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Discussion Paper: Fraud and Going Concern in an Audit of Financial Statements

Dear Tom

Dear Ladies and Gentlemen

The Wirtschaftsprüferkammer (WPK) is pleased to take this opportunity to comment on the Discussion Paper: Fraud and Going Concern in an Audit of Financial Statements.

We welcome the efforts of the IAASB to gather perspectives from different stakeholders about the role of the auditor in relation to fraud and going concern in an audit of financial statements. Serious corporate failures have drawn the public attention to the work of auditors, leading oftentimes to questioning the role and the benefit of the audit in general.

Considering fraud, it is oftentimes hard to differentiate where the responsibilities of the auditor ends and at what point auditor defectiveness begins. In combination with the so-called knowledge gap this may result in undermining the public trust in the auditor's opinion. Therefore, we agree with the IAASB that narrowing the expectation gap is one of the key measures in the context of fraud and going concern. The IAASB correctly states, that it cannot narrow the expectation gap alone. Also, the audit treatments of fraud and going concern are embedded in the financial reporting ecosystem therefore the IAASB is not is a position to resolve these issues alone.

We do not believe, that enhanced ISA requirements for planning and performing audits will avoid corporate failures in the future. Implementing additional audit requirements into the ISAs, especially requirements that may alter the character of the audit like mandatory forensic procedures, should only be made if a respective law or regulation requires to do so.

We hope that our comments below will be of use in the further discussion and will be pleased to answer any questions you may have.

Kind regards

Dr. Reiner Veidt	WP Heiko Spang
Chief Executive Officer	Head of Auditing and Accounting

Appendix

1. **In regard to the expectation gap (see Section I):**

   (a) What do you think is the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements?

We see the main cause of the expectation gap in the general public's misunderstanding of the role and the legal task of the auditor, including the inherent limitations of the audit ("knowledge gap"). The informational value of the auditor's opinion is accordingly overestimated and falsely rather considered as a guarantee for flawlessness of the financial statements and future viability of the audited company by a trustworthy, external party.

The number of professionals conducting statutory audits is small, at least in Germany, and regarding the audit of financial statements they operate rather unobserved by the public due to the trusting relationship with its clients and discretion obligations. The audit itself is conducted on the basis of a comprehensive set of rules (laws and statutes, standards, codes) containing complex requirements and concepts that are hard to understand for people outside the profession. These include amongst others concepts like reasonable assurance, materiality with all its different forms, or the elaborated allocation of responsibilities between auditor and management with regard to the going concern ability of the audited company. Knowledge of and interest in the conduct of a financial statement audit of the general public is accordingly limited.

Whereas the public image of the professionals seems to be one of well-paid, well-trained specialists with comprehensive expertise in various economic and business-related disciplines (e.g. tax, financial reporting, controlling, valuation services, forensic). This image may be reinforced by financial news in the media and self-presentation of the firms (image brochures, recruiting conventions, social media). In case of large corporate failures, like Wirecard, the media coverage swiftly reports about alleged duties and failures of the auditor and others even though legal investigations are still ongoing, thereby creating a potentially distorted picture of the role, responsibilities and capabilities of the parties involved.

Considering the evolution gap expectations in the digital expectations might be that technologies enable the auditor to perform 100% audits, resulting in absolute assurance auditor's reports.

(b) In your view, what could be done, by the IAASB and / or others (please specify), to narrow the expectation gap related to fraud and going concern in an audit of financial statements?

The Discussion Paper correctly presents, that the expectation gap has existed for decades. Various measures have been implemented in order to reduce the gap. One prominent example is the IAASB's revision of the auditor's report in 2015 by increasing the informational value of the auditor's report. Another example is the addition of a new Article 25a to the EU Audit Directive (2006/43/EC) in the context of the European Audit Reform. This Article states in particular that *the scope of the statutory audit shall not include assurance on the future viability of the audited entity*. Unfortunately, it is hardly measurable to what extend these measures lead to a reduction in the expectation gap.

Nevertheless, we believe that educational work for the public in general, policy makers and multipliers in particular, is need in order to address the expectation gap. We consider the IAASB to take the leadership for the global profession and to develop brochures, guidance and support material addressed either directly or through its members to relevant stakeholders.

2. This paper sets out the auditor's current requirements in relation to <u>fraud</u> in an audit of financial statements, and some of the issues and challenges that have been raised with respect to this (see Sections II and IV). In your view:

(a) Should the auditor have enhanced or more requirements with regard to fraud in an audit of financial statements? If yes, in what areas?

Unfortunately, we do not have information about how many attempted frauds have been avoided or how many committed frauds have been detected in the normal course of the audit. But we do know that the vast majority of audits – in Germany approximately 40,000 per year – is properly performed. Additionally, even in individual corporate failures due to fraud, we believe that deficiencies in the conduct of the audit with regard to fraud are not the result of insufficient audit requirements but rather the result of inadequate use of the audit standards. Accordingly, we do not see the need for enhanced or more audit requirements with regard to fraud.

