



Meeting Location: Hilton, 1335 Avenue of the Americas, New York, United States

Meeting Date: October 17-19, 2011

Responding to a Suspected Illegal Act

Objectives

1. To approve for exposure proposed Sections 225 and 360 addressing how a professional accountant responds when encountering a suspected illegal act.

Background to Project

Confidentiality is one of the fundamental principles with which the professional accountant is required to comply. Section 140 of the Code 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 guidance to the accountant on how to identify those situations and how to respond.

The Task Force¹ proposals were discussed by the IESBA at its June meeting and by the CAG at its September meeting.

The Task Force met on July 17-18th to consider the input received from the IESBA and revised the proposed wording for the section addressing professional accountants in public practice (new section 225) and professional accountants in business (new section 360). The Task Force met again on Sept 22nd-23rd to consider input from CAG members and to finalize its proposals.

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Overview of Proposed Approach

The exposure draft will contain two proposed sections dealing with responding to a suspected illegal act. Section 225 will apply to professional accountants in public practice and Section 360 will apply to professional accountants in business. Some changes will be proposed to paragraph 100.21 and Section 140 *Confidentiality* and Section 150 *Professional Behavior*. The IESBA also proposes to strengthen Section 210 in the area of client continuance decisions. Sections 210 *Professional Appointment* and Section 300 *Introduction* would also be strengthened to address unethical behavior by a client or employing organization.

A sequential approach is being proposed to respond to a suspected illegal act for both Sections 225 and 360.

Accountant Providing Professional Services to an Audit Client

Section 225 will provide guidance for professional accountants who perform an audit or other professional service for an audit client of the firm, or a network firm. When information obtained in the course of providing the service leads the accountant to suspect that an illegal act has been committed, the section would provide the following:

- Require the professional accountant to comply with any applicable legal or regulatory requirements governing how a suspected illegal act is to be addressed.
- If making a disclosure under law or regulation, require the accountant to comply with any prohibitions on alerting the client to the pending disclosure, as under anti-money laundering regulations.
- Where disclosure is not required by law or legislation:
 - Require the accountant to take reasonable steps to confirm or dispel that suspicion;
 - If unable to dispel the suspicion, require the accountant to discuss the matter with the appropriate level of management;
 - If management's response is not appropriate, require the accountant to escalate the matter to a higher level of management. Whether the response is appropriate the professional accountant shall consider such factors such as whether (i) the matter was adequately investigated, (ii) remedial action was taken, (iii) steps were taken to reduce the risk of re-occurrence (e.g., additional controls or training), and (iv) the entity has disclosed the matter to an appropriate authority or will do so within a reasonable period of time;
 - If the response is still not appropriate, require the accountant to discuss the matter with those charged with governance;
 - If the response is still not appropriate, require the accountant to determine the appropriate course of action to take, including whether to terminate the professional relationship with the client;
 - If the accountant determines that the suspected illegal act is of such consequence that disclosure would be in the public interest and the entity has not disclosed the matter, require the accountant to disclose the matter

to an appropriate authority, when not prohibited by law. The matters to be disclosed are:

- Suspected illegal acts that directly or indirectly affect the client's financial reporting; and
 - Suspected illegal acts, the subject matter of which falls within the expertise of the professional accountant.
- In determining whether disclosure would be in the public interest, require the professional accountant to take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances, would be likely to conclude that disclosure to an appropriate authority would be in the public interest.
 - In determining how to comply with the requirements of this section the accountant may wish to discuss the matter with the relevant professional body on an anonymous basis or with a legal advisor under the protection of professional privilege.
 - If the accountant concludes disclosure is in the public interest, require that the accountant determine whether there is an appropriate authority to receive the disclosure.
 - Require the accountant to document the steps taken to respond to the suspected illegal act, including the persons consulted, responses received, and the disclosure, if any, made to an appropriate authority.

