

Responding to a Suspected Illegal Act—Issues Paper

A. Introduction

1. At the March 2013 meeting, the IESBA considered an outline of an alternative approach¹ to responding to a suspected illegal act (SIA) that would not mandate disclosure of certain SIAs to an appropriate authority for professional accountants (PAs) in public practice providing professional services to audit clients. The Board expressed support for the Task Force to explore this approach further.
2. The Task Force also sought the IESBA CAG's initial reactions to this alternative approach at the April 2013 CAG meeting. CAG representatives generally felt that this approach was worth further exploration but indicated that they would only be able to properly assess it once it has been further developed.
3. The Task Force has fleshed out this approach in the straw man shown in Agenda Item 3-B. The key proposals included in the straw man are discussed in the following paragraphs.

B. Permission to Override the Duty of Confidentiality

4. The Task Force proposes that the Code establish in Section 140² that a PA is permitted to override the duty of confidentiality under the Code in appropriate circumstances (see first line of paragraph 140.8 of Agenda Item 3-B).³ These circumstances will include those already set out in paragraph 140.7 of the Code. The Task Force, however, proposes that the Code additionally permit the PA to override confidentiality when, in the circumstances set out in proposed Sections 225⁴ and 360,⁵ the PA judges that disclosure of a SIA to an appropriate authority would be in the public interest (see paragraph 140.10).
5. The Task Force felt it important to place this permission in the context of the essential role of confidentiality as a cornerstone of the profession, a role which some respondents to the exposure draft (ED)⁶ had highlighted as being in itself in the public interest, i.e., that confidentiality serves the public interest because it facilitates the free flow of information between the PA and the PA's client or employer (see paragraph 140.7). The Task Force believes that incorporating such a statement in Section 140 sets the appropriate tone for the permission that the Code then grants for the PA to override confidentiality in the identified circumstances.
6. In reviewing Section 140, the Task Force took the opportunity to lay out in a more logical manner, and refine, the circumstances set out in paragraph 140.7 of the Code in which a PA may override confidentiality (see paragraph 140.8).

¹ See the Appendix

² Section 140, *Confidentiality*

³ Paragraph numbers hereafter refer to the straw man presented in Agenda Item 3-B unless otherwise stated.

⁴ Proposed Section 225, *Responding to a Suspected Illegal Act*

⁵ Proposed Section 360, *Responding to a Suspected Illegal Act*

⁶ August 2012 exposure draft, *Responding to a Suspected Illegal Act*

7. The Task Force believes that the alternative of a permission to override confidentiality under the Code, supported by complementary guidance as outlined below, addresses many of the fundamental concerns that were expressed by respondents regarding the key proposals in the ED.

Matters for Consideration

1. IESBA members are asked whether they support the Task Force's proposals above and the changes proposed to Section 140 as shown in the straw man.

C. Ethical Obligation to Respond to a SIA

8. At the March 2013 meeting, the Board generally reaffirmed its view that a PA has an ethical obligation to respond to a SIA and not turn a blind eye to it, given the potential for certain SIAs to have serious consequences for the public. Given the importance of this principle, the Task Force believes that it should be anchored within the Code's fundamental principles.
9. In this regard, the Task Force believes the most appropriate fundamental principle that would support and stimulate this behavior is professional behavior. The Task Force is of the view that willfully ignoring a SIA would be tantamount to not living up to the public's high expectation of the profession to act in the public interest, and therefore represent conduct that would discredit the profession.
10. The Task Force therefore proposes that Section 150⁷ be amended to make clear that conduct that may adversely affect the good reputation of the profession may include, for example, not responding to circumstances where a PA suspects that an illegal act has been committed or is about to be committed by a client or employing organization, as described in proposed Sections 225 and 360 respectively (see paragraph 150.1). The Task Force also believes that an amendment to the definition of professional behavior in Section 100⁸ would be necessary to make clear that the fundamental principle is about avoiding in the broadest sense conduct, as opposed to mere action, that discredits the profession (see paragraph 100.5).

