

December 19, 2012

IESBA Technical Director

Dear Ken,

Small and Medium Practices (SMP) Committee Response to the Exposure Draft (ED), *Responding to a Suspected Illegal Act*

Introduction

The SMP Committee is pleased to respond to the IESBA on this ED.

The SMP Committee is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small- and medium-sized entities (SMEs). The constituents of the SMP Committee are small and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMP Committee have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies from 18 countries from all regions of the world.

General Comments

Maintaining trust in the accounting profession upholding the public interest is of paramount importance and we commend the IESBA on its willingness to tackle this sensitive and complex topic.

The contribution of SMEs to global, sustainable economic activity means that they are central to the pursuit of the public interest. SMPs rely heavily on their reputation as trusted business advisers for their (typically) SME clients, providing personalized and high-quality professional services to meet a wide range of client needs.

The ED addresses issues that are just as relevant to SMPs as they are to larger firms. It presents a number of challenges to the trusted relationship between SMPs and SMEs and balancing this with the need for the profession as a whole to uphold the public interest is not straightforward.

Given the wide range of jurisdictional differences in terms of levels of legal protection available, the existence, approach and rigor of enforcement agencies, and differing notions of the public interest, we have significant concerns that professional accountants and their clients following the proposed new requirements of the Code would in many cases face significant exposure to litigation, with potentially severe consequences. Furthermore, in the absence of an effective legal system that has the power and resources to effectively deal with suspected illegal acts, protect the party reporting such an act and prevent inadvertent “tipping-off” of potential perpetrators, the proposed actions on the part of professional accountants may fail to have the desired effect and, indeed, could even prove detrimental. In short, some jurisdictions may simply not yet be ready to adopt such requirements. On balance, when there are no



legal provisions to the contrary in a particular jurisdiction, we believe that the only workable proposals are for the Code to provide for professional accountants, whether they be in business or in practice, to have a right, but not a duty, to report illegal acts and matters in the 'public interest' to authorities outside the entity. We believe that 'rights' that are expected to be exercised are in fact obligations. Anything more poses a significant risk that the proposals will be widely ignored.

These comments and our specific comments below reflect a majority, rather than unanimous, view of the SMP Committee. A minority of members are wholly opposed to the proposals. These members are not a homogenous group and come from jurisdictions at different stages of economic development.

Rationale

The proposed new sections 225 and 360 of the Code may add significantly to the obligations of professional accountants, both in respect of existing ethical requirements and law and regulations and it is therefore important that professional accountants have a clear understanding of the rationale behind such additional obligations and their likely benefits. If and when changes to the Code resulting from this ED are agreed, we encourage the IESBA to include an explanation of why the new sections of the Code are proposed in the Basis for Conclusions.

Presentation

We are mindful of the issues previously raised by the IESBA's SME/SMP Working Group concerning the complexity and length of the Code, and are encouraged that the IESBA is actively exploring ways in which the Code could be reformatted.

We acknowledge the need for the proposed new sections 225 and 360 to fit with the existing format of the Code but these sections could and should convey more succinctly the essence of the proposals. In particular, we believe that if the IESBA were to proceed with this project then there would be scope to make it easier for the reader to focus attention on the requirements, the escalation process, the duties and rights, and the contrast between the different approaches to be followed, depending upon whether the client is an audit client or not. For example, inclusion of a visual aid such as a flow chart or decision tree could neatly encapsulate the substance of the proposals.

To help users navigate the various legal considerations which prevail throughout the ED, and which may vary significantly from jurisdiction to jurisdiction, it would be helpful for the proposed new sections to refer to the relationship between the Code and local legal requirements, as set out in the Preface to the Code. Whilst we acknowledge that the Preface holds true over all sections of the Code, the particular subject matter of this ED amplifies the need for the reader to be aware of the content of the Preface. This could easily be done by either a new opening paragraph to sections 225 and 360 or by way of a footnote to both sections, referring the reader back to the Preface.

Public Interest

We feel it important to stress the careful balance to be struck between the interests of the public, the client and the professional accountant. We believe that the public interest is best served by a strong economy driven by SMEs having access to the best business advice available to grow their business. SMEs will only seek advice from professional accountants where they can be assured of a trusted advisor



relationship where they are free to share information with their advisor and can trust them to maintain confidentiality in their dealings. In this context, we fear that uncertainty about the type of matters as well as the circumstances under which professional accountants would potentially be required to report any suspected illegal acts to external authorities as well as who would carry the costs of such additional work could drive potential clients to seek the services of accountants or other professionals who are not subject to the IESBA Code. If the trusted advisor relationship is broken SMEs and personal clients will not utilize the services of a professional accountant. It is not in the public interest to prompt these clients to second rate business advisors because their professional accountant cannot be trusted with their confidences.

