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Our ref SS/288
Contact Sylvia Smith

30 October 2015

Dear Sirs

Exposure Draft, Proposed Amendments to the IAASB's International Standards – Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations

We appreciate the opportunity to respond to the International Auditing and Assurance Board's ("IAASB" or "Board") Exposure Draft: Proposed Amendments to the IAASB's International Standards – *Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations* dated July 2015 (the "Exposure Draft" or "ED"). We have consulted with, and this letter represents the views of the KPMG network.

Our overarching comments are set out below. The appendices to this letter provide our responses to the specific questions posed in the Exposure Draft (Appendix 1), including our views regarding whether ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* would benefit from more extensive revision (Appendix 2).

We are supportive of the proposed changes to align the ISAs, in particular, ISA 250, with the changes proposed to the IESBA Code of Ethics for Professional Accountants (the "Code"), further to the IESBA Exposure Draft, *Responding to Non-Compliance with Laws and Regulations*, issued in May 2015. We concur with the view of the IAASB that it is important that the ISAs do not conflict with the IESBA Code, and furthermore, that the ISAs, where relevant, support the principles underpinning the Code and therefore draw appropriate attention to, or give recognition to, the revised requirements in the Code.

We highlight that in responding to the IESBA Exposure Draft we expressed our support for the proposals set out in that ED, as a result of the evolving nature of rules and regulations around non-compliance with laws and regulations ("NOCLAR"), the ever-increasing public calls for transparency more generally, and because the proposals further develop the long-established principle underpinning the Code, stated at its outset, that "*A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest*" (100.1).

We consider that the proposed scope of the amendments in order to better align the ISAs to the IESBA ED is appropriate at this time. We suggest below additional changes, which we believe will enhance the alignment and also further support the objectives of the Code.

We agree that more significant revision to ISA 250 is beyond the scope of this project and that any considerations in this regard should not delay the introduction of the proposed conforming amendments. However, we do believe that it would be beneficial to re-consider the scope and purpose of ISA 250, and undertake a more extensive project to explore revisions to the standard, in order to ensure that the ISA remains fit for purpose, as we describe in Appendix 2.

Reporting actual or suspected non-compliance with laws and regulations to an appropriate authority outside the entity

We agree it would be helpful to change the terminology in ISA 250.28 so that it encompasses the wider professional responsibilities under the Code. However, the proposed change to the wording is broad and not as helpful as it could be because it does not provide a context as to how an ethical duty or right might arise. To help address this, we recommend that the Board consider expanding the wording of ISA 250.28 as follows:

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a legal duty or right or ethical duty or right under the relevant ethical code with which the auditor complies to report the identified or suspected non-compliance to parties outside the entity. (Ref: Para. A19–A20)

We also recommend that the application guidance in paragraph A19 be expanded to include section 225.29 of the IESBA Code as an example of where an auditor has an ethical duty or right to report identified or suspected non-compliance to parties outside the entity. We do not believe it is sufficient for paragraph A19 to make reference to section 225.29 in a footnote.

We recognize that the considerations in paragraph 28 are complex and that the auditor will likely need to obtain legal advice to determine his/her duties and the appropriate course of action. However, suggesting that auditors obtain legal advice as the only course of action, in our view, does not provide auditors with sufficient guidance in an area that is so important to the public interest. The IESBA ED in 225.20 to .27 includes material that we believe is relevant to auditors because it deals with key considerations such as the response of management/audit committees; whether there is “credible evidence of substantial harm”; the significance of the matter to the public, and the potential consequences for the auditor. We therefore recommend that A19 be expanded to include the material set out in the IESBA ED as examples of considerations an auditor may make. This will help better align ISA 250 to the IESBA ED and will also provide auditors with guidance that is more practical and useful.

Finally, we consider it would be helpful to expand the documentation requirement in paragraph 250.29 to include consideration of the duties/course of action in paragraph 250.28. This is particularly important in light of the proposed introduction of a “public interest test” to the Code (225.25) in the context of exercising professional judgment when determining the nature and extent of further action needed, since any such test will be applied with hindsight, whereas an auditor will determine the appropriate course of action based on the facts and circumstances known at that time.

