Agenda Item 2-A

Responding to a Suspected Illegal Act—Issues Paper

A. Background

1. At the June 2013 meeting, the Board considered a straw man setting out an alternative approach to responding to a suspected illegal act (SIA) that would not mandate disclosure of SIAs to an appropriate authority for both professional accountants (PAs) in public practice and PAs in business (PAIBs). The Board tentatively agreed the following:

   - The Code should grant an explicit permission for PAs to override the duty of confidentiality under the Code and disclose a SIA to an appropriate authority in the appropriate circumstances.
   - The focus of the proposed Sections 225 and 360 should be to provide general guidance to support PAs in public practice and PAIBs, respectively, in responding to a SIA, as opposed to prescribing detailed process requirements for responding to such a matter.
   - The provisions applicable to PAs in public practice should all be contained in Section 225 but it should be clear which provisions are applicable when the client is an individual as opposed to an entity, and which provisions are applicable when the client is an audit client and when it is not.
   - The types of SIA that should be subject to disclosure should not be limited to the PA's expertise.
   - The Task Force should further explore options regarding disclosure to an appropriate authority in the case of audits of public interest entities (PIEs) where the legal framework affords protection.
   - The proposed thresholds for actions, including the public interest test for disclosure to an appropriate authority (subject to consideration of the need for further guidance on the meaning of "public interest"), generally are appropriate in the context of the voluntary disclosure.
   - Documentation should not be mandated but encouraged. In addition, guidance should be developed to explain why documentation can be helpful to PAs in those circumstances.
   - The proposed approach to Section 360 with respect to PAIBs appears generally appropriate but conforming changes may be needed based on changes to Section 225.

2. The Task Force has made further changes to the straw man in response to the Board comments. The key matters the Task Force wishes to bring to the Board's attention are discussed below.

B. Alignment with ISA Terminology

3. When the Board started discussing this project in October 2009, it focused on developing guidance to support a PA in responding to a suspected fraud or illegal act that he or she has encountered. The Board subsequently considered the difference between a fraud and an illegal act, and agreed that a fraud is an illegal act. The Board therefore determined that the project should address SIAs.

4. In continuing to reflect on the straw man, the Task Force felt that it would be confusing to continue to use the term "suspected illegal act" when the definition of that term is virtually identical to the

definition of "non-compliance" with laws or regulations in International Standard on Auditing (ISA) 250.[1] Indeed, the starting point for the definition of a SIA in the exposure draft[2] (ED) was the definition of "non-compliance" in ISA 250.[3] While there had been a suggestion in one of the earlier discussions with the CAG[4] that the guidance to be developed in this project should not conflict with the ISAs, it does not appear from a review of the minutes of past Board discussions on this project that the Board had previously considered aligning the SIA terminology with that used in the ISAs.

5. The Task Force believes that there would be benefit in making this alignment. Apart from avoiding the potential confusion that may arise from using different terminology in the Code for a concept that is effectively defined identically in the ISAs, doing so would more appropriately capture the idea that the provisions in Sections 225 and 360 address matters that are broader than just the law. Further, proposed Section 225 in the straw man maps to ISA 250 to a large degree and picks up where it ends, and therefore using the same terminology would support this closer alignment.

6. The Task Force also felt that there would be a number of other advantages, including the following:

   - Aligning terminology would help respond to a number of concerns from respondents to the ED and leadership of the International Auditing and Assurance Standards Board (IAASB) about the need to minimize differences with ISA 250.
   - Using the ISA terminology of "identified or suspected non-compliance with laws or regulations" throughout would help address the concern about whether the proposals are still only referring to "*suspected* illegal acts" at the disclosure stage. At the same time, this would eliminate the need to over-engineer the PA's response process by calibrating the precise thresholds at which specific actions would be called for.
   - The potential for complications, and therefore significant delay in finalizing this project, would be minimized as the Board seeks to further its discussions with the IAASB on the revised proposals.
   - The focus on "illegal acts" may obscure the fact that any form of non-compliance with laws or regulations identified in the performance of a professional service or activity should be brought to the attention of the client or employing organization.

7. Accordingly, the Task Force proposes changes to the straw man to conform terminology to the ISAs.

---

[1] ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, defines "non-compliance" as follows:

> 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.

