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Contact Sylvia Smith

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Dear Sir/ Madam

Invitation to Comment – *Enhancing Audit Quality in the Public Interest*

We appreciate the opportunity to respond to the International Auditing and Assurance Board's ("IAASB" or "Board") Invitation to Comment: *Enhancing Audit Quality in the Public Interest* dated December 2015, (the "ITC"). We have consulted with, and this letter represents the views of, the KPMG network.

Our comments and recommendations are set out below. We have decided not to provide detailed responses to the individual questions within the ITC since many areas are interrelated and would have resulted in extensive repetition. Therefore, we have instead provided our overall responses and recommendations as to how the IAASB may move forward with this initiative. To facilitate your categorisation of responses, we have cross-referenced our comments to the relevant questions in the ITC.

General Comments (G1 and G2)

Firstly, we would like to compliment the IAASB on a document that is thoughtful and thorough in considering these key issues facing the profession. We are broadly supportive of most of the proposals outlined in the ITC. We agree with the IAASB that audit quality is at the heart of the IAASB's work as the global auditing standard setter. We support the Board's focus on the three topic areas discussed in the ITC as areas for potential standard-setting and other activities that could enhance audit quality.

We agree that the public interest issues identified in Table 1 are the most relevant to the IAASB's work on professional skepticism, quality control, and group audits, as well as to other significant projects, such as consideration of revisions to ISA 540 / Special Audit Considerations Relevant to Financial Institutions; ISA 315, *Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment* and consideration of Data and Analytics in the audit.

We agree that the projects on ISA 540 / Special Audit Considerations Relevant to Financial Institutions, ISA 315 and Data and Analytics, all of which are on the IAASB's agenda, are high priority projects.

We suggest that the IAASB also consider adding to their agenda: (1) updating ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* and (2) consideration of IT risks in the audit, as part of the ISA 315 project, including auditors' responsibilities with respect to cybersecurity, in view of the significant developments in these areas in recent years. (G 2)

The possible actions set out in the ITC relate predominantly to standard-setting activities that the IAASB could undertake. Many of the proposals in the ITC should contribute to improved audit quality.

However, we note that there are influences on audit quality that are outside of the direct control of the IAASB including corporate governance processes, the regulatory environment and the complexity of financial reporting frameworks. We therefore encourage the IAASB to work with other key stakeholders such as IFAC member bodies; accounting standard setters such as the IASB; regulators such as IFIAR; legislators; oversight bodies, including those with oversight of Boards of Directors and Audit Committees; academics and educators, as well as the Joint Monitoring Group to address broader issues aimed at improving corporate governance and the quality and relevance of financial reporting. (G 1c)

Professional Skepticism

The IAASB Glossary of Terms definition of Professional Skepticism currently describes this as an "attitude, including a questioning mind". We are supportive of this description, and do not consider that the definition itself should be amended, although we consider that, as a fundamental mindset, which requires the exercise of significant professional judgement, the concept is somewhat elusive and this can result in difficulties in its application. Accordingly, we welcome the IAASB's considerations in this area, to attempt to clarify the meaning of "professional skepticism" and to help auditors and others both to apply this in practice and to demonstrate that they have applied the concept appropriately. (PS 1 and PS 2)

As an underlying mindset / behaviour, the application of which is a critical attribute of an auditor, we do not believe that issues in this area can be properly addressed solely by changes to the IAASB's standards.

We consider that Firms are best placed to drive appropriate application of professional skepticism since Firms are able to: (PS 2)

- Recruit the right individuals with an appropriately skeptical mindset;

- Provide high quality training to support auditors in further developing their critical thinking skills to enable them to exercise appropriate professional skepticism;
- Create and implement appropriate policies, procedures, incentives / rewards and mechanisms of accountability to promote professional skepticism on audits;
- Develop appropriate support mechanisms such as providing auditors with the requisite knowledge and experience and assigning tasks that are appropriate to the level of experience.

It is therefore important that Firms consider whether their current policies and procedures encourage appropriate behaviours by individual auditors. In this regard we refer to the proposals regarding a risk-based QMA approach, which we believe will be helpful to Firms in achieving their audit quality objectives, in particular by describing potential impediments to the exercise of professional skepticism as risks to a Firm's ability to achieve its quality objectives, and by providing guidance in terms of possible responses to those quality risks, including guidance relating to policies and procedures regarding monitoring and remediation. (PS 4)