Specific Comments

1. ***Do respondents agree that if a professional accountant identifies a suspected illegal act, and the accountant is unable to dispel the suspicion, the accountant should be required to discuss the matter with the appropriate level of management and then escalate the matter to the extent the response is not appropriate? If not, why not and what action should be taken?***

We believe the term "suspected illegal act" needs to be more clearly defined if professional accountants are to properly evaluate a given situation and, if appropriate, take further action. In the absence of a clearer definition we doubt whether professional accountants will be able to take the appropriate action. "Suspicion" in particular is not only fundamental to the ED but also has serious potential legal implications. Professional accountants in SMPs may be generally more exposed than those in larger firms, given the likely absence of a formal hierarchy within the firm and/or the client.

Subject to the IESBA defining and providing further guidance around the word "suspicion"¹ within the context of the ED, in principle we agree that if a professional accountant identifies a suspected illegal act, and the accountant is unable to dispel the suspicion, the accountant should be required to discuss the matter with the appropriate level of management and then escalate the matter within the entity to the extent the response is not appropriate.

Taking reasonable steps to confirm or dispel suspicion requires further elaboration. For example, the effort required should be proportional to the likely nature and extent of the issue, recognizing the inherent risk of missing items which appear to be minor at first sight, but which later prove otherwise. Then there is the issue of who will pay for the additional work: clients may be reluctant to pay unless they have an interest in uncovering illegal behaviour within their entities and may not want their accountant to act on every suspicion at potentially disproportionate cost. This may prompt the client to turn to other professionals.

It is important to clearly articulate the fact that investigations determining whether there are grounds for the suspicion could result in 'tipping off' the perpetrator and/or tainting forensic evidence. Those

¹ For example, in the UK, case law suggests that suspicion is a state of mind more definite than speculation, but falls short of knowledge based on evidence. It must be based on some evidence, even if that evidence is tentative - simple speculation is not sufficient grounds to form a suspicion. Similarly, a general assumption that low levels of crime (e.g. not declaring all cash takings) are endemic in particular industry sectors does not amount to reasonable grounds for suspicion of particular clients operating in that sector. [Taken from the UK CCAB's *Anti-Money Laundering Guidance for the Accountancy Sector*].



to whom the report is made may be parties to the act. The draft wording addresses the issue of doubts about whether the potential reportees are involved but does not otherwise seem to consider the possibility that the accountant simply may not be able to confirm or dispel suspicion.

Paragraphs 225.6-8 seem to have medium sized / large audit clients in mind rather than smaller entities, who may lack formal governance structures thus preventing any meaningful escalation of reporting through the entity. For example, a sole proprietor may have limited staff, if any, minimal governance and possibly only the proprietor as management. Perhaps a way of handling this for smaller entities with only one level of management is for the code to provide for something along the lines of section 225.19 which deals with clients who are individuals. Another suggestion would be a section or paragraphs that address “Considerations for smaller entities”, similar to that used in the International Standards on Auditing.

Finally, we wish to stress that professional accountants may lack the training, authority or rights of access to facilitate the detection of illegal acts, which, by their very nature, are typically perpetrated so as to make them difficult to detect. Whilst an audit of financial statements performed pursuant to ISA requires the auditor to exercise professional scepticism and to perform specific procedures in consideration of the potential for fraud, an audit should not equate to a forensic audit such as might be needed as part of a thorough investigation by the authorities. Professional accountants in public practice who provide services to non-audit clients and professional accountants in business will generally also lack the forensic accountant’s means and authority to pursue any suspicions they may have.

2. ***Do respondents agree that if the matter has not been appropriately addressed by the entity, a professional accountant should at least have a right to override confidentiality and disclose certain illegal acts to an appropriate authority?***

We agree with a right to disclose (notwithstanding any legal requirements around the need to maintain confidentiality), which professional accountants should be encouraged to exercise where they consider that the public interest in disclosure outweighs their professional duty of confidence. However, if the professional accountant is then ‘expected to exercise’ the right to disclose, the wording appears to be trying to impose a requirement in a roundabout manner.

