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29 January 2021

Consultation on the proposal to revise ISA (UK) 240 (Updated January 2020) *The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements*

Dear Keith,

I am writing on behalf of KPMG LLP in response to the Financial Reporting Council's (FRC) consultation paper on the proposal to revise ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("the Consultation") and its Exposure Draft of a revised ISA (UK) 240 ("the ED").

We agree that it is important to act now to start addressing concerns about the auditor's responsibilities in respect of fraud, given the gap between some stakeholders' expectations and what audits are currently required to deliver. We welcome the opportunity to comment on the Exposure Draft.

We would also encourage the FRC to continue to promote international debate in this area as international alignment and consistency can only be beneficial.

We support the proposal to revise ISA (UK) 240 to clarify the auditor's responsibilities in relation to fraud and to promote a more consistent and robust approach to those responsibilities. The ED makes a number of worthwhile enhancements to requirements and guidance to improve current practice, such as the requirements and guidance encouraging greater use of forensic expertise where appropriate, to perform updates to the engagement team's initial planning discussion on fraud risk where needed, and the application guidance on indicators that evidence may not be authentic.

There are also some areas where, in our view, the proposals are not sufficiently clear and in some cases could widen the gap between some stakeholders' expectations and auditors' practice under the proposed revised standard. One example of this is the revision stating that judgements about whether a misstatement is material involves both qualitative and quantitative considerations (paragraph 3). The ED could be read as suggesting that an audit is required to be designed to detect actual or suspected fraud involving key management

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personnel irrespective of size (say, a £10 expense claim). Unless the standard more clearly states the extent to which the auditor is expected routinely to design audit procedures to detect such qualitatively material fraud (including where no fraud risk factors relating to the integrity of management exist) and what the auditor's response should be if detected, this could lead to more divergence in practice and a widening of the expectation gap.

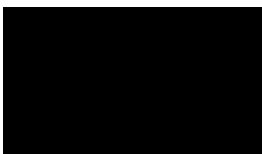
Furthermore, as detailed in our specific responses below, we believe there are several requirements which require further practical guidance material in order for them to be consistently and effectively applied. For instance, further application material clarifying the expected nature and extent of forensic professional involvement is needed, including clarification of when forensic professionals should be involved beyond risk-assessment activities. We are also concerned that this aspect of the ED could further restrict the choice of auditor, as not all firms will have sufficient forensic expertise. Guidance on what constitutes a forensic professional would be beneficial in this context. Guidance on when forensic expertise might be needed will be helpful along with consideration of what an auditor does if they find they don't have this expertise when they need it.

The proposed revisions to ISA (UK) 240 are only one of a number of changes which we believe need to be made, in order to deliver an audit product, as well as corporate reporting, which meet stakeholders' expectations in relation to fraud. On their own, these revisions, are unlikely to achieve this. The Brydon Review's recommendations acknowledge directors' primary responsibility for prevention and detection of fraud. Moreover, as we said in our submission to the BEIS Committee's inquiry *Delivering Audit Reform*¹, it is not only auditors, but management, directors and regulators who have a responsibility here. We look forward to the forthcoming government consultation on corporate reporting and audit to advance the reform agenda further.

Our responses to each of the specific consultation questions are set out in Appendix 1.

Please contact me if you have any questions on this response.

Yours sincerely



Jon Holt

Head of Audit

¹ <https://committees.parliament.uk/writtenevidence/10044/html/>

Appendix 1

Responses to specific questions

Q1. Has ISA (UK) 240 been appropriately revised to give increased clarity as to the auditor's obligations relating to fraud in the audit of financial statements? If you do not consider this to be the case, please set out why and how you believe those obligations should be clarified.

We support the objective of increasing clarity over the auditor's responsibilities relating to fraud in the audit and the update to the objectives of the auditor in paragraph 10. However, in our view, certain of the other proposed changes have the potential to widen, rather than narrow, the gap between stakeholders' expectations and auditors' actual responsibilities in relation to fraud, in the following areas.

