

**Meeting Location:** Conrad Ballroom, Conrad Hotel, Dublin, Ireland

**Meeting Date:** February 20-22, 2012

## Responding to a Suspect Illegal Act

### Objective of Agenda Item

1. To discuss alternative approaches for an accountant to respond to a suspected illegal act;
2. To review the two draft approaches and determine which approach is appropriate for each category of professional accountant;
3. To agree on the wording that would be included in proposed Sections 225 and 360 and other changes to the Code; and
4. To agree on the wording to the changes to the other sections of the Code.

### Background to the 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 may, 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.

At its October 2011 meeting the IESBA discussed a proposed exposure draft developed by the Task Force<sup>1</sup>. The exposure draft proposed that after escalating a matter within the client or employing organization, a professional accountant would be required to disclose certain illegal acts to an appropriate authority. Disclosure would be required when the accountant determined that the suspected illegal act was of such consequence that

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

disclosure would be in the public interest and the entity had not disclosed the matter. The types of illegal acts that would require such disclosure were:

- Suspected illegal acts that directly or indirectly affect the client’s financial reporting.
- Suspected illegal acts the subject matter of which falls within the expertise of the professional accountant.

The IESBA discussed the proposal and requested the Task Force to prepare an alternative approach that was based on a “robust right” to disclose to an appropriate authority.

The Task Force met on December 5-6<sup>th</sup> and again on January 25<sup>th</sup> to consider the IESBA comments and has developed an approach that is based on a right that the accountant is expected to exercise, a “robust right”, (Agenda Paper 3-C). The Task Force has also reviewed the requirement that was discussed with the IESBA in October with a view to seeing whether the concerns expressed could be addressed (Agenda Paper 3-A, in clean and Agenda Paper 3-B, in mark-up from the October meeting). The Task Force is presenting both approaches for the consideration of the IESBA.

The Task Force also discussed whether it had a preferred position and the majority view of the Task Force is that there should be a requirement for auditors and a “robust right” for others (Agenda Paper 3-D). A minority view is that there should be a requirement for all accountants.

### **Matters for Discussion**

#### *Expectation to Disclose*

The fundamental principle of confidentiality imposes an obligation on all professional accountants to refrain from disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority unless there is a professional *right or duty* to disclose (§140.1)

The Task Force felt that this “right” was appropriate with respect to disclosing certain illegal acts. In considering the IESBA’s direction to develop a “robust right” the Task Force is of the view that a professional accountant would be expected to exercise this right in order to fulfill the accountant’s responsibility to act in the public interest. This is also consistent with the nature of those illegal acts which are to be disclosed namely illegal acts that are “such consequence that disclosure would be in the public interest.” The Task Force also proposes a requirement for the accountant to document instances where the right to disclose was not exercised and the rationale for not disclosing.

#### **Action Requested**

IESBA members are asked to consider whether they agree with the right to disclose and an expectation that the accountant exercise the right.

*Responsibility to Disclose*

At its October 2011 meeting, the IESBA discussed a requirement for a professional accountant to disclose an illegal act that is of such consequence that disclosure would be in the public interest. Concern was expressed by some that such an approach would be disproportionate if the professional accountant would face significant reprisals as a result of this disclosure. The Task Force therefore proposes the following exception to address this concern:

“In exceptional circumstances a professional accountant in public practice is not required, under this section, to disclose the suspected illegal act if a reasonable and informed third party would conclude that the probable threats, harassment or reprisals to the professional accountant are sufficiently severe to outweigh the public interest in disclosure. In such cases, if the professional accountant determines not to disclose the suspected illegal act, the accountant shall document the rationale for not disclosing.”

The Task Force feels that it is important that the justification for not disclosing is also tied to the public interest and, therefore, has included this into the exception. The Task Force also feels that documentation is an important safeguard.

**Action Requested**

IESBA members are asked to consider whether they agree with the exception and whether they feel this adequately addresses the concerns raised at the October 2011 meeting.

*Other Changes to Proposed Sections 225 and 360*

The Task Force has made the following changes to the proposed sections:

- ¶225.1 and ¶360.1 The description of an illegal act and the explanation of why the section refers to a “suspected” illegal act has been moved to the beginning of the sections for clarity;
- ¶225.4 If a professional accountant performing a non-assurance service for an audit client of the firm, or a network firm, encounters a suspected illegal act, the accountant would be required to consult with the engagement partner for the audit because the engagement partner has access to those charged with governance and also may be able to more easily take steps to confirm or dispel the suspicion; and
- Documentation – the Task Force has added a requirement for the professional accountant to document when, after escalation, the professional accountant did not disclose a suspected illegal act that was of such consequence that disclosure was in the public interest (either because of exceptional circumstances or because the accountant did not exercise the right to disclose).

