



National Association of State Boards of Accountancy

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International Ethics Standards Board for Accountants
International Federation of Accountants
529 Fifth Avenue, 6th Floor
New York, NY 10017

janmunro@ethicsboard.org

Re: Exposure Draft: *Responding to a Suspected Illegal Act*

Dear Members of the International Ethics Standards Board for Accountants:

We appreciate the opportunity to offer comment to the International Ethics Standards Board for Accountants (IESBA) on its Exposure Draft – *Responding to a Suspected Illegal Act*.

The mission of the National Association of State Boards of Accountancy (NASBA) is to enhance the effectiveness and advance the common interests of Boards of Accountancy (BOAs) that regulate all public accounting firms and all certified public accountants (CPAs) in the U.S. NASBA provides a venue for all 55 BOAs to come together, discuss policy matters of common interest and generate responses to invitations to comment which then represent the official view of NASBA and its leadership. Of course each BOA may provide its own opinion on any matter it chooses.

Responsibilities for standard setting are bifurcated in the U.S. The Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have federal regulatory authority over financial reporting of publicly-held entities.¹ The SEC historically has looked to the private sector for the establishment of accounting, auditing, and ethical standards. This currently includes the Financial Accounting Standards Board (FASB) for accounting standards, and previous to the enactment of the Sarbanes-Oxley Act, the auditing and ethics boards of the American Institute of Certified Public Accountants (AICPA).

The States, acting through the BOAs, also have constitutionally been given regulatory and licensing authority over all public accounting firms and CPAs practicing in the U.S, as well as financial reporting services provided to all privately-held entities.² Like the Securities and Exchange Commission (SEC), BOAs have historically looked to the private sector for the establishment of accounting, auditing, and ethical standards. These are currently the FASB for accounting standards, and the auditing and ethics boards of the AICPA.

¹ See the *Securities Exchange Act of 1934* and the *Sarbanes-Oxley Act of 2002*

² See *U.S. Constitution, Article X* and the *Sarbanes-Oxley Act, Section 209*

BOAs enable state laws by issuing regulations that require compliance by public accounting firms and all CPAs, whether in public practice or business. The solitary purpose of these state accountancy laws and regulations is protection of the public interest. In that respect, the mission of BOAs, and by extension NASBA, is distinct from membership organizations whose primary purpose is generally to represent the interests of the profession

In furtherance of the common objectives of BOAs and NASBA, we offer the following comments on the Exposure Draft.

General Comments

We want to express our respect and appreciation for IFAC taking the initiative to explore the responsibilities of all professional accountants to protect the public interest by requiring an appropriate response to suspected illegal acts. We support your on-going efforts to strengthen the requirements of the IESBA *Code of Ethics for Professional Accountants* (the Code).

The public's expectations of the accounting profession are both a compliment and yet a burden. The profession is regarded by the public as a trusted gatekeeper. Accordingly, in recent years and especially after the financial crisis, the public has increased its demands for greater transparency and heightened standards of behavior from professional accountants.

The Code deals with the ethical behavior of professional accountants. Generally, this covers the integrity, objectivity, professional competence and due care, confidentiality and professional behavior of accountants, and not the behavior of third parties. For the first time in our collective memory, the Exposure Draft calls for an extension of a professional accountant's and a firm's responsibilities to make judgments about the behavior of parties over which the accountant has little or no control. This is a subtle shift which we believe may be at the root of the difficulty with the solutions presented.

This new construct places at risk the confidence of clients and employers and the willingness of management to communicate with both their external and internal accountants. Indeed, the fundamental principle of client or employer confidentiality and its interplay with the public interest is brought into question and forms the source of considerable tension for all parties involved if the accountant is required to disclose a suspected illegal act. That determination hinges on whether the act is of such grave consequence that disclosure is in the public interest.

The behavior of professional accountants is inevitably caught between certain aspects of these competing interests and tensions, resulting in ethical dilemmas that may be difficult, or even impossible, for the accountants to fully resolve in every situation. As a result, certain aspects of the Exposure Draft may be operationally unworkable in some jurisdictions.

Within NASBA and the BOAs there are a range of views and expressions of concern over certain aspects of the Exposure Draft revolving around the:

- Fundamental responsibility of accountants to protect the public interest and society in general;
- Degree to which confidentiality is intrinsic to the client/accountant relationship;

- Role of professional standards in the context of extant laws and regulations; and,
- Potential for an accountant acting in good faith to be put in harm's way due to no fault of his or her own.