Fraud involving key management personnel

Paragraph 3 in the introduction to the ED states that fraud or suspected fraud by a key member of management may be considered material even if the potential misstatement is less than materiality determined in quantitative terms. The inference of the wording is that misstatements of nominal amounts, such as a £10 discrepancy in an expense claim, would always be material.

While the auditor would take account of factors such as whether key management personnel were involved when the auditor assesses the materiality of a specific actual or suspected instance, the paragraph could be interpreted as meaning that the auditor is responsible for planning the audit to detect such low-value discrepancies. This would set an unreasonable expectation of what the audit can achieve and risk widening the expectation gap.

If the FRC intends that the paragraph only refers to cases of actual or suspected fraud that the auditor identifies, and not to the types of fraud the auditor aims to detect in planning the audit, we would recommend revising this paragraph to state this fact before incorporation into ISA (UK) 240. The paragraph should also be clarified to explain that such identified or suspected frauds involving key management personnel may be material even though below the quantitative materiality for the financial statements as a whole, but not necessarily irrespective of value; misstatements related to key management personnel and of very low value or demonstrated to be truly inadvertent, may still be clearly trivial in the context of the financial statements as a whole.

In the same paragraph, the ED states that the auditor considers qualitative as well as quantitative factors in assessing the materiality of actual or suspected fraud. We agree with this but believe that it is important that the FRC add application guidance identifying the

relevant qualitative considerations and clarify the extent to which the auditor is expected to plan the audit to detect such qualitatively material fraud. Without such guidance there is a risk of expanding the expectation gap.

The risk of not detecting a material misstatement resulting from fraud

In paragraph 6, the extant ISA (UK) 240 states, in line with the IAASB's ISA, that "the risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error", which the ED amends to say the risk "may be higher". It is unclear why the FRC has taken a different view as to the ability of the audit to detect fraud and why it felt it necessary to propose this revision. Such a divergence from the international standard can only add confusion into an area already not well understood by stakeholders.

Even an audit planned and performed in accordance with ED would be subject to additional limitations in its efforts to detect material fraud in addition to the inherent limitations of the audit in respect of misstatements due to error, as the remainder of the paragraph still highlights. In our view, to suggest that the obstacles to detecting material misstatements due to fraud are not necessarily greater than for risks of error could set inappropriate expectations as to what the audit can achieve. While we support many of the revisions in the ED, we do not believe that they fundamentally alter the fact that misstatements resulting from fraud are more difficult to detect than those occurring as a result of error.

In the same way, while we agree with the sentiments of paragraph 7-1, which states that the difficulty of detecting a fraud does not diminish the auditor's responsibility to seek reasonable assurance (subject to the prior point on the assertion that the risk of not detecting a material misstatement resulting from fraud may be higher), it does not serve to clarify what the auditor's responsibilities are, so could be removed without impairing the clarity of the ED.

Q2. Have appropriate enhancements been made to the requirements for the identification and assessment of risks of material misstatement due to fraud, and the procedures to respond to those risks, to promote a more consistent and robust approach to the auditor's responsibilities in relation to fraud? If you do not consider this to be the case, please set out why and how you believe the requirements should be enhanced.

Discussions among the engagement team

KPMG UK already requires certain engagement teams to hold a Risk Assessment Challenge meeting to update their earlier planning discussion on fraud and other risk assessment matters and intend to extend this requirement to more audit engagements. We are therefore pleased

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to see that the proposed paragraph 15-4 recognises the benefit of further discussion among the engagement team at later stages in the audit to revisit their initial fraud risk assessment.

We therefore agree with the insertion of 15-1 to 15-4. However, the supporting application material at A10-1 states that *“All members of the engagement team, including specialists, participate in the discussion”*, which goes further than the underlying requirement in ISA (UK) 315 (Revised July 2020) which only requires that *“The engagement partner and other key engagement team members shall discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement”* (our emphasis). Given that a single discussion is likely to be used to address both fraud risk and other risk assessment matters, the two ISAs should be consistent.