Accountant Providing Professional Services to a Client that is not an Audit Client

The approach taken in Section 225 for an accountant providing a professional service to a client that is not an audit client entails a similar sequential approach of escalation. The approach proposed is the same as for a professional accountant providing services to an audit client, with the following differences:

- If having discussed the matter with management and the response is not appropriate, the accountant shall discuss the matter with those charged with governance. If the accountant does not have access to those charged with governance, the accountant shall disclose the matter to the entity's external auditor. The auditor of the entity would then have the responsibility to take steps to confirm or dispel the suspicion, discuss with those charged with governance and, ultimately, if the auditor concludes that disclosure would be in the public interest and the entity has not disclosed the matter, disclose to an appropriate authority;
- If the matter has not been disclosed to an appropriate authority and the professional accountant determines that the suspected illegal act is of such consequence that disclosure would be in the public interest, the accountant shall make that disclosure if the subject matter relates to the professional services being provided by the professional accountant. If the matter does not relate to the accountant's professional services, the accountant shall disclose the matter to the entity's external auditor;
- If the client is an individual, the professional accountant shall discuss the matter with the individual. If the client admits to the illegal act, the accountant shall

advise the client to disclose the matter to an appropriate authority. If the client does not disclose the matter, the subject matter of the illegal act falls within the expertise of the professional accountant and the act is of such consequence that disclosure would be in the public interest, the accountant shall disclose the matter, when not prohibited by law.

Professional Accountants in Business

The approach taken in Section 360 for professional accountants in business is similar to the approach taken for accountants in public practice. It provides that the accountant shall generally disclose the matter within the reporting lines of the employing organization and escalate the matter if it is not appropriately addressed. If the matter is not appropriately addressed, the accountant is required to report it to those charged with governance or the entity's external auditor. If the response to the matter is still not appropriate the accountant shall determine the appropriate course of action, including whether to resign from the employing organization. If the accountant determines that the suspected illegal act is of such consequence disclosure would be in the public interest and the entity has not disclosed the matter, the accountant would be required to disclose the matter to an appropriate authority, when not prohibited by law.

Unethical Behavior

The proposal would strengthen Section 210 and 300 in relation to client or employing organization unethical behavior. The proposal would require a professional accountant when facing issues that threaten compliance with the fundamental principles and it is not possible to reduce such threats to an acceptable level to terminate the client or employment relationship.

The proposed text of Sections 225 and 360 and proposed modifications to other sections are contained in Agenda Paper 6-A (in mark-up) and 6-B in clean.

Responsibility to Disclose to an Appropriate Authority

The Task Force has carefully considered what responsibility a professional accountant should have to disclose a suspected illegal act to an appropriate authority if the accountant determines that the consequence of the illegal act is such that disclosure would be in the public interest. The Task Force considered whether there should be a requirement/obligation to disclose or a right to disclose (i.e., if the accountant determined disclosure was appropriate it would not be a violation of the confidentiality requirements of the Code if the accountant made the disclosure). The Task Force has also considered whether the obligation should be the same for all professional accountants, or whether the responsibility of an auditor, for example, should differ from the responsibility of a professional accountant in business.

Arguments in Favor of a Requirement

- As noted in the first paragraph of the Code, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. It is, therefore, appropriate to require a professional accountant to disclose a suspected illegal act to an appropriate authority, if such disclosure would be in the public interest;
- Requiring disclosure will result in disclosure occurring more consistently in these situations than providing a right to disclose because there will be less discretion for the accountant to determine whether to disclose;
- The proposed approach requires the professional accountant to escalate the matter within the client or employing organization and recognizes that the client or employing organization has the primary responsibility for disclosure to an appropriate authority. Disclosure by the professional accountant would represent a last resort when the client or employing organization has not disclosed and the professional accountant determines that such disclosure is in the public interest.
- A requirement will result in disclosure of more suspected illegal acts than would a right to disclose, which may have a deterrent effect, thus potentially reducing the number of illegal acts; and
- The appropriate authority has the responsibility and authority to take action against those who committed the act. It is therefore appropriate to require the accountant to disclose the matter to provide the authority with notification such that it can then investigate the matter further and determine whether action should be taken against those who committed the act.