Nevertheless, professional standards have a critical role to play in driving improvements, and the need for enhanced clarity within the standards regarding the concept of professional skepticism is becoming ever-more important as audit models evolve, becoming increasingly more complex (for example, subjective estimates requiring significant auditor judgement, complex group audit structures), as well as being significantly affected by recent technological developments such as data and analytics. It would be helpful if the IAASB's standards were to reinforce key principles in this area, and clarify how these are to be applied given the specific risks identified in respect of a particular audit engagement. (PS 3)

We are also supportive of the Board's acknowledgement that professional skepticism, as a fundamental mindset, needs to be applied throughout the audit process, and we welcome the recognition of the interrelationship between the exercise of professional skepticism and exercise of professional judgement during an audit. (PS 3)

We note that some Firms, including KPMG, have developed models or frameworks to guide the critical thinking of their professionals. For example, in 2011, KPMG published "*Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment*". We recommend that the IAASB consider these models, for example, we believe that the KPMG publication provides auditors with a helpful framework, which includes discussion of judgement traps and biases. (PS 3 and 4)

In exploring changes to the standards, we consider that it would be helpful if the IAASB were to explicitly acknowledge that the application of professional skepticism is

intrinsically linked to the auditor’s assessment of risk, and that the auditor’s response may therefore vary as a result of the auditor’s assessment of risk, which would include obtaining more audit evidence or less audit evidence in different situations. This is currently alluded to in ISA 240.A33, which acknowledges ways in which increased professional skepticism can be exercised as part of the overall response to address the assessed risks of material misstatement due to fraud, but we believe that this material should be given significantly greater prominence, as well as clarification that in terms of the auditor response, less audit evidence may be obtained, as well as more, as a result of the auditor’s assessment of risk. (PS 4)

In this regard it would be helpful if the IAASB were to clarify whether different “levels” of professional skepticism may be applied, and how this would relate to the current description of professional skepticism as an “attitude” or “mindset”. Furthermore, it would be helpful if the IAASB were to describe factors an auditor may consider in determining whether professional skepticism has been appropriately applied, based on the particular circumstances of an individual engagement. (PS 4)

Furthermore, we recommend that the standards provide clearer guidance as to how an auditor may demonstrate that professional skepticism has been appropriately applied throughout an audit. It would be helpful if the Board were to further explore the meaning of “sufficient appropriate audit evidence” in this regard since this determination may be difficult in the context of illustrating that professional skepticism has been appropriately applied, and how this may be evidenced directly in terms of auditor responses and outcomes, in particular when this varies as a result of the auditor’s assessment of risk. This is an area that may be particularly subject to “second guessing” by others and therefore would benefit from clarity in the standards to help auditors to achieve their aim clearly and consistently. (PS 3)

We also recommend that the IAASB work closely with IAESB, and with those responsible for the education and training of professional accountants across jurisdictions, to address enhancements to educational materials and processes in this area, to help ensure that these place appropriate emphasis and provide clear guidance on the application of professional skepticism. It would be helpful if such educational materials were to focus not only on technical knowledge, but also on “soft skills” such as how to question effectively and how to deal with difficult situations/ individuals. (PS 5)

Quality Control

We support the IAASB’s proposal to revise ISQC 1 to include the use of a Quality Management Approach (QMA) as described in the ITC. We believe this approach will improve audit quality as it is risk-based, which will enable Firms to design appropriate quality control policies and procedures in response to their individual circumstances. (QC 1a)

This approach will place leadership responsibilities and accountability for quality at the core of a Firm's governance objectives, which, coupled with appropriate monitoring systems, will provide a powerful tool to properly support Engagement Partners in performing an increasingly challenging role. (QC 5)

We consider that as audits become significantly more complex, both because entities subject to audit are becoming larger and increasingly globalised, as well as a result of the deployment of significantly more sophisticated audit techniques, e.g. Data and Analytics, it is critical for the standards to recognise that, although Engagement Partners are responsible for the quality of their audit engagements, they are able to rely on firm and network systems of quality control in order to appropriately fulfil their responsibilities. In this regard it is important that ISQC 1 / ISA 220 explicitly acknowledge the ability to place reliance and clarify when and under what circumstances it would be appropriate for such reliance to be placed. (QC 1c).

Examples of when Engagement Partners may be able to place reliance on firm / network systems include:

- Testing the reliability of centrally developed audit software for use by engagement teams across a network;
- Assessing the competence and capabilities of engagement team members and/or component auditors located in other cities or countries.

Examples of the circumstances under which it may be appropriate for such reliance to be placed are when the firm / network has appropriate monitoring and communication processes in place to give Engagement Partners reasonable assurance regarding the effectiveness of the relevant systems.

