

December 5, 2012

Via IEASBA website

RE: Invitation to comment on *Responding to Suspected Illegal Acts*

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on your recent Invitation to Comment on your proposal entitled *Responding to Suspected Illegal Acts*.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Contributors:

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Responses to Specific Questions in the Invitation to Comment

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?

In general, the contributors believe this proposed standard relates to professional accounting firms, rather than individuals. Many of the requirements can only be met by those at the highest levels of a firm, such as conducting an inquiry to confirm the existence of the illegal act, and discussing this act with the appropriate level of management. The actions The Exposure Draft recommends seem, in general terms, appropriate for a managing partner of the firm to perform, perhaps with the assistance of those at lower levels.

More specifically, we agree that discussing suspected illegal acts with a member of client management at least one level above the perpetrator, as recommended in 225.6, is appropriate. This step is consistent with academic research concerning effective reporting of wrongdoing within an organization because it allows the auditor to inform a client representative with authority to take action (Near and Miceli 1985; Grant 2002; Miceli et al. 2009).

However, this leaves the question as to what the individual professional accountant should do, if he or she identifies an illegal act by a client which is not addressed appropriately by the client and their firm. The contributors do not believe an individual in these circumstances can meet the requirements of this proposed standard. For example, an employee of a firm typically cannot “consider whether it is appropriate, based on all relevant facts and circumstances, to terminate the professional relationship with the client” or “take reasonable steps to confirm or dispel that suspicion” or “discuss the matter with the appropriate level of management”.

Moreover, one contributor believes that the proposed standard does not adequately address the auditor’s responsibility to discuss suspected illegal acts within the accounting firm. While paragraph 225.5 notes that auditors may wish to consult others within the firm or anonymously with a relevant professional body, we recommend adding more guidance on this issue. For several reasons, we believe the IESBA should consider adding wording that auditors below the rank of partner should discuss a suspected illegal act with another member of the engagement team at least one level above their own rank before discussing the situation with the appropriate client personnel.

First, junior auditors are especially unlikely to have the experience necessary to evaluate the legality of questionable acts and the confidence required to effectively approach client managers about sensitive situations. Second, academic research indicates that auditors prefer to discuss ethically sensitive situations with experienced colleagues such as a partner or mentor rather than reporting anonymously to regulators (Robertson et al. 2011). Accordingly, such guidance from standards may seem natural to auditors. Third, more experienced auditors such as partners and managers typically handle “big picture” issues with the client such as negotiations over audit fees and proposed financial statement adjustments. Thus, it seems reasonable that more experienced auditors may wish to discuss sensitive issues with junior auditors who detect suspected illegal acts before addressing the situation with the client. While this last reason may be more related to a given firm’s quality control practices, it is within the purview of standards setters to provide guidance on quality control.

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?

The contributors agree in principle. This requirement is similar to the current form 8-K required disclosure of reasons for auditor resignation/dismissals, such as auditor-client disagreements. In practice, however, we do not see such disclosures often. Moreover, auditors can disclose certain illegal acts in the audit report (presumably, such a report would have an adverse opinion).

Thus, contributors feel that merely allowing disclosure is nothing new for external auditors. However, requiring is a definite step in the right direction.

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?

In principle, the contributors agree. However, we are concerned that there are currently many disclosures which the public might feel it is in their interest to know, yet relevant facts are not routinely disclosed to them. Thus, this standard is open to considerable variation in interpretation.

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?

Here the opinions of contributors diverged. One contributor feels that the public accountant providing audit services is charged with protecting the interest of the investing public. However, those providing non-audit services are not responsible to entities outside of the client. Thus, this dichotomy of expectations seems reasonable. Two other contributors felt that since reporting of illegal acts is in public interest in general, then such requirements should also apply to accountants providing non-audit services as well.

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?

Yes. This is the appropriate requirement. However, there should also be some consideration of litigation risks to the auditor and possibly instituting appropriate safe harbor protections for the auditor (e.g. an auditor cannot be sued if he/she makes this disclosure in good faith).

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?

The contributors believe that this is the appropriate requirement. Any accountant should feel morally obligated to report illegal acts that could impact others. However, we also believe this carries a greater burden for the professional accountant than for the auditor. First, they may not be experienced in making the further inquiries required to ascertain the legality or impact of the suspected act. Second, they may not have the access or authority to make the further inquiries, and thus may imperil their professional engagement if they attempt such inquiries or in subsequently discussing the issue with management. Finally, individual accountants may not have the same litigation protections as an audit firm.

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?

It is conceivable that professional accountants could discover illegal acts unrelated to financial reporting in the process of tax or consulting engagements. Thus, it is appropriate to add "the subject matter of which falls within the expertise of the professional accountant".

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?

