



American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

VIA E-MAIL

December 15, 2012

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

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

Dear Members of the International Ethics Standards Board for Accountants:

The American Institute of Certified Public Accountants' (AICPA) Professional Ethics Executive Committee (PEEC) is pleased to submit this comment letter to the International Ethics Standards Board for Accountants (IESBA) on its Exposure Draft: *Responding to a Suspected Illegal Act* (the "Exposure Draft"). The AICPA is the national professional organization of certified public accountants comprised of approximately 386,000 members worldwide in business and industry, public practice, government, education, student affiliates and international associates. As part of our role in the United States, the AICPA sets ethical and independence standards for the CPA profession through the PEEC.

We support the IESBA's efforts to review and strengthen, where necessary, the requirements contained in the IESBA Code of Ethics for Professional Accountants (the "Code"). Throughout its history the AICPA has been deeply committed to promoting and strengthening independence and ethics standards. Through the PEEC, the AICPA devotes significant resources to independence and ethics activities, including evaluating existing standards, proposing new standards, and interpreting and enforcing those standards.

General Comments

The Exposure Draft discusses circumstances where a professional accountant shall or has a right to override the fundamental principle of confidentiality and disclose a suspected illegal act by a client or employer to an appropriate authority. Specifically, we understand that the IESBA is seeking to address the fact that, while the principle of confidentiality properly recognizes that candid communications between professional accountants and their clients or employers are desirable and enhance the ability of accountants to provide high-quality services that benefit the public, it might also discredit the profession if an accountant who suspected an illegal act by his or her client or employer did nothing or knowingly allowed his or her services to be used in furtherance of a client's misconduct.

We welcome the IESBA's consideration of ways in which the current standards in the Code

might be strengthened to provide guidance in situations that may give rise to such tensions. Indeed, the AICPA has long supported professional standards designed to promote the public interest that address accountants' responses to suspected illegal acts. Most recently, the AICPA's Auditing Standards Board has addressed this issue as part of SAS No. 122, *Clarification and Recodification*, which is effective for audits of financial statements for periods ending on or after December 15, 2012. In particular, Section 250 of SAS No. 122, *Consideration of Laws and Regulations in an Audit of Financial Statements*, is converged with no substantive differences with International Standards on Auditing ("ISA") 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, issued by International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

We do have concerns, however, with some of the IESBA's proposals in the Exposure Draft. As discussed in more detail below, we do not believe that the response to the tensions identified by the IESBA should place a professional accountant at risk of violating his or her legal or contractual duties of confidentiality to a client or employer or impose a potential responsibility on a professional accountant in the Code to disclose suspected illegal acts to an external authority. We believe that such an obligation should only be required of an accountant by a national regulator, pursuant to a law or regulation that also incorporates "safe-harbor" provisions that protect the accountant from potential liability for allegedly unauthorized or unjustified disclosures.

Instead, under our proposed solution, the IESBA might provide guidance that, *in appropriate circumstances*, a professional accountant should be expected to:

- report suspected illegal acts to the appropriate levels of management of a client or employer, and possibly to those charged with governance, if management's response is not timely and appropriate;
- consider disclosure to the external auditor, provided that such disclosure would not violate any legal or contractual confidentiality or non-disclosure requirements applicable to the engagement;
- encourage the client or employer to disclose the matter to an appropriate authority; and
- consider his or her continuing relationship with the client or employer if the client or employer fails to address the professional accountant's concerns.

We elaborate on the specific circumstances that should give rise to such obligations in greater detail below. In our view, such guidance would be timely and useful to professional accountants. However, as noted, any mandatory "reporting out" to external authorities should only be required pursuant to a national law or regulation that is carefully tailored to the specific circumstances in that jurisdiction and accompanied by appropriate liability safe-harbor and whistleblower protections.¹

¹ We use the term "national law or regulation" in this comment letter to refer generally to any home country law or regulation, whether national, state or local in nature.

Accordingly, we have noted below specific aspects of the Exposure Draft that we believe warrant further consideration by the IESBA in order to mitigate the risk of potential conflicts with existing laws and regulations; provide additional clarity to accountants as to the circumstances that may give rise to reporting obligations; and avoid unintended consequences and disruption to the markets for professional services. These observations are also consistent with our proposed solution, which we ask the IESBA to consider. Following the “General Comments,” we have also provided our responses to the specific questions posed by the IESBA in the Exposure Draft.

1. *Laws and Regulations May Preempt the Contemplated Disclosures*

In the United States, both federal and state laws recognize various accountant-client privileges or impose a general duty of confidentiality on accountants that applies to both audit and non-audit engagements as well as professional services performed for an employer. For example, most, if not all, states have confidentiality statutes or regulations that generally serve to prohibit CPAs from voluntarily disclosing client or employer records or information to third parties, including regulatory authorities, without client consent,² and some states also recognize an accountant-client privilege with regard to the disclosure of client information.

