



KPMG IFRG Limited
15 Canada Square
London E14 5GL
United Kingdom

Tel +44 (0)20 7694 8871
sylvia.smith@kpmgifrg.com

Ken Siong
Technical Director
International Ethics Standards Board for
Accountants (IESBA)
529 Fifth Avenue, 6th Floor
New York, NY 10017
United States of America

Our ref SS/288
Contact Sylvia Smith

4 September 2015

Dear Mr Siong

Exposure Draft, *Responding to Non-Compliance with Laws and Regulations*

We appreciate the opportunity to comment on the above Exposure Draft issued by the International Ethics Standards Board for Accountants (“IESBA” or “the Board”). We have consulted with, and this letter represents the views of, the KPMG network.

We set out our overarching comments in response to the Exposure Draft below. Our responses to the questions set out in the Exposure Draft are included in the Appendix to this letter.

Overarching Comments

We are supportive of the proposals set out in the Exposure Draft, in the context of the evolving nature of rules and regulations around non-compliance with laws and regulations (“NOCLAR”), and ever-increasing public calls for transparency more generally.

As we stated in our response to the previous IESBA Exposure Draft, *Responding to a Suspected Illegal Act*, we support the principle that professional accountants, both those in business as well as those in public practice, should act in the public interest. This principle is long-established and sets the tone for the existing IESBA Code of Ethics, which states at the outset that “A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest” (100.1).

In particular, therefore, we welcome the intention of the proposed changes to encompass the different categories of Professional Accountant (“PA”), including not only PAs in public practice, but also PAs in Business (“PAIB”), acknowledging the critical role they play in capital markets. We also consider that in general the Board has given appropriate recognition to their differing roles and responsibilities, seniority and spheres of influence and has proposed required actions that are proportionate, premised on the overriding principle to act in the public interest.

We support the emphasis that the proposals place on the primary responsibility of a client’s management and those charged with governance (“TCWG”) for the identification and resolution

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

of NOCLAR and, accordingly, the responsibilities of senior PAIBs for setting the right “tone at the top” and establishing appropriate controls in this area. We believe the proposals not only will help to reinforce and enhance requirements set out in professional standards regarding information exchange between auditors and management/TCWG, but also that they aim to extend these principles to improve information flow between other relevant parties, which will both encourage ethical behaviour and increase the likelihood of senior management being alerted to a problem in time to prevent serious harm.

We agree with the Board’s view that the Code operates as part of a wider framework, which needs to include strong corporate governance systems and robust, trusted and effective legal and regulatory regimes. We believe the Code plays a critical role in bringing about change to address the issue of NOCLAR.

We also believe that to drive a real and significant change in mindset and behaviour, changes need to be effected holistically, at a societal level, involving a number of parties and affecting many professions. As a result, it is right that the Code both recognises and responds to public expectations, whilst at the same time does not impose requirements that may not be practicable and may discourage entities from engaging PAs in favour of other professionals, as this would clearly not be in the public interest.

We are therefore supportive of the removal of the previously proposed requirement for auditors and other PAs to disclose identified or suspected NOCLAR to an appropriate authority, and we welcome the principles-based approach now set out in the ED, which enables the PA to exercise their judgement, supported by guidance as to whether disclosure may be appropriate.

Threshold of Credible Evidence of Substantial Harm

In this context we agree with the inclusion of the threshold of “credible evidence of substantial harm” as one of the factors to consider in determining an appropriate course of further action. We believe that the terminology and definition will provide helpful guidance to PAs, to determine when a matter is significant enough to warrant further action.

Reasonable and Informed Third Party Test

We are also supportive of the introduction of the third party test given its intention to help ensure that the PA performs an objective and rigorous assessment of whether it is necessary to take further action and if so, what form that action should take, based on the facts and circumstances known to the PA at that time. We believe this test, together with the documentation requirement, will help to ensure a robust approach.

Courses of Further Action

We agree in general with the courses of further action set out in the proposals and the factors to consider in determining whether further action is necessary in the public interest.

