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Seminar on Proposed Amendment to the Code of Ethics

*IESBA Exposure Draft on Responding to a
Suspected Illegal Act*

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YOUR HOSTS

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Agenda

- Background and requirements under the existing Code of Ethics
- The proposals
- Your views



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Background and requirements under the existing Code of Ethics



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- Confidentiality is one of the five fundamental principles in the Code
- The principle imposes an obligation on all professional accountants to refrain from disclosing outside their accounting firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose



- Section 140, *Confidentiality* identifies three circumstances where professional accountants are required, or may be required, to disclose confidential information:
 - Disclosure is permitted by law and is authorized by the client or the employer;
 - Disclosure is required by law; and
 - There is a professional duty or right to disclosure when not prohibited by law.
- Additional requirements are set out in Section 410 *Unlawful Acts or Defaults by Clients of Members* and Section 411 *Unlawful Acts or Defaults by or on Behalf of a Member's Employer* of HKICPA Code of Ethics for Professional Accountants



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- In November 2010, the IESBA approved a project proposal to provide additional guidance for all professional accountants on how to respond when encountering a suspected fraud or illegal act. The project was to address two main elements:
 - the process to be followed when a professional accountant encounters a suspected fraud or illegal act, and
 - the circumstances in which a professional accountant would override the fundamental principle of confidentiality and disclose the matter to an appropriate authority



- The project proposal stated that the initial presumption of the project should be to restrict the matters to be addressed to suspected fraud and illegal acts (as defined by International Standards on Auditing [ISAs] as issued by the International Auditing and Assurance Standards Board [IAASB])
- The project proposal, however, called for a consideration of whether the scope of the project should be wider to address, for example, personal misconduct and matters that are “unethical” or “improper”



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- The IESBA recognizes that ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* states that the auditor's professional duty to maintain confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside of the entity
- Subject to responses to the proposals on exposure, the IAASB will consider whether consequential changes to ISA 250 may be needed in light of changes to the Code. The IESBA will liaise with the IAASB in this regard



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The proposals



Suspected Illegal Act

- The proposal describes illegal acts as acts of omission or commission, intentional or unintentional, committed by a client, or by those charged with governance, management or employees of a client which are contrary to the prevailing laws or regulations
- Personal misconduct unrelated to the business activities of the entity is excluded
- The proposal addresses suspected illegal acts because whether an act is illegal is ultimately a matter for legal determination by a court of law



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- This description is consistent with ISA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements"



Escalation

- The proposal would require a professional accountant when encountering a suspected illegal act to take reasonable steps to confirm or dispel the suspicion and to discuss the matter with the appropriate level of management
- If the response of those with whom the matter has been discussed is not appropriate, the professional accountant shall escalate the matter to higher levels of management and those charged with governance, as appropriate
 - In the case of a suspected illegal act at a subsidiary level in a group of companies, this escalation would normally include escalation to the parent level as the management at the parent level would be responsible for governance in subsidiaries



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- Through escalating the matter, the professional accountant would obtain additional information about the suspected illegal act.
 - This would mean that before reaching the stage where disclosure to an appropriate authority would be required or expected the professional accountant would have been able to reach a reasonable level of suspicion.



Disclosure

- If the response is not appropriate and, in the judgment of the professional accountant, the suspected illegal act is of such consequence that disclosure would be in the public interest:
 - **Audit service** - a professional accountant providing professional services to an audit client would be **required to disclose** certain illegal **acts to an appropriate authority**; and



- **Non-audit service and PAIB** - a professional accountant providing non-audit services to a client that is not an audit client and a professional accountant in business would be required to disclose the matter to the entity's external auditor, if any, and, in certain circumstances, would have a right to disclose certain illegal acts to an appropriate authority and would be expected to exercise that right



Response consideration

- The determination of whether the response of the client or employing organization to the suspected illegal act is appropriate require professional judgment and include a consideration of the nature and magnitude of the matter and factors such as whether:
 - The matter has been adequately investigated;
 - Remedial action has been taken to address the matter; and
 - Appropriate steps have been taken to reduce the risk of re-occurrence, such as for example, additional controls or training.



Public interest consideration

- In making this determination on whether suspected illegal acts are of such consequence that disclosure to an appropriate authority 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
- The determination will require professional judgment and consideration of the nature and magnitude of the matter, including the number of people that could be affected by the suspected illegal act and the extent to which those people could be affected, irrespective of the size of the client or employing organization



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- The IESBA considered whether the proposal should contain additional factors that the professional accountant would consider in determining whether disclosure was in the public interest, including the significance of the act to financial reporting and the likelihood of re-occurrence
 - The IESBA concluded that including such factors was not appropriate in the context of the wide range of circumstances that could be encountered



