

18 December 2012

Mr Ken Siong  
Acting Deputy Director  
International Ethics Standards Board for Accountants  
International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017 USA  
By email: kensiong@ifac.org

Dear Ken,

**RE: Responding to a Suspected Illegal Act**

Accounting Professional & Ethical Standards Board Limited (APESB) welcomes the opportunity to make a submission on the IESBA's Exposure Draft *Responding to a Suspected Illegal Act*.

**APESB's role**

APESB is governed by an independent board of directors whose primary objective is to develop and issue, in the public interest, appropriate professional and ethical standards. These standards apply to the membership of the three major Australian professional accounting bodies (the Professional Bodies). A secondary objective of the APESB is to provide the opportunity or forum for the discussion and consideration of issues relating to professional standards for professional accountants. APESB is funded by the Professional Bodies, but has complete independence in its standard-setting activities.

Our essential function is the setting of standards, and in doing this we endeavour to incorporate a strong emphasis on professionalism and the role of sound judgement in those professional accountants who are obliged to follow our standards. We believe that setting high quality standards with demanding criteria contributes to the professional standing and behaviour of members of the accounting profession.

## General Comments

APESB supports the general principle that professional accountants must act in the public interest. However, APESB does not support the proposal to require a professional accountant to breach the fundamental principle of confidentiality and disclose a suspected illegal act to an appropriate authority where there is no legal or regulatory protection afforded to the professional accountant. Instead APESB believes that a professional accountant should have the right to disclose a suspected illegal act when it is in the public interest to do so and the Code should provide guidance to assist the professional accountant to make such a determination.

We recommend that IESBA considers the need for a balanced approach that assists governments and regulators in identifying suspected illegal acts whilst not requiring a professional accountant to act in a 'quasi' regulatory role and in doing so become subject to increased risk of civil or criminal litigation.

There are a number of areas of legislation in Australia which require mandatory disclosure in situations concerning suspected illegal acts, for example the *Corporations Act 2001* requires an external auditor to report any suspected breaches of the *Corporations Act 2001* to the Australian Securities & Investments Commission (ASIC).

In Australia there is no legal protection afforded to professional accountants by the Code and while compliance with the Code may be argued as a legal defence, this may not be sufficient support in a court of law. The proposed revisions to the Code mandate disclosure of confidential information and yet do not afford legal protection to the professional accountant from the potential adverse consequences of such a disclosure.

Another major area of concern is the likely impact of the proposed changes on the accounting profession, particularly on Small and Medium Practices (SMPs). The obligation to disclose confidential client matters in the SMP environment to the appropriate authorities may threaten the professional accountant's role and standing as a trusted advisor to these clients. There is a risk that these proposed requirements could deter clients from seeking professional advice to address compliance issues, as the professional accountant would have, under the proposed revisions, an obligation to report suspected illegal acts.

Finally, there may be unintended negative consequences as a result of requiring professional accountants to disclose suspected illegal acts in circumstances where clients or employers have subsidiaries in foreign jurisdictions. This is particularly true where subsidiaries are in emerging economies where the judicial systems may not be robust or where there are severe penalties including capital punishment. Disclosures that have relatively minor consequences for alleged perpetrators in Australia may, in contrast, lead to more severe penalties for employees or related parties of Australian subsidiaries in other jurisdictions.

## Specific Comments

APESB's responses to the specific issues raised by the IESBA are as follows:

- 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?**

APESB agrees in principle that if a professional accountant identifies a suspected illegal act, and the professional accountant is unable to dispel the suspicion, the professional accountant should be required to discuss the matter with the appropriate level of management and escalate the matter within the organisation.

We commend the IESBA's decision to use the reasonable third party test as the basis for discussion to be initiated with the appropriate level of management. Whilst in larger organisations there will be several layers of management, in smaller organisations there may only be one or two levels of management. This may pose a particular challenge for SMPs.

- 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?**

APESB supports the professional accountant having the right to override confidentiality in rare and exceptional circumstances and where it can be demonstrated that the disclosure is in the public interest.

We recommend that IESBA provide additional guidance to enable the professional accountant to determine the exceptional circumstances where such action would be appropriate, and to make an assessment whether the professional accountant has sufficient information and/or evidence to form a conclusion beyond reasonable doubt that the suspected illegal act occurred. It should be a higher test than "reasonable level of suspicion" as currently proposed.

Guidance could include criteria for:

- assessing the nature and significance of the suspected illegal act and the likelihood it has occurred;
- assessing the potential impact of the suspected illegal act on a third party, stakeholders or the general public;
- determining whether management's actions are appropriate or inappropriate as the case may be;
- documenting the decision reached; and
- determining what constitutes an appropriate authority.

