

28 December 2012

Ken Siong
Acting Deputy Director
International Ethics Standards Board for Accountants
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

**Exposure Draft – Code of Ethics for Professional Accountants –
Responding to a Suspected Illegal Act**

Dear Mr. Siong:

We are pleased to comment on the proposed changes to the *IFAC Code of Ethics for Professional Accountants* (the “Code”), to address the circumstances in which a professional accountant in public practice or business is required to, or has the right to, override the fundamental principle of confidentiality and disclose a suspected illegal act to an external authority.

We support the overall objective of increasing auditors’ responsibilities for the reporting of illegal acts. Indeed, we believe that laws and regulations should require the auditor to report certain illegal acts to appropriate authorities in carefully-drawn circumstances, and further believe that the existing Code’s confidentiality provision should not prevent this from happening.

However, the Exposure Draft adopts a different approach. It would require auditor whistleblowing even in the absence of a legal framework for doing so, which would mean, among other things, that auditors who report illegal acts would not have legal protections that are typically afforded by statute or regulation. In addition, the proposal includes whistleblowing provisions for accountants performing non-audit services, something that would be a major change from existing practice.

Moreover, the proposal raises a number of interpretive issues. Confidentiality is a core element of the accounting profession; our clients expect it, and we depend upon it in order to obtain information necessary to conduct effective audits and perform other services. If any changes are made to strip away longstanding confidentiality protections they should be done carefully and cautiously. It is important, therefore, that the words used in any revised standard be carefully chosen and clearly understood. If the proposal were to go forward there are numerous changes that would need to be made to clarify its requirements.

The IESBA requested comments on several areas of proposed changes to the Code and presented 18 specific questions. We will address each question individually, but our views are summarized below.

- **We support an illegal act reporting requirement for accountants providing audit services, but this objective can only be achieved through changes to laws or regulations, not through changes to the Code.**

We support illegal act reporting requirements for auditors. As auditors, we understand the important public role we serve. Auditors who uncover illegal acts should be required in specific circumstances to see that appropriate responsive remedial actions are taken by management and the board and, if not taken, to inform appropriate authorities. Such a requirement exists today for auditors in some jurisdictions. Our experience is that such provisions have generally achieved their desired objectives and have thereby served the broader public interest.

For example, in 1995 the United States Congress added Section 10A to the Securities Exchange Act to require auditor reporting to the SEC of likely illegal acts that have a material effect on the issuer's financial statements where the company, including its board or audit committee, has failed to take timely and appropriate remedial action. This requirement has assisted auditors in urging boards of directors and management to take potential illegal acts seriously, such as through conducting an internal investigation. As a result, it has helped protect investors against fraud.

Other countries also have requirements for auditors established through statute or regulation, with similar positive results. For example, the Singapore Companies Act requires reporting to a regulator where, among other things, the matter is not "adequately dealt with" by the company's directors after it has been brought to their attention.

We do not believe changes to the Code should or can be the mechanism for establishing such auditor reporting requirements. The responsibility of auditors to report possible illegal acts to government authorities involves complex and difficult issues. It is for this reason that it is an area appropriately addressed through legislatures or government rule-making authorities, who are positioned to give careful attention to jurisdiction-specific legal issues, to assess competing legal and professional interests, and to provide the protections and legal frameworks needed to make such requirements operable.

Accordingly, we support efforts to change laws in jurisdictions to require illegal-act reporting by auditors in specified circumstances where such requirements do not exist now. In our view the profession should actively support such legislative changes. IFAC could be particularly influential in this dialogue. Indeed, IFAC might assist in developing a model statute or guidelines that could be the basis for national laws in this area.

- **The proposal should not require an accountant performing a non-audit service for a non-audit client to disclose suspected illegal acts to government authorities**

The proposal goes much further than requiring an accountant performing a non-audit service to make a disclosure to the client's external auditor: it also provides a "right" of disclosure to government authorities and the accountant is "expected" to exercise that right. This is an unprecedented proposal -- we have examined the laws in a number of major jurisdictions and can find nowhere that such a sweeping requirement exists in law.¹

There is a fundamental difference between auditors and other professional accountants and the duties and expectations attached to each. We acknowledge and embrace the role that auditors play in maintaining trust in financial reporting. Shareholders and other stakeholders place reliance on audit reports, and this reliance creates a responsibility beyond that owed to client management. Auditors have both an opportunity and a public responsibility to contribute to the deterrence and identification of financial reporting fraud or illegal activity.