Communication with other parties outside the entity

In accordance with the obligation for professional accountants to act in the public interest, and the related changes to the Code to better support the free flow of information between relevant parties, we are supportive of the proposed introduction of paragraph A8a to ISA 220, *Quality Control for an Audit of Financial Statements*, to acknowledge that a successor auditor may have a responsibility to request information from a predecessor auditor regarding any facts or circumstances that, in the predecessor auditor’s judgement, the successor auditor needs to be aware of before deciding whether to accept the engagement.

We recommend that the above proposed paragraph may be enhanced by inclusion of an example specifically relating to laws and regulations, such as whether the predecessor auditor had concerns regarding the integrity of management/ TCWG, or had identified or suspected non-compliance with laws or regulations.

We also suggest that the above material be included in ISA 510, *Initial Audit Engagements – Opening Balances*, as an additional item in paragraph 6c, to broaden the focus beyond consideration of opening balances.

Categories of laws and regulations and related examples

We are supportive of the proposed addition of paragraph A5a to ISA 250, to provide examples of laws and regulations that address sensitive areas such as bribery and corruption, money laundering, terrorist financing, proceeds of crime and environmental protection, as well as those laws and regulations that may significantly affect particular industry sectors such as banking and financial services.

These are areas that have been subject to heightened public interest and significant regulatory scrutiny in recent years, and we consider it important that ISA 250 give sufficient emphasis to the consideration of such laws and regulations as an important part of an audit.

We note that in providing these examples, the Board has not identified to which of the two categories described in paragraph 6 (those that have a direct effect on the determination of amounts and disclosures in the financial statements and those that do not) each example would belong. We understand that this absence of categorisation may be intentional, as it would require matters to be addressed regarding the categorisation of laws and regulations that go beyond the

scope of the ED. However, we highlight that such absence of categorisation may lead to differing interpretations of the standard and inconsistency in practice.

We note that it may be difficult to make such a binary classification of the examples provided, in particular because certain of these examples may have such a fundamental effect on an entity and its financial statements that the concept of whether or not the effect is direct is no longer relevant to the planning and performing of audit procedures. The specified audit procedures currently set out in ISA 250.14 may not be sufficient to identify non-compliance with such laws or regulations and we therefore suggest that the Board re-consider the approach to such laws and regulations as part of a wider project to re-examine ISA 250 (please refer to our comments in Appendix 2). We recommend that this project be treated as a high priority.

We also recommend that the ISA better emphasise certain aspects of the internal control system, as areas that the auditor ought to give appropriate attention to, in particular:

- The application material at A2, which discusses policies and procedures that an entity may have implemented to assist in prevention and detection of non-compliance with laws and regulations, could refer to establishing whistleblowing hotlines or similar processes to enable employees to report actual or suspected non-compliance with laws and regulations, including illegal acts, anonymously, without fear of reprisal;
- A2 could be expanded to refer to establishing an appropriate “tone at the top”, as part of the system of internal control, to ensure that all employees understand the importance of compliance with laws and regulations and the consequences of non-compliance.

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

Yours faithfully

KPMG IFRG Limited

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cc: Jean Blascos

Appendix 1 - Specific Questions Posed by IAASB

- 1. Whether respondents believe the proposed limited amendments are sufficient to resolve actual or perceived inconsistencies of approach or to clarify and emphasize key aspects of the NOCLAR proposals in the IAASB's International Standards**

As we state in our overarching comments, we concur with the proposed limited scope of amendments at the current time, which are intended to align with, and complement, the proposed changes to the IESBA Code.

We are generally supportive of the proposed changes and consider they achieve the stated objectives of avoiding conflict between the requirements of the ISAs and those of the Code, and furthermore, that the ISAs, where relevant, support the principles underpinning the Code and therefore draw appropriate attention to, or give recognition to, the revised requirements in the Code.

We highlight in our overarching comments several recommendations to enhance the proposed changes, in order to provide more robust guidance to auditors and to better align ISA 250 with the key principles underlying the IESBA ED.