- 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?**

APESB agrees that the public interest test is a reasonable threshold for reporting to an appropriate authority, however this should only be in rare and exceptional circumstances

and where the suspected illegal act is of such consequence that the disclosure is in the public interest.

APESB believes that the Code should incorporate additional guidance to assist the professional accountant in determining what is in the public interest and also provide guidance on how to determine the significance of suspected illegal acts. We suggest that IESBA consider adopting a tiered approach for this guidance in the following manner:

- There will be rare and exceptional circumstances where it will be clear that the disclosure is in the public interest (e.g. major environmental disaster and related falsification of reporting);
- There will be some circumstances where the professional accountant's judgment will be required in making a determination on whether or not to disclose (e.g. an environmental spill has occurred but it has been promptly dealt by management); and
- There will be other circumstances where the issues will be minor and it will be clear that disclosure is not required (e.g. a minor fraud in the company and management has taken appropriate actions to address it).

Consideration should also be given to linking the term 'public interest' to the IFAC Policy Position Paper #5 – *A Definition of the Public Interest*. In the absence of public interest, APESB does not support the obligation to disclose a suspected illegal act unless there is a legal or regulatory obligation to do so or where there are protective mechanisms in place for the professional accountant.

***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?**

As noted above where the disclosure is in the public interest, APESB supports the professional accountant's right to disclose a suspected illegal act. We believe that such a right should apply to both professional accountants in public practice providing services to audit clients as well as non-audit clients.

In the Australian context, legislation mandates that public company auditors report breaches to the regulator in certain circumstances and also provides them with legal protection in such matters. Professional accountants in public practice providing services to an audit client should be held to a higher standard and this should apply only in consideration of matters that are within the scope of the financial report.

However, professional accountants serving non-audit clients should not be deterred from disclosing suspected illegal acts where the matter is within their expertise and providing them with a right to do so will support this objective.

- 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?**

APESB agrees with the right for an auditor to override confidentiality and disclose certain suspected illegal acts to an appropriate authority, in the public interest, if the entity has not made adequate disclosure within a reasonable period of time after being advised to do so. In the Australian context, public company auditors are required by legislation (section 311 of the *Corporations Act 2001*) to report to ASIC of any contravention of the specified legislation.

Where the entity has not taken action and it is in the public interest to disclose, another option available to the external auditor is to disclose the matter in the auditor's report, where it relates to the financial report.

- 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?**

APESB agrees that there should be no difference in standards for a professional accountant providing professional services to an audit client of the firm or a network firm. Subject to the public interest test, we support the professional accountant having a right to disclose a suspected illegal act.

Where the client is also an audit client of the firm, the professional accountant would be more appropriately advised to notify the audit engagement partner or the firm's risk management function of the suspected illegal acts, following which the appropriate person in the audit firm would be expected to progress the matter. We note that the exposure draft, as currently drafted, is silent on the issue of cascading responsibilities and the passing of information between professional accountants within a firm. It would be useful for the Code to state who has the ultimate responsibility (e.g. audit engagement partner) for the disclosure to an appropriate authority and provide guidance for handling situations where opinions differ on the significance of the suspected illegal act or whether the relevant matter actually is a suspected illegal act.

- 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?**

APESB agrees that the disclosure of suspected illegal acts should be limited to those acts that affect the client's financial reporting or subject matter which falls within the expertise of the professional accountant. This is important as the expertise of each professional accountant in public practice is different. Further these days firms provide a range of services that are not associated with financial reporting matters.

Making a determination whether a breach of environmental protection regulations has occurred may not be within the expertise of the professional accountant, however once the breach is reported the professional accountant may have expertise in terms of assessing the appropriateness of the recording and reporting of the financial impact of

such a breach. The Code could, for example, provide more guidance on reporting of financial impacts of social and environmental matters.

- 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?**

APESB does not support the requirement to disclose suspected illegal acts to the client's external auditor when unable to escalate the matter within the client unless there is a legal obligation to do so. The requirement to disclose a suspected illegal act to the entity's external auditor places a higher standard on professional accountants than what is required of other professionals. While the professional accountant should abide by the Code and spirit in which it is drafted, an obligation to disclose information places significant burden on the professional accountant with potential adverse consequences arising such as reduced competitiveness, loss of client trust and potential legal exposure for whistle-blowing and breach of confidentiality. For this reason, APESB believes that the professional accountant should be given the right to disclose a suspected illegal act when it is in the public interest to do so rather than an obligation.

