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Dear Mr Siong

### **IESBA Exposure Draft: Responding to a Suspected Illegal Act**

We welcome the opportunity to respond to the proposals set out in the IESBA's exposure draft dated August 2012: *Responding to a Suspected Illegal Act*. We have consulted with, and this letter sets out the views of, the KPMG network.

Our overarching comments are set out below. Our responses to the questions set out in the Exposure Draft are set out in the Appendix to this letter. Throughout this letter and the attached Appendix we refer to the exposure draft as "the proposals" except where the context implies otherwise.

#### ***Overarching comments***

It is firstly important to emphasise that we support the principle that accountants should act in the public interest. This principle is long established and sets the tone for the existing IESBA Code of Ethics, which states right 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). Therefore, in placing the requirement to act in the public interest at the centre of the proposals, the IESBA does no more than follow the precepts of the existing Code.

We also recognise that the aim of the proposals is to help professional accountants apply this principle to suspected illegal acts identified during the course of their duties. However, we have significant concerns because we believe that in many cases the proposed requirements in respect of disclosure are incapable of being effectively implemented in the Code. While we believe that the duty of confidentiality and the duty to disclose are both matters of public interest, it must be recognised that many countries have legislative requirements that determine when disclosure is appropriate and have laws that conflict with the Code's proposed requirements. Accordingly, we believe that disclosure requirements can only be effectively implemented through local laws and regulations.

Further, professional accountants who comply with the requirements of the Code, in the absence of local laws, will have no protection for good faith disclosures as this is something which can only be provided through legislation. The Code is not an instrument of law; it therefore is not capable of providing any legal shield for accountants involved in good faith disclosures. In the absence of such protection, the consequences on accountants could be far-reaching. Disclosure by the accountant is a last resort when the entity has failed to respond adequately and, in such situations, retaliatory action by the entity (and possibly others, such as shareholders) is a possibility. This action may go beyond claims for breach of contract and include charges of negligence, defamation, breach of employment obligations and associated litigation. It may also extend to attacks on the accountant's reputation through the media and, in the case of the accountant in business, termination of employment. This is likely to be the case, particularly where the suspected illegal act on which the disclosure is based cannot be proved in court.

We also have a number of other concerns about the proposals relating to their ability to be consistently implemented:

1. *The existence of an "appropriate authority"*. A factor which will influence the effectiveness of the proposals in different countries is the existence of an "appropriate authority" for receiving disclosures. In some countries there may be no such authority which would be trusted or competent to handle appropriately matters disclosed to it, while in others there could be a wide range of suitable authorities, such as law enforcement agencies, tax authorities and regulators. We note that in countries with established mechanisms for reporting of illegal acts there is almost always a specific authority named for reporting purposes.
2. *The application of the proposals to services on third parties*. Accountants are frequently retained to provide services for clients which involve obtaining information about third parties. Examples include due diligence services carried out for a client who is contemplating the acquisition of a business, or intellectual property audits carried out on licensees. It is not clear how the proposals are supposed to be applied in situations of this type when a suspected illegal act is identified in the entity which is the subject of the accountant's investigations rather than in the client itself.
3. *The impact of the proposals on choice of service provider*. We are concerned that the proposals may discourage entities from engaging accountants to provide (non-audit) services in favour of practitioners from other professions who are not under the same responsibility to disclose suspected illegal acts. Examples include forensic accountants who undertake investigations into suspected illegal acts, where entities are likely to engage service providers who have no requirement to make disclosures, and tax advisors, where an entity might prefer to engage a tax lawyer rather than an accountant to avoid the risk that the confidentiality of the relationship may be breached by the accountant. Such an outcome may not be in the public interest as the accountant may be best placed to provide the highest level of service to the client.

4. *Impact of proposals on non-accountants.* The workforces (including partners) of many larger accountancy firms include practitioners of other professions such as lawyers and actuaries. Such professionals are required to comply with their own ethical standards, including standards on confidentiality and professional secrecy. Where such standards conflict with the requirements imposed by the proposals, such professionals, and in particular auditors with dual qualifications, are placed in a potentially difficult position.
5. *The lack of consideration of the role of management.* In our view, a key issue that is missing from the proposals (and cannot be addressed by the Code in any case) is the role of management. The primary onus for addressing a suspected illegal act rests with an entity's senior management and those charged with governance. If the public interest is served by disclosing a matter, this should be primarily the responsibility of senior management and those charged with governance. Without any obligation on management or those charged with governance, there is, in effect, no legal mechanism by which the accountant can apply pressure on management to investigate and disclose an issue.

