

RESPONDING TO SUSPECTED FRAUD AND ILLEGAL ACTS

DRAFT IESBA PROJECT PROPOSAL

I. Subject

1. This project will include:

- (a) Revisions to Section 140 *Confidentiality* to provide additional guidance to professional accountants on how to respond when encountering a suspected fraud or illegal act;
- (b) A new section in Part B to provide guidance for professional accountants in public practice how to respond when encountering a suspected fraud or illegal act; and
- (c) A new section in Part C to provide guidance for professional accountants in business how to respond when encountering a suspected fraud or illegal act.

The project will not address a professional accountant's responsibility for detecting such acts or provide guidance on how to detect such acts.

II. Background

2. A professional accountant in public practice or business may encounter situations including:

- The professional accountant discovers a suspected fraudulent or illegal act;
- The professional accountant has reported an alleged fraudulent or illegal act but no action has been taken, or the action is inadequate; and
- Another individual within the organization has informed the professional accountant about the existence of a suspected fraudulent or illegal act.

3. The Code notes that a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. It also notes that a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. While confidentiality is one of the fundamental principles with which the professional accountant complies, Section 140 identifies three circumstances where professional accountants are 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 disclosure when not prohibited by law.

4. The Code does not contain any guidance on when there is a profession duty or right to disclose confidential information when not prohibited by law. The goal of the project is to provide guidance for professional accountants on how to respond in situations where they encounter a suspected fraud or illegal act.

III. Project Objective and How It Serves the Public Interest

A. Project Objective

5. The objective of the project is to revise Section 140 and develop two new sections in Parts B and C to provide additional guidance for professional accountants in public practice and in business on how to respond in situations where they encounter a

suspected fraud or illegal act.

B. How the Project Objectives Serve the Public Interest

6. Providing additional guidance for professional accountants on how to respond in situations where they encounter a suspected fraud or illegal act serves the public interest because it will promote more consistent behavior that is appropriate and expected under the Code. It will also provide the public with increased comfort that the professional accountant has a clear framework with which to address such matters.

IV. Outline of the Project

A. Project Scope

7. The scope of this project is to revise Section 140 and develop two new sections in Parts B and C to provide additional guidance for professional accountants in public practice and in business on how to respond in situations where they encounter a suspected fraud or illegal act. The project will focus on the actions that the professional accountant takes when encountering such a situation. It will not address actions that professional accountants should take to identify such matters.

B. Revision of Section 140 and Development of Additional Sections in Parts B and C – Major Problems and Key Issues that Will Be Addressed

B.1 AREAS FOR ADDITIONAL GUIDANCE

8. The task force will address the extent to which additional guidance is needed on the following:
 - *Legislative environment* – Many jurisdictions have “whistle blowing” legislation, some of which is quite extensive. The project will recognize the existence of such legislation and note that, depending on the jurisdiction, the professional accountant may have a legal obligation to report under such legislation. The project will not cross-reference to any particular piece of legislation nor attempt to categorize all types of existing legislation. There may be instances where the professional accountant cannot lawfully overcome confidentiality restrictions. The project will recognize this matter. The project will also consider the extent to which the professional accountant’s response to a suspected fraud or illegal act may differ depending on the extent to which “whistleblowers” are afforded protection under the law.
 - *Role of the Professional Accountant* – The task force will consider whether the role of the professional accountant with respect to the entity in which the suspected fraud or illegal; act exists is a factor to be considered in determining the nature of the items to be addressed, the threshold for taking action and the process for responding. The task force will consider matters such as whether there is a different expectation depending upon the seniority of the individual and his or her role within the organization, for example whether the expectation of a very junior employee would be to escalate the matter within the organization but only report outside of the organization in extreme circumstances. In the case

of a professional accountant in public practice, the task force will consider whether the expectations differ depending upon the nature of the professional service performed and the relevance of the suspected fraud or illegal act to the service.

- *Nature of Items to be Addressed* – A description of the types of matters that will be addressed is critical to solidifying the scope of the project. The task force will, therefore, at an early stage in the project define the types of confidential matters that the professional accountant may need to disclose as a result of a suspected fraud or illegal act. In addition to describing the types of matters that will be addressed, the task force will consider developing specific examples of these matters.
- Subject to the recommendation in the last paragraph of this bullet point, the task force should restrict this to suspected fraud or illegal acts.
- With respect to fraud, the task force should be mindful of *ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, which 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.”
- With respect to illegal acts, the task force should be mindful of *ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements*, which deals with the auditor's responsibility to consider laws and regulations when performing a financial statement audit. In this regard, the ISA 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 should consider whether this description of illegal acts is appropriate for the purposes of the Code or whether the definition should be broader and include other types of illegal acts.
- While the initial presumption of the task force should be to restrict the matters to be addressed to suspected fraud or illegal acts, the task force should consider whether the scope of the project should be wider and address, for example, matters that are “unethical” or “improper.” The task force should present its views on this matter at an early stage in the project. If the task force believes the project should have a wider scope, it should present its reasons to the IESBA, together with examples of the types of matters that would fall into this broader category, and thus would be appropriate for a professional accountant to disclose. It also should discuss the extent to which a broader project would intersect with the guidance in Section 100 on ethical conflict resolution.
- *Threshold for Taking Action* – The task force will consider what guidance can be

provided to a professional accountant regarding the threshold for taking action. In this regard the task force should consider the “probability” that a fraud or illegal act has occurred, the “effect” of such an act and who committed the act.

