Fraud and Going Concern in an Audit of Financial Statements

Exploring the differences between public perceptions about the role of the auditor and the auditor's responsibilities in a financial statement audit

Response to IAASB

1 February 2021

CA House 21 Haymarket Yards Edinburgh EH12 5BH
enquiries@icas.com +44 (0)131 347 0100 icas.com

Direct: +44 (0)131 347 0234 Email: jbarbour@icas.com

INTRODUCTION

ICAS welcomes the opportunity to comment on the IAASB's discussion paper, Fraud and Going Concern in an Audit of Financial Statements.

Our CA qualification is internationally recognised and respected. We are a professional body of over 22,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK's and the world's great companies.

Our Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Any enquiries should be addressed to James E Barbour, Director, Policy Leadership jbarbour@icas.com

General comments

Need for involvement of all actors
We commend the IAASB for taking forward this initiative. As the IAASB notes the debate is timely and such is its nature that it is vital to enhancing confidence in financial reporting. As is noted in the discussion paper the IAASB can increase what it requires of auditors in the areas of fraud and going concern, however, it cannot narrow the expectation gap alone. The primary responsibility for preventing and detecting fraud rests with directors as it does in relation to assessing whether an entity is entitled to make use of the going concern assumption as the basis for preparing its financial statements. The IAASB, however, only has direct influence over matters affecting auditors and therefore what can be included in auditing standards or guidance. A holistic approach requiring efforts from all of the actors involved in the financial reporting ecosystem is essential if fraud and going concern are to be appropriately addressed. However, issues such as the lack of global standards on corporate governance do bring challenges in that regard.

Importance of Corporate Culture
We firmly believe that leadership that promotes an organisational culture of honesty and ethical behaviour, is a key element of helping to prevent fraud. ICAS launched its the Power of One ethics initiative in 2015 that recognised the importance of ethical leadership. IESBA last year also published its final pronouncement on its Role and Mindset project that requires all professional accountants to adopt an "inquiring mind" and also places emphasis on professional accountants to encourage and promote an ethical culture in their respective organisations. It has to be remembered that professional accountants do not just work as auditors but rather in various roles throughout the financial reporting ecosystem. By placing greater focus on their responsibilities, e.g. the inquiring mind and not just accepting information at face value, professional accountants in business will also play a part in mitigating the risk of fraud within organisations. All of those involved in the corporate governance chain, including auditors, should have strong speak-up, listen-up, whistleblow programs in place that both encourage and protect those who make reports. Speak-up lines encourage matters to be flagged at an early stage which can prevent them from escalating into something far more serious.

Effective system of internal controls
We also believe that a strong focus by management and those charged with governance on having an effective system of internal controls over financial reporting can also play a key part in seeking to mitigate the risk of fraud occurring within an organisation. We do therefore believe that there is merit in jurisdictions considering whether they should impose requirements on directors to attest as to whether the entity concerned does have an effective system of internal control over financial reporting. Consideration would also need to be given to the potential involvement of the auditor, if any, in such attestations.

IAASB Quality Management Standards and ISA 315 Revisions
We also believe that the recent approval by the IAASB of its quality management standards and as well as the revisions to ISA 315 which includes a more robust and consistent risk identification and assessment, will help to narrow the performance gap.

Use of forensic specialists
We are not convinced that the use of forensic specialists should be mandated on the audits of public interest entities. However, consideration of their use by auditors in specific circumstances could be more prominently highlighted in the ISAs but their use should be left to the professional judgement of the auditor.

Automated tools and techniques
Technological advances, including increased usage of data analytics will also help auditors to enhance their respective fraud detection capabilities and further develop professional scepticism.

Going concern
On going concern, more could be required of the auditors in the shorter term. However, like fraud a holistic approach would be preferable with more being required in the first instance of directors. This would then provide a better foundation from which to build additional requirements for the auditor. Some stakeholders clearly believe that an auditor is providing a guarantee as to the continued existence of the audited entity, which can never be the case. Admittedly, part of the problem lies in the content of the accounting standards which present a low hurdle for an entity to be classed as a going concern, yet there is a high bar for directors having to disclose any "material uncertainties". There is also a limited awareness of the language of going concern. Merely adding to the obligations on auditors would not address this expectation gap.