¹ It should also be noted that this aspect of the Exposure Draft goes well beyond the original request made by IOSCO, which led to this project. IOSCO proposed, in a 2010 letter to the Board, that "some provision must be made to serve the public interest when an auditor is confronted with suspected fraud or illegal behaviour on the part of an audit client [emphasis added]."

In contrast, non-audit services are discretionary, deriving from a company's need for specialized services and/or advice. For example, we might assist a non-audit client in developing its internal audit or internal control processes in order to improve its risk management environment, or we might help a non-audit client in strengthening its finance function. Or our forensic accountants might assist a company in performing an internal investigation, performing services such as analyzing a company's financial data, conducting interviews of management, and so on. Accountants are particularly well-suited to uncover fraud or other wrongdoing and to determine the financial statement impact of such improprieties. Such investigations are typically conducted under a legal privilege – that is, the client's legal counsel rather than the client itself retains the firm's forensic accountants. But few lawyers would want to run the risk of the accountant's disclosure of potentially illegal acts to governmental authorities, so the proposal would likely harm, not serve, the interests of the investing public.

There are good reasons that companies often turn to accounting firms to provide these sorts of services. We are bound by the Code's fundamental principle of *Professional Competence and Due Care*, which requires "the professional accountant to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards." The Code reflects the public expectations associated with non-audit professional engagements – that is, that the accountant must deliver competent services and assist the client in making sound choices. Other service providers may not be governed by any sort of professional standards.

Accordingly, we do not believe the Board should disrupt traditional expectations for an accountant providing non-audit services. If such a fundamental change were to be considered, it should be by legislators or government rule-makers, after receiving broad input from a range of constituencies. We recognize that, unlike the audit context, the proposal would provide a "right" rather than requirement that the accountant providing non-audit services report a suspected illegal act. But the proposal also states that "the accountant is expected to exercise this right in order to fulfil the accountant's responsibility to act in the public interest." This statement seems to convert the "right" into something akin to an obligation. Moreover, even without this statement, the existence of a right would undoubtedly lead to situations where the accountant's judgment would be called into question, after the fact, as to why he/she

failed to exercise this right. Thus, we do not believe there is a meaningful difference in this context between a right and a requirement.

- **Changes in auditor whistleblowing requirements cannot be made without changes in applicable law because the Board cannot provide necessary legal protections**

One of the principal reasons we think changes in this area need to be made by legislators is that the Code would leave professional accountants vulnerable to litigation or retribution in jurisdictions where appropriate legal protections do not exist. Legislators, by contrast, can provide appropriate legal protections.

Section 10A is a useful prototype. In establishing auditor illegal act reporting requirements the U.S. Congress included a “safe harbour” with protection from retaliation afforded to those who make such disclosures. Other jurisdictions have done the same. For example, Article 26 of the Netherlands Audit Firms Supervision Act provides: “The external auditor who has made a notification . . . is not liable for the damage suffered by a third party as a result, unless it can be made plausible that, considering all facts and circumstances, a notification should not in all reasonableness have been made.”

The IESBA lacks authority to establish protective mechanisms, so the proposal if adopted would expose the accountant to considerable risk if the illegal-act report later turns out to be inaccurate. We note that we expressed concerns about this same issue in 2008 in response to a Consultation Paper for the review of the OECD Anti-Bribery Instruments. We stated:

A reasonable auditor will always ask “what are the consequences if I am wrong” in reporting something that seems suspicious but, in the end, is not an act of bribery. At a minimum the company will be required to pay often substantial sums for legal and other fees in connection with any investigation. Experience has shown that these can often run into hundreds of thousands of dollars or euros even if the investigation is closed without any action being taken. Corporate or individual reputations will have been called into question and perhaps never completely cleared of suspicion by the mere fact of an allegation of wrongdoing. Companies or even individuals may conclude that they have a legal claim against the auditor for making a report which, in the end, is not substantiated

as an act of bribery. For these reasons we believe that it is appropriate to afford external auditors a legal “safe harbour” regarding any reporting which the auditor makes reasonably and in good faith. The United States, for example, has done so [citing Section 10A].

In response, the OECD concluded in 2009, in its recommendation on anti-bribery measures, that member countries should ensure that auditors who reasonably and good faith report law violations be protected from legal action.