To prevent the professional accountant being unduly exposed, reporting outside the organization due to the lack of an appropriate response is likely only to be undertaken after appropriate consultation with legal counsel. This is costly for SMPs, both directly in terms of legal fees, and indirectly, through increased professional indemnity insurance premiums for example, which might even threaten the viability of the practice.

Finally we wish to reiterate that, since client confidentiality is fundamental to the relationship between a professional accountant and their client, robust enforceable criteria need to be established as to when confidentiality may be overridden. We question whether the proposal is sufficiently clear so as to give the necessary confidence, let alone legal certainty, to clients, potential clients and professional accountants in this regard. In many jurisdictions client confidentiality and exceptions thereto are governed by legislation.



3. ***Do respondents agree that the threshold for reporting to an appropriate authority should be when the suspected illegal act is of such consequence that disclosure would be in the public interest? If not, why not and what should be the appropriate threshold?***

We do not believe that there yet is sufficient common understanding of what is in the 'public interest' for these proposals to be mandated. Some consider tax evasion to be in the public interest, irrespective of the sums involved, others do not, whereas others may take a different view depending on the sums involved. Despite the guidance offered in paragraph 225.11, it is not sufficiently clear what the IESBA means by "public interest" or where the threshold for reporting would be.

Matters specific to professional accountants in public practice (Section 225 of the Code)

4. ***Do respondents agree that the standard for a professional accountant in public practice providing services to an audit client should differ from the standard for a professional accountant in public practice providing services to a client that is not an audit client? If not, why not?***

In principle at least the standard for a professional accountant in public practice providing services to an audit client should not differ from the standard provided to a non-audit client. The basic public interest/professional duty of confidence equation is the same albeit the factors to be considered by professional accountants in different roles may be different. Also, differential standards would devalue the services rendered by a professional accountant to a non-audit client (i.e. would elevate the status of auditor). In addition, other professions do not differentiate (i.e. you do not expect a reduced standard of care from a family physician than you do a cardiologist). However, there is an important distinction between that of an auditor and that of a business advisor. The auditor is perceived by the public as a "watch dog", independent of the client and with a responsibility to act in the public interest. This perception is reinforced by statutory obligations in many jurisdictions, On the other hand the business advisor will likely be seen by the public as an advisor to the business who owes a primary duty of care and confidentiality to the client. The trusted advisor relationship is evident in the business advisor case but not in the auditor case. In short, the public may have different expectations of the business advisor and the auditor such that the business advisor is expected to favor the client while the auditor is expected to favor the public interest and the users of the financial statements.

We also suggest a slight expansion to the penultimate sentence in paragraph 225.5, to the effect that the professional accountant may also wish to consult with a legal advisor under the protection of legal privilege. We acknowledge that this same text is subsequently included in paragraphs 225.8 and 225.22; however we believe that this repetition may be helpful in highlighting a further option available to practitioners, particularly SMPs, who may not have "others within the firm" or be part of a network.



5. ***Do respondents agree that an auditor should be required to override confidentiality and disclose certain suspected illegal acts to an appropriate authority if the entity has not made adequate disclosure within a reasonable period of time after being advised to do so? If not, why not and what action should be taken?***

We do not agree that an auditor should be required to override confidentiality and disclose certain suspected illegal acts to an appropriate authority if the entity has not made adequate disclosure within a reasonable period of time. This is not because we do not believe that this is not the 'right thing to do', rather it is because, in addition to the reasons set forth on the first page of this letter, the legal realities in many jurisdictions where there are no legal or regulatory protections mean that such a requirement would threaten to put many SMPs in the position of choosing between following these requirements, and being exposed to legal actions brought by clients and watching clients move to non-professional accountants who are not subject to the same requirements. This poses a significant risk that such a requirement would be widely disregarded.

6. ***Do respondents agree that a professional accountant providing professional services to an audit client of the firm or a network firm should have the same obligation as an auditor? If not, why not and what action should be taken?***

We agree on the basis that the public will likely have an expectation that such matters be drawn to the attention of the audit partner by the firm. However, we also refer to our response to Q4 in which we discuss the different relationships and duty of care aspects involved.