We are supportive of the possible actions outlined related to monitoring and remediation. We encourage the IAASB to take a principles-based approach related to setting requirements in this area, as the circumstances encountered by different Firms will vary widely. (QC 7)

In describing the QMA in the standards, we suggest the Board focus on indicators of quality, and the evaluation of monitoring systems directed at the Firm's quality control policies and procedures as well as those that operate at the engagement level. (QC 7)

We also believe that monitoring of quality at both the Firm level and the engagement level should be a dynamic process that provides real-time information, in greater depth, to enable a clearer understanding of any quality issues identified. For example, ISQC 1 could explicitly encourage certain reviews, or parts of reviews, to take place prior to the completion of the audit ("in-flight" reviews). This would improve audit quality in several ways: (QC 7)

- Such reviews could serve as a preventative measure rather than a detective measure. In instances where the engagement team has not obtained sufficient appropriate audit evidence, or otherwise not complied with the standards, the issue might be remedied before the audit is complete;
- “In-flight” reviews may provide Firm leadership with better insights into any quality issues that reside with particular Engagement Partners.

We are also broadly supportive of the proposals set out in the ITC regarding Engagement Partner performance in respect of quality control and rewards systems as an important feature of a Firm’s quality control systems. We recommend that these be principles-based to take account of the different structures and systems in place across different firms/ networks. (QC 8 and 9)

We note that the requirements that apply to staff performing work at local Member Firms and at component auditors also apply to staff utilised by ADMs (Audit Delivery Models). Many of the issues considered in paragraph 123 as being relevant to ADMs would, in our view, be just as relevant to team members working for one Member Firm in a (large) country who are located in offices that are different from the office of the Engagement Partner. The physical location of individuals performing the work should not affect the requirements that apply. (QC 4biii)

Application of Quality Control to a Network (QC 4)

We recognise that instituting requirements at the network level will be more difficult for the reasons cited in paragraph 116. Nevertheless, effective systems of quality control at the network level facilitate the ability of Member Firms and engagement teams to rely on those systems when performing global audits, e.g. group or other multi-location audits. Therefore, we support the idea of clarity in ISQC 1 and ISA 220 about what should be considered and documented by an individual firm as a basis for reliance on network policies and procedures at the Firm level. We recommend that the standards:

- Acknowledge that Engagement Partners are able to rely on network systems of quality control to help them meet their responsibilities provided they are able to obtain reliable assurance on the effectiveness of those systems;
- Clarify how such assurance may be obtained and to what extent publication of a Transparency Report by the network / Member Firm that describes their QMA and the systems they have in place, including monitoring systems, to facilitate Member Firm / engagement team reliance would be helpful in this regard.

We agree with the observation that Transparency Reports are likely to continue to evolve, and that setting requirements at this stage could inhibit innovation. Therefore, we support the IAASB in issuing guidance at this stage to assist Firms in implementing best practice. (QC 10)

Engagement Quality Control Reviews and Engagement Quality Control Reviewers (QC 3 and QC 6)

We generally support strengthening the requirements relating to Engagement Quality Control (EQC) reviews, in particular, the alignment of requirements with a risk-based approach, and the documentation thereof. Specifically, we agree that it would be helpful for the IAASB to consider mandating the performance of EQC reviews beyond audits of listed entities, perhaps including other public interest entities in the scope. We do not believe that it is necessary to develop a separate standard for EQC reviewers, however, we consider that it is helpful to retain the current presentation of requirements in respect of EQC reviewers to enable these to be better understood in a broader context, including clarifying and differentiating between the respective roles and responsibilities of the Engagement Partner and the EQC reviewer. Furthermore, although a separate standard might raise awareness, it will result in a great deal of repetition in the literature.

We do not support specifically communicating in the auditor's report about whether an engagement was subject to an EQC review. Although an EQC reviewer is an important element of a Firm's system of quality control, it is only one element and therefore identification of this element in isolation may not give a clear picture regarding the quality controls applied overall. Furthermore, the fact that an engagement has not been subject to EQC reviewer does not necessarily mean it has not been subject to other, meaningful and appropriate quality control procedures.

In terms of other proposals, such as whether the EQC reviewer should be supported by additional subject matter experts, or engage in communications with those charged with governance, we do not believe such proposals to be helpful or appropriate. The EQC reviewer is an important part of the Firm's internal quality control process and, as such, it is critical that he/she remain objective and independent of the engagement team. We are concerned that such proposals may compromise this position, such as by creating a "shadow team" or by creating a perception that those charged with governance have an open channel to communicate directly with the EQC reviewer and obtain a "second opinion".