We have a concern with the suggestion that a PA in public practice performing a service other than an audit may disclose the matter to the external auditor, if one exists, as a potential course of further action. Whilst we are fully supportive of the underlying intention to encourage an appropriate exchange of significant and relevant information with the auditor, which may impact on audit quality and clearly would be in the public interest, we question the inclusion of this in the specific context of “further action”. This is because the Code appears to equate this to making a disclosure to an appropriate authority, in order to discharge professional responsibility. (The Explanatory Memorandum itself describes the courses of further action as “pressure release valves”). Since the Code clearly explains that raising a matter to an appropriate authority is a specific course of action that may be taken in order that the authority can “cause the matter to be investigated and take action in the public interest”, we believe this may place undue responsibility on the auditor. Depending on the nature of the matter, the effects of relevant law and regulations, and also the timing of disclosure relative to the audit cycle, the auditor may not be able to take appropriate action within a reasonable timeframe, and/or may themselves need to consider whether to disclose to an appropriate authority. This could result in the PA who is not the auditor effectively “passing the buck” to the auditor, and leaving the auditor in a difficult situation, especially when the matter is merely a suspicion and/or the auditor does not have “credible evidence” or is not able at that point in time to obtain the necessary further information.

Instead we recommend that disclosure to the external auditor is included as a required additional consideration (as opposed to as a potential course of action), aligned with that of disclosing to another network firm in paragraph 225.40.

Informing a group auditor about a matter

In connection with providing information to the external auditor, we also recommend introducing a requirement to consider informing the group auditor of a matter, if the entity subject to audit procedures is a component of a group. This would give recognition to the serious nature of NOCLAR and the effect an event may have on a group audit. This would also address an apparent inconsistency since potential courses of further action for senior PAIBs, set out at paragraph 360.23, include consideration as to whether to inform the parent entity of the matter if the employing organisation is a member of a group.

We suggest that the requirement to consider such communication be placed immediately after paragraph 225.19, i.e. prior to the section addressing determining whether further action is needed. This would emphasise the importance of this communication, irrespective of whether management/ TCWG have taken appropriate steps to address the matter and whether the professional accountant determines that he/she needs to take further action as set out in the Code. This would be aligned with the placement of the equivalent requirements for a professional

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

accountant performing a non-audit service to communicate such a matter within the firm at paragraph 225.39 and to consider whether to communicate the matter to the network firm, at paragraph 225.40.

We believe this requirement would be in accordance with, and would complement ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 41 which states that “the group engagement team shall request the component auditor to communicate matters relevant to the group engagement team’s conclusion with regard to the group audit. Such communication shall include... d) Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements.” We consider it appropriate, and not duplicative, to include this requirement given the broader scope and objectives of the Code as compared to ISAs.

Authority of the Code

One of the key challenges in meeting its objectives is the authority of the Code in different jurisdictions, since it is not, in and of itself, an instrument of law. Accordingly, it needs to both provide a platform to support high standards of ethical behaviour that places the requirement to act in the public interest at its core, and ensure that proposals are capable of being effected clearly and consistently across multiple jurisdictions. This requires careful consideration as to how the proposals are to integrate with and complement differing legal and regulatory requirements and regimes, as well as the varying forms of infrastructure in place to support their practical implementation.

Importantly, we believe the proposals have struck the right balance between encouraging PAs to act in the public interest in respect of NOCLAR, but without establishing requirements, in particular in relation to disclosing a matter outside the entity, that are not practicable, or which could result in restrictions to openness and transparency in the relationships described.

In connection with the interaction of the proposals with prevailing laws and regulations in different jurisdictions, we highlight that the proposals state that if the PA determines that disclosure of a matter to an appropriate authority is an appropriate course of action in the circumstances, this will not be considered a breach of the duty of confidentiality under Section 140 of the Code. While we are supportive of this clarification, we consider that its application may be more complex, as a result of the interaction of the Code with the various legal and regulatory requirements in place in different jurisdictions. In particular, where the Code and ISAs are adopted directly into law, consideration would need to be made as to any conflicts between the Code and applicable law, which may not be straightforward.

Accordingly, we recommend that the Board reach out to key jurisdictions to discuss this, in order to understand the implications of including these statements.

Please contact Sylvia Smith at +44 20 7694 8871 if you wish to discuss the contents of this letter.



KPMG IFRG Limited
Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

Yours sincerely

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Appendix – Responses to Specific Questions

- 1. Where law or regulation requires the reporting of identified or suspected NOCLAR to an appropriate authority, do respondents believe the guidance in the proposals would support the implementation and application of the legal or regulatory requirement?**

We believe the guidance in the proposals would support and complement the application of applicable legal or regulatory requirements to report identified or suspected NOCLAR and therefore may be of benefit in stimulating an increase in such reporting.

We consider that the proposals help to emphasise the responsibility of PAs to comply with laws and regulations of this nature, and provide useful context to enable PAs to better understand the nature of such requirements.

