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Company Secretarial Services & Performance Reports

APESB 2013\IESBA Comment

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“RESPONDING TO A SUSPECTED ILLEGAL ACT” PROPOSED CHANGES TO EXPOSURE DRAFT OF IESBA ED August 2012

1. PAGE 7: INSERT A NEW SECTION headed **“Risks”** BEFORE **“Appropriateness of Action Taken”**: with the following suggested:

“Professional accountants need to be on their guard in obtaining evidence of illegal acts. An investigator and his/her family may be subject to physical threat in a minority of cases. Studies of white-collar crime have indicated a sub-set of perpetrators have convictions for violent crime including murder. It may be preferable to appoint a forensic specialist in cases involving significant sums of money, and/or to have an experienced police officer accompany investigators. Professional accountants need to exercise caution in discussing evidence, and ensure detailed and up to date records of progress are maintained in a safe place on a daily basis. Interviews may be dangerous in pushing interviewees to provide the truth. Regular contact with a senior support person is important. Increasing trade and operations in developing countries with poor records for corruption are likely to exacerbate risks for professional accountants seeking to explain anomalous transactions. In these countries, the police and legal systems may not provide adequate protection to investigators.”

COMMENT: Whilst destruction of evidence and collusion in denial are probably more common responses to a fraud investigation, the studies cited below indicate a sub-set of violent white-collar criminals exist; the threat of fraud detection motivates a few to kill; and that sadism may be involved. Whilst security measures may not be within the scope of the Standard proposed, it is suggested that it is appropriate and necessary to warn professional accountants who wish to clarify their suspicions of fraud.

- *Brody GB & Kiehl “From white-collar crime to red-collar crime” (Journal of Financial Crime Vol 17 No 3, 2010 pp 351-364 Emerald Group Publishing Limited): study of 6 cases of murders in association with white-collar crime; concluded some white-collar criminals do kill and that preparation of investigators may prevent them from becoming victims.*
- *Perri JD Lichtenwald G “A Proposed Addition to the FBI Criminal Classification Manual: Fraud-Detection Homicide” (The Forensic Examiner Winter 2007 pp 18-30) 2007: Report on 27 homicide cases associated with white collar crime: recommended a new FBI Manual sub-classification of white collar criminals who are violent.*
- *Weisburd D Waring E & Chayet FE “White Collar Crime and Criminal Careers” (Cambridge University Press Cambridge 2001): reported 24.5% of a sub-set of 465 repeat offenders*

(part of a sample of 968 white collar crime convictions), had a record of violence; and only 15% of the same sub-set limited themselves to white-collar crimes.

2. PAGE 7: ADDITION TO SECTION “**Appropriateness of Action Taken**”, AT END:
 “It is important to distinguish facilitation payments from bribery and fraud. In the latter cases, and if the family or person of the professional accountant is deemed to be at extreme risk, the most appropriate action may be cessation of enquiries and no further direct action.”

3. PAGE 7: CHANGES TO SECTION “**Disclosure in the Public Interest**”:
 AT END:
 “In the event that an investigation is stopped due to perceived threats to the professional accountant and/or his/her family, it needs to be considered that the existence of threats is itself a matter of public interest, maybe requiring some disclosure in order to protect others in the future. (See Circumstances involving Threats, below).”

4. PAGE 8: CHANGE TO SUB-SECTION “*Types of Suspected Illegal Acts to be Disclosed*”: Delete second and third last paragraphs starting ‘For professional accountants...’ and ending ‘...such engagements’, as they add nothing to the dot points above.
 Delete last para “For other categories...member of society” as it implies a professional accountant in business is in the same position as a member of the public, which is not correct. A professional accountant in business is likely to be part of the management team.
 Add a last paragraph:
 “In the event that a professional accountant discovers or suspects significant illegal acts outside his/her professional expertise, the accountant would be expected to liaise with his/her professional association. If the legal position is not obvious and the situation appears to be a serious threat to the public interest, then it may be necessary for the professional association to obtain confidential advice, possibly on a hypothetical basis. If the illegality is sustained and it is seriously in the public interest, then resignation from the engagement or employment would seem appropriate.”

5. PAGE 10: CHANGE TO FIRST PARAGRAPH: LINE 5: add “adequately, in the opinion of the professional accountant.” so sentence ends “...and the entity has not self-reported adequately, in the opinion of the professional accountant.”