In our view, the participation in the discussion described in ISA (UK) 315R is appropriate, and it is not necessary to require every engagement team member to attend, provided that the discussion is thoroughly documented and the substance communicated, as appropriate, to any engagement team members (including specialists) who do not attend.

Forensic expertise

KPMG UK currently requires a defined level of forensic involvement in audits where significant actual or suspected fraud is identified and require all our audit engagements to determine whether forensic expertise is needed. We therefore support the revisions requiring all auditors to determine whether forensic expertise is required but, as noted in our covering letter, believe that guidance on who constitutes a forensic professional and what represents forensic skills would be beneficial. We do not believe that this should be linked to a job title or department names but should be linked to the knowledge and experience of the relevant individuals.

We note that in paragraphs 27-1 and A34, the ED refers to forensic experts whereas A27-1 refers to forensic skills. We are unclear whether this is an intentional distinction – for example, the Brydon Report stressed the benefits of auditors themselves having the mindset and some of the skill set of a forensic professional, so the ED may have intended to distinguish between the involvement of a forensic professional and circumstances where that is not necessary because the core engagement team already possesses the necessary competencies. Clarification would be helpful in this respect. As explained in our covering letter there is also a concern that this aspect of the ED could further restrict the choice of auditor, as not all firms will have sufficient forensic expertise.

To help consistency of application, further application material clarifying the expected nature and extent of forensic professional involvement is needed, including clarification of when forensic professionals should be involved beyond risk-assessment activities.

Additional required inquiries

We support the insertion of paragraph 18-1 requiring the auditor to make inquiries of management, or others within the entity as appropriate, who are responsible for dealing with allegations of fraud raised by employees or other parties. Expansion of the application guidance to indicate what inquiries the auditor undertakes will aid consistent application of the requirement. It will be helpful if the FRC, outside of this ISA, were to remind management and those charged with governance of their responsibilities to provide full and comprehensive responses to such inquiries, and to inform the auditor of actual or suspected fraud and other matters relevant to the audit as they become aware of them.

Q3. Have appropriate enhancements been made to the application material? If you do not consider this to be the case, please set out why and how you believe the application material should be enhanced.

We support a number of the revisions to the application guidance in the ED, though, in our view, it would further benefit from specific guidance in places. We have set out areas where the ED makes progress over the extant ISA (UK), as well as areas for further enhancement, in our responses to other questions.

Q4. Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk assessment procedures, the procedures to respond to those risks and the evaluation of audit evidence obtained? If you do not consider this to be the case, please give reasons and describe how you consider the exercise of professional scepticism could be better supported.

We support the proposed revisions – in particular, paragraph 13-1 and the supporting application guidance A9-1 which provides helpful examples of indicators that audit evidence may not be authentic.

Further guidance in the standard on how auditors may best document application of appropriate professional scepticism with respect to fraud will be of benefit. For example, when documenting the rationale regarding identified fraud risk factors, to what extent are fraud risk factors which have been considered and deemed not to be applicable required to be documented to on the file.

As the FRC has acknowledged, the practice of professional scepticism requires audit firms to instil a culture of challenge; there are limitations to what one can achieve through revision of

professional standards only. However, the ED makes some small but useful steps forward in enhancing the ISA (UK) in supporting auditors in applying professional scepticism.

Q5. ISA (UK) 240 establishes a rebuttable presumption that there are risks of fraud in revenue recognition (paragraph 26). Are there other account balances, transactions or disclosures for which such a rebuttable presumption should be established? If you consider there are, please identify them and set out why.

We agree that the rebuttable presumption that there are risks of fraud over revenue recognition should be retained.

Financial reporting fraud aiming to achieve the same objectives as manipulation of revenue (such as inflation of profits) may also be perpetrated through intentional misstatement of other accounts. However, in our view, it would not be helpful to add further rebuttable presumptions for other account balances or transactions, since this may inadvertently narrow the auditor's focus onto those accounts only when identifying the risks of fraud. The auditor's identification of fraud risk factors and resulting fraud risks ought to suffice in taking a broad view of where fraud risks may exist and ensuring fraud risks are identified across the range of accounts where they may exist on the engagement.