- 2. Where there is no legal or regulatory requirement to report identified or suspected NOCLAR to an appropriate authority, do respondents believe the proposals would be helpful in guiding PAs in fulfilling their responsibility to act in the public interest in the circumstances?**

We believe that, in the absence of legal or regulatory requirements to report identified or suspected NOCLAR to an appropriate authority, the proposals would be helpful in guiding PAs to fulfil their responsibility to act in the public interest.

Firstly, we note that paragraph 225.27 states that such disclosure would be precluded if it would be contrary to law or regulation. We are supportive of the inclusion of such a clear statement since it is important that the Code does not place PAs in a difficult position with regard to following a course of action that may result in a breach of prevailing laws, such as those addressing confidentiality.

We welcome the focus on auditor communication with an appropriate level of management and TCWG, whilst obtaining an understanding of a matter and considering whether their response is appropriate, including the emphasis placed on related requirements set out in professional standards.

We also consider the factors set out at paragraph 225.27, in guiding PAs in their determination as to whether or not to disclose a matter to an appropriate authority, to be helpful and balanced, since they refer to whether or not an appropriate authority can be identified; whether there would be robust protection from liability or retaliation, and whether there would be a risk of harm to the accountant or other individuals. Since related protections attach to pre-existing laws and regulations, it is important that the Code gives clear recognition to these matters, which may present particular complexity and challenges when there is no legal or regulatory requirement to disclose.

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

3. The Board invites comments from preparers (including TCWG), users of financial statements (including regulators and investors) and other respondents on the practical aspects of the proposals, particularly their impact on the relationships between:

In general we are supportive of the proposals and consider that they are likely to enhance the relationships described below, since broadly they encourage the free flow of information between relevant parties.

Importantly, we believe the proposals have struck the right balance between encouraging PAs to act in the public interest in respect of NOCLAR, but without establishing requirements, in particular in relation to disclosing a matter outside the entity, that are not practicable, or which could result in restrictions to openness and transparency in the relationships described.

a) Auditors and audited entities

We consider that the proposals are beneficial in that they encourage two-way communication between auditors and audited entities. In particular:

- As noted above, we welcome the focus on auditor communication with an appropriate level of management and TCWG;
- Certain provisions in the proposals remind and encourage management and TCWG to make full and frank disclosure to auditors in accordance with their obligations to provide all information necessary to the auditor to enable the auditor to fulfil their professional responsibilities.

b) Other PAs in public practice and their clients

We believe the proposals better recognise the specific nature of engagements and relationships between other PAs in public practice and their clients, and the inclusion of reference to the nature and terms of arrangements is helpful in recognising privileged relationships, the specific terms of any contract in place between PAs in public practice and their clients and the often stringent confidentiality laws and regulations in force in certain jurisdictions.

c) PAIBs and their employing organisations.

We believe the proposals are proportional and balanced in terms of encouraging PAIBs to act in the public interest, whilst avoiding placing PAIBs at a professional disadvantage when compared to others within an organisation.

4. Do respondents agree with the proposed objectives for all categories of PAs?

We agree with the proposed objectives and consider it appropriate that these are applicable to all categories of PA. We believe all PAs should be bound by the same fundamental principles of integrity and professional behaviour and accordingly, should act in the public interest and not bring the profession as a whole into disrepute.

We recognise that the ability of the PAs to respond, and the form of the response, will differ between the categories, according to their different roles and responsibilities, seniority and spheres of influence. We therefore welcome the proposed differential approach among the four categories, as we explain in our response to question 6.

5. Do respondents agree with the scope of laws and regulations covered by the proposed Sections 225 and 360?

We agree that the scope of laws and regulations encompassed by the proposals is appropriate, in particular, because it is aligned with the scope of laws and regulations addressed by ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

We recognise that the application of the proposals differs between the ISAs and the Code, which we believe to be appropriate given that the scope of the Code encompasses wider public interest implications of NOCLAR, and in view of the differing objectives of the ISAs and the Code.

6. Do respondents agree with the differential approach among the four categories of PAs regarding responding to identified or suspected NOCLAR?

We are supportive of the differential approach among the four categories of PAs as we believe that this establishes requirements and provides guidance in a proportionate matter that recognises the different roles and responsibilities, seniority and spheres of influence of the PAs in each category.