Many of our concerns stem from our perception of a lack of clarity in the Exposure Draft regarding definitions of terms, including “public interest” and in the implementation of the proposed standard. Further, we believe the focus in the Exposure Draft should be solely on situations involving public interest entities (PIEs).

Scope of the Proposed Standard

Since the proposal is directed at significant suspected acts that may impact or have impacted the public interest, the focus should be appropriately scoped on material matters of significant consequence and probability of occurrence. We believe the discussion in the following sections could ease the tensions described above and therefore should be considered.

Public Interest

The Exposure Draft is clearly aimed at protecting the public interest, yet “public interest” is not defined in the proposal. In June 2012, *IFAC Policy Position 5* was issued, which very broadly defines the public interest.³ The IFAC definition is followed by eight pages of discussion, illustrative of the difficulty of the task.

While we too have our own notion of what the “public interest” means, we freely acknowledge that there are many other views, none necessarily authoritative. Since the Exposure Draft itself is silent on what is meant by public interest and the status and authority of the IFAC policy position is unclear, there would likely be confusion in implementing a final standard.

One might surmise, upon reading the Exposure Draft, that should only acts having “such consequence that disclosure would be in the public interest” be considered, a reasonable starting point would be acts involving PIEs.⁴ Apparently this was not a matter of consideration in drafting the proposal. If the scope of the proposal were limited to significant matters impacting solely PIEs, it might help bring into balance concerns over breaches of confidentiality. This would be particularly the case in jurisdictions requiring, by law or regulation, the discussion or reporting of suspicions to appropriate clients, employers and potentially external regulatory authorities.⁵

Materiality

We note that there is no explicit discussion of materiality in the Exposure Draft. Since the proposal is directed at matters of consequence to the public interest, this is an area needing further

³ The definition reads as follows: “IFAC defines the public interest as the net benefits derived for, and the procedural rigor employed on behalf of, all society in relation to any action, decision or policy.”

⁴ See *IESBA Code, Definitions – public interest entity*

⁵ In the U.S. there are such extant laws and regulations. Please refer to footnotes 7 and 8.

development. Accountants are quite capable of understanding materiality concepts relating to financial statements. Here, of course, the frame of reference is not necessarily limited to matters that might influence financial statements, but extends to those that might impact the public interest which, as stated above, is not a clear concept.⁶ Since the factors entering into the IFAC public policy definition of the public interest vary from society to society, the related materiality measures will vary also, making application of materiality all the more problematic.

Suspicion Threshold

The Exposure Draft refers throughout to a “suspected” illegal act. In the audit of U.S. private entities, auditors are responsible to detect and report to management and potentially those charged with governance (TCWG) the possibility certain illegal acts may have occurred.⁷ Similarly, in the audit of U.S. public entities, auditors are responsible to determine whether it is “likely” that an illegal act has or may have occurred and discuss with management and potentially notify TCWG and externally, the SEC.⁸

The proposed standard puts forth a threshold requiring only a reasonable level of suspicion. In our view, the proposed standard should be more specific and address the probability an illegal act may occur, or may have occurred. We do not believe suspicion alone should be the triggering event to set in motion the other requirements proposed. Considering the seriousness of breaching confidentiality, the threshold for reporting an illegal act should be greater than a contingency. Accordingly, we suggest the bar be set high, rising to a *likely* level.

Applicability to Individual Professional Accountants and Accounting Firms

We understand the intended scope of this standard applies to all accounting firms and professional accountants engaged in public practice as well as those professional accountants employed in business.

We do not believe that the level of service rendered to a client or employer should govern disclosure requirements. Rather, disclosure requirements should be based on critical knowledge of an illegal act and the firm’s or accountant’s ability to disclose such information in a timely manner to prevent harm to real or potential victims. The question here is whether there is a duty to the public as a result of the trust the public places in the professional accountant. We believe this duty is defined by existing laws and regulations governing professional accountants providing services principally to PIEs, as determined by duly appointed legislatures.

When an illegal act is identified by accountants in public practice, the obligation to escalate the discussion rests with the accounting firm and not the individual professional accountants, who can

⁶ We note in the recent financial crisis that public interest losses were not caused solely by the result of misstated financial statements or substandard disclosures including an absence of attention to the ability of an entity to continue as a going concern..

⁷ AU-C Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

⁸ U.S. Securities Exchange Act of 1934, Section 10A, *Audit Requirements*

be numerous and located in multiple jurisdictions. As long as the individual accountant does not subordinate his or her judgment to the firm, we believe the standard should recognize the disclosure obligation rests with the firm rather than the individual accountant. However, individual accountants have a responsibility to voice and, if necessary, document their disagreement in the event of their firm's failure to escalate when escalation is warranted.