In certain circumstances, federal and state statutes and regulations may require, permit, or forbid an accountant from disclosing confidential client information to third parties. For example, recognizing the important role that accountants and other tax return preparers play in helping their clients comply with the requirements of the Internal Revenue Code, Congress has provided for the imposition of civil and criminal penalties on preparers who knowingly or recklessly disclose to third parties information furnished to them in connection with the preparation of tax returns, subject to narrow exceptions.³ Under one such exception, the Internal Revenue Service allows, but does not require, preparers to disclose information relating to actual or potential violations of criminal laws to government authorities. Notably, however, this exception does *not* authorize tax return preparers to disclose information relating to suspected violations of other laws (*i.e.*, civil or administrative laws) to government authorities, nor does it authorize preparers to disclose information relating to suspected violations of civil or criminal laws to professional accountants employed by other firms, such as a client’s external auditors.⁴

The proposed requirements in Sections 225 and 260 relating to the disclosure of suspected illegal acts to appropriate authorities and to external auditors would, in many instances, conflict with existing confidentiality requirements under U.S. federal and state laws. Accordingly, numerous revisions to federal and state laws likely would have to be adopted in order to override these existing confidentiality requirements. Similar issues undoubtedly would arise in other jurisdictions.

2 See, *e.g.*, Ariz. Rev. Stat. Ann. § 32-749 (2012); Cal. Bus. & Prof. Code § 506.3 (2012); Ill. Admin. Code tit. 68 § 1430.3010 (2012); N.Y. Comp. Codes R. & Regs. tit 8, § 29.10(c) (2012); 21 N.C. Admin. Code 08N.0205 (2012).

3 See 26 USC § 6713 (civil penalties); 26 USC §7216 (criminal penalties).

4 See 26 CFR 301.7216-2(q) (2012).

While the Preface to the Code, Section 100.1 of the Code and the proposed revisions to Section 140.7 of the Code suggest that the disclosures contemplated under proposed Sections 225 and 260 would not be required if “prohibited by law,” we believe the adoption of the proposed revisions to the Code, as currently drafted, could result in substantial confusion in practice among both accounting firms and professional accountants as to their obligations when confronted with inconsistent duties and obligations proposed in the Exposure Draft. Such confusion could arise, for example, if a national regulator or authority retained existing confidentiality laws that provided for limited disclosures to external authorities in specific circumstances, but also purported to require professional accountants to comply with the Code’s requirements. The Preamble to the Code states that professional accountants should comply with the “more stringent” requirement in such situations, but it would by no means always be clear which requirement should be considered the most “stringent” under such circumstances.

Accordingly, in light of existing confidentiality laws, and the potential for confusion as to the relationship between such laws and the proposed revisions to the Code, many member bodies of the IESBA may be reluctant or unwilling to adopt the proposed revisions in their current form. Were this to occur, this would seriously detract from the IESBA’s objective, as stated in its Terms of Reference, of “facilitating the convergence of international and national ethics standards, thereby enhancing the quality and consistency of services provided by professional accountants throughout the world and strengthening public confidence in the global accounting profession.” We fully support this key objective, but believe that the IESBA’s adoption of the proposed revisions to the Code, as currently drafted, would likely hinder its advancement. In comparison, we believe that the alternative approach that we have outlined above is more workable and would attract broader support while still protecting the public interest.

2. The Responsibility to Disclose Suspected Illegal Acts to Authorities Should Rest with Clients and Employers, Not Professional Accountants, Unless Required by National Law or Regulation

The Exposure Draft would require professional accountants to report suspected illegal acts to the appropriate levels of management of a client or employer, and possibly to those charged with governance, if management’s response is not timely and appropriate. We agree with this basic approach and generally would also support a requirement to encourage a client or employer to disclose a suspected illegal act to an external authority, in appropriate circumstances. However, we do not believe that the Code should impose a responsibility on a professional accountant to disclose suspected illegal acts by a client or employer to an authority. Instead, we believe that any such obligation should only arise pursuant to a separate requirement outside the Code, based on a national law or regulation.

The concept of client confidentiality is one of the fundamental principles of the accounting profession. While there may be situations in which auditors and other professional accountants are required or permitted to report suspected illegal acts involving clients to external authorities, such provisions have been carefully and narrowly crafted by national regulators in a manner that typically recognizes the general interest in preserving client confidentiality, safeguards the information received from accountants in the hands of regulators, and provides accountants with

a liability “safe harbor” against potential claims that an accountant has prematurely or improperly disclosed information to an authority. Indeed, as noted in the Exposure Draft, “[r]equirements to disclose illegal acts are normally established by law and are generally accompanied by regulations that afford protection from retaliation to those who make such disclosures.”

For example, Section 10A under the United States Securities Exchange Act of 1934 (the “Exchange Act”) imposes an obligation on auditors to “blow the whistle” and notify the Securities and Exchange Commission (“SEC”) of certain illegal acts involving their public company audit clients which they become aware of “in the course of conducting an audit.” Exceptional circumstances must be met, however, to require such disclosure. In particular, before the auditor is required to report directly to the SEC, (1) the auditor must have concluded that an issuer has “likely” engaged in an illegal act that has a “material” effect on its financial statements; (2) neither management nor the board of directors has taken timely and appropriate remedial action in response to the illegal act; (3) the issuer’s failure to take remedial action is reasonably expected to warrant departure from the auditor’s standard report or to warrant resignation; (4) the auditor has directly reported its conclusions to the issuer’s board of directors; and (5) the issuer has failed to notify the SEC of the auditor’s report on a timely basis, as required by statute. In addition, SEC regulations implementing Section 10A expressly provide that information provided by an auditor to the SEC under Section 10A is non-public and exempt from disclosure to third parties under the Freedom of Information Act.⁵ Moreover, Section 10A includes an “auditor liability” safe harbor that provides that no accounting firm shall incur liability in any private action relating to “any finding, conclusion or statement” in a firm’s Section 10A report to the SEC.⁶