Other Matters

We do not believe that it is necessary to establish an explicit requirement in ISQC 1 for Firm leadership to act in the public interest. It is already a long-established principle in the Code of Ethics for Professional Accountants that the profession act in the public interest, and this principle underpins many of the requirements set out in auditing standards. As a result we do not consider it necessary to establish a specific requirement in the context of ISQC 1. The various proposals in the ITC aimed at clarifying leadership responsibility and accountability for quality and enhancing auditor performance clearly demonstrate how this principle is being applied to auditing. (QC 5)

With respect to the circumstances in which an individual other than the Engagement Partner is also required to sign the auditor's report or is otherwise identified in that report, we recommend that rather than imposing minimum responsibilities on such individuals that may not, in fact, be relevant to their role as set out in applicable law / regulation, instead the auditor's report provide greater transparency as to the role played by the second signatory, e.g. by including an appropriate title. (QC 2b)

Group Audits

We support the IAASB's consideration of ISA 600 at this time in response to the feedback received by the IAASB as part of the ISA Implementation Monitoring Project that was completed in 2013, as well as input from regulators. (GA 1)

We consider that a thoughtful reconsideration of ISA 600 will help to address the issues identified, while maintaining the useful material in the extant standard that we believe has improved audit quality since its issuance as a clarified standard in 2008.

As the Board notes in the ITC, the current group audit model is driven by structural considerations, based on a hierarchy of separate legal entities, or geographic locations, which prepare separate financial reporting for consolidation. This approach, while still applicable to many groups, is difficult to apply to a number of group entities, or aspects of these, for example: (GA 1a)

- Shared services centers;
- Entities with operations or that otherwise conduct business in multiple locations that do not meet the definition of components;
- Entities that are registered in one jurisdiction for statutory purposes and have operations in another jurisdiction ("letterbox" entities);
- Significant investments accounted for at cost or the equity method.

Furthermore, the increased sophistication of financial reporting processes often results in circumstances whereby much of the audit is performed at the group level by the group auditor and therefore identification of components, and application of the requirement for an audit of the financial information of the component may present challenges.

We also highlight that mandatory auditor rotation / tendering in many parts of the world will increase the number of group audits that are performed by group auditors using the work of other auditors from a different network. This anticipated increase in the number of inter-network audits will challenge the concepts in ISA 600 today.

Accordingly, we recommend that the IAASB consider whether the current model set out in ISA 600 could be adapted to include a more principles-based approach that focuses on using the work of other auditors, which does not place conceptual restrictions on multi-location entities that do not necessarily meet the current definition of a “group,” or aspects of which do not meet the current definition of “component”, since we believe this would better serve the needs of “group” auditors. We believe such a revised standard may help the group auditor, in particular, to:

- Assess the risk of material misstatement in accordance with ISA 315, irrespective of whether those risks reside in a component, a location, a shared service center, the group, or some other element of the corporate structure;
- Respond appropriately to the risks of material misstatement in accordance with ISA 330, to obtain sufficient appropriate audit evidence, including consideration as to whether to use the work of another auditor to do so;
- Use the work of another auditor to assist in assessing the risk of material misstatement, responding appropriately to those risks, and obtaining sufficient appropriate audit evidence;
- Consider whether the auditor has sufficient involvement with the audit to take responsibility for the audit opinion on the group financial statements; and
- Determine whether sufficient appropriate audit evidence has been obtained.

In adopting such a principles-based approach, we consider that the standard should retain the current overarching requirement that the group auditor is responsible for the group audit and that it is not appropriate for such responsibility to be divided in any way if other auditors are also involved in assisting the group auditor. (GA 1c)

Notwithstanding this, we are supportive of the group auditor providing more transparency in the group auditor’s report around the nature and extent of the use of the work of other auditors, as well as the support received from the systems of quality control at the Member Firm and network level. (GA 1c)

We note one possible exception to our recommendation to continue to prohibit division of responsibility between multiple auditors: we believe the IAASB should reconsider whether, for example, in the case where the group is invested in an entity accounted for by the equity method, the ability to make reference to the work of another auditor might be preferable from a public interest standpoint to requiring a scope limitation when the group auditor is unable to be involved in the work of the other auditor to the extent required by ISA 600, and is therefore unable to obtain sufficient appropriate audit evidence related to the investee. We expect such cases to be rare, and suggest that this approach would apply only in the event that all other avenues to obtain sufficient approach audit evidence have been explored without success. (GA 1c)

Acceptance and Continuance of the Group Audit Engagement (GA 2)

We are broadly supportive of the proposals related to acceptance and continuance of the group audit engagement. In particular, we support strengthening the link in ISA 600 to the requirements in ISQC 1 that address the Firms' acceptance and continuance policies and procedures, and the requirements in ISA 220 that address the Engagement Partner's related responsibilities for quality at the engagement level. As we note earlier, we recommend that ISQC 1 and auditing standards clarify the extent of reliance that the Engagement Partner can place on the Firm or network's quality control systems in doing so and under what circumstances such reliance can be placed.