- **Although Section 140.7 of the Code makes clear that the Code cannot override local laws such as confidentiality laws, the result would be considerable confusion and uncertainty about an accountant’s obligations if the proposal were adopted**

The Code cannot override local law; without question, legal obligations trump professional standards. Indeed, Section 140.7 of the Code states that accountants are not required to do something that is “prohibited by law.” Many jurisdictions have statutory confidentiality requirements, so it may be the case that the IESBA’s mandatory reporting proposal, if adopted, would result in no real changes in such jurisdictions. But, in fact, the juxtaposition of the proposed IESBA Code with statutory confidentiality protections would result in considerable confusion.

A look at the laws in Germany and the United States shows why this is so. Germany has strict confidentiality obligations imposed by law on the auditor. But these obligations have exceptions for “severe breaches” or “severe infringements” of certain legal provisions, in which case illegal-act reporting is required. See 1 § 29 Abs. 3 KWG (Banking Act); 2. § 341k i.V.m. § 321 Abs. 1 S.3 HGB (Commercial Code). So in Germany when the auditor learns of a potential illegal act he would need to decide whether this “severity” exception would allow him to comply with the Code’s reporting requirement; because of the different standards used in the Code (“public interest”, and no materiality threshold) this would not be an easy process.

As a further example, many states in the United States have adopted the following statutory language:

Except by permission of the client or the authorized representatives of the client, a person or any partner, officer, shareholder, or employee of a person shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional

accounting services or professional accounting work rendered to the client by the person. Such information shall be deemed confidential. However, nothing herein shall be construed as prohibiting the disclosure of information required to be disclosed . . . *by the standards of the public accounting profession in reporting on the examination of financial statements . . .*²

Exactly what is meant by the italicized language is unclear, and it has not been the subject of any significant court interpretation. An auditor could not be certain whether the Code's reporting requirement would be prohibited by local law in jurisdictions that have adopted this provision.

Moreover, it would be unfortunate if the Board were to adopt a rule that could not be implemented because of applicable legal restrictions. The IESBA's objective is to facilitate the convergence of international and national ethics standards; no such convergence would be possible in this area unless changes in laws were first obtained.

- **A number of elements in the Exposure Draft should be clarified or amended**

In addition to the concerns discussed above, there are a number of specific issues raised by the language in the proposal. The proposal would require that the auditor report "suspected" illegal acts if "the suspected illegal act is of such consequence that disclosure to an appropriate authority would be in the public interest, there is an appropriate authority to receive the disclosure, and the matter has not been disclosed." This language would need to be modified and clarified.

First, the proposal refers to "suspected" illegal acts. While we agree that the threshold of "suspected" may be appropriate when investigating and escalating within the entity, for reporting purposes we are concerned that it is a low threshold, and urge the word be replaced with "likely" or a similar word.

Second, the proposal uses a "public interest" standard as the basis for reporting. This will be very difficult to apply, particularly since the proposal does not include any sort of materiality threshold. We do not believe this is a workable standard in this circumstance.

² 22 Texas Admin. Code § 501.75 (emphasis added).

Third, the proposal may be interpreted as imposing an auditor-reporting requirement even where the client has taken remedial measures. Where a client has taken appropriate steps in response to a potential illegal act, the Code should be clear that reporting should not be required.

Fourth, the proposal would impose an unmanageable range of governmental bodies to which a report must be made. It states: “The appropriate authority to which to disclose the matter will depend upon the nature of the suspected illegal act; for example, a competition regulator in the case of a suspected cartel and a securities regulator in the case of suspected fraudulent financial reporting in a listed entity.” Apparently, auditors would be expected to report “suspected” illegal acts to trade regulators, environmental regulators, communications/broadcast regulators, food and drug safety regulators, and a host of others. We believe that the authorities to whom reporting should be made would be limited to those with direct jurisdiction over financial statement reporting issues.

- **We acknowledge that our proposed approach described above would not address a fundamental concern that gave rise to the Exposure Draft – namely, that the Code should not prevent auditors from disclosing illegal acts; we urge the Board to issue a consultation paper on this topic**

We understand that the principal reason for the IESBA’s undertaking of this project was a concern expressed by IOSCO and others that auditors should not be able to “hide behind” the Code’s confidentiality provisions as a basis for not disclosing illegal acts to appropriate authorities. We appreciate this concern, and we recognize that our proposed approach, which would primarily rely on legislative actions rather than changes in the Code, would not satisfy this concern.

We have two observations in this regard. First, we would support a change in the Code so to allow reporting to the external auditor as discussed above.