The SEC’s “up-the-ladder” reporting requirements for attorneys who represent issuers before the SEC provide another example of a regulatory judgment that, in extraordinary circumstances, it may be appropriate to override professional privilege and a professional’s duty of confidentiality to a client. Under those requirements, an attorney representing an issuer is expected to make inquiries within a company when he or she receives “evidence of a material violation,” which is defined as “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.”⁷ However, an attorney is only allowed to disclose confidential information regarding a client to the SEC when, among other things, the attorney reasonably believes such disclosure is necessary “[t]o prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors.”⁸ As with the Section 10A requirements for accountants, the “up-the-ladder” rules include a liability safe harbor that protects attorneys who

5 *See* 17 CFR § 240.10A-1(c).

6 *See* Section 10A(c),

7 *See* 17 CFR § 205.2(e).

8 *See* 17 CFR § 205.3(d)(2)(i).

provide information to the SEC in good faith against any discipline or liability under any inconsistent standards in other jurisdictions where the attorney is admitted or practices.⁹

In comparison, the Exposure Draft contemplates a much wider range of potential disclosures by professional accountants to external authorities, yet the IESBA has no ability to afford such disclosures confidential treatment in the hands of the authorities that receive them or to provide accountants who make such disclosures with whistle-blower or liability safe-harbor protections. Indeed, the IESBA acknowledged “[s]uch protective mechanisms can only be established by law and it is not possible for the IESBA to establish protective mechanisms for professional accountants who have to comply with the Code.”¹⁰ Accordingly, we believe that it should be the responsibility of national regulators in the various jurisdictions, and not the IESBA, to determine the circumstances under which suspected illegal acts should be reported by professional accountants to external authorities and to provide for appropriate safe-harbor protections. Without such protections, both accounting firms and individual accountants who disclose suspected illegal acts to appropriate authorities pursuant to the Code might be subjected to claims from clients and third parties alleging that they had made premature or inappropriate disclosures of confidential client information.

3. The Proposed Disclosure Requirements Could Have a Chilling Effect on Accountant-Client Communications and the Engagement of Professional Accountants

We also believe that requiring a professional accountant to disclose suspected illegal acts to external authorities in the range of circumstances contemplated in the Exposure Draft could have a chilling effect on the accountant-client relationship. If an accountant was required to disclose suspected illegal acts to external authorities, without satisfying the stringent criteria set forth in national laws such as Section 10A of the Exchange Act, the client may be more inclined to withhold information from the accountant and less forthcoming on issues that could affect an audit or other services provided. In addition, if a professional accountant and a client were to have a difference of opinion as to whether, for example, (i) an illegal act had actually occurred, (ii) the client had taken appropriate remedial action, or (iii) the client had implemented proper controls to reduce the risk of future violations, each of which could bear on the advisability of disclosing a matter to an appropriate authority, it could place the client and professional accountant in an adversarial relationship that could hinder audit quality, potentially threaten auditor independence, or negatively impact the quality of other services performed.

These concerns are magnified here by the fact that the proposals, as drafted, would apply not only to professional accountants providing audit services, but also to accountants providing non-audit services to clients and accountants in business. In those situations, subjecting a professional accountant to inquiry obligations and potential disclosure requirements that would not apply to non-accountants providing similar services could well lead clients and employers to retain or hire less qualified firms or individuals to perform such services. We believe this could have a profound impact on the market for professional services, with unintended, negative consequences for the public interest, including businesses and investors.

9 See 17 CFR § 205.6(c).

10 Exposure Draft at 9.

4. *Information Learned by Professional Accountants Providing Non-Audit Services Should Be Excluded from the Scope of the Standard*

As discussed in General Comment No. 3, the IESBA's proposed disclosure requirements could have a chilling effect on the willingness of companies to retain professional accountants to provide non-audit services. We believe that this risk is sufficiently great with respect to certain categories of non-audit services that the IESBA should consider excluding information acquired by professional accountants while performing such services from the scope of the proposed requirements.

For example, professional accountants provide forensic accounting services, where they are retained for the purpose of investigating suspected wrongdoing, in many instances in response to the discovery of suspected fraud or illegal acts. In an investigative or litigation setting, such services may include, by way of illustration, the analysis of company books and records, data discovery and management, interviews, valuations, modeling, and expert testimony. Clients will be reluctant to hire professional accountants to provide such services, if any suspected illegal acts that are uncovered or confirmed are subject to potential disclosure by the forensic accountants to external authorities. Instead, clients may turn to other service providers, not subject to the Code's requirements, who may not be as competent to render such services. That result would not be in the public interest. Similar considerations exist with respect to other types of consulting services provided by professional accountants, such as environmental remediation assessments.

The Exposure Draft also does not address the specific issues raised where a professional accountant is requested by legal counsel to assist counsel, whose own client may have committed, or been alleged to have committed, an illegal act. When professional accountants are retained in the United States to perform the types of forensic accounting services described above, they are typically retained by legal counsel to do so. In such situations, the accountant's client is the law firm, who retains the accountant on a privileged basis, pursuant to contractual arrangements that include strict confidentiality provisions. The attorney will have his or her own legal and ethical obligations to the client, want to coordinate discussions with the client, and need to control what, if any, communications are made to third parties, including external auditors and regulators. By exercising such control and supervision over the accountant's work and communications with third parties, the attorney ensures that relevant privileges are protected and that he or she is satisfying his or her ethical duties.

