

**Meeting** IESBA Consultative Advisory Group  
**Meeting Location:** Grand Hyatt New York, United States  
**Meeting Date:** March 7, 2011

## Responding to a Suspected Fraud or Illegal Act

### Objectives

1. To consider the Task Force proposals and to provide input on the direction of the project.

### Background

At its November 2010 meeting, the IESBA approved a project proposal to provide ethical guidance for professional accountants when encountering a suspected fraud or illegal act (Agenda Paper D-1). 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. The objective of this project is to determine what guidance can be provided. The key issues on the project include:

- Whether the professional accountant should have a duty to disclose confidential information about a suspected fraud or illegal act.
- How the professional accountant should exercise a duty or right to disclose confidential information regarding a suspected fraud or illegal act.
- The nature of the items to be addressed, including whether the project scope should be expanded to include unethical or improper acts.
- To whom should the professional accountant should disclose the matter.

- What the professional accountant should do if the matter has not been addressed by the client or employer appropriately and the factors to consider in determining whether that is the case.
- Whether the guidance should differ between professional accountants in public practice and those in business

At its February 2011 meeting, the IESBA discussed Task Force<sup>1</sup> proposals and provided input on the proposed direction. The Task Force met after the IESBA meeting to consider the input received. The IESBA will consider draft wording for two new sections addressing this matter at its June 2011 meeting, with the view to approving an exposure draft at its October 2011 meeting.

This agenda paper contains the latest thinking of the Task Force in response to input received from the IESBA. The positions contained in this paper are, therefore, characterized as the views of the Task Force.

### **Overview of Approach**

The Task Force recommends that the guidance address suspected frauds and illegal acts and possible improper or unethical matters.

In responding to such a matter, a professional accountant in public practice and a professional accountant in business would be required to first disclose the matter upwards within the client or employing organization. For certain suspected frauds and illegal acts, if the client or employer has not disclosed the matter outside the organization to an appropriate authority and such disclosure would be in the public interest, the accountant would be required to make the disclosure. The frauds and illegal acts that would be covered by this requirement are those that (a) have a direct or indirect effect on the financial reporting or (b) are otherwise within the professional accountant's area of expertise. For other suspected frauds and illegal acts, the accountant would be permitted but not required to disclose outside the organization if such disclosure would be in the public interest.

The Task Force is considering whether, in some circumstances disclosure outside the employing organization would be too onerous for a professional accountant in business. The Task Force is considering whether disclosure should be required only if the following pre-requisites are present:

- Disclosure is not contrary to laws and regulations;
- A whistle-blowing protection scheme is in place which affords both anonymity and protection from liability; and

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<sup>1</sup> Bob Franchini (Chair), Caroline Gardner, Felictas Irungu (from February 2011), Isabelle Sapet, Kate Spargo and Brian Walsh (Aiko Sekine was a member of the Task Force in 2010).

- There is an appropriate authority to receive the disclosure and there is a judicial process that can be trusted.

## Issues

### 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.”

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 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 is of the view that because “a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest,” the sections should provide guidance on suspected fraud, illegal acts, and unethical or improper acts – but the actions to be take will differ depending upon the nature of the act.

### Action requested

CAG members are asked to comment on the proposed nature of items to be addressed.

## **Process for Responding**

The Task Force recognizes that the accountant will likely encounter a "suspected" matter – that is, the determination of whether a fraud or other illegal act exists is a matter that would be decided by a court. The Task Force is of the view that if the accountant has a reasonable level of suspicion, he or she should take action. A reasonable level of suspicion is a concept that has some foundation in law.

In considering how the professional accountant should respond to a matter, the Task Force developed the following sequential approach for disclosing within the client or employing organization before considering whether the matter should be disclosed to a regulator or other outside authority:

- A professional accountant in public practice discloses the matter as follows:
  - To client management at an appropriate level;
  - If client 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 following factors would assist an accountant in determining 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 recurrence, 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**

CAG members are asked to comment on 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 the following matters:

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

#### *Matter not Satisfactorily Addressed*

If a client or employing organization does not satisfactorily address a matter, it may call into question the professional accountant's ability to comply with the fundamental principles— for example, if it does not take appropriate steps to prevent a recurrence of the matter.