- 2. The impact, if any, of the proposed limited amendments in jurisdictions that have not adopted, or do not plan to adopt, the IESBA Code. For example, would any of the changes to the IAASB's International Standards be deemed incompatible with the relevant ethical requirements that would apply in those jurisdictions?**

We do not consider that the proposed changes would have an adverse impact or be deemed incompatible with the relevant ethical requirements applicable in those jurisdictions that have not adopted, or do not plan to adopt, the IESBA Code. This is because the terminology used is sufficiently broad to take account of the different ethical responsibilities that may be established across jurisdictions, as well as the prevailing legal and regulatory environments. Although these proposed changes conform to those of the proposed revised Code, we do not consider that they impose responsibilities on the auditor that would be beyond the stated scope and purpose of the ISAs.

- 3. Effective date – it is anticipated that the effective date of the amendments to the IAASB's International Standards would be aligned with the effective date of the NOCLAR standards, with the IESBA will determine in due course.**

We agree with the effective date proposed by the IAASB, in particular, we consider it appropriate that this is aligned with the effective date of the IESBA NOCLAR standards.

Appendix 2 – Invitation for Additional Input Regarding Potential Revisions to ISA 250

The explanatory memorandum included as part of the ED notes that consultations undertaken as part of developing the IAASB's current Strategy and Work Plan had not demonstrated that ISA 250 warranted immediate revision at this time. The IAASB is soliciting views as to whether there is merit in exploring other aspects of ISA 250 where further improvements may need to be considered in due course. For example, further consideration of the following areas may be viewed as beneficial:

- **Whether the existing distinction between the types of laws and regulations and the different levels of work effort applied to each under extant ISA 250 warrants further investigation or revision;**
- **Whether ISA 250 should address making inquiries of management or, when appropriate, TCWG, regarding NOCLAR that may occur;**
- **Whether ISA 250 should include a requirement to obtain an understanding of how management identifies and addresses known or suspected NOCLAR as an essential component in obtaining an understanding of the entity and its environment;**
- **How ISA 250 addresses personal misconduct related to the business activities of the entity or parties associated with the entity, including contractors;**
- **How NOCLAR is addressed in other ISAs, such as when dealing with auditor's experts and in a group audit situation.**

We consider that it would be beneficial to conduct a thorough review of ISA 250 with a view to making more fundamental changes to this standard. We believe it is important to update the ISA to ensure it remains fit for purpose, in particular to address an increasingly globalised business environment, to take a more robust approach to the consideration of laws and regulations that do not have a direct effect on the financial statements but that could lead to a material misstatement in the financial statements in the event of non-compliance. This is important as it will take account of significant legislative activity in sensitive areas over recent years, for example, regarding anti-bribery and corruption, anti-money laundering, and the resulting regulatory scrutiny of such areas.

Whether the existing distinction between the types of laws and regulations and the different levels of work effort applied to each under extant ISA 250 warrants further investigation or revision

We believe that it is helpful to distinguish between types of laws and regulations in order to determine the most appropriate audit approach, and that it remains appropriate to have different levels of work effort applied to each, in view of the challenges that auditors face, in particular, in relation to laws and regulations that may not have a direct effect on the financial statements.

We agree it is important that the ISA draw attention to these challenges, for example regarding the limitations of an audit in respect of identifying material misstatement as a result of non-compliance with laws and regulations, as well as the restricted ability and expertise of an auditor in this area. Notwithstanding this, we consider that the ISA should place more emphasis, upfront, on the consideration of laws and regulations as being an important and integral part of any audit, and should explicitly recognise the fundamental effect that non-compliance with such laws and regulations may have on an entity's financial statements, to encourage auditors to give appropriate attention to this area.

We also consider that there is a need to further explore the auditor's approach to laws and regulations that do not have a direct effect on the financial statements, to ensure that this is sufficiently robust in order to support auditors in achieving their objective of identifying instances of non-compliance with such laws and regulations that may have a material effect on the financial statements. Much of extant ISA 250 is procedures-based in relation to these laws and regulations and we believe the ISA would benefit from a more balanced, risk-based approach, which emphasises the need for the auditor to exercise professional judgment in designing specified audit procedures. We believe this would provide clearer linkage between the understanding of the legal and regulatory framework developed, the identification or significant risks, and the performance of specified audit procedures that the auditor develops in order to respond appropriately to these risks.