- Whether an act constitutes a fraud or illegal act is ultimately a matter for legal determination in a court of law. The professional accountant will, therefore, likely identify a "suspected" fraud or illegal act. The task force will consider what guidance can be given to the professional accountant regarding the level of suspicion that should be brought to bear in making that identification.
- The task force will also consider the effect or magnitude of the suspected fraud or illegal act. For example, a minor breach of a regulation would be unlikely to be of such a magnitude that the accountant would need to consider disclosure. In this regard, the task force will consider whether useful guidance can be given on how the professional accountant would consider the level of public interest associated with the matter and what steps the accountant would take to ensure an understanding, to the extent possible, of the complete picture so that the accountant is not acting on unsubstantiated information.

The task force will also consider the extent to which the threshold for taking action depends upon who committed the act.

- *Process for Responding* – The task force will develop guidance on the thought process the professional accountant would use in determining how to respond to a suspected fraud or illegal act. Given the wide range of matters that might be encountered, the task force should consider a sequential approach with differing actions depending upon the severity of the matter encountered. For example, an approach could be that the professional accountant first discusses the matter with a superior and, if appropriate action is not taken, then elevates the matter within the employing organization or client, as the case may be. If the matter is still not resolved, the professional accountant would then consider whether there is a need to report outside of the employing organization or client. The task force should consider the extent to which the guidance in Section 100 on ethical conflict resolution interacts with its recommend guidance on fraud and illegal acts. The task force should also consider whether there are any cases where the severity of the matter is such that even if the matter is resolved, the professional accountant should consider reporting that matter outside of the client or employing organization.
- *Timing of Disclosure* – The task force will consider what guidance is necessary regarding the timing of disclosure in situations when the matter cannot be resolved and the professional accountant determines that disclosure is necessary, taking into consideration the Section 100 guidance on ethical conflict resolution.
- *Documentation* – The task force will consider what guidance should be given regarding the matters that should be documented by the professional accountant.

B.2 STRUCTURE OF THE GUIDANCE

9. Section 140 provides guidance for all professional accountants. The task force will consider whether guidance that is common to all accountants should be included in Section 140 or whether it should be repeated in the two new sections in Parts B and C.

V. Implications for Any Specific Persons or Groups

10. The project has particular implications for the following:
 - (a) Professional accountants in public practice;
 - (b) Professional accountants in business; and
 - (c) Regulatory bodies;
 - (d) Business community; and
 - (e) National standard setters.

VI. Development Process, Public Consultation, Project Timetable and Project Output

11. The revision of Section 140 and development of new sections will follow due process for the development of a pronouncement. Specific consideration will be given to the need to hold focus groups or roundtables to ensure relevant feedback is obtained as necessary.

A. Project Timetable

Project Stage	Timing
Approval of project proposal by IESBA	Q4 2010
Exposure Draft first read	Q2 2011
Exposure Draft approval	Q4 2011
Final standard approval	Q4 2012

B. Project Outputs

12. Revisions to Section 140 and two new sections in Parts B and C of the Code.

VII. Impact Assessment Considerations

13. The primary benefit in identifying and developing additional guidance for professional accountants when encountering suspected fraud and illegal acts will be to improve accountants' ability to respond to such matters in a more consistent manner and provide the public with greater comfort that the professional accountant has a clear framework with which to address such matters.

VIII. Resources Required

14. A project task force consisting of up to 6 individuals, including a member of the IESBA as chair.
 - IESBA technical staff will provide staff support to the task force.

IX. Relevant Sources of Information that Address the Matter Being Proposed

15. Relevant sources of information include the following:

- Practice Note 19 – The Audit of Banks and Building Societies in the United Kingdom Revised APB <http://www.frc.org.uk/apb/publications/pub1254.html>
- OECD Anti-bribery Convention http://www.oecd.org/department/0,3355,en_2649_34859_1_1_1_1_1,00.html
- Tech 17/99 Public Interest Disclosure Act 1988 Guidance ICAEW http://www.icaew.com/index.cfm/route/121330/icaew_ga/pdf
- Defining and Developing an Effective Code of Conduct for Organizations IFAC Public Accountants in Business Committee <http://www.ifac.org/Members/Downloads/DefiningandDevelopinganEffectiveCodeofConductforOrgs.pdf>
- ICAEW Guidance on defaults and unlawful acts http://www.icaew.com/index.cfm/route/162830/icaew_ga/Members/Member_support/Professional_conduct/Members_handbook/7_1_Members_Handbook_2009/pdf
- CCAB Anti-Money Laundering <http://www.ccab.org.uk/PDFs/070612%20CCAB%20Guidance%20Clean.pdf>
- UK Financial Action Task Force Recommendations http://www.fatf-gafi.org/document/28/0,3343,en_32250379_32236930_33658140_1_1_1_1,00.html
- EU 3rd Money Laundering Directive http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_309/l_30920051125en00150036.pdf
- Other member body guidance