Yes, this is the appropriate path. However, we also agree that their responsibility should not stop there, in the unlikely event that the external auditor does not respond or is complicit in the illegal act (e.g. as was the case in Enron). The accountant thus may need to report an illegal act to the appropriate security regulator (e.g. SEC or PCAOB in the U.S); however, such reporting should also be mindful of the appropriate whistle-blowing standards in a country in question.

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?

The contributors believe that this is the appropriate path. However, given the difficulties stated above and the burden this would place on the professional accountant, such reports are very unlikely to occur. Such reports are more likely to arise if appropriate whistle-blowing legislation is in place. In addition, if an accountant can frivolously be sued for defamation in a country

where he/she seeks to report an illegal act, expecting them to report such illegal acts is increasingly difficult. In other words, there has to be a well defined connection between expectations of reporting of illegal acts and legislative protections against retaliation for reporting of such illegal acts.

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?

Any concerns of illegal acts should be reported to the external auditors. Only those in which the professional accountant has expertise should be reported to external parties. Otherwise, the accountant may incur significant legal liability for reporting in areas in which he cannot defend his expertise.

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?

We do not agree. Any accountant should feel morally obligated to report illegal acts that could impact others. However, unless adequate legal protections are available to deter retaliation, the requirement to disclose imposes significant cost on the accountant in business. Indeed, the Ethics Resource Center (2012) reports that retaliation on whistleblowers is rising, even in the US where Sarbanes-Oxley Act and Dodd-Frank Act protections were legislated. Studies indicate that even those who feel an act has great impact (moral intensity) are unlikely to report the act (Taylor and Curtis 2010, Taylor et al. 2012). Thus, when that act is ultimately discovered, the accountant who did not report may be punished, rather than, or in addition to, the perpetrator. This seems to be too great a burden to place on an accountant. We believe they should be encouraged to report, and provided mechanisms to facilitate anonymous reporting, but they should not be required to report.

This also raises the question of how the accountant should report. The issue of confidential reporting should be raised. While accountants typically prefer to report internally if possible (Robertson et al. 2011), they may also feel more inclined to report if there is a confidential hotline available (Curtis and Taylor 2009, Taylor and Curtis 2010). Confidential reporting mechanisms can help to mitigate the perceived and actual risk of retaliation.

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?

This places the burden on the accountants to first attempt to resolve the issue within their organization. Indeed, most accountants prefer to follow this path (Robertson et al. 2012). However, we believe the accountant should be free to determine the most appropriate path for resolution. The accountant is in the best position to judge whether the most appropriate path is talking immediately with the external auditors, rather than subjecting oneself to possible retaliation from internal reporting. Therefore, there is no need for the qualification “who is unable to escalate the matter within the client or who has doubts about the integrity of management” above.

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?

Professional accountants in business have a wider range of knowledge regarding company activities than a professional accountant or auditor from outside. Thus, the requirement of expertise need not necessarily apply here, as long as an illegal act in question falls within purview of an accountant’s general expertise.

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. The discussion of retaliation above addresses these ‘exceptional circumstances.’ In instances in which the accountant fears retaliation for their report, they should be exempt from the requirement.

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?

Specifically, the exposure draft states “Exceptional circumstances would arise where a reasonable and informed third party would conclude that the consequences of disclosure are so severe as to justify not exercising the right to disclose for example, where there would be threats to the physical safety of the professional accountant or other individuals.” Further, it prohibits consideration of circumstances of a commercial nature for professional accountants providing services, but does not prohibit this consideration for those employed by the business committing the illegal act.

The prohibition of commercial consequences for accountants providing services to the company is appropriate, while that prohibition on the individual working for the business committing the

illegal act would not be just. The accountant providing services to the company has, or should have, many other clients and therefore many other sources of income. The accountant working for the company has only one source of income, this employer, so that losing this job would constitute a complete loss of all income. This impacts not just the accountant, but also those who depend financially on the accountant, such as his or her family. Therefore, we agree the exclusion of commercial interests for public accountants providing services, and the absence of such an exclusion for accountants working for the company.

However, the following requirement is appropriate: "If the professional accountant does not exercise this right the accountant shall consider whether to resign from the employing organization." An accountant should not remain employed by an unethical organization simply for commercial consequences, any longer than is absolutely necessary to find other employment.

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

These requirements mirror reasonable and prudent practices.

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?

The changes require the consideration of past illegal acts or questionable issues in the client continuance decision. This is appropriate.

In sections discussing professional accountants employed in business, there appears to be a conflict in the message. For example, section 300.5 states "Established ethics policies and whistle-blowing procedures that have been communicated to all employees may be useful to achieve the objective of establishing and maintaining an ethics-based culture. Such procedures help to encourage ethical behavior and increase the likelihood of senior management being alerted to a problem in time to prevent serious damage." This appears to authorize professional accountants to use anonymous hotlines to communicate the existence of illegal activities. However, section 300.15 requires "professional accountant shall discuss the matter with the appropriate level of management. If the response to the matter is not appropriate, the professional accountant shall escalate the matter to higher levels of management to the extent possible." This precludes anonymous reporting by these professionals.