Matter for Consideration

2. IESBA members are asked whether they agree with the Task Force's proposals above.

D. Alternative Approach to Proposed Section 225 – PAs in Public Practice

11. In the light of respondents' comments on the ED, the Task Force has reconsidered Section 225 and proposes the revised approach outlined below.
12. On exposure, there was greater opposition to, than support for, establishing a distinction in the ED between PAs providing professional services to audit clients and PAs providing NAS to non-audit clients, mainly because many did not believe the obligation to address an illegal act and the steps to be taken should depend on the nature of the professional services provided. Accordingly, the Task Force proposes that Section 225 no longer make that distinction. Instead, the Task Force proposes that Section 225:

⁷ Section 150, *Professional Behavior*

⁸ Section 100, *Introduction and Fundamental Principles*

- (a) Establish the responsibilities that should apply to both categories of PAs; and
 - (b) Only provide specific guidance where a distinction truly needs to be made (for example, see paragraphs 225.17-19).
13. With respect to PAs providing NAS to non-audit clients, the Task Force also proposes that Section 225 not deal separately with clients that are entities and those that are individuals. Instead, the Task Force proposes that guidance that applies specifically to entities be qualified as such (see paragraph 225.11), unless it is already clear that the guidance applies only to entities, i.e., in the context of audits.
14. In moving away from a requirement to disclose certain SIAs to an appropriate authority, and taking into account input received from Committee 1 of the International Organization of Securities Commissions (IOSCO), the Task Force has focused on developing guidance for Section 225 that would assist the PA in dealing with the difficult, and often stressful, situation that arises when the PA encounters a SIA. Broadly, the Task Force has structured the guidance as follows:
- (a) Recognizing *a priori* that the responsibility for complying with laws and regulations rests first and foremost with the client or its management and those charged with governance (TCWG). This responsibility includes addressing any illegal acts committed, or about to be committed, by the client or by TCWG, management or employees of the client (see paragraph 225.2). The Task Force believes that articulating this fact would be responsive to the many respondents to the ED who argued that addressing a SIA should be the overriding duty of management, including consideration of whether the matter may need disclosure to an appropriate authority. This is also broadly consistent with the approach taken in ISA 250;⁹
 - (b) As in the ED, making it clear that when the PA encounters a SIA, the PA's first responsibility should be to comply with any laws or regulations that govern how a SIA should be addressed (see paragraphs 225.3-4);
 - (c) Explaining then that this section deals with the PAs' responsibilities under the Code when there are no legal or regulatory requirements governing how a SIA should be addressed (see paragraphs 225.5);
 - (d) With respect to the latter circumstance, laying out the appropriate requirements and guidance regarding:
 - (i) Communicating with the client (paragraphs 225.6-14);
 - (ii) Evaluating the response of the client (paragraphs 225.15-20); and
 - (iii) Disclosing a SIA to an appropriate authority (paragraphs 225.21-25); and
 - (e) Dealing with documentation.

Communicating with the Client

15. The Task Force proposes that Section 225 move away from what many respondents perceived to be an overly prescriptive approach in the ED to one that is couched more in terms of how the Code may help the PA deal with the situation. Accordingly, in the communication phase, rather than

⁹ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

focusing on confirming or dispelling a suspicion, the straw man articulates the PA's responsibilities and options in terms of:

- Seeking to obtain an understanding of the nature of the matter and the circumstances in which it arose, consistent with ISA 250 (paragraph 225.6);
- Explaining why choosing to consult with others within the firm, a network firm, a relevant professional body or legal counsel as part of seeking an understanding of the matter may be beneficial (paragraph 225.8);
- Explaining why a PA performing a NAS for an audit client of the firm or network firm should discuss the matter with the engagement partner for the audit (paragraph 225.9);
- Explaining why the PA should communicate with the client regarding the matter (paragraph 225.10);
- Given the PA's role as a trusted advisor to the client, considering whether the client or its management or TCWG understand their legal or regulatory responsibilities to address the matter and, if not, assisting them in doing so (paragraph 225.12); and
- Explaining what courses of action are available where:
 - The PA suspects that management or TCWG are involved in the SIA (paragraph 225.13); or
 - The client does not provide sufficient information to satisfy the PA that the client is in compliance with laws and regulations, or sufficient information about the SIA cannot be obtained (paragraph 225.14).

Evaluating the Response of the Client

16. The Task Force does not believe that the PA's responsibility should end at the point of communicating the matter with the client or its management or TCWG given that certain SIAs may materially impact the entity's operations and its financial statements, and may have serious consequences for the public. Accordingly, the Task Force proposes that an explicit requirement be established for the PA to evaluate whether the client, its management or TCWG have appropriately addressed the matter (paragraph 225.15).
17. The Task Force then proposes guidance to:
 - Assist the PA in making such an evaluation (paragraphs 225.16-17); and
 - Lay out possible courses of action if the PA judges that the response of the client is not appropriate or the PA is unable to assess whether the response is appropriate (paragraphs 225.18-19).
18. The Task Force proposes to single out the following two possible courses of action as being options to be considered in exceptional circumstances once all other courses of action have been pursued and the PA believes that the client still has not appropriately addressed the matter:
 - Overriding the duty of confidentiality and disclosing the matter to an appropriate authority.
 - Withdrawing from the engagement and the professional relationship where permitted by law or regulation. (See paragraph 225.20).

