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KICPA's Comments on IAASB's Discussion Paper on Fraud and Going Concern in an Audit of Financial Statements: Exploring the Difference Between Public Perceptions About the Role of the Auditor and the Auditor's Responsibilities in a Financial Statement Audit

Dear Willie Botha,

The KICPA is pleased to have an opportunity to comment on the Discussion Paper issued by the International Auditing and Assurance Standards Board for Accountants (IAASB), regarding 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. The KICPA is a strong advocate of IAASB for your relentless efforts to serve the public interest by setting high-quality international standards for auditing, assurance, and other related standards, and by facilitating the convergence of international and national auditing and assurance standards.

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Questions for Respondents

Please see the below for our responses to the questions.

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?

   (KICPA response) The gap between what the general public expects from audit and what the auditor actually provides is mostly about the knowledge gap, and the gap is mostly associated with the hindsight gap, a gap between expects of stakeholders on auditors prior to a negative event and those after that event occurs, due to the lack of understanding on the inherent limitations of audits, thereby giving rise to the overestimation of the government, regulators and media about the extent to which audit services could provide, which could mislead investors, consumers and other financial statement users about the limitation of auditors' responsibilities.

   In addition, auditing standards and practical guidance relating to fraud and going concern issues have difficulties with providing clear guidelines fit for each case. Therefore, in most of the parts, these standards and guidance require that the auditor exercise "professional judgment" throughout the audit procedures, thereby bring about differences in their understanding and application. While the public expectation level and fraud scheme, in particular, have continuously evolved, driven by technological transformation, specified audit methodologies have not advanced in a timely manner, in response to the public expectation and fraud scheme changes, but lagged behind the changes, all of which have resulted in the expectation gap.

(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?

(KICPA response)

① IAASB should provide auditing standards on fraud and going concern and relevant specified practice guidance fit for each case (e.g., circumstances in which forensic audit are necessary).

② IAASB and auditor should communicate strongly efforts that enable stakeholders, including the government, regulators, media, investors, and general information users, to sufficiently understand inherent limitation of audits, the limitation of responsibilities of auditors, entities and those charged with governance (or 'TCWG'), respectively.

③ IAASB and auditor should also persuade governments and regulators at the respective jurisdictional level into making the management and TCWG provide sufficient information to auditors, and enhancement of the responsibilities of the management and TCWG to assess as to the findings of events and circumstances related to going concern assumptions and set-up applicable implementation plans accordingly.

④ Management and TCWG should address the expectation gap on frauds via work audit reports conducted by internal auditors or the disclosure of inspection reports prepared by external experts based on a separate contract, instead of being addressed by auditors. They should address the expectation gap on going concern via the disclosure of assessment reports of the management and board of directors.

⑤ Regulators should supervise procedures performed by auditors within the context of what the auditing standards requires to auditors, even though stakeholders (e.g., information users) have strong expectations on the detection of frauds. If the auditing standards are considered to fail to track increasing fraud risks in an effective manner, the auditing standards or practical guidance could begin with revising various laws and regulations or common practice to prevent accounting frauds.

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?*

(KICPA response) We believe the current auditing standards and relevant law and regulation provide sufficient requirements on auditors in relation to frauds. However, it has still room for improvements as follows: ① cooperation from the management, TCWG, government and regulators, thereby making it possible for audit procedures related with frauds not to be performed just as a formality, and build-up of appropriate environments and thorough application of requirements in practice; and ② emphasis should begin with the responsibility of the management, prior to highlighting the auditor's responsibility, in relation to frauds.

(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?*

(KICPA response) N/A

(ii) What enhancements are needed?

(KICPA response) N/A

(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.

(KICPA response) N/A

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

(KICPA response) Inclusion of the definition of concepts of the "professional skepticism" and "suspicious mindset" and illustrative examples where a "suspicious mindset" is required would be helpful in performing audits. Even though auditors have suspicious mindsets, however, we believe just requiring a "suspicious mindset" is not enough to contribute to enhanced fraud identification, taking into account audit procedures and evidence auditors can perform and access and inherent limitation of audits.