Legal Expertise of Accountants

The proposal is very broad in its consideration of illegal acts, covering violations of laws and regulations involving civil, administrative and public policy matters, all the way to those that may result in criminal charges. It should be acknowledged that accountants are not experts in the law, although they are typically more familiar with legal concepts governing financial matters than the average person. We believe the standard should specifically address these realities. Further, we believe the expectation for disclosure should be limited to those that fall within the subject matter expertise of the professional accountant.

Section 360.13 of the proposal mentions seeking legal advice on protection afforded by legislation, but we would suggest the proposal also include wording advising accountants to seek appropriate legal or confidential outside expert⁹ counsel if needed to form conclusions as to whether an act might actually be illegal, and /or assessing the threshold level of suspicion, under relevant laws and regulations.

Duty and Right to Disclose

All professional accountants have a duty to comply with laws and regulations in their respective jurisdictions. This is particularly the case when an illegal act is identified that can reasonably be expected to result in victims incurring substantial losses. Consequently, the accountant truly faces ethical dilemmas of dramatic proportions considering acts of "such consequence that disclosure would be in the public interest."

However, we are concerned about the possibility a private-sector standard setter might enact a duty, having the effect of law, without having the legal authority to do so. In that regard, we are concerned disclosure obligations might cause professional accountants to breach client or employer confidentiality causing the accountant to be out of compliance with applicable laws or regulations. Breaches may damage the relationship between the accountant and his or her clients or employers and stifle candid discussions that might otherwise lead a client to make appropriate disclosures on their own.

Conversely, if the professional accountant withholds knowledge that could have prevented or brought to light an act in a timely manner so as to prevent a crime, the accountant could be accused as a co-conspirator. Consequently, to disclose or not is a dilemma the professional firm or accountant faces that requires careful analysis and judgment. Of course this dilemma is not new

⁹ Professional membership organizations at the national or local level often have experts on staff that regularly consults on difficult ethical issues.

and will continue regardless of the outcome of your final deliberations. We believe it is questionable whether all, or even most, situations can be adequately addressed to fully balance the matter of confidentiality with the duty to the public interest.

National and local legislatures enact laws setting forth both duties and rights which are outside of the authority of private-sector standard setters. With respect to rights, we are unaware of other private-sector standard setters' efforts to create rights. The Exposure Draft discusses circumstances when there is an *expectation* that the accountant exercise the right to disclose. This expectation blurs any distinction between a "duty" and a "right." In summary, an attempt to create rights is moving into uncharted territory and we advise curtailing any such effort and focus on an affirmative duty to respond.

Independence

The Exposure Draft does not address circumstances when responding to a suspected illegal act might affect independence. When issues arise involving the legality of behavior, the relationship between a professional accounting firm engaged in public practice and attest clients can be strained to the point where communication may be inhibited and the firm and management placed in adversarial positions. The significance of such pressures on independence could result in a requirement that the firm must withdraw from the engagement to avoid impairment of its independence.¹⁰ We believe the proposal should acknowledge the impact that an appropriate response by an attest firm could have on independence, and provide guidance.

Other Considerations

There are other situations where existing laws and regulations have requirements limiting or requiring disclosure:

- Forensic or litigation support situations subject to attorney - client privilege;
- Tax laws and regulations that may bar disclosure; and,
- Knowledge required to be conveyed to or between internal or external auditors.

We believe the Exposure Draft needs to expand on these and possibly other disclosure situations and provide unambiguous guidance and examples.

Many entities have hotlines to encourage reporting of illegal acts. Also, some jurisdictions have recently adopted or are considering adoption of whistleblowing provisions that afford certain protections. The Exposure Draft surprisingly does not address the use of hotlines or whistleblowing protections. For accountants at junior levels, it may be difficult to escalate a discussion of illegal acts without the availability of hotlines or whistleblowing protections. We believe properly sanctioned use of hotlines and whistleblowing provisions may be an appropriate means for some professional accountants to discharge their duty to respond.

¹⁰This circumstance would be comparable to the adverse interest threats in the actual or threatened litigation discussions in IESBA Code Sections 290.231 and 291.159.

Responses to Specific Questions

We have included our responses to the Exposure Draft's specific questions as Attachment A to this letter.

Thank you for giving us the opportunity to comment on the Exposure Draft.

Sincerely,

Handwritten signature of Gaylen R. Hansen in cursive script.