- 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?**

Where the disclosure is in the public interest, APESB supports the professional accountant having a right to disclose a suspected illegal act. We agree in principle with the right to override confidentiality. However, we disagree with placing an obligation or expectation on the professional accountant to do so. Creating such an obligation treats professional accountants as "quasi" regulators or whistle-blowers which is likely to create practical commercial difficulties for the professional accountant.

This is particularly the case in SMPs where professional accountants are assisting and guiding clients to be up to date with their compliance obligations. Further there is likely to be a detrimental impact on the trusted advisor status that professional accountants often assume when assisting SMP clients. If the current IESBA proposals are adopted then some SMP clients may prefer to deal with lawyers for tax matters as they will have the protection of legal professional privilege.

Finally, in some jurisdictions professional accountants may not be protected by whistle-blowing legislation which would prevent professional accountants from fulfilling such an obligation and there may also be personal repercussions.

For SMP clients there are often limited levels of management and no requirement for an audit. Therefore based on these proposals the only option available to the professional accountant is disclosure of suspected illegal acts. This could place significant legal and administrative burdens on SMPs, for limited benefit.

- 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?**

APESB agrees that the suspected illegal acts to be disclosed referred to in question 9 should be restricted to those acts which relate to the subject matter of the professional services being provided by the professional accountant.

***Matters specific to professional accountants in business (Section 360 of the Code)***

- 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?**

APESB does not support the requirement to disclose suspected illegal acts to the external auditor when in doubt of the integrity of management unless it is in the public interest or there is a legal obligation to do so. The mandatory requirement to disclose a suspected illegal act to the entity's external auditor places a higher standard on professional accountants in business than what is required of other professionals in the business environment.

The professional accountant in business when encountering challenging circumstances relating to a suspected illegal act should have the right to disclose the suspected illegal act, where in the professional accountant's judgment, the situation satisfies the public interest test. Given the nature of the relationship between auditor and client, disclosure to the auditor is unlikely to be considered a breach of confidentiality requirements.

APESB suggest that the Code be revised to include a definition of appropriate authority and that the IESBA should consider whether to include the external auditor in that definition. Guidance on disclosure to the appropriate authority could then be used by the professional accountant when determining whether the disclosure is considered reasonable and to which authority the disclosure is most appropriate in a given circumstance.

- 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?**

Where it is in the public interest to disclose, APESB agrees that the professional accountant should have the right (as opposed to an obligation) to override confidentiality and disclose suspected illegal acts. We do not agree with making this right an expectation as this is akin to imposing an obligation.

The expectation to disclose certain illegal acts creates an obligation on the professional accountant to potentially override legal obligations. This may in turn result in exposure of the professional accountant to legal reprimands in certain jurisdictions.

APESB does not believe that the Code provides the protective mechanisms and accordingly it is unreasonable for the Code create a mandatory obligation for

professional accountants to exercise this right. The alternative is for the Code to provide the professional accountant with the right to override confidentiality when it is the public interest and taking into consideration personal and legal ramifications of such a disclosure.

**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?**

APESB agrees that where suspected illegal acts are disclosed, they should be limited to acts that affect the financial reporting, and acts the subject matter which falls within the expertise of the professional accountant. Without limiting the scope of the acts to those within the professional accountant's expertise, there is the potential that the professional accountant would be obliged to take on the role of investigator or forensic specialist, a role for which the professional accountant may not have the relevant experience and expertise.

APESB is of the view that it would be useful for the Code to provide guidance on what would be subject matter expertise (other than financial reporting) for professional accountants given the diversity of roles they perform in the current business environment. Some professional accountant's subject matter expertise encompasses more general management responsibilities such as human resources, environmental and sustainability reporting, contracts management, or operations. For example, the responsibilities of a Chief Financial Officer (CFO) often extend beyond financial reporting.

Refer also to comments on question 7 above.

**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?**

APESB agrees that in exceptional circumstances a professional accountant should not be expected to exercise the right to disclose suspected illegal acts. In particular the professional accountant should not be expected to place themselves in harm's way or to be subject to severe hardship as a result of the act of disclosure of the suspected illegal act.

**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?**

The professional accountant should be encouraged to consider factors in addition to those currently listed when determining if the circumstances are exceptional. For

example, relevant considerations for the professional accountant are jurisdictions which have poor judicial systems or where penalties for disclosure could be severe.