Conversely, if legal counsel understands that a professional accountant may have an independent obligation to interact with management, external auditors or regulators, counsel will be far less inclined to retain an accountant in such an advisory or consultative role. For example, legal counsel would be concerned that certain steps taken by an accountant retained by such counsel to escalate an issue within an organization, or any mandatory disclosures by that accountant to external authorities, might waive privilege broadly with respect to the underlying issues on which the accountant was consulted by legal counsel. Were such a waiver found to have occurred, the attorney and his or her client might be required to disclose other communications between legal counsel and the accountant, or between legal counsel and his or her client, to third

parties, including investigatory agencies and adverse parties in private litigation. This could have significant ramifications for the attorney's client and expose both the attorney and accountant to a significant liability risk, since the attorney's client could allege that the attorney and accountant were responsible for a waiver of a privilege that properly belonged to the client, and not to the accountant or attorney, and which the client should have been allowed to control. Few legal counsel would be willing to assume that potential risk, and professional accountants should not be placed in a position where, by providing advisory services that they may be well qualified and best suited to render, they might nevertheless subject legal counsel to a significant liability risk or incur such potential exposure themselves.

These examples are not intended to be exhaustive, but they illustrate the dangers of imposing inquiry obligations and reporting requirements on professional accountants. In a related whistleblower context, the SEC has determined that individuals who become aware of information about potential illegal acts while providing services that are intended to promote a company's compliance with laws and regulations, or in connection with an entity's legal representation, should not be encouraged to "blow the whistle" on the company, absent exceptional circumstances that are not set forth in the Exposure Draft.¹¹ We believe that a similar sensitivity to the significant role that accountants play in helping companies achieve compliance with their legal and regulatory obligations and assisting legal counsel would justify an exclusion of the types of non-audit engagements described above from the scope of the IESBA's proposed requirements.

5. Professional Accountants Should Be Required to Consider Disclosing Suspected Illegal Acts to a Company's External Auditor, Where Permitted

The IESBA proposal would require a professional accountant in public practice providing professional services to a client that is not an audit client of the firm or of a network firm, as well as professional accountants in business, to disclose a suspected illegal act to the client's external auditor, where one exists, in two situations. Specifically, disclosure to the external auditor would be required if the professional accountant either (i) encountered difficulty in escalating the matter within the client or employer, or (ii) concluded that the client or employer had failed to make an adequate disclosure of the matter to an appropriate authority within a reasonable period of time after the professional accountant advised the client or employer to make such a disclosure.

It would often be beneficial for the external auditor to have knowledge of a suspected illegal act in a timely matter, and such knowledge might enable or require the auditor to escalate the matter to the appropriate levels of the client's management and possibly those charged with governance. In the United States, such disclosure might also be required in some cases under existing professional standards, which require professional accountants in business to be candid in dealing with his or her employer's external auditors and to not "knowingly fail to disclose

11 See 17 CFR § 240.21F-4(b)(4)(iii)(B) (addressing information learned by an individual retained to "perform compliance or internal audit functions" for an entity); 17 CFR § 240.21F-4(b)(4)(iii)(C) (addressing information learned by an individual retained "to conduct an inquiry or investigation into possible violations of law"); 17 CFR § 240.21F-4(b)(4)(i)-(ii) (addressing information learned by an individual through a communication subject to the attorney-client privilege or in connection with the "legal representation" of a client on whose behalf the individual or his or her firm is providing services).

material facts.”¹² At the same time, situations might also arise where a low-level staff person who has not had any prior dealings with the external auditor becomes aware of a suspected illegal act involving his or her client or employer. In such situations, it would be more practical for the accountant to report the suspected activity to a superior than to require him or her to bring it to the attention of the external auditor directly.

Accordingly, we would support a requirement that a professional accountant in public practice who is not the auditor and a professional accountant in business consider disclosing a suspected illegal act to the external auditor, provided that such disclosure would not violate any legal or contractual confidentiality or non-disclosure requirements applicable to his or her engagement or employment. We believe this approach would provide professional accountants with an appropriate degree of flexibility in determining how best to bring a suspected illegal act to the attention of those in a position to act upon such information.

Finally, in those situations where the information is provided to the external auditor by another professional accountant, we believe that the client or employer, and not the external auditor, should be responsible for deciding whether the matter should be disclosed to an appropriate authority. General Comment No. 2 explains the basis for our position in more detail.

6. The Specific Circumstances Requiring Warranting Inquiry, Escalation and Potential Disclosure Should Be Refined and Clarified

In general, we believe that it is appropriate for a professional accountant to report suspected illegal acts to the appropriate levels of management of a client or employer, and possibly to those charged with governance, if management’s response is not timely and appropriate. However, we believe that the IESBA should refine and clarify the circumstances under which a professional accountant should discuss a matter involving a suspected illegal act with management or those charged with governance at a client or employer. This would also apply to the circumstances where an accountant would be expected to encourage a client or employer to make disclosure to an appropriate authority (or to make such disclosure to the authority directly, if the IESBA moves forward with the proposal as drafted).