6. PAGE 11: ADDITION TO SECTION “**Documentation**”: last paragraph line 4: add “, and safeguarding critical copies in a safe place,” after “...maintaining such documentation”

7. PAGE 14: CHANGES TO SECTION “SECTION 225: **Responding to a Suspected Illegal Act**”:
 Include definition of “Illegal Act”, “Public Interest”, “Audit Client”, and “Facilitation Payments” in Definitions Section of Code

8. PAGE 14: CHANGES TO “SECTION 225: **Responding to a Suspected Illegal Act**”:
 Para 225.2: Delete the entire paragraph “If a professional accountant...pending disclosure”.
 Substitute the following:

“If a professional accountant in public practice identifies a suspected illegal act or activity, the accountant shall ascertain:

- Does the act or activity effect financial reporting?
- Is the act or activity in a subject within his/her professional expertise?
- What are the applicable legal or regulatory requirements?
- What are the professional requirements and guidelines?
- What is the effect on the public interest of the act or activity?
- What are the possible risks to him/her-self and staff and family?”

COMMENT: the above dot points all represent issues to consider; it is not a simple black or white case of “Is it illegal?”

9. PAGE 15: CHANGE TO PARAGRAPH 225.10: Delete the existing paragraph and substitute the following:

“If a professional accountant or the engagement audit partner determine:

- An act or activity has been detected that appears in their opinion to be a breach of applicable legal or regulatory requirements;
- The act or activity effects financial reporting;
- The act or activity is in a subject within his/her professional expertise;
- Disclosure or further disclosure is legally required or clearly important to the public interest; and

“Then the professional accountant or the engagement partner for the audit shall ordinarily document formal advice to the audit committee of the entity, or others of equivalent authority within the entity. The advice may include advice to clarify the legal position, and recommendations as to action within a stated time frame:

1. “In the opinion of the professional accountant or the engagement partner for the audit, the matters need further investigation (maybe by forensic specialists) to clarify the extent of the illegal act or activity, with a statement in confidence by the entity with a copy to the auditor, or alternatively directly by the auditor with a copy to the entity, to appropriate governance authorities and government authorities that this is in process;
or
2. “In the opinion of professional accountant or the engagement partner for the audit, the matters should be disclosed, or further disclosed, forthwith to the appropriate governance authorities and government authorities, either by the entity with a copy to the auditor, or alternatively directly by the auditor with a copy to the entity.

“In other circumstances the professional accountant or the engagement audit partner may formally advise the audit committee or equivalent others that the situation is likely to be high-risk for any investigators, that it is necessary to employ police support, and that formal statements to governance authorities and government authorities should be made on progress.

“If the professional accountant or the engagement audit partner does not have confidence in the integrity and competence of the governing authorities of the entity, in which an illegal act or activity is strongly suspected, then the appropriate action is resignation from the engagement.”

COMMENT: It is preferable that the ED contains one “operating section” which is an overall guide to the situation.

The proposal in the IESBA ED that the professional accountant or the engagement audit partner have a responsibility of reporting illegal acts direct to appropriate authorities is not supported, for the following reasons:

- It is important that risks to the investigating staff and their families are primarily considered, as endeavours to clarify the issues will lead to stress on those committing the illegal acts or activity, if they are aware of the investigation. This awareness is likely to lead to destruction of evidence and obstruction of the investigation, but may also result in violent action including murder.
- As pointed out in the US Public Company Accounting Oversight Board AU Section 317 on “Illegal Acts by Clients”, accountants and auditors are not lawyers, and specific legal advice may be required as whether a suspected illegality is in reality a breach of legislation.
- Legislation is often capable of alternative interpretations, and a court may take an alternative view to legal counsel that an internal illegality justifies breach of confidentiality with a client.
- Reporting to government authorities may entail unacceptably high risks for the professional accountant or the audit engagement partner in developing countries. Government authorities may not provide adequate protection to foreigners.
- The professional accountant or the engagement audit partner need to report to an audit committee or equivalent but may need to have the freedom to not commit to reporting to government authorities if, for example, the governing authorities for an entity wish to maintain its good name, and a detected fraud whilst illegal has not affected the public interest, and stakeholder investments have not been affected, and the perpetrator has been cooperative and returned all the funds, etc.

10. PAGE 15: CHANGE TO PARAGRAPH 225.11: Line 1: add “or further disclosure” so it reads “...disclosure or further disclosure...” Line 4: add “further” before “disclosure”.