Arguments in Favor of a Right

- Requirements to disclose illegal acts are normally established by law and are generally accompanied by regulations that afford protection from retaliation to those who make such disclosures. Such protective mechanisms can only be established by law and it is not possible for the IESBA to establish protective mechanisms for professional accountants who have to comply with the Code. It is disproportionate to establish a requirement to disclose without providing those who would be required to make the disclosures with any protective mechanisms.
- A requirement to disclose would be disproportionate in a country where there is uncertainty regarding the fairness of the judicial system. In such jurisdictions it would be more proportionate for the professional accountant to have the discretion to disclose rather than a requirement.
- Requiring all professional accountants to disclose suspected illegal acts would be disproportionate when compared with existing legislation in many countries. Requirements to disclose illegal acts under anti-money laundering legislation or securities laws apply only to professional accountants in public practice and not professional accountants in business or other employees. For such latter categories of individuals, legislation normally establishes a right to disclose, rather than a requirement, coupled with whistle-blowing protection mechanisms and, occasionally, incentives to disclose.

- What is deemed to be in the public interest will vary from person to person and it is unclear how the determination that a matter is in the public interest should be made. The subjective judgment required to make this determination could result in a wide range of conclusions and produce inconsistent results.
- The accountant may not have access to all the information needed to be able to confirm or dispel the suspicion that an illegal act was committed and a requirement may lead to an increase in disclosures of a frivolous nature.

The Task Force concluded that both a professional accountant in public practice providing professional services to an audit client and a professional accountant in business should be required to disclose a suspected illegal act to an appropriate authority, when disclosure would be in the public interest.

The Task Force initially proposed that a professional accountant in practice providing services to a non-audit client would not, however, be required to disclose the matter to an appropriate authority. Such an accountant might not have access to enough information within the company to be able to confirm or dispel the suspicion. The initial proposal would have, therefore, required these accountants to disclose the matter to the entity's external auditor – who would then be required to confirm or dispel the suspicion and, ultimately, if the matter is not appropriately addressed disclose the matter to an appropriate authority.

This proposal was discussed with the CAG at its September meeting. While CAG members recognized that it was a difficult issue, many CAG members while acknowledging that it would be a challenging standard expressed support for a requirement to report. Two CAG members expressed the view that the accountant should have a right to report as opposed to a responsibility, with one CAG member noting that it was not appropriate to impose western morality on other cultures and a requirement may be particularly problematic in some jurisdictions. The other CAG member in favor of a right noted that the primary responsibility for reporting should be the company's and not the professional accountant's.

CAG members then discussed the Task Force proposal to require a professional accountant providing services to an audit client, and a professional accountant in business to disclose a suspected illegal act to an appropriate authority when the accountant determines that disclosure would be in the public interest and to require a professional accountant providing non-assurance services to a non-audit client to disclose the matter to the entity's external auditor. CAG members questioned having a different test for professional accountants providing non-assurance services to non-audit clients and thought that this complicated the standard. It was also noted that, for example, if an accountant was providing tax services, it did not seem to be appropriate to require the accountant to disclose that to the auditor as opposed to disclosing directly to the tax authority if the matter was such that disclosure would be in the public interest.

The Task Force considered the input of CAG members and concluded that if the subject matter of the suspected illegal act related to the professional service the professional accountant is providing, the accountant should be required to disclose the matter to an appropriate authority. Because the subject matter relates to the professional service, the accountant has the ability to take reasonable steps to confirm or dispel the suspicion. If the matter does not relate to the professional service, the accountant might not have such an ability and, therefore, reporting to the auditor is appropriate because the auditor would have the ability to take such steps.