We suggest that application material is included noting that fraud committed over time will manifest in one or more balance sheet account. This material would highlight the importance of performing appropriately rigorous analytical procedures during risk assessment, with a specific focus on balance sheet accounts, in order to identify amounts, ratios, and trends which may be indicative of fraud.

Q6. ISA (UK) 240 specifies particular audit procedures responsive to risks related to management override of controls (paragraphs 31 – 33). Are there other audit procedures responsive to those risks, or any other risks of material misstatement due to fraud, that you believe should be required for all audits? If you consider there are, please describe them and set out why.

The standard will benefit from additional application material clarifying how to apply the requirement to test the appropriateness of journal entries. Specifically, the expected nature and extent of work to be performed with respect to the relevant data elements the auditor uses to identify high-risk entries for testing should be included in the revised ISA (UK).

When identifying high-risk journal entries, the auditor relies upon certain fields in the journals listing, e.g. fields which distinguish automated and manual journal entries, or the username of

the person who posted/authorised the journal entry. A common challenge is that the auditor may be unable to conclude that these fields are reliable. This can occur in both scenarios where GITCs are tested and deficiencies are identified and also when GITCs are not tested due to the nature of the entity and the audit approach. The ISA could make clear that this does not prevent the auditor from using these relevant data elements to identify high-risk journal entries. The standard would then require auditors to consider the associated risk, i.e. the possibility that not all high-risk journal entries have been identified based on the determined criteria, and to determine the impact, if any, on the audit approach, e.g. the identification and application of additional high-risk characteristics.

A43 states that “*effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls and concluded that they can be relied on.*” In cases where relevant automated controls and supporting GITCs have been tested and the auditor considers that the risk of material misstatement due to fraud associated with automated journal entries is remote, the standard should make clear that it may be appropriate to select and test manual journal entries only.

Q7. In complying with the requirements of ISA (UK) 240 (Revised), the auditor may also need to consider whether there has been non-compliance with laws and regulations, and therefore that requirements in ISA (UK) 250 Sections A and B (Revised November 2019) also apply. Is it sufficiently clear in these ISAs (UK) of the interaction between them?

The ED² adds a cross-reference to ISAs (UK) 250A and 250B, highlighting in particular the requirements of those standards relevant to reporting to others outside the entity. We agree that the requirements and guidance related to reporting to others, such as the reporting of proceeds of crime described in the Appendix to ISA (UK) 250A and the requirements of both ISAs (UK) 250A and 250B on reporting in the public interest, may be relevant in the case that the auditor identifies or suspects fraud.

If the FRC intended to suggest other requirements and guidance of ISAs (UK) 250A and 250B as being particularly relevant, we would recommend specifically describing those linkages in additional application guidance.

The recent revisions to ISAs (UK) 250A and 250B introduced a connection between the standards in the other direction, with ISA (UK) 250A.A18-1 stating that, when the auditor

² ED ISA (UK) 240.A5a-2

determines that the identified or suspected non-compliance with laws and regulations is intentional, the requirements of ISA (UK) 240 apply.

As we commented in our response letter to those standards, ISA (UK) 240 focusses on fraudulent financial reporting and misstatements resulting from misappropriation of assets. Non-compliance with laws and regulations does not fit in either category, unless those charged with governance misstate financial statements by failing to account for or disclose non-compliance of which they were aware, in order to mislead shareholders. As such, we commented that it was unclear what, if any, effect this additional paragraph was intended to have on auditors' work.

The distinction between the broad scope of ISA (UK) 250A/B and the narrower definition of fraud relevant to the audit in ISA (UK) 240 is important in that the auditor's responsibilities in respect of fraud are much more extensive than their responsibilities in respect of "indirect" laws and regulations (those laws and regulations other than those generally recognised as having a direct effect on the financial statements).