19. The Task Force notes that the latter course of action is in line with ISA 250, as that standard indicates that withdrawal from the engagement is an action that may be considered in exceptional circumstances.¹⁰

Disclosing a SIA to an appropriate authority

20. With disclosure to an appropriate authority now being only an option as opposed to a requirement, the Task Force felt it important to link voluntary disclosure to the distinguishing mark of the profession in terms of the profession's acceptance of its responsibility to act in the public interest. Therefore, overriding the duty of confidentiality established by the Code in these circumstances would only be appropriate where the PA judges that disclosure would be in the public interest (see paragraph 225.21).
21. The Task Force proposes enhanced guidance, including relevant factors to consider, to assist the PA in determining whether or not to disclose the matter to an appropriate authority (see paragraphs 225.22-24).
22. Given that the PA now has full discretion in choosing whether or not to disclose a SIA to an appropriate authority, the Task Force did not believe it would be necessary to retain the exception provision in the ED (paragraph 225.14 of the ED). Accordingly, that provision has been deleted.
23. One of the matters that IOSCO had raised in its comment letter is that a consideration of disclosure of a SIA to an appropriate authority should have regard to the capacity of that body to intake, process and address reports of SIAs. The Task Force did not believe that PAs in all cases will have the means or ability to make such an assessment. Also, with the proposal to replace the requirement to disclose with the concept of discretion, the Task Force believes this particular consideration becomes less relevant. Accordingly, the Task Force proposes that this suggestion not be identified as a specific factor to consider.
24. Equally, the Task Force believes that with the discretion to disclose, it no longer becomes an impediment to compliance with the Code if there is no appropriate authority in the relevant jurisdiction to whom to disclose the SIA, and therefore this matter is of less concern.

Matters for Consideration

3. Taking into account that a detailed comparison with the ISAs has not yet been performed to ascertain the degree of alignment with the ISAs or the extent to which the straw man goes beyond the ISAs, IESBA members are asked whether they support the general approach outlined above. In particular:
- (a) Do members agree with the restructuring of Section 225 into one section for all PAs in public practice?
 - (b) Is it sufficiently clear that Section 225 addresses clients that are individuals as well as entities?
 - (c) Is there more that can be said to make the permission to disclose to an appropriate authority more robust without making it a de facto requirement?

¹⁰ ISA 250, paragraph A18

- (d) Are the nature and extent of the proposed enhanced guidance appropriate?
- (e) What other matters should be considered in further developing the approach in the straw man?

E. Probability Thresholds for Actions

- 25. Respondents to the ED as well as a few CAG representatives have questioned whether the ED had specified the appropriate threshold, in terms of level of suspicion, for disclosure of certain SIAs to an appropriate authority, as they perceived the same threshold to apply to both the investigation and disclosure phases. Some of them were of the view that the threshold for disclosure should be higher than for investigation, with some suggesting that the disclosure threshold should be a “likely” or “more than likely” test.
- 26. The Task Force believes that two separate thresholds should apply:
 - (a) A relatively low bar at which the PA would be prompted to seek to obtain an understanding of the matter and the circumstances in which it arose, i.e., upon the PA becoming aware that an illegal act may have been committed or may be about to be committed (see paragraph 225.6); and
 - (b) A “reason to believe” threshold at the point of raising the matter with management, as at that point the PA should have gathered sufficient evidence to have a reason to believe there is an issue to discuss with management.
- 27. The Task Force did not believe that a further threshold should apply at the point of disclosure. This is because by that stage, the PA should have filtered out matters that the PA has no reason to believe are illegal. The Task Force believes that the only conditions for disclosure to an appropriate authority then would be whether the PA judges that the disclosure would be in the public interest and such disclosure would not be contrary to law or regulation in the relevant jurisdiction.

Matter for Consideration

- 4. Do IESBA members agree with the Task Force’s proposals above?

F. Types of SIAs to Disclose

- 28. The ED had proposed filtering SIAs for disclosure based on the category to which a PA belongs, i.e.:
 - For a PA in public practice providing services to an audit client:
 - SIAs that directly or indirectly affect the client’s financial reporting; and
 - SIAs the subject matter of which falls within the PA’s expertise.
 - For a PA in public practice providing services to a non-audit client:
 - SIAs that relate to the subject matter of the professional services being provided by the PA. (This recognized the limited scope of the engagements in these circumstances.)