6.1 Materiality Considerations

As drafted, the Exposure Draft does not expressly mention or incorporate the notion of “materiality” for purposes of determining when a professional accountant should (i) look into a suspected illegal act, (ii) discuss the matter with the appropriate level of management, (iii) escalate the matter to higher levels of management or those charged with governance, (iv) advise a client or employer that matter should be disclosed to an appropriate authority, or (v) disclose the matter directly to an appropriate authority. Instead, the Exposure Draft deals with the concept of materiality indirectly by suggesting that, in making such determinations, a professional accountant is expected to exercise “professional judgment” and weigh “all the specific facts and circumstances,” including “the magnitude of the matter” and whether a suspected illegal act is “of such consequence” that disclosure would be in the public interest.

12 See Interpretation 102.3 under Rule 102 of the AICPA’s Code of Professional Conduct, ET § 102.05.

We believe that expressly introducing the notion of materiality for purposes of the various determinations expected of professional accountants under the proposed standard would provide clearer guidance. Professional accountants are familiar with the concept of materiality, and existing laws and professional auditing standards addressing illegal acts incorporate a materiality standard. Conversely, they also make clear that accountants are not expected to pursue or escalate immaterial items. For example, Section 10A(b)(2)(A) of the Exchange Act requires auditors to report illegal acts to the SEC only if they have a “material effect” on an issuer’s financial statements and the issuer has failed to respond appropriately, while current International Standards on Auditing and United States Generally Accepted Auditing Standards provide that an auditor has no obligation to communicate with those charged with governance about matters that are “clearly inconsequential.”¹³ Since professional accountants are well-versed with such standards, we believe the IESBA should also employ them here.

6.2 *Level of Suspicion*

The Exposure Draft would require a professional accountant who suspects that an illegal act may have occurred at a client or employer to take “reasonable steps” to “confirm or dispel” that suspicion. If the accountant is “unable to dispel” the suspicion, the accountant may then be required to take a series of steps, beginning with discussing the matter with the appropriate level of management at the client or employer and possibly concluding with the disclosure of the matter to an appropriate authority.

We believe that the IESBA should provide further guidance as to what types of steps it believes are “reasonable” for a professional accountant to take when he or she suspects that an illegal act may have occurred. While professional accountants providing audit services to clients may be comfortable under current standards assessing the potential impact of a suspected illegal act on a client’s financial statements and other aspects of an audit, neither auditors nor other professional accountants are likely to have similar familiarity making inquiries about a client’s or employer’s compliance or non-compliance with other laws and regulations that may have, at most, an immaterial and indirect effect on the financial statements. If the IESBA decides to move forward with its proposal, we believe that it should provide more detailed and explicit guidance as to how accountants providing such non-audit services would satisfy themselves that they have taken “reasonable steps” to address their suspicions.

We also believe that the IESBA should recognize, in considering the need for additional guidance (or potential exceptions from the scope of the proposed requirements) that professional accountants performing non-audit services are frequently engaged by clients for a limited purpose. In such circumstances, the client may be unwilling to respond to questions, or grant access to additional information, that might enable the accountant to confirm or dispel his or her initial suspicions. The client may also take the position that any such inquiries or procedures are outside the scope of the accountant’s engagement and that all costs relating to the accountant’s inquiries should be borne by the accountant. In addition, the client might quickly decide to

13 See ISA 250, § 22; AU 317.17.

replace the accountant with another service provider not subject to similar obligations, leaving the accountant uncertain as to his or her obligations.

Accordingly, we believe that, if the IESBA moves forward with its proposal, it should offer practical guidance to professional accountants providing non-audit services as to how they should fulfill their obligations under some of these challenging scenarios, which readily could be expected to arise in practice. Absent such guidance, we believe that professional accountants might also face an unacceptable risk that they had taken what they believed in good faith to have been reasonable steps to dispel their suspicions that a client or employer had engaged in an illegal act, only to be second-guessed for “not having done enough” if, at a later point, a determination was made by a court or a regulatory body that the client or employer had engaged in illegal conduct.

In addition, the IESBA has not specified what level of suspicion a professional accountant should continue to have before pursuing the various escalation steps set forth in the Exposure Draft, such as discussing a matter with those charged with governance or with external authorities. In our view, a professional accountant should be required to have a reasonable belief that a suspected illegal act is at least “likely” to have occurred before the accountant is expected to take such additional steps. We believe such a requirement would be consistent with current professional auditing standards, which contemplate that auditors will exercise professional judgment in determining whether to escalate a discussion of suspected non-compliance with laws or regulations within a client.

Without such clarification, an accountant may believe that he or she is required to continue to pursue the matter further, so long as he or she harbors *any* suspicion that an illegal act may have taken place. We do not believe that the IESBA intended this result, which might lead to the costly and time-consuming escalation of matters involving the mere possibility that a client or employer may have violated a law or regulation or an accountant’s inability to satisfy himself or herself “beyond the shadow of a doubt” that a violation has not occurred.

6.3 *The “Public Interest” Disclosure Standard*

As drafted, new Sections 225 and 360 of the Code would require a professional accountant (or, in some cases, the audit engagement partner) who became aware of a suspected illegal act to advise a client or employer to disclose a suspected illegal act to an appropriate authority, if the accountant determines that such disclosure would be in the “public interest.” If the client or employer then failed to make the recommended disclosure, the professional accountant or engagement partner would be required, or would have a right, to disclose the suspected illegal act to an appropriate authority in certain circumstances.

