESBA meeting that unethical or improper behaviour is a somewhat nebulous matter and it is difficult to define – what might be considered ethical today might be considered unethical in five years time. Also what might be seen as ethical in one jurisdiction might be viewed as unethical in another jurisdiction. It was also noted that if a matter is deemed to be unethical but it is not illegal, requiring an accountant to breach confidentiality and report the matter outside of the client or employing organization could be a very onerous requirement. CAG members raised similar comments noting that while it is possible to define a fraud or an illegal act there is considerably more subjectivity associated with determining whether something was improper or unethical.

The Task Force considered this feedback with the view to determining whether the proposed sections should address acts that the professional accountant determines to be unethical or improper. The Task Force was mindful that there is no accepted definition of an unethical act and what would be considered to be unethical by one professional accountant may not be considered to be unethical by another professional accountant. In addition there is no accepted framework for determining whether a matter is unethical. While the determination of whether a matter is illegal can be judgmental, and may differ from jurisdiction to jurisdiction, there is a legal framework for assessing whether a matter is illegal. There are also issues with determining the appropriate authority to whom to report a suspected unethical act. Even if there is an appropriate authority, it is

questionable whether the authority would take action regarding a matter that was legal but considered to be unethical.

In light of this, the Task Force is of the view that the proposed sections should not address unethical matters because of their nebulous nature. The Task Force is of the view that the matter should be addressed in the section dealing with ethical conflict resolution (see Appendix). The Task Force is of the view that the guidance would be more appropriate in this section because if the professional accountant is of the view that a client or employing organization is engaging in a matter which though legal, the accountant considers to be unethical, the accountant is facing an ethical conflict.

The Task Force also reviewed section 210, for professional accountants in practice, and section 300 for professional accountants in business.

Section 210 addresses client acceptance. Paragraph 210.1 states:

“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).”

Paragraph 210.5 states:

“It is recommended that a professional accountant in public practice periodically review acceptance decisions for recurring client engagements.”

The Task Force recognizes that the matter is addressed but is considering whether the guidance should be strengthened to provide more guidance on client continuance.

With respect to professional accountants in business, paragraph 300.15 states:

“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.”

The Task Force’s view is that this guidance is likely sufficient.

Action requested

IESBA members are asked to consider the Task Force's proposal regarding the nature of the item to be addressed.

If the IESBA agrees that suspected unethical matters should be addressed in the section dealing with ethical conflict resolution, IESBA members are asked to confirm that they wish this Task Force to develop the proposed changes to this section to be included in the exposure draft planned for approval at the October IESBA meeting. IESBA members are also asked for their views on whether sections 210 and 300 need to be strengthened.

Process for Responding

In considering the thought process that the professional accountant would use in determining how to respond to a suspected 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 the response to the matter is not appropriate, the professional accountant shall escalate the matter;
 - If the highest level of management has not appropriately responded to the matter, the professional accountant shall discuss the matter with those charged with governance;
- A professional accountant in business discloses the matter as follows:
 - Within the reporting lines of the organization, to a superior;
 - If the response to the matter is not appropriate, the professional accountant shall escalate the matter;
 - If the highest level of management has not appropriately responded to the matter, the professional accountant shall discuss the matter with those charged with governance or shall disclose the matter 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 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, if any, 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 is of the view that a professional accountant should be required to disclose certain illegal acts when the accountant determines that disclosure would be in the public interest and the client or employing organization has not disclosed the matter.

The Task Force has considered whether guidance can be given on when reporting would be in the public interest. At the February 2011 IESBA meeting, the IESBA discussed the following factors that would be considered in determining whether disclosure was in the public interest:

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

The IESBA considered these factors and it was noted that

- The first factor, significance to financial reporting, would seem to indicate that if two entities (one large and one small) engaged in the same level of money laundering, the matter would have to be disclosed outside of the smaller entity because of the significance to financial reporting but disclosure would not be necessary for the larger entity. This did not seem to be the right answer because what was important was the significance vis a vis the public interest; and
- With respect to the third factor of likelihood of recurrence this could be interpreted as meaning that no disclosure was necessary if there was an assurance from management that there would be no repetition of the illegal act.