Rather than just requiring the suspicious mindset, we would like to suggest that audit teams exercise "professional skepticism" in their internal discussion, excluding the belief that the management and TCWG are honest and diligent, and obtain insights from the discussion, which will eventually enhance fraud identification throughout the performance of audits.

In a circumstance where a "suspicious mindset" is required, which is expected to take substantial amount of time and costs while conducting thorough verifications, it would be appropriate to define new examples of engagements (forensics etc.) applying a "suspicious mindset," differentiated from audit engagements, if considered necessary, thereby enabling such engagements based on a separate contract.

(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?

(KICPA response) We believe auditors should exercise "professional skepticism" throughout audits, while the requirement of a "suspicious mindset," which stands at a higher level than above, should be confined to a certain circumstance in which a fraud is identified (that requires a suspicious mindset), thereby making it appropriate for the "suspicious mindset" to be performed in a separate engagement, apart from audit engagements.

(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.)?

(KICPA response) We believe the current auditing standards and relevant law and regulation set out requirements at a sufficient level, and it would be important to perform audit engagements within the current standards. However, transparency could be improved with the following measures: ① disclosing the limitation of the auditor's responsibilities on frauds, and audit procedures and outcomes at the audit reports to increase the understandability; ② transparent communication throughout the comprehensive fraud-related procedures with the TCWG or audit committees and making it mandatory to document communication in the working papers.

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?*

(KICPA response) We believe more enhanced requirements on auditors with regard to going concern would not be necessary. Instead, within the context of the extant auditing standards, more requirements need to be placed around the management's control activities related to assessment of going concern, such as what kinds of controls are put in place and whether such controls are implemented. As for auditors, it would be necessary to perform practical procedures based on what is required in the extant standards.

(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?*

(KICPA response) The obligation of an entity and its management to assess its ability to continue as a going concern

(ii) *What enhancements are needed?*

(KICPA response) Enhanced requirements on the entity's obligation of assessing going concern is prerequisite to auditors' evaluation of the management's assessment of going concern in a practical manner, which requires the enhancement of the obligation of the management and TCWG to assess the entity's ability to continue as a going concern.

(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*

(KICPA response) As we believe, the IAASB could consider the obligation of the management's assessment be explicitly enhanced within the ISAs, while specific circumstances in which the assessment is exempted be included in the ISAs or the assessment be obliged to the TCWG.

(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.)?

(KICPA response)

Proposal A) Going concern uncertainties are currently included in a separate paragraph of audit opinions, thus no need for additional information to be provided.

Proposal B) Enhanced transparency could contribute to improvements in knowledge gap, as we expect. The following could be considered in audit reports to support the understandability of information users and general public.

(1) Clarity of wordings: The current wordings of "Future events or conditions may cause an entity to cease to continue as a going concern." described in audit reports could be revised into "Auditors' opinions do not assure or guarantee an entity's

ability to continue as a going concern." to provide information users with clarified meanings, thereby increasing the understandability.

(2) Assessment period: Referring to the period during which the management makes an assessment on going concern (e.g., a year starting from the date of financial statements according to the K-IFRS) in the paragraph of management's responsibility in audit reports, thereby making it possible to prevent information users from misunderstanding the assessment period of an entity's ability to continue as a going concern.

(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?

(KICPA response) We believe it should be done outside the auditor's work.

A. Events and circumstances on an entity's sustainability, the entity's quarterly assessments and future plans, resilience and others could be addressed via corporate information disclosures of annual reports.

B. In case an entity's TGWG and regulators specifically define the assessment of the entity's ability to continue as a going concern and disclosure requirements as pursuant to financial reporting frameworks and other relevant law, and then management conclude that significant doubt is casted on the entity's ability to continue as a going concern but there is no material uncertainties, independent from auditor's assessment, or other cases, the grounds for judgments of an entity on going concern need to be obliged to be disclosed from the perspective of accounting standards.

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?*

(KICPA response) If adopted, enhanced procedures should be phased in not to burden both companies and auditors in all.