Longer-term viability
The focus of the IAASB is on going concern. There is evidence that stakeholders are also looking for more information on the long-term viability of a business. That is why we are strongly supportive of the resilience statement approach as recommended by Sir Donald Brydon[1] in the UK. This incorporates and builds on the Going Concern and Viability Statements, and would greatly improve transparency and avoid surprise failures (it is impossible to avoid corporate failure completely). The tiered outlook would address one of the criticisms of the current viability statement regime, whereby corporates may have taken an overly short-term view in their assessments, with a three-year outlook being prominent. However, we would caution that this is a complicated and developing field. The last 12 months have reinforced some of the practical difficulties that boards will encounter trying to predict the speed of change, and the impact of, as yet unknown, future scenarios and external threats.

Cost/benefits
The costs and benefits of any proposed changes by the IAASB will need to be very carefully considered.

Specific questions

Question 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?
(b) In your view, what could bSOXe 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?

[1] Assess, Assure and Inform Improving Audit Quality and Effectiveness: Report of the Independent Review Into the Quality and Effectiveness of Audit, (2019)
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf

Response 1

(a) We note the audit expectations gap model adopted by the IAASB for the purposes of this paper. From the model used by the IAASB, the main cause in our view is the “knowledge gap”, i.e. the difference between what the public thinks auditors do and what auditors actually do. This recognises that the public may misunderstand the role of auditors and the requirements of the auditing standards. We do need to be careful here, however, as to regards what constitutes “the public”. Given the inherent complexities associated with business, and indeed financial reporting, it is questionable whether it would be possible for an average member of the public to properly understand the purpose and objectives of an audit. Therefore, we believe that closing the perceptions gap has to be targeted at a particular group, e.g. an informed investor or equivalent in relation to the audits of public interest entities to have any real hope of closing this gap.

We would also note that as the IAASB highlights there is an information gap which may be consumed within the knowledge gap. Auditors with their privileged access to company records and personnel are in possession of far more information about an entity than is reported in their audit report. One of the key aspects of that is information relating to any weaknesses in internal controls that are reported to those charged with governance. Whilst they have always been important, internal controls are taking on even more importance nowadays given the rapid development of new technology. Efforts targeted at improving an entity’s system of internal controls should help to reduce the risk of fraud occurring in the first place and, where it does occur, of detecting the particular fraud in question. Therefore, at a jurisdictional level we believe that there is merit in jurisdictions considering whether they should impose requirements on directors of public interest entities to attest as to whether the entity concerned has an effective system of internal control over financial reporting. The more effective such systems are, and we fully appreciate that they cannot be absolute, the less is the risk that these controls can be bypassed, or circumvented by management. We need to build on strong foundations, audit is at a disadvantage if an entity does not have in place an effective system of internal control. Such jurisdictions could also decide on the extent to which the auditor should provide assurance, if any, over such attestations. Such developments would help to improve the financial reporting ecosystem. In those UK companies which are subject to the US SOX regime there is general acceptance that this has led to a better control environment within those organisations.

(b) With respect to fraud, a first stage would be to provide greater clarity in ISA 240 as to the responsibilities of the auditor. The UK FRC has recently consulted on proposed revisions to the UK version of ISA 240 which we believe better clarify the auditor's responsibilities in relation to fraud and promote a more consistent and robust approach to those responsibilities. We would therefore draw the IAASB’s attention to the FRC’s proposed changes which include requirements and guidance to enhance the auditors’ procedures to identify and assess risks of material misstatement due to fraud and to plan and perform procedures responsive to those risks.