The factors were discussed at the CAG meeting in March and similar comments were raised.

The Task Force has revisited these factors and recognizes that whether disclosure is in the public interest is a matter requiring professional judgment and it will ultimately be a decision that the individual professional accountant has to take. Different individuals may have differing thresholds for disclosure. In light of this and the fact that there is no accepted definition of the public interest, the Task Force is of the view that the sections should not describe factors that the professional accountant would consider in determining whether disclosure is in the public interest. The Task Force is concerned that factors might be seen as limiting. The Task Force is of the view that in making the determination, the professional accountant should take into account whether a reasonable

and informed third party, weighing all the specific facts and circumstances, would be likely to conclude that the public interest is best served by disclosing the matter to an appropriate authority.

The Task Force considered the types of illegal acts that the professional accountant would be required to disclose to an appropriate authority. In considering this matter the Task Force considered the principle of confidentiality which would be over-ridden because disclosure was in the public interest.

The Code describes the fundamental principle of confidentiality as follows:

“Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.”

In considering this principle noted that information is deemed to be confidential if it is “acquired as a result of professional and business relationships. The Task Force considered what types of suspect illegal acts would be encountered through information that was acquired as a result of professional and business relationships. The Task Force is of the view that such illegal acts would be:

- Suspected illegal acts that directly or indirectly affect the client’s/employing organization’s financial reporting; and
- Suspected illegal acts the subject matter of which falls within the expertise of the professional accountant, such as fraud, bribery or insider trading.

Information regarding illegal acts that do not affect the financial reporting and that fall outside the expertise of the professional accountant would not be information that was acquired as a result of the professional and business relationship. This information would not, therefore, be deemed to be confidential – such as would be the case if the professional accountant obtained information about the personal conduct of management of a client. Accordingly, the Task Force is of the opinion that it is not necessary for the Code to address such matters.

Action requested

IESBA members are asked to consider the Task Force’s proposal regarding the public interest and the types of illegal acts that the professional accountant would be required to disclose to an appropriate authority.

Material Presented

Agenda Paper 4	This Agenda Paper
Agenda Paper 4-A	Proposed Wording
Agenda Paper 4-B	Draft Impact Analysis

Action Requested

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

Appendix

Extract from the Code Addressing Ethical Conflict Resolution

Ethical Conflict Resolution

- 100.17 A professional accountant may be required to resolve a conflict in complying with the fundamental principles.
- 100.18 When initiating either a formal or informal conflict resolution process, the following factors, either individually or together with other factors, may be relevant to the resolution process:
- (a) Relevant facts;
 - (b) Ethical issues involved;
 - (c) Fundamental principles related to the matter in question;
 - (d) Established internal procedures; and
 - (e) Alternative courses of action.

Having considered the relevant factors, a professional accountant shall determine the appropriate course of action, weighing the consequences of each possible course of action. If the matter remains unresolved, the professional accountant may wish to consult with other appropriate persons within the firm or employing organization for help in obtaining resolution.

- 100.19 Where a matter involves a conflict with, or within, an organization, a professional accountant shall determine whether to consult with those charged with governance of the organization, such as the board of directors or the audit committee.
- 100.20 It may be in the best interests of the professional accountant to document the substance of the issue, the details of any discussions held, and the decisions made concerning that issue.
- 100.21 If a significant conflict cannot be resolved, a professional accountant may consider obtaining professional advice from the relevant professional body or from legal advisors. The professional accountant generally can obtain guidance on ethical issues without breaching the fundamental principle of confidentiality if the matter is discussed with the relevant professional body on an anonymous basis or with a legal advisor under the protection of legal privilege. Instances in which the professional accountant may consider obtaining legal advice vary. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant may consider obtaining legal advice in that instance to determine whether there is a requirement to report.

- 100.22 If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant shall, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant shall determine whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.