#### ***Conclusion and recommendations***

Given the significant concerns we have noted above, we do not believe it is appropriate for the Code to impose disclosure requirements on professional accountants. We believe that disclosure requirements can only be effectively implemented through local laws and regulations as this will ensure that the requirements:

- Are aligned with other local laws and regulations that relate to the public interest, e.g. confidentiality laws, auditor privilege laws, money laundering laws, existing laws relating to disclosure, governance requirements, etc.
- Provide appropriate protection when individuals apply requirements and make good faith disclosures in the public interest.
- Identify an appropriate authority to whom professional accountants are able to confidentially disclose relevant matters.
- Apply to all individuals providing specified services, not just professional accountants, thus resulting in an even playing field.

In terms of the Code itself, we suggest that, rather than imposing a set of prescriptive steps, it includes guidance both for auditors and other accountants on the action they should consider taking in the event they identify a suspected or actual illegal act during the course of their work. Of course, any such action involving disclosure of a suspected illegal act would need to be considered against the backdrop of local laws and regulation.



We also recommend that IESBA works closely with governments and regulators, and engages closely with industry and other interested parties to influence appropriate changes in local laws and regulation.

We hope the points made in this letter are a helpful contribution to the discussion.

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

Yours sincerely

*KPMG IFRG Limited*

KPMG IFRG Limited

## **IESBA Exposure Draft – Responding to a suspected illegal act**

### **Appendix: Responses to specific questions**

**We note that all our below responses are subject to the comments made in our covering letter. In particular, we think that the requirements in the Code in respect of disclosure, even for auditors, are incapable of being effectively implemented. Disclosure requirements can only be effectively implemented through local laws and regulations.**

**We suggest that, rather than imposing a set of prescriptive steps, the Code includes guidance both for auditors and other accountants on the action they should consider taking in the event they identify a suspected or actual illegal act during the course of their work. Of course, any such action involving disclosure of a suspected illegal act would need to be considered against the backdrop of local law and regulation.**

- 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?*

We strongly support the principle that the accountant should discuss a suspected illegal act with the appropriate level of management. However, before taking this step, the accountant is required to take reasonable steps to confirm or dispel the suspicion. In this context we have the following interrelated concerns:

- The term “reasonable” is very subjective, and because in taking reasonable steps to confirm or dispel the suspicion, the accountant shall apply “knowledge, judgement and expertise” to the matter and each accountant’s knowledge, judgement and expertise differs, it is likely that these requirements will be given widely varying interpretations in practice. For example, an accountant with extensive forensic investigation experience is likely to adopt a different approach to satisfying the requirements of the proposals than an expert in supply chain management.
- There are obvious difficulties in determining the threshold for when a matter is to be regarded as a “suspected illegal act”. The proposals state that they refer to suspected illegal acts “because whether a matter constitutes an illegal act is ultimately a matter for legal determination by a court of law” (225.1). However, the proposals do not explicitly address the situation, which is very likely to arise in practice, where there is insufficient evidence to determine whether the matter arose in the first place, but there is nevertheless a suspicion that it did. This is a serious omission and one which is likely to cause confusion, particularly for accountants who are required to comply with money laundering reporting requirements where the term “suspected” is generally taken to reflect evidential as well as legal uncertainty.

We believe these requirements should be clarified. This may be done, for example, by giving recognition to the complexity and subjectivity of the judgements involved.

We also agree that if, having discussed the matter with the appropriate level of management and the response is inadequate, there should be a requirement to escalate the matter to those charged with governance.

- 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?*

For the reasons set out in our covering letter, we believe that requirements relating to overriding the duty of confidentiality can only be effectively addressed in local laws and regulation.

We also question the purpose of recognising that a professional accountant has a right to override confidentiality. Although such a right might confer moral or ethical authority on the accountant, it would not confer any legal authority.

Further, we disagree with inclusion of the statement that “a professional accountant is expected to exercise this right in order to fulfil the accountant’s responsibility to act in the public interest”. We see this statement as tantamount to a requirement.

- 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?*

Yes, but for the reasons set out in our covering letter, we believe that requirements relating to overriding the duty of confidentiality can only be effectively addressed in local laws and regulation. It must be recognised that the duty of confidentiality and the duty to disclose are both matters of public interest and many countries have legislative requirements that determine when disclosure is appropriate.

- 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 see no reason why the standard should be different for an accountant providing services to a non-audit client from an accountant providing services to an audit client. The guidance in the Code should apply equally to both in respect of communicating suspected illegal acts to the appropriate level of management. In the event that appropriate action is not taken, the Code should provide guidance as to next steps which should include considering the requirements of local laws and regulation and obtaining legal advice on how to proceed. We see this as important since, as discussed in our response to question 3, local laws and regulations may have a different view as to how the balance between confidentiality and disclosure should be struck for auditors (who typically have a statutory responsibility) and for most advisors, including professional

accountants, (who ordinarily do not, such relationship being limited to a contractual relationship with a client).

- 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?*

Please refer to our responses to questions 1 to 4 above. Our suggested approach in the responses to these questions is in line with the requirements of ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements. Also, we believe that the requirements of ISA 250 appropriately set out the auditor's responsibilities when the entity does not take appropriate action after being made aware of a suspected illegal act by the auditor.