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Detailed Questions in Discussion Paper on Fraud and Going Concern

Ⅰ. BACKGROUND

The IAASB is interested in perspectives about the impact of corporate culture on fraudulent financial reporting and what, if any, additional audit procedures for the auditor should be considered by the IAASB in this regard.

(KICPA Comment) Tone at the top affects corporate cultures and is likely to increase audit failure risks arising from frauds, but the judgement on corporate culture is very subjective, making it difficult to provide the objective basis of judgments on the adoption of additional audit procedures in relation to corporate culture.

Given this, we believe audit procedures described in the extant auditing standards would be sufficient. In case signs of frauds are found during audit procedures, it would be enough for fraud-related auditing standards to provide guidance as to what kinds of additional procedures to be required.

Ⅱ. FRAUD

The IAASB is interested in perspectives about requiring the use of forensic specialists or other relevant specialists in a financial statement audit, and, if considered appropriate, in what circumstances the use of specialists should be required.

(KICPA Comment) When auditors ① bring into question the reliability of documents or find frauds or signs of frauds that could make substantial impacts on financial statements or whose impacts are not identifiable, arising from ② embezzlements or ③ accounting frauds, it would be necessary for the IAASB to set out in the ISAs that the frauds or signs of frauds should be notified to the TCWG to come up with necessary measures, such as hiring forensic specialists or other relevant experts, instead of auditors doing forensics by themselves.

As such, the IAASB is interested in perspectives about the perceived responsibilities of the auditor regarding non-material fraud in a financial statement audit (i.e., a broader focus on fraud) and what additional procedures, if any, may be appropriate. The IAASB is also interested in perspectives about whether additional audit procedures should be required when a non-material fraud is identified, and if so, what types of procedures.

(KICPA Comment) Evaluation criteria should be specified about qualitative characteristics (motives behind the occurrence of frauds, the possibility of complicity, reasons for control failures, corporate culture etc.) of frauds and then an assessment should be made as to whether frauds could affect the financial statements in a comprehensive or limited manner. If it is concluded that ① the impact of identified frauds are below the materiality threshold, it would be enough to communicate them with the TCWG, as required by the extant ISAs. Only when ② frauds are likely to exceed the materiality threshold, additional audit procedures are considered necessary to be conducted, as we believe.

The IAASB is interested in perspectives on whether enough emphasis is placed on the auditor's responsibilities around fraud related to third parties. We are also interested in feedback about the auditor's role in relation to third party fraud that does not result in a material misstatement of the financial statements but may have a severely negative impact on the entity (e.g., cybercrime attacks).

(KICPA Comment) We believe making auditors responsible for third party frauds that are not directly related with financial statements would excessively expand the responsibility of auditors beyond the inherent limitation of audits. It would be ① appropriate not to include the third party frauds in the scope of audits, ② in case when third party frauds or the signs of such frauds, not directly associated with financial statements, are found, it could be addressed via communication with an entity's management or TCWG, and ③ when such frauds impact financial statements (provisions, contingent liabilities etc.), it would be necessary to identify whether the direct or indirect impacts are appropriately disclosed in the notes to the financial statements.

<u>The IAASB is interested in perspectives on whether additional engagement quality control review procedures specifically focused on the engagement team's responsibilities relating to fraud should be considered for audits of financial statements of listed entities, and those other engagements, if any, for which the firm has determined an engagement quality control review is required.</u>

(KICPA Comment) When conducting quality control review, it would be unnecessary to deal with explicit procedures. Review as to whether audit procedures on frauds are appropriately performed, as described in the extant auditing standards, is the basic of quality control review, which means that the additional description of explicit procedures do not necessarily result in the improvements of audit quality in relation with frauds.

If specified examples of possible frauds are described, they could be taken into account, when considered necessary, in conducting quality control review to enable the control of audit failures arising from frauds. The description of explicit procedures could mean that procedures required to the engagement team contain more clarity, thereby being able to narrow the performance gap. In addition, with above requirements on auditors, the requirements on an entity related to frauds need to be reinforced.