7. ***Do respondents agree that the suspected illegal acts to be disclosed referred to in question 5 should be those that affect the client's financial reporting, and acts the subject matter of which falls within the expertise of the professional accountant? If not, why not and which suspected illegal acts should be disclosed?***

Subject to our response to question 5 and our following comments, disclosure should only be expected if it relates directly to engagement subject matter, is material, and is within the expertise of the professional accountant. A professional accountant working as or for an SMP or a professional accountant in business may have a broad role which would widen the scope of the new sections of the Code far more than what we think is intended. For example, a CFO (either employed by the company or outsourced to a SMP) may be responsible for areas that fall largely or completely outside the ambit of financial reporting such as, tax, treasury, human resources, occupational health and safety, business systems and process, IT, and the environment.

Question 5 relates to an auditor disclosing matters to an external authority under certain circumstances. We note that the ISAs already deal with this to some extent and we question whether the ED is compatible with the ISAs, in particular the requirements of and approach taken by ISA 250. Hence, we suggest that the IESBA work closely with the IAASB on this matter. Most especially we note that ISA 250 explains the inherent limitations of an audit in this context, differentiates between different categories of legal provisions, and requires the auditor to consider the need to obtain legal advice in certain situations – but does not require the auditor break client confidentiality. The ED does not mention inherent limitations nor does it provide any form of de minimis consideration. Taken together, these omissions mean that the ED risks giving the impression that all suspected illegal acts, irrespective of their probable impact, will be followed



through and potentially may ultimately be reported to the authorities. Clearly this is not the intent. Another major difference in the IESBA's and the IAASB's approach, which gives us grounds for concern, is that while the ISAs follow a risk-based approach and look at material matters the ED appears to require every suspicion to be followed up in the first instance before the professional accountant is required to consider the potential magnitude or public interest implications. Paragraph 225.5 does not even foresee the professional accountant to dismissing matters of a minor or insignificant nature. Furthermore, we wonder whether the reasonable steps to be taken in paragraph 225.5 is equivalent to the concept of reasonable assurance in the ISAs, and are unclear as to the level of suspicion that an accountant is required to reach, for example in cases where little firm evidence exists to allay or confirm the suspicion.

8. ***Do respondents agree that a professional accountant providing professional services to a client that is not an audit client of the firm or a network firm who is unable to escalate the matter within the client should be required to disclose the suspected illegal act to the entity's external auditor, if any? If not, why not and what action should be taken?***

If the matter has a bearing on the subject of the audit, then it would clearly be appropriate for the accountant to be encouraged to inform the auditor. However, for the reasons set out in our response to question 5, this should not be mandated. We note that many SMEs are not audited and so this avenue of discharging an obligation to report would not be available to a professional accountant.

9. ***Do respondents agree that a professional accountant providing professional services to a client that is not an audit client of the firm or a network firm should have a right to override confidentiality and disclose certain illegal acts to an appropriate authority and be expected to exercise this right? If not, why not and what action should be taken?***

We agree in principle with a right (subject to the law). Indeed, the accountant should be encouraged to make disclosure where he or she believes that the public interest in disclosure outweighs the professional duty of confidence. However, we have major concerns with the wording as drafted. It is quite unclear what a 'right' that the accountant is 'expected to exercise' actually means. We assume that it is not intended to be an obligation, given the different wording used elsewhere, but it appears to be more than encouragement, rather an obligation by a roundabout route. It is vital that the wording is such that it is not interpreted as an obligation.

10. ***Do respondents agree that the suspected illegal acts to be disclosed referred to in question 9 should be those acts that relate to the subject matter of the professional services being provided by the professional accountant? If not, why not and which suspected illegal acts should be disclosed?***

Please refer to our response to question 7.



Matters specific to professional accountants in business (Section 360 of the Code)

11. ***Do respondents agree that a professional accountant in business who is unable to escalate the matter within the client or who has doubts about the integrity of management should be required to disclose the suspected illegal act to the entity's external auditor, if any? If not, why not and what action should be taken?***

Please refer to our response to question 8.

However, it is unclear how the escalation process set out in paragraph 360.6 would end in the situation where the professional accountant may be in an SME with no additional layers of management through which the issue can be escalated, and the SME in question does not have an external auditor. Given the continuing increase in audit exemption thresholds and the resultant increasing numbers of entities dispensing with audit, such a situation may become more likely in years to come.

We understand from reading the Explanatory Memorandum that, in such situations, the IESBA would expect the professional accountant to default to exercising their right to report to an appropriate authority (paragraph 360.9), although this is not entirely clear from reading the ED.