[2] August 2012 exposure draft, *Responding to a Suspected Illegal Act*

[3] See minutes of the February 2011 IESBA meeting

[4] See minutes of the September 2011 IESBA CAG meeting

Matters for Consideration

1. IESBA members are asked whether they support the Task Force's proposal above and the related changes to the straw man.

C. **Disclosure in the Case of an Audit of a PIE**

8. At the June 2013 meeting, the Board explored whether to include a specific provision in Section 225 to deal with disclosure of a SIA to an appropriate authority in the case of an audit of a PIE where the legal framework affords protection for disclosure. The Task Force tentatively floated two options with respect to disclosure in this situation, i.e., an expectation and a requirement, subject to the following further conditions:

   (a) The matter is material to the financial statements;

   (b) There is an appropriate authority to receive the information; and

   (c) The client has not already adequately disclosed the matter to an appropriate authority.

9. The Task Force has further reflected on these options in the light of the Board discussion. The Task Force firstly considered the option of requiring disclosure in particular circumstances. The Task Force felt that establishing an outright requirement, even in the limited circumstances circumscribed by the above conditions, would run up against several of the same fundamental concerns respondents had raised on the ED. Chief among those is the argument that a disclosure requirement is a matter that can only be properly addressed by legislators or regulators at the national level as only they, and not the Code, will be able to operationalize such a requirement in the context of the specific legal and regulatory frameworks of their jurisdictions. In addition, an outright requirement would raise the issue of how PAs should resolve the potentially complex interactions between a requirement in the Code and national laws and regulations.

10. The Task Force also felt that the option of an expectation, coupled with the permission to override confidentiality, could give rise to the same question that was raised by a number of respondents to the ED as to whether this would mean a de facto requirement to disclose. In particular, an expectation might be thought to create a moral obligation on the PA, such that if the PA does not disclose the PA would be falling short of the standard of professional conduct expected by the Code. To this extent, the PA might even be thought to be in breach of the Code.

11. Given the above and the remit from the Board to evaluate the possibilities, the Task Force's preference would be that the Board consider the merits of establishing a *presumption* (which can be rebutted) that disclosure will be made in certain specific circumstances. A presumption would provide the PA with the ability to determine not to disclose if non-disclosure can be justified in the circumstances. The Task Force notes that the concept of a rebuttable presumption is already established in the professional literature – specifically, ISA 240 requires auditors to evaluate certain matters based on a presumption that there are risks of fraud in revenue recognition but allows for the auditor to conclude that the presumption is not applicable in the particular circumstances of the engagement.[5]

[5] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 26

12. For the alternative of a presumption to set a robust standard, the Task Force believes it would be necessary for the presumption to be accompanied by a documentation requirement should the PA identify valid reasons not to make disclosure in the circumstances. The Task Force has proposed relevant text in paragraphs 225.22 and 225.26 in the revised straw man to illustrate how this notion would be articulated. In addition, for there to be proper conditions for the presumption to exist, the Task Force believes a tightening of the legal protection condition would be necessary – specifically that the PA should be satisfied that the legislation or regulation that is providing the protection is sufficiently established to protect the PA from civil or criminal liability (see paragraph 225.22(d)).

13. The Task Force also discussed the need to include materiality as one of the preconditions. As the presumption that disclosure will be made would follow from the PA's evaluation of the gravity of the matter to determine whether disclosure would be in the public interest, the Task Force felt that materiality may appear to be an unnecessary condition. The Task Force, however, recognizes that materiality is a well-established concept in an audit of financial statements and is well understood by auditors. On balance, therefore, the Task Force proposes that this precondition be retained to assist PAs in judging when they would face situations in which there could be a presumption of disclosure (see paragraph 225.22(a)).

Matters for Consideration

2. Do IESBA members support including a specific provision in Section 225 to establish an appropriate disclosure standard in the case of an audit of a PIE?

3. If so, do IESBA members agree that the Task Force's preference of a presumption as described above would be the most appropriate option?

D. Clarity of Application of Section 225

14. Pursuant to the June 2013 Board discussion, the Task Force has reflected on whether there is sufficient clarity regarding the application of the Section 225 provisions in the different circumstances where the client is an individual vs. an entity, and where the client is or is not an audit client. Having reconsidered the section, the Task Force believes that it would be unnecessary to make structural or other changes to the section for this purpose as the provisions can clearly be adapted according to whether the client is an individual or an entity, and whether the client is an audit client or not.