Communications between the Group Engagement Team and Component Auditors (GA 3)

We support the proposals regarding enhancing the sufficiency and timeliness of two-way communication between the group engagement partner and component auditors, to enhance cooperation.

In particular, we welcome the suggestion to introduce specific requirements and application material directed at component auditors, to give greater emphasis to their role and responsibilities. We do not consider that such material would be most appropriately introduced by way of a separate standard, but instead suggest that such matters could be addressed within a discrete section of revised ISA 600 that is specifically directed at component auditors.

We consider such emphasis to be of particular importance if the revised standard moves away from a series of prescriptive requirements to take a more principles-based approach, which would allow a group auditor increased flexibility in determining how best to involve a component auditor. In taking this approach, it would be helpful that greater responsibility is placed on component auditors to communicate matters such as fraud or non-compliance with laws and regulations to the group auditor, irrespective of the restrictive "scoping" decisions which are the focus of paragraphs 26-29 of extant ISA 600.

Using the Work of the Component Auditors (GA 4 and GA 8)

The decision as to whether a group auditor will use the work of a component auditor should be focused on whether the use of the work of the component auditor will result in a more effective approach to obtaining sufficient appropriate audit evidence. The current approach focuses on *whether* a group auditor can use the work of a component auditor, and we therefore recommend a more balanced approach that also considers the *benefits* of using another auditor.

For example, in many circumstances a component auditor will have a better understanding of the component jurisdiction, including its business culture, risks, laws and regulations, ethical standards, corporate governance standards and practices, customs, and language, which may be of particular importance in jurisdictions that are considered to be “higher risk” because, for example, they involve a rapidly changing regulatory and business environment, and are subject to heightened fraud risks. (GA 11)

We also suggest that the Board consider inclusion of guidance as to how to use another auditor to best effect, for example, by setting out factors that a group auditor may consider in making this determination. This is of particular importance if the revised standard gives greater emphasis to taking a risk-based approach and therefore the group auditor is no longer constrained by traditional “scoping” decisions.

We also recommend that the IAASB clarify the nature and extent of “sufficient, appropriate documentation” that needs to be held by a group auditor to demonstrate the nature and extent of their involvement in the work of the component auditor throughout the engagement.

We do not believe that the ability of the group auditor to demonstrate their involvement through the documentation they hold would necessarily involve transfer of audit documentation from the component auditor to the group auditor. Instead we consider that the current flexibility afforded by the extant standard should be retained and it is important that the revised standard achieves an appropriate balance between enabling the group auditor to demonstrate their involvement whilst also focusing on the ability of the component auditor to demonstrate that they have appropriately performed the role assigned by the group auditor.

Identifying and Assessing the Risks of Material Misstatement in a Group Audit (GA 5 and GA 7)

We support the suggestion to reinforce that the auditor’s understanding of the risks of material misstatement builds upon the requirements in ISA 315 (Revised), and that the responses to the assessed risks of material misstatement are to be framed in terms of ISA 330. This clearer linkage will help group auditors to address risk more effectively and to use component auditors in a more focused way. In this regard we refer also to our comments above regarding moving away from a prescriptive standard that is based on a structural approach, to a principles-based standard that focuses on involvement of another auditor.

As part of this, we encourage the IAASB to reconsider the binary terminology of “significant” and “non-significant” components. Instead, as we highlight above, we recommend that the standard build on the current approach to give greater emphasis to consideration as to where risks may arise, and the most appropriate approach to respond to such risks. The current approach set out in extant ISA 600 may result in group engagement teams focusing on coverage of account balances, or excluding certain

components altogether on the basis that these may be categorised as non-significant, which we do not believe is the underlying intention of the ISA.

Issues Relating to Component Materiality and Other Aspects of Materiality Relevant to Group Audits (GA 6)

We do not believe that the IAASB needs to await changes to ISA 320 before considering materiality in the context of a group audit. Materiality, as described in ISA 320, is determined with users' needs in mind, and it is a financial reporting framework concept. Component materiality, performance materiality and the clearly trivial threshold at the component level are all determined with aggregation risk in mind and, although there is some interrelationship with materiality, these are primarily auditing concepts. Consequently, we suggest that the IAASB consider providing additional guidance on these areas as a matter of priority.

Please contact Sylvia Smith at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG IFRG Limited

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cc: Jean Blascos, KPMG