11. PAGE 15: CHANGE TO PARAGRAPH 225.12: Transfer this entire paragraph as explanation of the term “Appropriate Authority” to a Glossary section

12. PAGE 16: CHANGE TO PARAGRAPH 225.13: start with “If in the opinion of the professional accountant or the engagement audit partner,”

A third dot-point is advocated here, to be fair to the client:

- “Management action reported to have been taken in response to the matters being raised.”

13. PAGE 16: CHANGE TO PARAGRAPH 225.14: Rather than referring to “exceptional circumstances” it is preferable to refer to “situations of high risk”. The studies mentioned in 1 above indicate violence is not so exceptional in cases of fraud.

14. PAGE 18: CHANGES TO SECTION "SECTION 360: **Responding to a Suspected Illegal Act**": Include definition of "Illegal Act", "Public Interest", "Audit Client", and "Facilitation Payments" in Definitions Section of Code

15. PAGE 18: CHANGE TO PARAGRAPH 360.2: delete this paragraph and replace it with the following:

"If a professional accountant in business determines:

- An act or activity has been detected that appears in his/her opinion to be a breach of applicable legal or regulatory requirements;
- The act or activity effects financial reporting;
- The act or activity is in a subject within his/her professional expertise;
- Disclosure or further disclosure is legally required or clearly important to the public interest;

"Then the professional accountant in business shall ordinarily document a request to the appropriate executive management of the entity. The request may include a request to clarify the legal position, and recommendations as to action within a stated time frame:

1. "In the opinion of the professional accountant in business, the matters need further investigation (maybe by forensic specialists) to clarify the extent of the illegal act or activity, with statements on progress to the auditor and to the audit committee; or
2. "In the opinion of professional accountant in business, the evidence as collected and countermeasures taken or planned should be disclosed forthwith to the auditor and to the audit committee, with recommendations on disclosure to appropriate governance authorities and government authorities.

"In other circumstances the professional accountant in business may formally advise the appropriate executive management that the situation is likely to be high-risk for any investigators, that may be necessary to employ police support, and that formal statements to governance authorities and government authorities should be made on progress.

"If the professional accountant does not receive a satisfactory response from executive management within a reasonable time that an investigation is being made, or corrective action being taken, then the professional accountant shall consider:

- "Referral to the audit committee and the internal auditor;
- "Use of an ethics hot line if it is available;
- "Referral to the external auditor, if other avenues are unsuccessful.

"If the professional accountant in business does not have confidence in the integrity and competence of the executive management of the entity, in which an illegal act or activity is strongly suspected, then the appropriate action is resignation from the entity. The professional accountant should obtain confidential advice in this respect from his/her professional association, and possibly from lawyers on his/her own account."

COMMENT: It is preferable that the ED contains one "operating section" which is an overall guide to the situation.

The proposal in the IESBA ED that the professional accountant simply discloses direct, as indicated in the last 3 lines of existing 360.2, is not supported, for the following reasons:

- It is important that risks to the investigating staff and their families are primarily considered, as endeavours to clarify the issues will lead to stress on those committing the illegal acts or activity, if they are aware of the investigation. This awareness is likely

to lead to destruction of evidence and obstruction of the investigation, but may also result in violent action including murder. Reporting to entity management may entail unacceptably high risks for the professional accountant if the management could be part of the illegal activity, and it is unlikely in the beginning at least that the extent of the illegal activity and the persons involved are known.

- The professional accountant is part of the management team of the entity: he/she will likely play a direct part in countermeasures to remedy the situation.
- He/she needs to have the freedom to not commit to reporting to the external auditor if, for example, the governing authorities for an entity wish to maintain its good name, and a detected fraud whilst illegal has not affected the public interest, and stakeholder investments have not been affected, and the perpetrator has been cooperative and agreed to an orderly repayment plan, etc.
- Governance authorities for the entity, and Government authorities, may not provide adequate protection to foreigners in developing countries.

16. PAGES 29-33: CHANGES TO “**Appendix: Impact Analysis**”

COMMENT: As it is at present this section is not felt to be a useful reference point for a stressed professional accountant facing a crisis with personal threats and haemorrhaging cash flows. It would be preferable for there to be 3 clear and distinct sections with tables or flowcharts summarising the text for ready reference:

- Professional accountant in public practice providing services to an audit client
- Professional accountant in public practice providing services to a non-audit client
- Professional accountant in business.

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