The proposed changes to Section 140 address confidentiality of information obtained by the professional accountant. We suggest the IESBA add clarification to paragraph 140.7, which addresses circumstances in which the accountant may disclose confidential information. Section (a) provides guidance on situations in which the client authorizes the disclosure of information. It is unclear whether sections (b) and (c) of paragraph 140.7 discuss situations in which the accountant does not need consent from the appropriate party to disclose confidential information. The proposed standard seems to imply that client consent is not necessary under the circumstances outlined in sections (b) and (c). If this is the case, one contributor proposes

another situation in which the auditor can disclose without client consent. It seems logical that if an audit client has been sued and the plaintiff's attorneys approach the auditor, the auditor may not be able to obtain client consent to cooperate with a valid subpoena in such a case.

A second suggestion for Section 140 involves the list of situations in which the accountant can disclose information in 140.7(b)(i). We suggest the IESBA consider the insertion of more specific wording involving disclosure of documents or providing evidence in legal proceedings. Is the intent to require disclosure during all phases of legal proceedings, or should disclosure be mandated only under a valid subpoena or similar order from an authoritative body? Such wording could be similar to an exception to client confidentiality in the AICPA Code of Professional Conduct Rule 301 involving subpoenas (AICPA 2012).

Scope of the Proposed Standard

The proposed standard is unclear regarding the scope of the auditor's responsibility for illegal acts. Is the auditor responsible for detecting all possible illegal acts, or is the scope limited to illegal acts related to financial reporting? Paragraph 225.5 is the primary source of this confusion. This paragraph is somewhat contradictory in stating that the accountant does not have extensive knowledge of laws and regulations outside of the scope of the professional service involved, but the proposed statement does not include any wording that places restrictions on the type of illegal act an auditor can be reasonably expected to detect. A related issue arises in paragraph 225.10, which requires auditors to determine the severity of the illegal act. However, it does not provide any guidance on determining severity. Is it based on financial statement impact of another metric? It seems reasonable that auditors would be most able to detect illegal acts related to financial reporting.

This is an important distinction because if the intent is to include all possible illegal acts in the scope of the standard, unintended consequences are likely. For example, the auditor's engagement risk likely will increase, driving up audit fees. Further, will firms need to spend an excessive amount of time training auditors on a multitude of laws rather than focusing training efforts on more traditional audit activities such as risk assessment and detecting misstatements? If the intent is to limit the scope of this standard to illegal acts related to financial reporting, I recommend the addition of wording similar to that found in AU 317 (PCAOB 2010). This standard makes multiple references to illegal acts related to financial reporting, and provides the example of illegal acts that may arise following insider trading in AU 317.06.

Implementation of Reporting to Appropriate Authority

The contributors felt that the language of the document is unclear as to how many sources of "appropriate authority" the auditor is responsible for reporting. Certainly everything in the document is in the singular. But, for example, assume an auditor suspects an "indirect effect" illegal act relating to occupational safety that requires financial statement disclosure. On the one hand the securities regulator authority might be informed due to omission of, say, a contingent liability from the financial statements. Does a professional accountant also have a responsibility to inform an occupational safety authority in a country that has such an authority? Related there

may be various “appropriate authorities” at different levels of the government (e.g., in US state authorities).

If the singular form of “appropriate authority” means only one authority, it would seem helpful to tell accountants how to “pick one” in situations such as the above.

In particular, if an audit client discloses an illegal act in the financial statements in accordance with the provisions of paragraph 225.10 of the Exposure draft, is requirement of “disclosure to the appropriate authority” met? Guidance on the form of disclosure is needed. Moreover, does audit report disclosure of information on the suspected illegal act constitute auditor disclosure to an appropriate authority when those financial statements are filed with that authority (e.g., a securities regulator)? Or must there be another communication with that authority?

Paragraph 225.9 of the Exposure Draft provides the adequate investigation, remedial action, and appropriate steps to reduce the risk of re-occurrence criteria. Where does proper disclosure in the financial statements (for a suspected illegal act so requiring) fit in? Is it a remedial action? Or should there be a fourth bullet relating to financial statement disclosure?

Disclosure of Suspected Illegal Acts

The contributors also expressed concerns over the definition of “suspected” illegal acts, and whether disclosure of “suspected” illegal acts is in public interest. What exactly constitutes a “suspected” illegal act? What is the probability threshold for a disclosure of “suspected” illegal act (e.g. is it a likelihood of 50% or higher, i.e. “more likely than not” that an illegal act has occurred)?

Moderate Impact of Disclosures

The contributors felt that it is unclear how to define “a moderate impact” of such disclosures. Moreover, it is unclear how such “moderate disclosures” may impact client-auditor relationship.

Editorial Comment

The definition of an “audit client” appears in paragraph 225.4, well after “client” is introduced in 225.1. WE suggest integrating this definition into the first paragraph.

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