In terms of future steps, we believe there is a need for discussions to take place with regulatory bodies around the globe to try and arrive at a more holistic approach to addressing fraud in the corporate environment. Matters such as internal controls, responsibilities of directors and requirements of financial reporting standards should be considered. A holistic approach would then depend on additional requirements being placed on directors. This could follow the approach as envisioned in Sir Donald Brydon’s report, however, this will be difficult to achieve at the global level and to some extent will require to be jurisdiction specific.

Question 2

This paper sets out the auditor’s current requirements in relation to fraud 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?

(b) Is there a need for enhanced procedures only for certain entities or in specific circumstances?1
If yes:
  (i) For what types of entities or in what circumstances?
  (ii) What enhancements are needed?
  (iii) Should these changes be made within the ISAs or outside the scope of an audit (e.g., a different engagement)? Please explain your answer.

(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?

(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, in the auditor’s report, etc.)?

Response 2a
Firstly, we believe it is essential that it is remembered that the primary responsibility in relation to the prevention and detection of fraud rest with the directors of the entity. Therefore, we are supportive of a more holistic approach, that will involve additional requirements on those charged with governance. However, such an approach is not within IAASB’s mandate which is solely focussed on setting standards for auditors. Therefore, whilst we believe there is scope for enhancement of the auditor’s procedures, these would be most beneficial in an environment in which additional responsibilities are also being placed on those charged with governance of an entity.

That said, we do believe there is room for improving extant ISA 240 and would flag the proposals in the recent consultation by the UK FRC which proposed a number of enhancements to the standard. These including those intended to further promote the exercise of professional scepticism by the auditor and the addition of new paragraphs requiring that the auditor shall determine whether the engagement team requires specialised skills or knowledge to perform particular procedures and, that if the auditor identifies a misstatement due to fraud or suspected fraud, the auditor shall determine whether a forensic expert is needed to investigate further.

Response 2b
(i) There is in our view a need to focus primarily on the audits of public interest entities, although some enhancements may well be scalable to other entities.
(ii) We believe that in the first instance consideration should be focussed on what enhancements could be made to the existing ISAs.
(iii) In terms of another engagement, entities are free to engage a firm to perform a more specific forensic assurance type engagement if that is what they require. Directors should engage with their shareholders to determine if there is a demand for any such assurance to be provided.

Response 2c
We are not convinced that starting from the premise of adopting a “suspicious mindset” is necessarily conducive to high quality audits and therefore do not believe that such an approach should be mandated. However, there would appear merit in further exploring the approach that has been adopted in Japan which appears to require more of the auditor in certain specific circumstances, particularly when the auditor has determined that any suspicion of a material misstatement due to fraud exists. Please also see our comments in our response to question 2a above.

Whilst we would not mandate the adoption of a “suspicious mindset” we do believe, however, that there is more that can be done by means of the firms with regards to training. Several audit firms have already taken steps to enhance their training in this regard and that is to be welcomed.

We do also believe that auditors should consider more external factors and sources of information to better inform their understanding of the entity being audited and to better assess its financial performance and position. Given its very nature, collusion is difficult to detect when only using information from inside the entity being audited. Therefore, consideration might be given by the auditor to accessing information from outside the entity to get better insights into the performance of the audited entity. Such additional audit procedures might include performing key ratio analysis comparisons with competitors which may help to identify any areas where the entity may appear to be an outlier.

We would also highlight that the UK FRC recently consulted on whether the rebuttable presumption that there are risks of fraud in revenue recognition should be extended to other account balances, transactions or disclosures for which such a rebuttable presumption should be established. We believe that such matters should be left to the professional judgement of the auditor and therefore would not support widening the scope of the extant rebuttable presumption. Currently, in the midst of this Covid-19 pandemic, many businesses and individuals are under extreme financial pressure. Therefore, in the current environment it would appear a reasonable assumption that the financial statements of some businesses may be more susceptible to material irregularities in a range of areas as a consequence of error and/or fraud. It will therefore be key for audit teams to look at a broad range of risks relevant to the entity being audited.