7. With respect to auditors and senior PAIBs:**(a) Do respondents agree with the factors to consider in determining the need for, and the nature and extent of, further action, including the threshold of credible evidence of substantial harm as one of those factors?**

In accordance with the principles-based approach set out in the Code, which enables PAs to exercise professional judgement in this regard, based on the facts and circumstances relevant to each particular scenario, we consider it helpful to include

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

factors to consider in determining the need for, and the nature and extent of, such further action to assist PAs in making this assessment.

We believe the factors themselves are appropriate and helpful, in particular, because they begin with the consideration of the legal and regulatory framework, which is a critical feature that is fundamental to any determination of a suitable course of action.

We also consider it helpful that the Board has included considerations regarding the appropriateness and timeliness of the response of management and TCWG, and whether the PA has confidence in their integrity. We believe this reinforces the intention that the primary responsibility for the identification and resolution of NOCLAR rests with client's management and TCWG and therefore the quality of their response is a critical factor to consider.

In terms of the threshold of "credible evidence of substantial harm", there may be some practical difficulty in determining whether there is "credible evidence" and/ or "substantial harm", since any assessment conducted by the PA will necessarily be subjective. Difficulties may arise in relation to determining what quality and quantity of evidence is necessary to be "credible". We also note that the threshold of "substantial harm" is derived from the SEC approach in relation to attorneys who learn of client misconduct, and that this approach may not be well understood by PAs who do not deal with U.S. requirements. Notwithstanding these two factors, we are, overall, supportive of the threshold because it provides an appropriate balance between providing PAs with some protection and ensuring that the broader public interest objectives of the Code are met.

(b) Do respondents agree with the imposition of the third party test relative to the determination of the need for, and nature and extent of, further action?

As we have stated in our overarching comments, we are supportive of the removal of the previously proposed requirement for auditors and other PAs to disclose identified or suspected NOCLAR and instead that a principles-based approach is proposed, which enables the PA to exercise their judgement, supported by guidance as to whether and when this approach may be appropriate, including factors to consider.

In this context we agree with the inclusion of the third party test based on its intention to help ensure that the PA performs an objective and rigorous assessment of whether it is necessary to take further action and if so, what form that action should take, given the facts and circumstances known to the PA at that time. We believe this test, together with the documentation requirement, will help to ensure a robust approach.

We consider that this is aligned to the particular nature of the auditor's remit (as compared to other PAs in public practice) and the higher public expectations imposed

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

on them, as well as the greater emphasis on responsibility to act in the public interest that is set out in the Code in respect of senior PAIBs.

We also note that this approach may help to ensure that an auditor (or senior PAIB) makes a rigorous assessment as to whether they have achieved their objective to act in the public interest, which requires a more demanding assessment than simply considering whether they have complied with specific procedures set out in the Code. We consider this intention to be consistent with other relevant frameworks. For example, ISA 200.21(a) requires the auditor to determine whether any additional procedures are necessary in order to meet the objectives of the ISAs, on the basis that circumstances vary and all circumstances cannot be anticipated in the ISAs. The IAASB noted, in their Basis for Conclusions, when introducing this material, that it was not in the public interest to lead the auditor to believe that mere compliance with the requirements of the ISAs is expected, nor to give the auditor a false sense of security that the ISAs address all the audit procedures necessary in all circumstances.

(c) Do respondents agree with the examples of possible courses of further action? Are there other possible courses of further action respondents believe should be specified?

We believe these examples are appropriate since they are intended to enable PAs to redress actual or suspected NOCLAR in situations when those with primary responsibility for ensuring compliance with applicable laws and regulations, i.e. management and TCWG of an entity, have not fulfilled their obligations within a reasonable timeframe, even after being informed of issues.

In light of this, we believe the courses of action to be appropriate in the context of the public interest objective, in particular because the proposals explain that:

- The purpose of disclosure to an appropriate authority is to enable that authority to investigate the matter and take action in the public interest;
- Withdrawal from the engagement and/or professional relationship (where permitted by law or regulation) is not a substitute for taking other actions in order to fulfil the public interest objective.

We highlight that in respect of PAs in public practice providing professional services other than audits of financial statements, consideration of whether to remain associated with the client is included in paragraph 225.47 but this is not specifically identified as a possible course of further action. We consider that the placement of this consideration for such PAs is inconsistent with that for both auditors as well as senior PAIBs (for whom withdrawal from an engagement or professional relationship, or resignation from an employing organisation, respectively, are provided as potential courses of further action). Notwithstanding the difference in

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

nature of the relationship between these PAs and their clients to that of auditors and their clients, we believe this difference in placement may lend an unintended reduction in emphasis.

