



Meeting Location: IFAC Offices, New York, USA

Meeting Date: June 18-20, 2012

Responding to a Suspected Illegal Act

Objective of Agenda Item

1. To approve for exposure proposed Sections 225 and 360 *Responding to a Suspected Illegal Act* and conforming changes to other sections of the Code.

Background

At its conference call on April 19, 2012, the IESBA considered draft wording. The IESBA confirmed the following:

- An auditor and a professional accountant in public practice providing non-assurance services to an audit client should have a requirement to report certain illegal acts to an appropriate authority.
- A professional accountant in public practice providing non-assurance services to a client that is not an audit client would have a requirement to report certain suspected illegal acts to the entity's external auditor. If the suspected illegal act relates to the subject matter of the professional service the accountant is providing, and the response to the matter is not appropriate, the accountant would have a right to disclose the matter to an appropriate authority. The accountant would be expected to exercise the right in order to fulfill the accountant's responsibility to act in the public interest.
- A professional accountant in business would have a requirement to disclose a suspected illegal act to the entity's external auditor if the accountant is unable to escalate the matter and there is no established mechanism such as an ethics policy. If, having escalated the matter or disclosed to the entity's external auditor, in the professional accountant's judgment the response to the matter is not appropriate, the accountant would have a right to disclose the matter to an appropriate authority. The accountant would be expected to exercise the right in order to fulfill the accountant's responsibility to act in the public interest.

The IESBA also agreed that in exceptional circumstances the accountant would not be expected to make such disclosure. The IESBA discussed the proposal developed by the Task Force¹ and

¹ Bob Franchini (chair), Carline Gardner, Felicitas Irungu, Isabelle Sapet and Brian Walsh

provided input to the Task Force. The IESBA also asked the Task Force to consider the application of the proposals in a group audit situation.

The Task Force met on June 5, 2012 to address the IESBA comments

Discussion

Exceptional Circumstances

On the April 2012, conference call, the IESBA considered whether “physical safety” was the only exceptional circumstance in which disclosure would not be required. It was noted that limiting the exception to only physical safety might be inappropriate given the number of jurisdictions without effective whistle blowing protection and the potential consequences of disclosing an act which, after further investigation is determined not to be illegal. The IESBA tentatively concluded that the exception should not be limited to physical safety but that the circumstances in which it would apply should be unusual and that the guidance should not be so broad as to permit any circumstance to qualify. Physical safety could be provided as an example of an exceptional circumstance.

The Task Force has developed language for the exceptional circumstances in ¶225.13 (accountants providing services to auditors), ¶225.19 (accountants providing services to non-audit clients), ¶225.20 (accountants providing non-audit clients that are individuals) and ¶360.9 (professional accountants in business).

As requested by the IESBA, the Task Force has developed language which would provide threats to the physical safety of the professional accountant or others as an example. The text continues to be based on whether a reasonable and informed third party would conclude it was appropriate not to disclose. The Task Force also proposes that for professional accountants in public practice the exceptional circumstances be limited to those that are not of a commercial or financial nature. The Task Force is of the view it would be inappropriate for such accountants not to disclose because of the concern that disclosure would result in losing a client or because it may adversely affect the reputation of an individual, the firm or the profession.

Group Audit Situations

On the April conference call, IESBA considered the application of the proposals in a group audit situation. The IESBA noted that the definition of audit client includes related entities in specific circumstances. In light of this definition, the IESBA asked the Task Force to consider to whom disclosure would be required if the professional accountant were providing professional services to an entity that was not an audit client but was a related entity of an audit client.

The Task Force has considered the matter. The Task Force noted that for listed entities the definition of audit client includes entities over which the client has control (downstream entities), entities that have control over the client and entities that have significant influence over the client (upstream entities) and entities which are under common control with the client (sister entities). Under the proposal discussed on April conference call, a professional accountant providing professional services to an upstream or sister entity of an audit client would have been required to escalate the matter and if the response was not appropriate disclose to an appropriate authority (i.e. the auditor requirements would apply). The Task Force is of the view that this is not appropriate. The professional accountant providing non-audit services to a sister entity of an audit

client might not have the necessary access to management to escalate the matter. The Task Force is of the view that the professional accountant should have the same obligations as any other professional accountant providing non-audit services to a non-audit client. The Task Force proposes, therefore the following new paragraph:

“For the purposes of this section, “audit client” is the entity in respect of which a firm conducts an audit engagement and those related entities over which the client has direct or indirect control.”

Other Sections

At the February 2012 meeting in Dublin, IESBA discussed and agreed on proposed changes to other section of the Code. The agreed changes are presented on Agenda Paper 2-C shown in mark-up from the existing Code.

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 2	This Agenda Paper
Agenda Paper 2-A	Proposed Sections 225 and 360 (mark-up)
Agenda Paper 2-B	Proposed Sections 225 and 360 (clean)
Agenda Paper 2-C	Proposed Changes to Other Sections of the Code

Action Requested

1. IESBA members are asked to approve the document for exposure.