Matter for Consideration

4. Do IESBA members agree with the Task Force's view above?

E. Documentation

15. Pursuant to the June 2013 Board discussion, the Task Force has developed guidance to explain why documentation would be helpful to the PA (see paragraphs 225.25 and 360.21). Some Board members had suggested considering placing such guidance elsewhere in the Code given the more general nature of the guidance.

16. The Task Force has considered this matter and proposes that the guidance be retained in proposed Sections 225 and 360 for the time being as it is especially relevant to those sections. The Task

Force believes that there would be an opportunity under the Structure of the Code initiative to consider in due course the placement of the documentation provisions in the Code in a more holistic manner.

Matters for Consideration

5. IESBA members are asked whether they agree with the proposed guidance and its placement in the proposed Sections 225 and 360.

F. Changes to Other Sections

17. The Task Force has reconsidered, in the light of the ED comments, the changes that were proposed to a number of other sections of the Code in the ED. The Task Force's proposed changes to these other sections as amended in the ED are set out in Agenda Item 2-D.

18. One specific comment from a respondent[6] that the Task Force would like to bring to the Board's attention is the following:

> Paragraphs 210.9 through 210.13 of the Code address changes in professional appointments and refer the predecessor accountant to the client confidentiality provisions (section 140) of the Code. The client confidentiality provisions include proposed amendments which refer to the proposed suspected illegal acts disclosure provisions. However, it is not clear whether the predecessor accountant has a responsibility to disclose suspected illegal acts to a possible successor accountant in addition to disclosure to an appropriate authority. We suggest that any such obligation should be clarified, preferably within paragraphs 210.9 to 210.13.

19. The Task Force notes that the Code currently does not impose any obligation on the outgoing PA in public practice to communicate to the incoming PA any professional reasons why the outgoing PA is resigning from the client relationship. The Task Force recognizes that the nature and extent of any communication between outgoing and incoming PAs have to date largely been a matter of custom and general practice at the national level. Further, the Code already acknowledges in Section 210 that any communication between outgoing and incoming PAs will generally be subject to client permission and any applicable law or regulation governing such requests:

> 210.14: A professional accountant in public practice will generally need to obtain the client's permission, preferably in writing, to initiate discussion with an existing accountant. Once that permission is obtained, the existing accountant shall comply with relevant legal and other regulations governing such requests. Where the existing accountant provides information, it shall be provided honestly and unambiguously. …

20. The Task Force considered, as a fundamental matter, whether it would be appropriate for the Code to impose some degree of obligation, or for there to be at least an aspiration in the Code, for the outgoing PA to communicate to the incoming PA relevant information where the outgoing PA is resigning from the client relationship because the client has not appropriately responded to a SIA. The Task Force felt that if such communication could be achieved, it could potentially result in a

[6] CICA (see ED comments on Section 210 in Agenda Item 2-D)

more effective outcome in terms of an appropriate client response to the matter than what might be achieved through the operation of law or regulation.

21. The Task Force, however, came to the view that communication between outgoing and incoming PAs is a very complex issue. In particular, given the potentially complex interactions with national law or regulation, the Task Force felt that it would be difficult to establish a communication requirement between outgoing and incoming PAs in the Code that would be capable of global application. Nor would it be appropriate, for purposes of this project, to seek to address such communication in any other ways in the Code beyond the existing provisions in Section 210 given that the topic of communication between outgoing and incoming PAs goes beyond responding to a SIA. Accordingly, the Task Force believes that this communication matter should continue to be dealt with as a matter of custom and practice at the national level.

Matters for Consideration

6. IESBA members are asked whether they agree with the Task Force's proposals in Agenda Item 2-D?

7. Do IESBA members agree that this project should not seek to establish any specific communication provision between outgoing and incoming PAs in the Code with respect to responding to a SIA?

G. Proposed Section 360 – PAIBs

22. The Task Force has generally conformed Section 360 to the changes proposed in Section 225.

Matter for Consideration

8. IESBA members are asked for any comments on the changes proposed to Section 360.