Integrity is a fundamental principle of the Code and requires the accountant to be straightforward and honest in all professional and business relationships. The Code contains some guidance on the threats to integrity.

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 the matter has not been appropriately addressed, and the professional accountant has disclosed the matter further, as described above, the professional accountant should determine the appropriate course of action, including whether to resign from the client or employing organization.

Paragraphs 210.1-201.5 address client acceptance. The Task Force plans to develop some additional guidance to address client continuance - situations where a matter is identified with an existing client.

*Disclosure Outside of the Client or Employer*

In considering whether to disclose a 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.

In considering the types of matters that a professional accountant might disclose outside of the client or employing organization, the Task Force was of the view that breaching confidentiality is a significant act and it would not be appropriate for an accountant to undertake such an action based on a subjective judgment of what is improper or unethical. It is not possible to define such matters and they will differ depending upon the judgment of the individual. In any case, the Task Force was of the view that an unethical or improper act that related to financial reporting would likely meet the definition of a suspected fraud or illegal act and be treated as such. Absent a matter that related to financial reporting, the Task Force is of the view that a professional accountant should not have any additional obligation to disclose such matters outside the client or employing organization.

The Task Force is of the view that a professional accountant should be required to disclose suspected fraud or other illegal acts that have a direct or indirect effect on the financial reporting or are otherwise within the professional accountant's area of expertise outside of the client or employing organization, if such disclosure has not been made and disclosure would be in the public interest. The Task Force is of the view that such a requirement would be consistent with public expectations and consistent with the profession's acceptance of a responsibility to act in the public interest.

With respect to other frauds or illegal acts, unrelated to financial reporting or that are not within the professional accountant's area of expertise, the Task Force is of the view that there should not be a requirement under the Code to disclose such matters as the professional accountant's position is similar to that of any other provider of professional services or employee. The Task Force believes that a requirement to disclose such matters would not be appropriate; the professional accountant may only have a reasonable level of suspicion about a matter which is outside his or her level of expertise. The accountant should, however, have the right to disclose such a matter if he or she believes that it is in the public interest.

This can be summarized as follows:

| Nature of Matter   | Response  |
|--|---|
| Suspected fraud or illegal act that has a direct or indirect effect on financial reporting of client or employing organization | Requirement to disclose if disclosure is in the public interest |
| Other suspected frauds or illegal acts that are within the expertise of the accountant   | Requirement to disclose if disclosure is in the public interest |
| Other suspected fraud or illegal acts  | Permitted to disclose if disclosure is in the public interest   |

There is no common definition of the public interest. The Task Force recognizes that the determination of whether a matter is in the public interest will ultimately be a matter of the professional judgment of the individual making the determination. In considering what guidance can be given, the Task Force is of the view that whether a matter is in the public interest will ultimately depend upon whether it affects the rights, health, or finances of the public at large. This would involve a consideration of matters such as:

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

The Task Force is considering whether a requirement to disclose could be disproportionately onerous in certain circumstances. For example, where the professional accountant may be subject to threats of physical harm or where there is an absence of a regulatory authority to receive such disclosure or there is a regulatory authority but it has a history of not acting on such information or acting in a selective manner. The Task Force also recognizes that a requirement to disclose can be particularly onerous for a professional accountant in business. Accordingly, the Task Force is considering whether a professional accountant in business should be obligated to disclose only if the following pre-requisites are present:

- Disclosure is not contrary to laws and regulations;
- A whistle-blowing protection scheme is in place which affords both anonymity and protection from liability;
- There is an appropriate authority to receive the disclosure and there is a judicial process which can be trusted.

**Action requested**

CAG members are asked to comment on the proposed obligation and right to disclose if disclosure would be in the public interest.

CAG members are asked to comment on the factors that would be considered to determine whether disclosure would be in the public interest.

CAG members are asked to comment on the possible pre-requisite conditions for disclosure.

**Material Presented**

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| Agenda Paper D   | This Agenda Paper |
| Agenda Paper D-1 | Project Proposal  |

**Action Requested**

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