Since ISA (UK) 240 is now being revised, we would recommend the FRC take this opportunity to clarify these links from ISA (UK) 250A to ISA (UK) 240 by clarifying the circumstances under which other non-compliance with laws and regulations identified through procedures performed under ISA (UK) 250A would be considered to be fraud in the sense defined in ISA (UK) 240, and what specific elements of ISA (UK) 240 would be particularly relevant in this case.

Q8. Are the requirements and application material sufficiently scalable, including the ability to apply ISA (UK) 240 (Revised) to the audits of entities with a wide range of sizes, complexities and circumstances? If you do not consider this to be the case, please set out why and how you believe that could be addressed.

It is our opinion that overall, the requirements and application material are sufficiently scalable. There are certain aspects however which we wish to comment on.

In respect of the proposed amendment to A10-1, as discussed in our response to Q2, on larger or more complex audits, including every engagement team member, including specialists, in the fraud discussion is not appropriately scalable to larger/more complex engagements. In our view, the discussion between the engagement partner and other key engagement team members and specialists required under ISA (UK) 315R is more appropriate.

In our response to Q2 we have provided our comments on the amendments relating to the use of forensic expertise, including the need for further application material. It is important that this provides sufficient scalability in application such that it does not introduce a barrier for

smaller audit practices. Similarly, our response to Q6 includes discussion of the impact of GITC testing on the testing of journals. This is another area where the standard will benefit from application material addressing scalability considerations for the audits of smaller or less complex entities.

Q9. References to 'computer assisted audit techniques' have been updated to 'automated tools and techniques' and we have identified that these may enable more extensive testing and assist in identifying unusual transactions or relationships (paragraphs A44, A48 and A50). Is there other guidance in relation to the use of automated tools and techniques that you believe could assist auditors in relation to their obligations with regard to fraud? If you consider there is, please give an explanation of it.

We support the change in terminology in referring to automated tools and techniques. In A44 it will be beneficial to provide examples of automated tools and techniques that can be used in this context, such as the automated analysis and assessment of the appropriateness of journal double-entries. It will also be helpful to clarify how the use of AI and machine learning to detect anomalies in a population, without human intervention, may be appropriately applied.

The revisions to A48 and A50 are clear in their meaning, but we would suggest that the line in A44 “Where there are high numbers of journals, automated tools and techniques may enable more extensive testing through further analysis based on particular characteristics” be clarified to confirm that it is the FRC’s intention that the further analysis performed by these tools and techniques may be used to obtain the evidence relating to the high-risk journals, as opposed to solely for the purposes of identifying a larger number of high-risk entries for manual testing.

The ED should also clarify that, while automated tools and techniques may allow more extensive testing, such testing is responsive and proportional to the assessed risk and that auditors are not required to obtain additional evidence simply because it is possible.

Q10. Do you agree with the proposed effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted, which is aligned with the effective date of ISA (UK) 315 (Revised July 2020)? If not, please give reasons and indicate the effective date that you would consider appropriate.

It is important for the FRC to take prompt action to narrow the expectation gap, while noting that such a gap is always likely to exist.

Given there are links between ED ISA (UK) 240 and the recently revised ISA (UK) 315, we agree that the effective date should match that of ISA (UK) 315.

Q11. Should an additional requirement be placed on auditors to have a specific discussion with those charged with governance on the risks of material fraud in the business, including those which are business sector specific, in order to further the risk assessment process in respect of the risk of material error in the financial statements relating to fraud?

The question refers to “furthering the risk assessment process” which implies the auditor is seeking views from those charge with governance as to the risks of fraud in the business, including those which are business sector specific. In our view, this is already adequately addressed by the auditor’s required inquiries of those charged with governance, so an additional discussion appears unnecessary if it is for that purpose.

Such a discussion may, however, serve to communicate the auditor’s assessment of fraud risks to those charged with governance. In principle we would support the requirement to have a specifically fraud-focused discussion with those charged with governance.