We therefore recommend that consideration as to whether to remain associated with a client is elevated to a potential course of further action for PAs providing services other than audit, with specific reference to the consideration of the nature and terms of the engagement in this context.

We also have a concern with the suggestion that a PA in public practice performing a service other than an audit may disclose the matter to the external auditor, if one exists, as a potential course of further action. Whilst we are fully supportive of encouraging an appropriate exchange of significant and relevant information with the auditor, we question the inclusion of this in the specific context of “further action”. This is because the Code appears to equate this to making a disclosure to an appropriate authority, in order to discharge professional responsibility. Since the Code clearly explains that raising a matter to an appropriate authority is a specific course of action that may be taken in order that the authority can “cause the matter to be investigated and take action in the public interest”, we believe this may place undue responsibility on the auditor. Depending on the nature of the matter, the effects of relevant law and regulations, and also the timing of disclosure relative to the audit cycle, the auditor may not be able to take appropriate action within a reasonable timeframe, and/or may themselves need to consider whether to disclose to an appropriate authority. Instead we recommend that disclosure to the external auditor is included as a required consideration aligned with that of disclosing to another network firm in paragraph 225.40.

(d) Do respondents support the list of factors to consider in determining whether to disclose the matter to an appropriate authority?

We are supportive of the factors to consider set out in the proposals, including the related examples, which we believe collectively represent a balanced view and will be helpful to PAs when determining whether to disclose a matter to an appropriate authority.

Firstly, we find it helpful that the Board has specified that the purpose of making a disclosure to an appropriate authority is to enable that authority to investigate the matter and take action in the public interest. The related examples help to clarify that situations that may merit disclosure constitute very significant matters such as serious consequences to an entity’s operations, financial market disruption more generally, or potential harm to public health or safety.

We consider that the Board has explicitly acknowledged the significant difficulty, including professional risk, which auditors and senior PAIBs may face when considering whether to make a disclosure outside the entity, as well as the fact that

Exposure Draft, Responding to Non-Compliance with Laws and Regulations

4 September 2015

any protections in place against potential consequences attach to established legal and regulatory requirements. Accordingly, we welcome the inclusion of the “external factors”, in particular, whether there is robust and credible protection from civil, criminal or professional liability or retaliation afforded by legislation or regulation.

We are also supportive of the factors proposed in respect of PAs in public practice other than auditors, in recognition of the different nature of their roles.

8. For PAs in public practice providing services other than audits, do respondents agree with the proposed level of obligation with respect to communicating the matter to a network firm where the client is also an audit client of the network firm?

We consider it helpful to require, subject to applicable law and regulation, the consideration of communication of the matter to a network firm when the non-audit service performed is for an audit client of the network firm. Such information may be very significant to the audit engagement and therefore we believe this requirement to consider communication is aligned with the approach taken elsewhere to encourage the free flow of information to appropriate parties, which is clearly in the public interest.

9. Do respondents agree with the approach to documentation with respect to the four categories of PAs?

We are supportive of the emphasis placed on the importance of preparing clear documentation on a timely basis, for all categories of PAs.

The Code rightly reminds auditors of their documentation obligations under professional standards, in particular ISAs, and also imposes requirements that build on those of ISAs, e.g. the inclusion of documentation requirements in respect of the considerations made with regard to whether or not to take further action, which we believe to be appropriate as a result of the broader purpose and context of the Code.

We also agree that PAs in public practice providing services other than audit are held to the same standard of documentation requirements, with the exception that documentation of judgements and decisions does not need to have regard to the third party test.

We support the approach proposed in respect of PAs in business, i.e. that they are encouraged but not required to prepare documentation, commensurate with the fact that there are no equivalent professional standards that address the preparation, review and retention of their documentation. Instead, applicable law and regulation will dictate the approach to be taken, if any, and we believe the Code would support and complement any such requirements, and provide suitable guidance in their absence.

However, we highlight that because the matters that the PAIB is encouraged to document do not distinguish between senior and junior PAIBs, certain more junior PAIBs may find it difficult to respond to all of these and be uncertain as to the standard expected of them.



Exposure Draft, *Responding to Non-Compliance with Laws and Regulations*

4 September 2015

In particular, documenting how management and TCWG have responded to a matter, and the judgements made and decisions taken may present challenges for a junior PAIB to capture appropriately, since their responsibility is restricted to raising a potential issue to a superior in order that the superior can take action to resolve the matter.