**Action Requested**

IESBA members are asked to consider the other proposed changes

*Majority Task Force Position*

The Task Force discussed the factors that support a requirement to disclose and the factors which support a right to disclose. These factors are contained in the appendix to this paper.

The Task Force considered the following categories of accountant:

1. Auditor
2. Professional accountant in public practice providing non-assurance services to an audit client;
3. Professional accountant in public practice providing non-assurance services to a client that is not an audit client of the firm or a network firm; and
4. Professional accountant in business.

The Task Force is of the view that there should be no distinction between the first two categories of accountant. The public would expect an audit firm to take the same action irrespective of whether the suspected illegal act was encountered by a member of the audit team or another individual within the firm or network firm providing non-assurance services. The Task Force, therefore, considered the remaining three categories.

The majority of the Task Force are of the view that the auditor should have a requirement to disclose and accountants performing non-assurance services to non-audit clients and accountants in business should have a right to disclose, and these accountants should be expected to exercise that right. Agenda Paper 3-D contains this approach. The minority Task Force position is that all accountants should have a requirement to disclose, which is the position presented in Agenda Paper 3-A.

**Action Requested**

IESBA members are asked to consider the three categories of accountant and determine appropriate level of responsibility for each category.

*Proposed Changes to Other Sections*

The Task Force proposed changes to other Sections of the Code (Agenda Paper 3-E) to either conform to the proposed new sections 225 and 360 or to address unethical behavior.

- ¶100.22 The Task Force feels that it would be clearer to state that the accountant shall refuse to be associated with an unethical act unless prohibited by law. The Task Force is concerned that as currently drafted the Code is open to interpretation as to what is meant by “where possible.”
- ¶140.4 Sections 225 and 360 envisage a professional accountant, having escalated the matter within the client or employing organization, to disclose the matter to the entity’s external auditor. This Task Force proposes a change to ¶140.4 to make it clear that this would not breach confidentiality under the Code.
- §210 The Task Force proposes changes to this section to strengthen the guidance regarding client acceptance and proposes a new paragraph stating:
- “A threat to compliance with the fundamental principles may be created by client pressure to reduce fees or a client’s unethical behavior such as persistent aggressive earnings management or balance sheet valuations. If a professional accountant in public practice identifies a threat to compliance with the fundamental principles, the accountant shall evaluate the significance of the threats and apply safeguards when necessary to eliminate the threat or reduce it to an acceptable level. Where it is not possible to reduce the threat to an acceptable level, the professional accountant in public practice shall terminate the client relationship.
- ¶300.5 The Task Force proposes a change to refer to established whistle-blowing procedures within the organization.
- ¶300.6 The Task Force proposes strengthening this paragraph to refer to persistent aggressive earnings management or balance sheet valuations.
- ¶300.15 The Task Force proposes modifying this paragraph to require a professional accountant in business who believes that there is unethical behavior in the organization to discuss the matter with the appropriate level of management and then escalate if the response to the matter is not appropriate.

**Action Requested**

IESBA members are asked to consider the proposed revisions to other sections of the Code.

**Next Steps**

The CAG meets on March 5, 2012. These agenda papers have been included in the CAG materials and the decisions of the IESBA will be presented at the CAG meeting. The Task

Force will meet on March 20, 2012 to discuss the input from CAG members and will revise the document accordingly.

Assuming that the Task Force is able to address all responses from the IESBA and from CAG members, the Task Force requests that the IESBA hold a conference call in April to approve the document for exposure. The Task Force recommends this approach so that comments on exposure can be discussed by the IESBA at its October meeting. If the exposure draft is approved at the June meeting it will not be possible to have a meaningful discussion of comments at the October meeting.

### **Material Presented**

Agenda Paper 3	This Agenda Paper
Agenda Paper 3-A	Sections 225 and 360 Requirement (clean)
Agenda Paper 3-B	Sections 225 and 360 Requirement (marked-up from October 2011 draft)
Agenda Paper 3-C	Sections 225 and 360 Expectation
Agenda Paper 3-D	Sections 225 and 360 Task Force Majority Position
Agenda Paper 3-E	Proposed Changes to other Sections

### **Action Requested**

1. IESBA members are asked to address the questions set out in the agenda paper.

## **Appendix**

### **Factors supporting a Requirement to Disclose and a Right to Disclose**

#### *Factors to Support 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 ultimate determination of whether it is in the public interest to take action against those who committed the act should be made by an appropriate authority and not the professional accountant, 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.

#### *Factors to Support 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.