Response 2d
Yes, we are supportive of increased transparency, however, we question whether this will provide the silver bullet or indeed have a greater than minimal impact on the current situation. There is a need for a wider debate as to what more the auditor could do and the related costs and benefits associated with such extra work. Mandating a forensic phase to the audit would add additional cost and may provide benefit but is the related cost one that stakeholders believe is worth paying.

Question 3
This paper sets out the auditor's current requirements in relation to going concern 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?
(b) Is there a need for enhanced procedures only for certain entities or in specific circumstances? If yes:
  - (i) For what types of entities or in what circumstances?
  - (ii) What enhancements are needed?
  - (iii) Should these changes be made within the ISAs or outside the scope of an audit (e.g., a different engagement)? Please explain your answer.

(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.)?
  - (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?

Response 3(a)
Yes, we believe this to be case. In the shorter-term these could follow a similar approach to those of the UK FRC which revised its version of ISA 570 in 2019 with its enhancement requirements becoming applicable for periods commencing on or after 15 December 2019. The revisions require:
- Greater work on the part of the auditor to more robustly challenge management's assessment of going concern, incorporating thorough testing of the adequacy of supporting evidence and evaluation of the risk of management bias.
- Greater use of the viability statement (for entities who apply the UK Corporate Governance Code).
- New enhanced reporting requirements for auditors.
- A stand back requirement when the auditor draws their conclusions on going concern in consideration of all evidence obtained, whether corroborative or contradictory.

Over, the medium to longer-term there is a need for a more holistic assessment as to what is required in relation to going concern by stakeholders. As the primary responsibility for assessing whether an entity is a going concern lies with management, more detailed and considered disclosures should be required from the directors to explain why the entity is a going concern according to their assessment. The reliability and relevance of the evidence regarding the assumptions made by the directors is key. We acknowledge that this is not in the remit of the IAASB's standard setting area and that part of the problem lies in the accounting standards, which present, for many right reasons, a low hurdle for an entity to be classified as a going concern. If such disclosures were to be required, it would be feasible to further extend the auditor's role regarding these statements.

Response 3(b)

(i) Whilst there should be a focus on the audits of public interest entities it is likely that at least some of any proposed enhancements to ISA 570 would be scalable.

(ii) In the shorter-term we believe that such enhancements could focus on similar areas to those of the UK FRC in its 2019 revised ISA (UK) 570.

(iii) We believe that the focus of any such changes on going concern should be within the ISAs.

Response 3(c)

Do you believe more transparency is needed:

(i) Yes, we believe that more transparency is required about the auditor's work in relation to going concern in an audit of financial statements. This should be communicated in the auditor's report.

(ii) Users of financial statements are not just concerned about the short-term prospects of an entity. They are now far more interested in the longer-term viability/sustainability of an organisation. The review undertaken by Sir Donald Brydon in the UK proposed revising the current UK model for large listed entities, which currently only focussed on going concern and viability to also include resilience. We are supportive of this proposed model. However, such a change is not something within the mandate of the IAASB. There is no globally accepted standard of governance and this ultimately hinders the extent to which positive changes can be made by the IAASB to improve auditing standards and ultimately audit quality.

Question 4

Are there any other matters the IAASB should consider as it progresses its work on fraud and going concern in an audit of financial statements?

Response 4

Consideration needs to be given to the different factors that apply to the audits of public interest entities and those which apply to small and medium sized entities. There is a need to ensure that any changes carefully consider the respective needs of, including their respective stakeholders, and are appropriately proportionate and scalable.

The IAASB therefore should undertake outreach with various stakeholders, including IOSCO, to understand what other changes could be made to the financial reporting ecosystem, to complement changes to the ISAs to better reduce the risk of frauds occurring and not being detected. Such matters could then be taken up in outreach with bodies with the ability to progress such matters. The IAASB most certainly has a role to play but there is a need for involvement of other bodies in initiatives related to fraud and going concern.

We also believe that the current climate provides an ideal opportunity for research to be undertaken to identify the extent to which there has been increased reporting of matters relating to going concern by companies and also by auditors. This will help to better assess the effectiveness of the current requirements.