A hallmark of the accounting profession is its acceptance of the responsibility to act in the public interest, and we fully agree that accountants should always strive to do so. However, in the context of the Exposure Draft, the term “public interest” is undefined. Proposed Sections 225.11 and 360.11 merely state that, in determining whether disclosure would be in the public interest, the professional accountant “shall take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances would be likely to conclude that the

suspected illegal act is of such consequence that disclosure would be in the public interest.” This standard does not provide professional accountants with clear guidance as to what a “reasonable and informed third party” would conclude to be in the “public interest,” since the public interest may reflect the views of various constituencies and stakeholders with different and competing perspectives.

We note that IFAC Policy Position 5 currently defines the public interest as “[t]he net benefits for, and procedural rigor employed on behalf of, all society in relation to any action, decision, or policy.” The Exposure Draft does not state whether the term “public interest” should be similarly understood for purposes of proposed Sections 225 and 360. However, the IFAC’s definition in Policy Position 5 only underscores the difficulties that accountants might face if they were expected, in essence, to undertake a cost-benefit analysis on behalf of “all society” each time they were faced with a decision whether to advise a client or employer to disclose a suspected illegal act to an appropriate authority or to notify such authority directly.

As a result, we believe that the “public interest” standard for disclosure set forth in the Exposure Draft is unduly vague, and would likely lead to varying and inconsistent interpretations by professional accountants at - and within - different firms and in different jurisdictions. Since the obligations contemplated under the Code presumably would be imposed on individual accountants, as well as their firms, this could lead to situations, for example, in which one professional accountant reached a conclusion that a suspected violation was not of sufficient consequence to warrant disclosure, while another professional accountant with the same information may reach the opposite conclusion. The Exposure Draft provides no guidance on how such differences of opinion should be resolved and, in our view, the prospect of such inconsistent and subjective interpretations of a new ethics standard would not serve the needs of investors or other capital markets participants.¹⁴

6.4 *Determining the “Appropriate Authority”*

The Exposure Draft contemplates disclosures of suspected illegal acts to “the appropriate authority” in various circumstances, and describes “[a]n appropriate authority” as “one with responsibility for such matter.” In practice, however, we believe that it might prove difficult for a professional accountant to determine who would be considered the “appropriate authority” for reporting purposes.

For example, there may be multiple authorities in one or more countries with jurisdiction over a

14 By way of contrast, in the SEC’s “up-the-ladder” rules, the agency’s “permissive disclosure” standard for attorneys who represent issuers before the SEC and receive “evidence of a material violation” by an issuer is more clearly and narrowly defined. Specifically, the SEC’s rules authorize an attorney to disclose confidential client information to the agency *only* if the attorney has a reasonable belief that the disclosure is necessary (i) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (ii) to prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury, suborning perjury, or committing an act that is likely to perpetrate a fraud upon the SEC; or (iii) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used. *See* 17 CFR § 205.3(d)(2).

client's or employer's suspected illegal acts, and a professional accountant may be uncertain as to which authority a proposed disclosure should be made. The Exposure Draft also does not address what a professional accountant's responsibilities would be if the accountant recommended that a client or employer disclose a matter to a particular authority, and the client or employer responded that it believed any such disclosure should be made to a different authority. In addition, if a client or employer is not subject to regulation by authorities such as a competition regulator or a securities regulator, the only "appropriate authority" to receive a report may simply be a local law enforcement authority with limited personnel and resources. This might be the case, for example, with respect to many small and medium-sized private companies.

Accordingly, accountants may face uncertainties both in determining which entity should be considered the "appropriate authority" for reporting purposes and in determining whether disclosures should only be made to authorities that reasonably might be expected to take some action upon receiving disclosure of a suspected illegal act. In our view, these uncertainties further support the conclusion that the types of external reporting requirements contemplated under the Exposure Draft should be imposed, if at all, by regulators with appropriate subject-matter jurisdiction and expertise, and not by the IESBA in the Code.

6.5 *Distinguishing Between a Requirement and a "Right" to Disclose a Suspected Illegal Act*

The IESBA's proposal would *require* a professional accountant in public practice providing professional services to an audit client, or the audit engagement partner, to report certain suspected illegal acts to an appropriate authority, if the client had failed to make such disclosure after being advised to do so by the professional accountant or the engagement partner. In comparison, professional accountants providing services to a non-audit client or in business would have a *right* to disclose such acts, if the client or employer had failed to follow the accountant's advice to disclose, and normally would be "expected" to exercise that right.

It does not appear to us that there is any significant difference between the proposed requirement to disclose suspected illegal acts and the "right" to disclose such acts, when the proposal states that the professional accountant is "expected" to exercise this right in order "to fulfill the accountant's responsibility to act in the public interest." In either case, the disclosure apparently would be excused only if "exceptional circumstances" existed in which a reasonable third party would conclude that "the consequences of disclosure are so severe as to justify" not making the disclosure to an appropriate authority. Should the IESBA decide to move forward with the proposal, we believe it should eliminate this distinction, which might lead to unnecessary confusion as to the scope of the obligation that the IESBA is seeking to impose on professional accountants.

Responses to Request for Specific Comments

In response to the questions posed in the Exposure Draft's request for specific comments, we are also providing additional comments below. These comments should be read in light of, and are qualified by, our recommendation that the IESBA consider the alternative solution that we

outlined in the “General Comments” section and our other comments on the proposed standard set forth in that section.