In some jurisdictions the consequences of disclosing a suspected legal act may have significant ramifications for the suspected guilty party and their families, which may not necessarily be commensurate with the suspected illegal act committed. This may also be true for employees of subsidiaries of Australian companies in foreign jurisdictions who may face prosecution abroad for allegations made in Australia. We note also that in certain developing economies, potential job loss could be considered an exceptional circumstance.

APESB encourages IESBA to broaden the definition of exceptional circumstances to incorporate such circumstances and to include further guidance on determining what constitutes exceptional circumstances in different socio-economic contexts.

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

APESB is supportive of the professional accountant documenting his or her decision making process. However, APESB suggests that documentation requirements be expanded to provide guidance on circumstances where management takes appropriate action to resolve the suspected illegal act as well as circumstances where management commits to act but fails to deliver.

It is important that documentation principles be set out in such a way to ensure neutrality and unbiased recording of facts, so as to avoid any assumptions of necessary guilt or wrongdoing.

APESB also recommends that IESBA provide guidance on the importance of applying professional judgment when assessing the extent of documentation required. IESBA should also provide guidance for the professional accountant to consult with legal or other professional counsel in determining how to proceed with documentation without prejudicing the legal process or the professional accountant.

Documentation should be proportional to the suspected illegal act and the consequences of disclosure of such an act. The more serious the suspected illegal act, the more extensive the documentation should be. Guidance should also consider whether the professional accountant is qualified to document suspected illegal acts and whether the courts will accept this documentation as evidence. The potential risk is that the actions of the professional accountant in these circumstances may inadvertently compromise the case for the prosecution and prejudice the investigation.

**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?**

As noted above APESB has some major concerns with this exposure draft as it is creating mandatory obligations on professional accountants to override the fundamental principle of confidentiality. APESB is of the view that IESBA should address the concerns noted above in its deliberations of the respondents' comments.

Apart from the objections described in this paper and the use of an undefined term "questionable issues" in paragraphs 210.2 and 210.3, APESB agrees with the proposed changes to the existing sections of the Code. Instead of "questionable issues" we propose the use of "matters with the potential to develop into suspected illegal acts".

As a general principle APESB agrees that where new sections are to be inserted into the Code, existing sections of the Code should be amended to incorporate reference to such sections.

**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?**

APESB supports the use of impact analysis in presenting stakeholder views and concerns. We believe the analysis as currently presented should be expanded to consider the following additional considerations. In particular, the professional accountant is potentially subject to:

- Commercial impact from the loss of trusted advisor status particularly in the SMP environment;
- Conflict between their obligations under local tax regulations and the Code, leading to the potential loss of registered taxation agent status due to a breach of client confidentiality;
- Increased administrative, legal and compliance costs associated with documentation and disclosure actions;
- The need to revise and reissue all engagement letters to responsibly notify the client of additional professional obligations which impact on the client relationship;
- Reduced competitiveness compared to other similar-standing professional advisers not subject to comparable requirements;
- Additional pressure arising from the creation of an expectations gap, where clients and the public will have an expectation that the members of the accounting profession will identify suspected illegal acts;
- Potential risk of damaging the forensic trail when investigating matters which could make evidence inadmissible in subsequent legal proceedings; and
- Potential exposure to harm or adverse legal consequences.

**Other Comments**

APESB suggests the IESBA consider the following additional matters in the final drafting process:

- Professional accountants in the public sector in statutory positions of responsibility, such as Auditors General, securities regulators, and tax commissioners, may be in office for a specified period of time and may not be able to resign. Accordingly, we recommend that the IESBA consider qualifying the applicable provisions with “where permitted by law or regulation”;
- Whether there are certain circumstances where the scope of work is so limited that it affects the ability of the professional accountant to be in a position to appropriately identify a suspected illegal act, such as an auditor of a small subsidiary company who does not have access to all the relevant information of the client;

- Some professional accountants also serve in an executive or governance role such as CEO, CFO or Board member and the revisions should reflect guidance on circumstances where the professional accountant is within Those Charged with Governance; and
- Additional guidance for the auditor or professional accountant in an executive or governance role on circumstances to consider disclosing the suspected illegal act in the audit report or the financial report.

We hope you find these comments useful in your final deliberations. Should you require any additional information, please do not hesitate to contact me at [kspargo@bigpond.net.au](mailto:kspargo@bigpond.net.au) or Channa Wijesinghe, Technical Director at [channa.wijesinghe@apesb.org.au](mailto:channa.wijesinghe@apesb.org.au).

Yours sincerely

A handwritten signature in cursive script that reads "Kate Spargo".

Kate Spargo

**Chairman**