- For a PAIB:
 - SIAs that directly or indirectly affect the employing organization’s financial reporting; and
 - SIAs the subject matter of which falls within the PA’s expertise.
29. While there was some support from respondents for these different filters, a greater majority of the respondents did not support them for each of the three categories of PAs. Many felt that any restriction would be inconsistent with the public interest argument used to justify a requirement or right to disclose, or would be inappropriate in a code dealing with “ethics.”
30. At the March 2013 meeting, there were a few views at the Board that some filtering would still be appropriate given a general expectation that PAs would act on matters closer to their expertise. However, there were other strongly held views that placing such a limitation on disclosure would not be appropriate if PAs are to uphold their responsibility to act in the public interest.
31. Pending further consideration of the straw man, CAG representatives did not express a view on the matter at the April 2013 CAG meeting.
32. In the light of the ED responses and the general direction of the discussion at the March Board meeting, the Task Force proposes that the various filters in the ED as to the types of SIAs that may be disclosed be removed. While it made sense to limit matters to disclose to the PA’s expertise when there was a requirement in order to avoid placing an undue burden on the PA to report matters outside the PA’s expertise, the Task Force believes that in the absence of a requirement the PA should be free to disclose matters that are also outside the PA’s expertise.

Matter for Consideration

5. Do IESBA members agree with the Task Force’s proposal above?

G. Documentation

33. The explanatory memorandum to the ED had asked respondents whether they agreed with the documentation requirements in both Sections 225 and 360. The explanatory memorandum had explained that the Board intended the level of documentation to be commensurate with the gravity of the SIA.
34. At the March 2013 meeting, the Board noted that responses to this question were divided. Many respondents were supportive of the requirements as proposed, with a few suggesting that further guidance be provided to facilitate proportionate application and to avoid PAs inadvertently prejudicing the legal process.
35. Many others, however, were opposed to the proposal. In particular, several of them were concerned that:
- The requirements would be disproportionate as they seemed to call for documentation regardless of whether the SIAs were of any consequence; and
 - The resulting documentation may be legally discoverable.

36. Several other respondents were of the view that the proposal seemed to move the Code away from its current position of generally advocating documentation in the PA's interests but not requiring it. A view was expressed that documentation requirements are adequately addressed elsewhere in professional standards.
37. The Task Force recognizes that the Board did not discuss this issue at the March meeting, nor did the CAG at its April meeting. However, in the light of the significant concerns expressed on this proposal in the ED, the Task Force proposes that the requirement be replaced with an encouragement for the PA to document the steps the PA took to respond to the SIA.

Matter for Consideration

6. Do IESBA members agree with the Task Force's proposals above?

H. Alternative Approach to Proposed Section 360 – PAIBs

38. The Task Force has restructured Section 360 in the ED along the lines of the restructured Section 225.
39. One specific matter the Task Force wishes to highlight is how it is proposing to address the interaction between a consideration of any internal ethics policy within the employing organization and a consideration of whether to raise the SIA within the PA's reporting lines. As part of the communication phase, the Task Force proposes that the PAIB be required to consider the protocols and procedures, if any, that the employing organization may have established to address the SIA (see paragraph 360.5). If, after gathering the relevant information, the PA has reason to believe that an illegal act has been committed or is about to be committed, the Task Force believes that the PA should generally *first* address the matter within the reporting lines of the employing organization by discussing the matter with the PA's immediate superior or higher levels of management as appropriate (paragraph 360.7).
40. The Task Force proposes that Section 360 make clear, however, that in certain circumstances, the PA may consider it more appropriate to communicate the matter in accordance with the protocols established by the employing organization if those protocols provide for anonymity. This may be the case, for example, when the PA is employed in a relatively junior position and believes that the illegal act is deliberate and involved different layers of management (see paragraph 360.10).

Matter for Consideration

7. Do IESBA members support the proposed restructuring of Section 360 and the enhanced guidance provided to assist PAIBs in responding to SIAs?

Outline of Alternative Approach

1. Section 140 – Confidentiality

- PA is permitted to override confidentiality in the Code in certain circumstances and if in public interest

2. Sections 225 and 360 – Responding to a Suspected Illegal Act

- Consider regulatory requirements regarding reporting of SIAs and comply with them
- Align guidance with ISAs 240¹¹ and 250 with respect to SIAs
- Beyond ISAs 240/250, assess additional guidance for PAs on who they should be talking to, who they should obtain advice from, assisting management and TCWG understand their responsibilities, etc
- Determine whether management or TCWG have taken appropriate action
- If response from management or TCWG is not appropriate, then consider actions to take
- Determine whether disclosure to an appropriate authority would be justified in the public interest (cf first provision in the Code re distinguishing mark of the profession)
- Consider factors to make determination on whether to disclose

¹¹ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*