Gaylen R. Hansen, CPA
NASBA Chair

Handwritten signature of Ken L. Bishop in cursive script.

Ken L. Bishop
NASBA President and CEO

Appendix A: Responses to Specific Questions

Our primary reservations and suggestions about the Exposure Draft are presented above under the General Comments. In addition, our responses to specific questions posed in the Exposure Draft follow.

- 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?**

Yes, assuming there are no “tipping-off” prohibitions and if unable to dispel the suspicion, the accountant should be required to discuss the suspected illegal act with the appropriate level of management and TCWG if necessary. As noted elsewhere, we believe this reporting responsibility falls to the audit firm, as an organization, in client audit scenarios.

- 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?**

We have concerns here. Please see General Comments above and the section “Duty and Right to Disclose.”

- 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?**

We have mixed views on this complex issue and much of our response is colored by uncertainty about what is meant in the proposal by “such consequence that disclosure would be in the public interest.”

Primary responsibility for disclosure always rests with management. The duty of professional accountants should be driven, at least initially, by national and local laws and regulations and not by a private-sector standard setter. However, we also recognize that on rare occasions ethical dilemmas arise, pitting the duty of confidentiality to a client or employer against a duty to the public interest.

Also, please see General Comments above and the section “Scope of the Proposed Standard” and subsections “Public Interest” and “Suspicion Threshold.”

- 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?**

No. The nature or the level of service rendered to a client has no bearing on the accountant's duty to the public interest. We recognize that the inputs of information will differ based on the nature or level of the service rendered, but the output response should be the same.¹¹

- 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 have mixed views on this question. Please see our response to Question 3.

- 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 focus of this question is a bit confusing as it raises questions about the nature of the firm (non-network firm or network firm) as well the nature of the services provided to the client (non-attest services or audit services). However, our response is the same in both scenarios: neither the network nature of the firm nor the nature of the services provided to clients has any bearing on a firm's duty to respond. Also, please see our response to Question 4.

- 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?**

Yes, but only in the same context discussed in Questions 1 through 4.

- 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?**

We believe all professional accountants have a duty to comply with laws and regulations in their respective jurisdictions regardless of the scope or level of service rendered to a client or employer.

- 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?**

¹¹ Since the issue in this question centers on confidentiality, it is worth noting that the "principle of confidentiality imposes an obligation on *all* professional accountants," *IESBA Code, Confidentiality, Section 140.1*.

No. We fundamentally disagree with the notion that a private-sector standard setter is capable of creating rights. Please see our response to Question 4 and the General Comments above in the section, "Duty and Right to Disclose."

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?

No. Please see the second paragraph of *Applicability to Individual Professional Accountants and Accounting Firms*, which expresses our view that the responsibility to disclose should not hinge on the nature of services being provided. However, we do agree as stated in the *Legal Expertise of Accountants* section, that the expectation for disclosure should be limited to those that fall within the subject matter expertise of the professional accountant. Also, to the extent the question relates to the creation of rights, please see our responses to Questions 9 and 12.

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 believe the Exposure Draft's discussion of how an accountant in business might escalate is inadequate. It does not address other options such as using an anonymous hotline or available whistleblowing protections.

Also, please see General Comments above, particularly with regard to "Other Considerations" and the concerns expressed in the section "Duty and Right to Disclose."

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?

No. We fundamentally disagree with the notion that a private-sector standard setter is capable of creating rights. Please see our response to Question 4 and the General Comments above in the section "Duty and Right to Disclose."

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?

No, to the extent the question relates to the creation of rights (please see our response to Question 12), otherwise we agree (that the acts should relate to the financial statements and the expertise of the professional accountant).

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?

No. We fundamentally disagree with the notion that a private-sector standard setter is capable of creating rights. Please see our response to Question 4 and the General Comments above in the section, "Duty and Right to Disclose."

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?

Yes, however please see our response to Question 14.

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

Yes. Steps taken to report or escalate the matter, the professional accountant's conclusion about the response of management and TCWG (when known), and the decision about continuing a relationship with the entity all represent appropriate matters the accountant in public practice should document. However, we believe that greater clarity for documentation requirements for accountants in business is needed. For instance, accountants in business may be faced with the dilemma of complying with the documentation standard while at the same time creating a roadmap that is subject to legal discovery.

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?

We do not support all of the proposed changes. We believe that our answers to the questions above should help you understand our concerns with the Exposure Draft.

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 are pleased that the IESBA has the foresight of undertaking an impact analysis considering the fundamental changes contemplated in the Exposure Draft. We are hopeful that the analysis will address the concerns we have outlined above.