Types of Suspected Illegal Acts to be Disclosed

- The proposals require a professional accountant to consider any applicable legal or regulatory requirements and to comply with the requirements
- The IESBA considered the types of illegal acts that a professional accountant would be required, or have a right, to disclose to an appropriate authority. The IESBA is of the view that such acts are those that are related to the expertise and responsibilities of the professional accountant in his or her particular role:



- For a professional accountant in public practice providing services to an audit client:
 - Suspected illegal acts that directly or indirectly affect the client's financial reporting; and
 - Suspected illegal acts the subject matter of which falls within the expertise of the professional accountant;
- For a professional accountant in public practice providing services to a non-audit client:
 - Suspected illegal acts that relate to the subject matter of the professional services being provided by the professional accountant;



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- For a professional accountant in business:
 - Suspected illegal acts that directly or indirectly affect the employing organization's financial reporting; and
 - Suspected illegal acts the subject matter of which falls within the expertise of the professional accountant.



Requirement or Right to Disclose

- **For a professional accountant in public practice providing professional services to an audit client of the firm**
 - The IESBA concluded that a professional accountant in public practice providing professional services to an audit client of the firm, or a network firm, should be **required to report certain suspected illegal acts to an appropriate authority**, if the accountant determines that the suspected illegal act is of such consequence that reporting would be in the public interest and the entity has not self-reported.



- **For a professional accountant in public practice providing professional services to a non-audit client of the firm and professional accountants in business**
 - The IESBA also concluded that professional accountants in public practice providing services to a non-audit client and professional accountants in business should **have a requirement to disclose certain acts to the entity's external auditor** and would then **have a right to disclose such acts to an appropriate authority**, if the accountant determines that the suspected illegal act is of such consequence that reporting would be in the public interest and the entity has not self-reported. The professional accountant would be expected to exercise this right in order to fulfill the accountant's responsibility to act in the public interest



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- The IESBA is of the view that it is appropriate for an auditor to be required to disclose certain suspected illegal acts because of the auditor's role in safeguarding the public interest
- The IESBA is of the view that imposing a requirement on other professional accountants in public practice and professional accountants in business would not be consistent with the role of such professional accountants which is more of a fiduciary nature towards the client and employer.



- A professional accountant providing services to a non-audit client may not have appropriate access to management or those charged with governance to adequately escalate the matter.
- A professional accountant in business also might not have this access. The IESBA proposes, therefore, that such accountants have a requirement to disclose the matter to the entity's external auditor. Having received the disclosure, the external auditor would then be required to follow the outlined process and ultimately the external auditor may be required to disclose the matter to an appropriate authority



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- The proposals also require a professional accountant to consider whether it is appropriate to terminate the professional relationship with the client or resign from the employing organization
 - Termination or resignation is not a substitute for disclosure to an appropriate authority



Exceptional circumstances

- The proposals provide that in exceptional circumstances the professional accountant would not be required to disclose the matter or be expected to exercise the right to disclose the matter
- Such exceptional circumstances would arise where a reasonable and informed third party would conclude the consequences of disclosure are so severe as to justify not disclosing
 - An example of such an exceptional circumstance would be threats to the physical safety of the professional accountant or others



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- Circumstances of a commercial nature, such as the loss of a client or income, would not constitute exceptional circumstances
 - The IESBA is of the view that commercial consequences to the professional accountant or others are not sufficient ground to warrant justification for not disclosing.



- If the professional accountant determines not to disclose because exceptional circumstances exist, the proposals call for the professional accountant to determine whether to terminate the professional relationship with the client (in the case of a professional accountant in public practice) or resign from the employing organization (in the case of a professional accountant in business)
- In the case of a professional accountant providing professional services to an audit client, the proposals also require the professional accountant to determine whether it is appropriate to provide professional services in the particular jurisdiction
 - The IESBA is of the view that such actions are consistent with a professional accountant's responsibility to act in the public interest



Documentation

- The proposals require documentation of the steps the professional accountant took to respond to suspected illegal acts
- The documentation shall include the persons consulted, responses received, and the disclosure, if any, made to an appropriate authority
- The proposal does not require extensive documentation of every individual suspected illegal act. The level of documentation would be commensurate with the gravity of the suspected illegal act



- The proposal would also require documentation when the professional accountant, due to exceptional circumstances, did not make the required or expected disclosure to an appropriate authority. The documentation would include:
 - the rationale for not disclosing;
 - if the accountant did not terminate the professional relationship or resign from the employing organization, the rationale for not doing so; and
 - in the case of a professional accountant providing services to an audit client of the firm or a network firm, if the accountant determined it was appropriate to continue providing professional services in the particular jurisdiction, the rationale for doing so



- The IESBA is of the view that it would only be in exceptional circumstances that a professional accountant would determine that it was not appropriate to make the required or expected disclosure to an appropriate authority. It is, therefore, appropriate that such circumstances and the rationale for not disclosing be comprehensively documented.
- The IESBA is of the view that maintaining such documentation is also in the interest of the professional accountant.



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Your views



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Thank you for your attention