We suggest the IESBA considers this type of requirement more thoroughly before it finalizes changes to the Code. For example, without provisions to safeguard the interests of the individual professional accountant, (whistleblower protection etc.) we have some doubts whether the provision is practicable.

12. ***Do respondents agree that a professional accountant in business should have a right to override confidentiality and disclose certain illegal acts to an appropriate authority and be expected to exercise this right? If not, why not and what action should be taken?***

Please refer to our response to questions 9 and 11.

13. ***Do respondents agree that the suspected illegal acts to be disclosed referred to in question 12 above should be acts that affect the employing organization's financial reporting, and acts the subject matter of which falls within the expertise of the professional accountant? If not, why not and which suspected illegal acts should be disclosed?***

Per question 7 in principle, although we believe such delineation could be more subjective for a professional accountant in business and, in some situations, inappropriate. For example, the accountant may not have expertise and/or responsibilities specifically related to financial reporting within their organization.

Other

14. ***Do respondents agree that in exceptional circumstances a professional accountant should not be required, or expected to exercise the right, to disclose certain illegal acts to an appropriate authority? If not, why not and what action should be taken?***

We agree, though in essence the exceptional circumstances may in fact be part of the determination of whether disclosure is in the public interest. Requiring a professional accountant to disclose information related to suspected illegal acts even in circumstances when that individual's



physical safety or that of others is likely to be threatened would seem untenable. We wonder whether the use of the word “exceptional” is a very high bar that is likely to be difficult for a professional accountant to justify when not in the position to know all of the facts and/or when there is no certainty in the law relating to the matter. This seems to be more the province of a lawyer rather than an accountant.

15. ***If respondents agree that in exceptional circumstances a professional accountant should not be required, or expected to exercise the right, to disclose certain illegal acts to an appropriate authority, are the exceptional circumstances as described in the proposal appropriate? If not, how should the exceptional circumstances be described?***

The fundamental principles in the code already require accountants to put duty ahead of self-interest. Exceptional circumstances should focus on significant threats to personal well-being, or of damage to the business or to personal property, or of financial ruin, all with due regard to the likelihood of protection by the authorities.

In such circumstances, we also propose allowing the professional accountant the option to disassociate from the client, or employer, where permitted by law.

16. ***Do respondents agree with the documentation requirements? If not, why not and what documentation should be required?***

The proposals seem to be disproportional given that there is no de minimis threshold at the start of the process. It should be sufficient to advocate the maintenance of ‘appropriate’ documentation, which would likely vary between jurisdictions depending on local legal and other environmental factors. This would also deal with a concern that, if the accountant is subject to legal action in respect of a reported suspicion, the documentation may be legally discoverable in some jurisdictions.

If the professional accountant’s judgement proves to be wrong and the client takes legal action for damages caused, then the professional accountant has in effect just documented the case of the prosecutor. Given the litigious climate that many accountants find themselves operating and the increase in class actions, there is a real risk that Professional Indemnity insurance may become unobtainable in the future.

17. ***Do respondents agree with the proposed changes to the existing sections of the Code? If not, why not and what changes should be made?***

We agree.

18. ***Do respondents agree with the impact analysis as presented? Are there any other stakeholders, or other impacts on stakeholders, that should be considered and addressed by the IESBA?***

We believe that the impact analysis should be developed further to evaluate the impact of the proposals on the operational efficiency of the professional accountants or on the cost of their services. The analysis is also silent on how the conflict between the legal obligations and enhanced ethical obligations can be resolved, thus minimizing the true impact and cost, in particular to SMPs. We suggest a more comprehensive evaluation of the proposals on SMPs and



on professional accountants working in emerging economies. In addition, we believe the impact of loss of confidentiality to be significantly greater than medium.

Other Matters

As one can see from our responses to the questions above we have identified a number of issues and concerns which we feel demand further consideration before the Code is finalized. Since the public interest is central to this ED we suggest that the IESBA might wish to conduct an impact analysis of the proposals to determine the likely net benefits or otherwise of the proposals including the impact on client relationships.

For the avoidance of doubt it might be helpful to clarify that the proposed revision to the Code applies to known as well as suspected illegal acts.

Concluding Comments

We hope the IESBA finds this letter helpful in addressing a very challenging and sensitive topic. We are committed to helping the IESBA in whatever way we can and we look forward to strengthening the dialogue between us.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

A handwritten signature in black ink, appearing to read 'Giancarlo Attolini', written over a horizontal line.

Giancarlo Attolini
Chair, SMP Committee