At this point we would like to emphasize, that the primary responsibility for preventing and detecting fraud lies with management as overseen by those charged with governance. Management needs to establish internal controls as part of the corporate governance structure and those charged with governance (e.g. supervisory board) are responsible for overseeing this. Enforcing corporate governance should be the starting point and the driver for any measures addressing fraud prevention. This requires a joint effort by all relevant parties, including those charged with governance, management, auditors, regulators and standard-setters.

Sensitizing the profession for specific fraud related issues (e.g. by corresponding training requirements) seems reasonable in order to create awareness and to foster professional scepticism. Whereas, we consider the use of forensic specialist in the normal course of the audit as problematic. The performance of "some random forensic procedures" during the audit does not avoid highly sophisticated fraud. Instead we see the risk that the expectation gap might even widen. A comprehensive forensic audit support on the other hand alters the character of the audit as we currently know it and must therefore only be implemented by policymakers.

In this context it is worth to mention, that investors, shareholders and certain other stakeholders are always free to request the management of the audited company to engage external parties to perform forensic investigations – separate from the audit and therefore separately paid for. We are not aware of any company exercising this option without cause.

(b) Is there a need for enhanced procedures only for certain entities or in specific circumstances?

No, please see answer to question 2. (a).

Nevertheless, we would like to mention at this point the reporting requirements for auditors of public interest entities in Article 7 (*irregularities including fraud*) and Article 12 (*going concern*) of the EU Audit Regulation.

(c) Would requiring a "suspicious mindset" contribute to enhanced fraud identification when planning and performing the audit? Why or why not?

(i) Should the IAASB enhance the auditor's considerations around fraud to include a "suspicious mindset"? If yes, for all audits or only in some circumstances?

Generally, we welcome all reasonable measures that help sensitize the profession for fraud related issues, create awareness and foster professional scepticism / suspicious mind. We consider such measures to be rather of educational character than comprehensive audit standard requirements.

Nevertheless, the introduction of a new term ‘suspicious mindset’ will require an explanation of its meaning and a clear distinction from ‘professional scepticism’. Accordingly, we rather support the specification of ‘professional scepticism’.

(d) Do you believe more transparency is needed about the auditor’s work in relation to fraud in an audit of financial statements? If yes, what additional information is needed and how should this information be communicated (e.g. in communications with those charged with governance, auditor’s report, etc.)?

We believe that more educational work about the auditor’s work in relation to fraud in an audit of financial statements is needed in the first place.

Additionally, we support the idea of increasing the transparency in the auditor’s report in accordance with the requirements in Article 10 of the EU Audit Regulation in order to reduce the expectation gap. According to this Article auditors of public interest entities are required to explain in the auditor’s report to what extend the audit was considered capable of detecting irregularities, including fraud. Nevertheless, extensive, boiler plate explanations in the auditor’s report should be avoided. This dilutes the informational value of the report, possibly increasing the expectation gap.

3. This paper sets out the auditor’s current requirements in relation to <u>going concern</u> in an audit of financial statements, and some of the issues and challenges that have been raised with respect to this (see Sections III and IV). In your view:

(a) Should the auditor have enhanced or more requirements with regard to going concern in an audit of financial statements? If yes, in what areas?

The public often considers the audit opinion as a guarantee by the auditor that the audited company is in good conditions and will stay in business for the foreseeable future. However, the auditor’s responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management’s use of the going concern basis in the preparation of the financial statements (ISA 570.16).

Regardless of the requirements in the audit standards, the auditor cannot predict future events or conditions. Assessing a company’s ability to continue as a going concern has its inherent limitations as it always involves a level of uncertainty. Consequently, neither does an audit opinion include assurance on the future viability of the audited entity nor does the absence of any reference to going concern uncertainty in an auditor's report create such a guarantee (see question 1. (b) above as to Article 25a of the EU Audit Directive). Therefore, we are convinced that the existing Auditing Standards are sufficient.

As the primary responsibility for assessing the going concern status lies in the hands of management (and those charged with governance), rather management should be obliged by respective requirements in the financial reporting standards to make a clear statement regarding Going Concern and substantiate its assessment.

(b) Is there a need for enhanced procedures only for certain entities or in specific circumstances? If yes:

No, please see answer to question 3. (a).

(c) Do you believe more transparency is needed:

(i) About the auditor's work in relation to going concern in an audit of financial statements? If yes, what additional information is needed and how should this information be communicated (e.g., in communications with those charged with governance, in the auditor's report, etc.)?

ISA 700.39 (b) (iv) should be extended by a statement in the sense of Article 25a EU Audit Directive: The statutory audit does not include assurance on the future viability of the audited entity.

(ii) About going concern, outside of the auditor's work relating to going concern? If yes, what further information should be provided, where should this information be provided, and what action is required to put this into effect?

Educational work in order to reduce the expectation gap (see question 1. (b)) and requirements in Financial Reporting Standards (see question 3. (a)) is needed.