

**Meeting Location:** Marriott, Prague, Czech Republic

**Meeting Date:** September 14, 2011

## Responding to a Suspected Illegal Act

### Objectives

1. To provide input to the Task Force on the question of whether the professional accountant should have a responsibility to report externally a suspected illegal act if doing so would be in the public interest.

### Background to 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 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 guidance to the accountant on how to identify those situations and how to respond.

The Task Force<sup>1</sup> proposals were discussed by the CAG at its March 2011 meeting and by the IESBA-National Standards Setters (IESBA-NSS) at its April meeting, and again by the IESBA at its June meeting.

The Task Force met on July 17-18<sup>th</sup> to consider the input received and revised the proposed wording for a section to address professional accountants in public practice (new section 225) and professional accountants in business (new section 360). The Task Force will meet again on Sept 22<sup>nd</sup>-23<sup>rd</sup>, to consider input from CAG members and to

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

finalize its proposals. It is anticipated that the proposals will be presented to the IESBA for approval as an exposure draft at its October 17<sup>th</sup>-19<sup>th</sup> meeting.

### **Overview of Approach Taken**

The IESBA is proposing two new sections dealing with responding to a suspected illegal act. Section 225 will apply to professional accountants in public practice and Section 360 will apply to professional accountants in business. The IESBA is also proposing some conforming changes to paragraph 100.21 and Section 140 *Confidentiality*. The IESBA also proposes to strengthen Section 210 in the area of client continuance decisions.

The IESBA has developed a sequential approach to responding to a suspected illegal act for both Sections 225 and 310. There will be some differences in the approach between the two sections to reflect the differing circumstances faced by professional accountants in public practice and in business.

#### *Accountant Providing Professional Services to an Audit Client*

Section 225 will provide guidance for professional accountants who perform an audit or other professional service for an audit client of the firm, or a network firm. When information obtained in the course of providing the service which leads the accountant to suspect that an illegal act has been committed, the guidance would provide the following:

- Requiring the professional accountant to make any disclosures required by law or regulation;
- Where disclosure is not required by law or legislation:
  - Requiring the accountant to take reasonable steps to confirm or dispel that suspicion;
  - If unable to dispel the suspicion, requiring the accountant to discuss the matter with the appropriate level of management;
  - If management's response is not appropriate, requiring the accountant to escalate the matter within management. Whether the response is appropriate would be assessed based on whether (i) the matter was appropriately investigated, (ii) remedial action was taken, (iii) steps have been taken to reduce the risk of re-occurrence (e.g., additional controls or training), (iv) the entity has disclosed the matter to an appropriate authority or will do so within a reasonable period of time;
  - If the response is still not appropriate, requiring the accountant to discuss the matter with those charged with governance;
  - If the response is still not appropriate, requiring the accountant to determine the appropriate course of action to take, including whether to terminate the professional relationship with the client;
  - If the accountant determines that disclosure of the suspected illegal act would be in the public interest and the entity has not disclosed the matter, requiring the accountant to disclose the matter to an appropriate authority, when not prohibited by law. The matters to be reported are:

- Suspected illegal acts that directly or indirectly affect the client's financial reporting; and
- Suspected illegal acts, the subject matter of which falls within the expertise of the professional accountant.
- In making the determination of whether disclosure would be in the public interest, the professional accountant is required to take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances, would be likely to conclude that the public interest is best served by disclosing the matter to an appropriate authority;
- If the accountant concludes disclosure is in the public interest, the accountant shall determine whether there is an appropriate authority to receive the disclosure.

*Accountant Providing Professional Services to a Client that is not an Audit Client*

The approach taken in Section 225 for an accountant providing a professional service to a client that is not an audit client entails a similar sequential approach of escalation. The approach does not, however, require the professional accountant to disclose the matter to an appropriate authority, rather if the response to the matter is not appropriate, the accountant is required to disclose the matter to the external auditor of the entity. The auditor of the entity would then have the responsibility to take steps to confirm or dispel the suspicion, discuss with those charged with governance and, ultimately, if the auditor concludes that disclosure would be in the public interest and the entity has not disclosed the matter, disclose to an appropriate authority.

*Professional Accountants in Business*

The approach taken in Section 360 for professional accountants in business is similar to the approach taken for accountants in public practice providing professional services to an audit client. It provides that the accountant shall generally disclose the matter within the reporting lines of the employing organization and escalate the matter if it is not appropriately addressed. If the matter is not appropriately addressed, the accountant is required to report it to those charged with governance or the entity's external auditor. If the response to the matter is still not appropriate the accountant shall determine the appropriate course of action, including whether to resign from the employing organization. If the accountant determines that disclosure of the suspected illegal act would be in the public interest and the entity has not disclosed the matter, the accountant would be required to disclose the matter to an appropriate authority, when not prohibited by law.

The proposed text of Sections 225 and 360 and proposed modifications to other sections are contained in Agenda Item C-1.

**Responsibility to Disclose to an Appropriate Authority**

The Task Force has carefully considered what responsibility a professional accountant should have to disclose a suspected illegal act to an appropriate authority if the

accountant determines that disclosure would be in the public interest. The Task Force considered whether there should be a requirement/obligation to disclose or a right to disclose (i.e., if the accountant determined disclosure was appropriate it would not be a violation of the Code if the accountant made the disclosure). The Task Force has also considered whether the obligation should be the same for all professional accountants.

*Arguments in Favor of 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;
- 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 should be made by an appropriate authority and not the professional accountant, it is therefore appropriate to require disclosure to such an authority.

*Arguments in Favor of 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 appears disproportionate to establish a requirement to disclose without also being able to establish such 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 seem 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.
- The accountant may not have access to all the information to be able to make the determination of whether the act was illegal and a requirement may lead to an increase in disclosures of a frivolous nature.

After consideration, the Task Force has concluded that a professional accountant in public practice providing professional services to an audit client and a professional accountant in business should both be required to disclose a suspected illegal act to an appropriate authority, when disclosure would be in the public interest. A professional accountant in practice providing services to a non-audit client would not, however, be required to disclose the matter to an appropriate authority. Such an accountant might not have access to enough information within the company to be able to confirm or dispel the suspicion. The proposals would, therefore, require these accountants to disclose the matter to the entity's external auditor – who would then be required to confirm or dispel the suspicion and, ultimately, if the matter is not appropriately addressed disclose the matter to an appropriate authority.

To address the concern that there may not be an appropriate authority to disclose the matter to, the Task Force proposes that the guidance state:

If the professional accountant concludes that such disclosure is appropriate, the professional accountant shall determine whether there is an appropriate authority to receive the disclosure and disclose the matter to the authority.

**Action requested**

IESBA CAG members are asked to consider whether they agree with the proposal to require a professional accountant providing services to an audit client, and a professional accountant in business to disclose a suspected illegal act to an appropriate authority when the accountant determines that disclosure would be in the public interest.

**Material Presented**

Agenda Item C	This Agenda Paper
Agenda Item C-1	Proposed Wording
Agenda Item C-2	March 2011 Feedback Statement

**Action Requested**

IESBA CAG members are asked to

1. consider the questions raised in the paper, and
2. raise any other matters that they consider should be considered by IESBA prior to finalization of the exposure draft from publication.