In the case of a client that is an individual, the escalating approach is not appropriate because it is the individual who is responsible for the suspected illegal act. In such circumstances, the professional accountant should discuss the matter directly with the individual. If the individual admits the matter, the accountant should advise that individual to disclose the matter to an appropriate authority. If the individual does not admit the matter or does not disclose to an appropriate authority, the accountant should disclose the matter.

Action requested

IESBA members are asked to consider whether they agree with the proposal to require a professional accountant to disclose certain suspected illegal acts to an appropriate authority if the illegal act is of such consequence that disclosure would be in the public interest.

The IESBA members are also asked to consider whether a requirement is appropriate for all three categories of professional accountant (auditor, professional accountant performing services to a non-audit client, and professional accountant in business) or whether there should be a differentiation.

Disclosure in the Public Interest

The proposal would require disclosure of suspected illegal acts that would affect financial reporting and suspected illegal acts the subject matter of which falls within the expertise of the professional accountant when the act is of such consequence that disclosure would be in the public interest.

The IESBA has discussed whether additional guidance could 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 fraudulent financial reporting 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, the 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 Task Force revisited these factors and recognized 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 make. 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 proposed 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 was concerned that factors might be seen as limiting.

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 IESBA discussed this approach at its June meeting and the IESBA generally agreed with the approach.

The Task Force has discussed the matter further and is of the view that the clarity of the requirement would be improved if it stated that:

“In making the determination, the professional accountant shall take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances, would be likely to conclude that the act is of such consequence that disclosure would be in the public interest.”

The Task Force is of the view that this proposed change emphasizes that the severity of the consequences of the act must be such that disclosure would be in the public interest. Under such an approach, for example, if an accountant acquired information that led the accountant to suspect an employee had committed a minor financial fraud, the accountant would report the matter to client management. The accountant would not, however, disclose the matter to an appropriate authority if the client or employing organization had not done so because the consequences of the fraud are not material to the financial statements and management had taken appropriate remedial action. On the other hand, if an accountant acquired information that led the accountant to suspect that the entity was not in compliance with environmental regulations, for example, emissions from a factory

were significantly higher than the accepted level such that the health of the local population could be at risk, the accountant would report the matter to management and to those charged with governance. If the matter was not adequately addressed, the accountant would be required to report the matter to an appropriate authority. The suspected illegal act affects the financial reporting as the entity might be subject to a fine and the illegal act is of such a consequence that disclosure would be in the public interest.

Action requested

IESBA members are asked for their views on the Task Force's proposed clarification of the reasonable and informed third party test in the determination of whether disclosure would be in the public interest.

Exposure Draft

IESBA members are asked to approve the proposed changes for release as an exposure draft. Due process requires the IESBA to expose changes for a period of no less than 90 days. The Task Force is of the view that the standard period of exposure is appropriate.

An affirmative vote of two-third of IESBA members (twelve) is necessary to approve an exposure draft.

Each exposure draft is accompanied by an explanatory memo. The IESBA does not vote on this memo but it is provided to Board members for comment and input. This document, which will include the impact analysis, will be circulated to Board members for their comment before the exposure draft is released.

Effective Date - The Task Force has considered the effective date. The Task Force is of the view that the proposals do not call for any changes in systems; what is required is escalating a suspected illegal act through successive levels of management, to those charged with governance if necessary and, in certain cases, disclosing the matter to an appropriate authority. The Task Force, therefore, recommends a relatively short transition period and proposes the revisions become effective approximately one year after approval of the final standard.

Material Presented

Agenda Paper 6	This Agenda Paper
Agenda Paper 6-A	Proposed Wording – mark-up from Warsaw
Agenda Paper 6-B	Proposed Wording – clean version

Action Requested

1. IESBA members are asked to consider the questions raised in this paper.
2. IESBA members are asked to approve the proposals as an exposure draft.