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. We believe it would be appropriate for a professional accountant to report suspected illegal acts to the appropriate levels of management of a client or employer, and possibly with those charged with governance, if management’s response is not timely and appropriate. However, we believe that the specific circumstances warranting escalation should be refined and clarified. *See* General Comment No. 6.

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?

No. For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on a professional accountant to make such disclosures, accompanied by appropriate liability safe-harbor protections. In addition, as discussed in General Comment No. 6.5, we do not believe that there is any actual difference between a professional accountant’s requirement and “right” to disclose certain illegal acts to an appropriate authority under the proposed standard, since the Exposure Draft states that the accountant generally would be “expected” to exercise that right.

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. For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on a professional accountant to make such disclosures, accompanied by appropriate liability safe-harbor protections. In addition, as discussed in General Comment No. 6.3, we believe that the “public interest” standard for disclosure in the Exposure Draft is unduly vague, and would likely lead to inconsistent and subjective interpretations of the obligations that the IESBA proposes to place on professional accountants who become aware of a suspected illegal act.

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 agree that it may be appropriate to establish a standard for a professional accountant in public practice providing services to an audit client that differs from the standard for a professional accountant in public practice providing services to a non-audit client. For example, a non-auditor providing services to an audit client may be able to share information about a suspected illegal act with the audit engagement partner for that client. In comparison, a professional accountant who is providing services to a non-audit client may be restricted by law or contract in his or her ability to provide such information to an external auditor. In addition, due to the audit relationship, a professional accountant providing services to an audit client may be able to take advantage of existing lines of communication at a client, in order to escalate a matter with senior levels of management or those charged with governance, whereas a professional accountant providing services to a non-audit client may not have access to similar lines of communication.

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?

No. For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant in public practice. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on a professional accountant to make such disclosures, accompanied by appropriate liability safe-harbor protections. If an entity has not made adequate disclosure to an appropriate authority in a situation where the auditor believes such a disclosure is warranted, we believe the auditor should be required to consider his or her continuing relationship with that entity.

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?

Yes. We believe it would be appropriate for such individuals to report suspected illegal acts to the appropriate levels of management of a client, and possibly with those charged with governance, if management's response is not appropriate. If the suspected illegal act relates to the client's financial statements, however, it may be appropriate for the non-auditor to bring the matter to the attention of the audit engagement partner and for the engagement partner to escalate the matter, if appropriate.

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?

For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to

disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the auditor. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on an auditor to make such disclosures, accompanied by appropriate liability safe-harbor protections. However, subject to our observations in General Comment No. 6, we believe it would be appropriate to require an auditor to consider encouraging a client to disclose to an appropriate authority certain suspected illegal acts that affect the client's financial reporting, or that relate to subject matters that fall within the expertise of other professional accountants at the firm, if management's response is not appropriate.

8. Do respondents agree that 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?

For the reasons discussed in General Comment No. 5, we would support a requirement that professional accountants in public practice providing services to a client that is not an audit client of the firm or a network firm and professional accountants in business consider disclosing a suspected illegal act to the external auditor, provided that such disclosure would not violate any legal or contractual confidentiality or non-disclosure requirements applicable to the accountant's engagement or employment.

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 in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant in public practice. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on a professional accountant to make such disclosures, accompanied by appropriate liability safe-harbor protections. In addition, as discussed in General Comment No. 6.5, we do not believe that there is any actual difference between a professional accountant's requirement and "right" to disclose certain illegal acts to an appropriate authority under the proposed standard, since the Exposure Draft states that the accountant generally would be "expected" to exercise that right.

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?

For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant in public practice. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on a

professional accountant to make such disclosures, accompanied by appropriate liability safe-harbor protections. However, subject to our observations in General Comment No. 6, we believe it would be appropriate to require a professional accountant to consider encouraging a client to disclose to an appropriate authority certain suspected illegal acts that relate to subject matters that fall within the expertise of the professional accountant, if management's response is not appropriate.

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?

For the reasons discussed in General Comment No. 5, we would support a requirement that professional accountants in public practice providing services to a client that is not an audit client of the firm or a network firm and professional accountants in business consider disclosing a suspected illegal act to the external auditor, provided that such disclosure would not violate any legal or contractual confidentiality or non-disclosure requirements applicable to the accountant's engagement or employment.

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. For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on a professional accountant to make such disclosures, accompanied by appropriate liability safe-harbor protections. In addition, as discussed in General Comment No. 6.5, we do not believe that there is any actual difference between a professional accountant's requirement and "right" to disclose certain illegal acts to an appropriate authority under the proposed standard, since the Exposure Draft states that the accountant generally would be "expected" to exercise that right.

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?

For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on an auditor to make such disclosures, accompanied by appropriate liability safe-harbor protections. However, subject to our observations in General Comment No. 6, we believe it would be appropriate to require a professional accountant in business to consider encouraging an employer to disclose to an appropriate authority certain suspected illegal acts that affect the employer's financial reporting,

or that relate to subject matters that fall within the expertise of the professional accountant, if the employer's response is not appropriate.

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?