- 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?*

There are no grounds for treating accountants providing professional services to an audit client differently from an auditor. So, please refer to our responses to questions 1 to 4 above.

- 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?*

ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements, sets out the auditor's responsibility with respect to laws and regulation and suspected illegal acts identified during the course of the audit. We believe that any requirements in the Code dealing with the auditor's responsibilities should be consistent with these requirements.

- 8) *Do respondents agree that a professional accountant providing professional services to a client that is not an audit client of the firm or a network firm who is unable to escalate the matter within the client should be required to disclose the suspected illegal act to the entity's external auditor, if any? If not, why not and what action should be taken?*

As noted in our covering letter, we do not believe it is appropriate for the Code to impose disclosure requirements on professional accountants. The decision as to whether disclosure is appropriate requires an assessment of the facts, circumstances and local requirements. This is elaborated on in our responses to questions 1 to 4 above. Given this, we believe that the furthest the proposals can go is to suggest that a professional accountant consider whether it is appropriate to disclose a suspected illegal act to the external auditor.

- 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?*

We disagree for the reasons noted in responses to questions 1 to 4 above.

- 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?*

As noted in our response to question 9, overriding the duty of confidentiality and disclosing suspected illegal acts, irrespective of whether they relate to the subject matter of the professional services being provided by the professional accountant should be addressed by local laws and regulations.

- 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?*

Please refer to our responses to questions 1 to 4 above.

It is important to emphasise that we believe that the professional accountant in business is in a different position from the accountant in professional practice. The proposals recognise this to an extent, but in circumstances where the accountant has no whistle-blowing protection the requirements are demanding, particularly for accountants in business who are in junior positions. Employees who have the courage to disclose the misconduct of their employers are likely to find the process very stressful, and may be placed under intense pressure from their employers to withdraw their allegations. It is also possible that their employment would be terminated. They may find themselves the subject of law suits for matters such as breach of their employment contracts and their duty of fidelity/confidentiality to their employer. In addition, it is not unknown for attempts to be made to discredit the character and integrity of whistle-blowers making it much less likely that they would ever find suitable employment in future, even where they are commended for their pursuit of transparency and justice. We also believe, consistent with our comments in our covering letter, that any disclosure requirement or right must be accompanied by statutory protection for the disclosing party for any disclosures made in good faith.

- 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?*

As noted in our covering letter and in our responses to questions 1 to 4, we do not believe it is appropriate for the Code to impose disclosure requirements on professional accountants. The decision as to whether disclosure is appropriate requires an assessment of the facts, circumstances and local requirements. This is elaborated on in our responses



to questions 1 to 4 above. Given this, we believe that the furthest the proposals can go is to suggest that a professional accountant consider whether it is appropriate to disclose a suspected illegal act to an appropriate authority.

*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?*

As noted in our response to question 12, overriding the duty of confidentiality and disclosing suspected illegal acts, irrespective of whether they affect the employing organisation's financial reporting or relate to the expertise of the professional accountant, should be addressed by local laws and regulations.

*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?*

In view of our responses to questions 1 to 4 above, this question is not relevant.

*15) If respondents agree that in exceptional circumstances a professional accountant should not be required, or expected to exercise the right, to disclose certain illegal acts to an appropriate authority, are the exceptional circumstances as described in the proposal appropriate? If not, how should the exceptional circumstances be described?*

Please refer to our response to question 14.

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

We believe it is difficult to impose documentation requirements on a professional accountant in business. Unlike auditors, professional accountants in business have no standards that address the preparation, review and retention of documentation. The approach to be applied by professional accountants in business should be dictated by local laws and regulation.

*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?*

For the reasons noted in our covering letter and the responses above, we believe that the proposed changes to the Code will need to be revisited. Having said this we have the following specific points:

- In paragraph 150.1, we are not sure why the example which has been added is needed. Inclusion of a single example of a matter which would affect the good reputation of the profession may discourage the accountant from considering other instances where the same might apply.



- In paragraph 300.6, we believe the requirement for the accountant to act in the public interest has already been adequately set out in paragraphs 100.1 and 100.6 of the IESBA Code, and the reference here is not needed. Further, we do not agree with the inclusion of improper earnings management or balance sheet valuations as examples of matters that would lead the professional accountant to not engage in a business, occupation or activity. This is not consistent with the ISAs which consider these matters as indicators of management bias that need to be further investigated and addressed by the auditor.

*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?*

The impacts noted are highly subjective and in any case are incapable of quantification. Given that the successful implementation of the proposals is dependent upon the requirements of local laws and regulations, we believe that the impact of the proposals can only be addressed if they are compared to, and significant analysis is undertaken in respect of, the requirements of laws and regulations of a number of jurisdictions.