As part of this project we also recommend that clarification be included within the standard that the requirements and guidance beginning at paragraph 18 apply to non-compliance identified or suspected by the auditors in respect of *all* laws and regulations, and are not limited to those laws and regulations described in paragraph 6. We consider that, as currently drafted, the standard does not make this explicit, which may lead to inconsistency in practice.

Whether ISA 250 should address making inquiries of management or, when appropriate, TCWG, regarding NOCLAR that may occur, and

Whether ISA 250 should include a requirement to obtain an understanding of how management identifies and addresses known or suspected NOCLAR as an essential component in obtaining an understanding of the entity and its environment

As we state in our overarching comments, we recommend that ISA 250 better emphasise certain aspects of the internal control system, as areas that the auditor ought to give appropriate attention to, in particular:

- The application material at A2, which discusses policies and procedures that an entity may have implemented to assist in prevention and detection of non-compliance with laws and regulations, could refer to establishing whistleblowing hotlines or similar processes to enable employees to report actual or suspected non-compliance with laws and regulations, including illegal acts, anonymously, without fear of reprisal;

- A2 could be expanded to refer to establishing an appropriate “tone at the top”, as part of the system of internal control, to ensure that all employees understand the importance of compliance with laws and regulations and the consequences of non-compliance.

In the context of a broader set of revisions to the standard, we recommend that IAASB consider including a requirement to obtain an understanding of policies and procedures to identify and address the risks of NOCLAR that could have a material effect on the financial statements. We consider such a requirement would be appropriate as part of the requirement for the auditor to obtain an understanding of the entity and its environment, specifically, to understand how the entity is complying with the legal and regulatory framework applicable to the entity.

It also would be helpful if the IAASB clarified the procedures auditors would normally perform to obtain such an understanding.

How ISA 250 addresses personal misconduct related to the business activities of the entity or parties associated with the entity, including contractors

We support the addition of paragraph 8a, which refers to the identification of information regarding (potential) non-compliance with laws or regulations as a result of complying with specific responsibilities under ethical requirements.

We note that the definition of non-compliance in paragraph 11 of the ISA refers to acts of non-compliance as being entered into “by, in the name of, or on behalf of the *entity* [emphasis added]”, and that personal misconduct is not within scope. This is subtly different to the Code, which includes personal misconduct, although scopes out such misconduct that is unrelated to the business activities of the client or the employing organization. We believe that the difference in scope is appropriate since the ISA is focused on the responsibilities of the auditor in the context of a financial statement audit. Notwithstanding this, it would be helpful for the ISA to explicitly acknowledge that if the auditor becomes aware of actual or potential acts of personal misconduct, irrespective of whether such personal misconduct is within the scope of the IESBA Code, this may provide information that is relevant to the audit, since it may have a bearing on the integrity of management, TCWG, employees of the entity or parties associated with the entity, including contractors.

How NOCLAR is addressed in other ISAs, such as when dealing with auditor’s experts and in a group audit situation

We believe it is important that whenever an auditor involves another party in performing the audit the auditor should inform the other party of the scope and purpose of their work and the use that the auditor will make of this. Additionally the auditor should inform the other party of the auditor’s responsibilities, including duties pertaining to laws and regulations and how these responsibilities may affect the work to be performed by these other parties. The auditor should also request the other party to alert them immediately regarding any information that the other

party may identify as part of performing their procedures that may have a bearing on the auditor's ability to fulfil their responsibilities.

We consider that the above should apply irrespective of whether the other party involved is another auditor (e.g. a component auditor performing work on behalf of the group auditor) or is not an auditor (e.g. an auditor's expert); the scope of the procedures that the other party is to perform (e.g. whether a component auditor is requested to perform an audit or specified audit procedures over the financial information of a component), or the nature of the engagement (e.g. whether this is an audit engagement, another form of assurance engagement, or a non-assurance engagement, such as an agreed-upon-procedures engagement or a compilation engagement).