For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant. National regulators, and not the IESBA, should decide whether to impose a requirement or confer a right on an auditor to make such disclosures, accompanied by appropriate liability safe-harbor protections. However, subject to our observations in General Comment No. 6, we believe it would be appropriate to require a professional accountant to encourage a client to disclose to an appropriate authority certain suspected illegal acts that relate to subject matters that fall within the expertise of the professional accountant, if management's response is not appropriate. As part of that consideration, we believe that a professional accountant reasonably might take into account exceptional circumstances that weigh against making such a recommendation.

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 be the exceptional circumstances be described?

For the reasons discussed in General Comments Nos. 1-4, we believe that the decision to disclose a matter to an appropriate authority ordinarily should lie with management and those charged with governance, not the professional accountant. However, subject to our observations in General Comment No. 6, we believe it would be appropriate to require a professional accountant to consider encouraging a client to disclose to an appropriate authority certain suspected illegal acts that relate to subject matters that fall within the expertise of the professional accountant, if management's response is not appropriate.

As part of that consideration, we believe that a professional accountant reasonably might take into account the types of exceptional circumstances described in the Exposure Draft when considering whether to encourage a client or employer to disclose suspected illegal acts to an appropriate authority. In addition, if the IESBA decides to move forward with the proposal as drafted, we believe the types of exceptional circumstances that relieve a professional accountant of a reporting obligation should be expanded to include, for example, circumstances in which disclosure would expose the accountant to significant legal risk due to the lack of liability safe-harbor and whistleblower protections.

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

No. While professional auditing standards require the documentation of certain issues addressed in connection with an audit engagement, the Code does not currently impose similar

documentation requirements on other professional accountants. We believe that, if the IESBA moves forward with the proposal, the standard should instead call upon a professional accountant to consider documenting such factors as his or her understanding of the suspected illegal act, the inquiries made by the accountant, and management's response.

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?

No. We believe that any changes to the existing sections of the Code discussed in the Exposure Draft should be consistent with our "General Comments." In particular, we do not believe that Section 140.7 of the Code should be amended to require professional accountants to comply with the requirements of proposed Sections 225 and 360, as currently drafted.

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 commend the IESBA for undertaking an impact analysis and including the analysis in the Exposure Draft. There are aspects of the analysis that we do not fully understand, however, as well as other factors that are not reflected in the analysis and which we believe warrant greater consideration.

The impact analysis identifies as "high" and "ongoing" the increased exposure of professional accountants to litigation, if they disclose suspected illegal acts to appropriate authorities and their suspicions turn out to be unfounded. Similarly, the analysis identifies the potential exposure of professional accountants to retaliation for making such disclosures as "high" and "ongoing," since not all jurisdictions would presently afford whistle-blowing protection to the accountants. These risks do not appear to be reflected, however, in the IESBA's actual proposals. In our view, they underscore why national regulators, which unlike the IESBA have the ability to confer liability safe-harbor and anti-retaliation protections on professional accountants, should determine whether to impose a requirement, or confer a right, on a professional accountant to disclose suspected illegal acts involving clients or employers to external authorities. *See* General Comment No. 2.

In addition, the impact analysis states that, if the proposals were adopted, professional accountants in public practice who are not auditors and professional accountants in business would now have "have a process for confirming or dispelling suspicion of illegal acts." The proposals would require such professional accountants to "take reasonable steps" to confirm or dispel their suspicions, and identifies their obligations if they were unable to do so. However, they do not identify what steps or procedures would be considered "reasonable" to confirm or dispel an accountant's suspicions, other than to state that the accountant may wish to consult with others within his or her firm or, on an anonymous basis, with a relevant professional body. Accordingly, the proposed standard does not appear to provide professional accountants in public practice who are not auditors or professional accountants in business with a specific "process" for confirming or dispelling their suspicions in situations involving suspected illegal acts. In practice, we believe some firms might be required to devote significant time and

expense to developing new policies and procedures for satisfying their responsibilities under the proposed standards. These costs are not reflected in the impact analysis.

The impact analysis also suggests that the proposals, if adopted, could lead to a possible reduction in the number of illegal acts because of the deterrent effect associated with a client's or employer's knowledge that a professional accountant providing non-audit services to a client that is not an audit client or a professional accountant in business would be expected to exercise his or her right to disclose certain illegal acts to an appropriate authority. While the proposals, if adopted, might have some deterrent effect, we believe the impact analysis should also acknowledge that the existence of such disclosure obligations might also chill communications between professional accountants and their clients or employers. This could reduce the quality of the services provided by professional accountants, with an adverse impact on clients, employers and other stakeholders. In addition, we believe the proposals, if adopted, would result in a significant, ongoing risk that clients and employers might turn to less qualified individuals and firms that are not professional accountants or composed of professional accountants for consulting and other non-audit services, since other service providers would not be subject to these inquiry obligations and potential disclosure requirements upon learning of a suspected illegal act. See General Comments Nos. 3-4. The impact analysis does not discuss this risk, which could have an adverse impact on the public interest, including but not limited to clients, employers, investors and other stakeholders.

* * *

We appreciate this opportunity to comment. We would be pleased to discuss in further detail our comments and any other matters with respect to the IESBA's Exposure Draft.

Sincerely,

A handwritten signature in black ink that reads "Wes Williams, CPA". The signature is written in a cursive, slightly slanted style.

Wes Williams, CPA
Chair, Professional Ethics Executive Committee

cc: Lisa A. Snyder, Director, Professional Ethics Division
Brian Caswell, IESBA