Second, and perhaps more significantly, we would also support the issuance of a consultation paper to address how a narrow and precise exception to the Code might be developed for auditors in this area. As discussed above, we think illegal-act disclosures should be required by legislators rather than by the IESBA. But the Board could consider developing an exception modelled on confidentiality exceptions that exist for other professionals, such as for psychiatrists, where disclosures of otherwise confidential information are sometimes statutorily permitted to

avoid serious or imminent harm to third parties. For example, some professional bodies in Canada have created an exception for discretionary disclosure of potential “criminal” acts which limit the disclosure right to instances of very serious harm or wrongdoing^{3,4}.

We would be pleased to work with the Board in developing such a tailored standard. Any change in the Code along these lines would need to include a materiality standard and would need to make clear that disclosure is a right rather than a requirement.

Conclusion

We support the objective of requiring auditors to report illegal acts in certain specified circumstances but believe such a requirement should be addressed through local law or regulation. The profession, including IFAC, should actively support enactment of laws to establish “whistleblower”-reporting legal frameworks for auditors. These efforts should focus on audits, where there exists a public reporting responsibility and a set of duties owed to the investing public, and not on other types of services performed by accountants. Due to the scope of our concerns outlined above, we respectfully urge the Board to reassess its approach, including giving consideration to the issuance of a consultation paper that would focus on development of a right for auditor illegal-act reporting in precise circumstances.

³R201.2, Code of Ethical Principles and Rules of Conduct, Certified General Accountants Association of Canada or to prevent an "act of violence", and 48.1 Code of Ethics for Chartered Accountants, Ordre des comptables professionnels agréés du Québec.

Responses to request for specific comments⁵:

- 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?**

As described in our summary above, we support an illegal act reporting requirement for accountants who provide audit services but believe this objective can be best achieved through changes to laws or regulations rather than through changes to the Code.

- 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?**

In our view there should not be a right of illegal-act disclosure established through the Code; instead, there should be an illegal-act disclosure requirement established through changes in law, as long as certain thresholds and elements, such as a materiality standard and safe harbour protection, are included.

- 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?**

No. As discussed above, the “public interest” is much too vague to be useful in this context. We believe a materiality threshold tied to the financial statements is a more precise measure and is consistent with other existing illegal act reporting frameworks.

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?**

We would support a change in the Code to permit an accountant who is providing a non-audit service to a non-audit client to inform the client’s external auditor of potential illegal acts discovered at the client, although this right should not impact forensic accounting and similar non-audit services which are provided under legal privilege or pursuant to contractual confidentiality obligations. .

- 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 support a requirement in the Code to override *Confidentiality* and disclose a suspected illegal act. In principle, we support illegal act reporting requirements for auditors but believe these requirements are better addressed through national law or regulation. In jurisdictions where such requirements exist, we believe the responsibilities

⁵ We have excluded questions relating solely to professional accountants in business and will not be providing views on proposed changes in this area.

of the auditor cease once the client has taken adequate steps to address an illegal act and it is not the auditor's role to determine whether the client should disclose the matter to the appropriate authority.

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?

If an accountant providing non-audit services to an audit client finds a potential illegal act, the accountant should ensure that the audit engagement team is aware of the matter. Consistent with existing professional standards, the auditor would take appropriate steps to inform management and, if necessary, the company's board or audit committee (or others who are responsible for corporate governance).

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?

We believe auditor illegal act reporting requirements should relate to financial reporting issues and not to matters outside of the accountant's professional expertise.

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?

As discussed above, we would support a change in the Code to allow (but not require) illegal-act disclosure to a client's external auditors by accountants providing non-audit services to the client.

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?

No, for the reasons discussed above.

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?

We support the establishment, through changes in national law, of illegal act reporting requirements for auditors, and we believe such requirements should be limited to illegal acts that impact financial reporting.

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?

As we do not support changes to the Code to require illegal act reporting, we have no comment on the exceptional circumstances provisions included in the proposal.

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?

As we do not support changes to the Code to require illegal act reporting, we have no comment on the exceptional circumstances provisions.

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

We believe documentation requirements are adequately addressed elsewhere in the professional standards.

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?

Please refer to our other question responses and our summary above.

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 there is further work needed in developing an appropriate proposal. We look forward to working with the IESBA in developing an approach that meets investors' needs while maintaining the confidentiality of information exchanged during the accountant/client relationship.

We would be pleased to discuss our comments with members of the International Ethics Standards Board or its staff. If you wish to do so, please contact Karen M. Golz, Global Vice Chair, Professional Practice (+1 212 773 8001) or Susan Nee (+44 20 79 8 0 08 77).

Sincerely,

Ernst + Young Global Limited

Ernst & Young Global Limited