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Ⅲ. GOING CONCERN

The IAASB is interested in perspectives on whether entities should be required to assess their ability to continue as a going concern for longer than twelve months, and therefore whether auditors should be required to consider this longer time period in their assessment, beyond the current required period. If stakeholders believe a longer timeframe should be required, alignment will need to be retained between the requirements under the applicable financial reporting framework and the auditing standards in order for auditors to be able to adequately perform their procedures.

(KICPA Comment) It is difficult for auditors to assess an entity's ability to continue as a going concern for longer than twelve months or other concepts of resilience. Given that the liquidity criteria in the extant IFRS are based on a yearly basis, the revision of IFRSs should be made first, then an entity assessing its sustainability as a going concern for more than 12 months, thereby leading up to auditors assessing going concerns for more than 12 months.

To extend the timeframe of going concern assessment, assessments and rationality should be secured along with additional efforts to make reliable assessments, but with no possibility of assuring an entity's sustainability, which would raise a doubt over whether such efforts are worthwhile to make.

The IAASB is interested in perspectives about whether changes are needed with regard to going concern and other concepts of resilience (within the purview of the IAASB's remit).

(KICPA Comment)

(Proposal 1) The concept of resilience is not familiar in Korea, but it is assumed to be the prospect on an entity as to their sustainability for a long term. Going concern is an assumption that is prepared based on financial statements, which means that the period and purpose of going concern differ from those of the review on entity's ability to sustain.

Therefore, when an event or circumstance upon which a significant doubt is casted is identified, the assessments on an entity's resilience that goes beyond the purpose of assessing the management's implementation plan in response to such event or circumstance, is not about the work scope of auditors. Considering this, we are opposed to including the concept of resilience to the ISAs.

(Proposal 2) The management has more information not only on an entity's financial conditions but also on its future strategy plans, which means that the management reporting on the possibility of the entity's sustainability for a long term or making a statement on its payment capacity would be significant from the perspective of information users. Additional information for investment decision-making, however, should be evaluated by and provided to experts, such as analysts, by offering investment-related information, and such information could be shared upon the request of information users, in the entity's annual reports.

<u>The IAASB is interested in perspectives on what more is needed to narrow the knowledge gap with regard to the meaning of material uncertainty related to going concern, to enable more consistent interpretation of the concept.</u>
<u>In addition, the IAASB is interested in perspectives about whether the concept of, and requirements related to, a material uncertainty in the auditing standards is sufficiently aligned with the requirements in the international accounting standards.</u>

(KICPA Comment) The term of "uncertainty related to going concern" in itself, is difficult to understand. Thus, instead of using the term, it would be useful for information users to be provided with specified explanations of the term.

In addition, if an entity provides following objective information to information users in the notes the financial statements, along with explanations as to the material uncertainty related to going concern, it would contribute to narrowing the knowledge gap, in terms of uncertainty about the entity's ability to continue as a going concern.

1) Whether there is a debt whose maturity and obligation are due in 12 months,
2) An entity's plan on repayment and extension of maturity of the above debt,
3) Basis of the management's judgements as to why the above repayment and extension plan is feasible,
4) Other considerations that could impact the going concern assumptions; and
5) Basis of the management's judgements on other considerations that are not material (possibility of occurrence, amounts etc.)

The paragraph 20 of the ISAs 570 requires auditors to "evaluate whether financial statements provide adequate disclosures of events or conditions of close call," while financial reporting frameworks, such as IASs, do not require the disclosure of close call.

If IFRSs require that the management's assessments on the rationality of going concern be disclosed in the notes to the financial statements, it would lead to actual assessment of the management on the entity's ability to continue as a going concern, while at the same time the auditor's evaluation would be performed in a more effective manner. Given the effectiveness, we would like to suggest that financial reporting frameworks, such as IFRSs, should require the disclosure of close calls first.

Ⅳ. OTHER MATTERS RELEVANT TO BOTH FRAUD AND GOING CONCERN

<u>The IAASB is interested in perspectives about whether more is needed related to professional skepticism when undertaking procedures with regard to fraud and going concern and what additional procedures, if any, may be appropriate.</u>

(KICPA Comment)

Fraud: Basis of materiality judgements on frauds and judgments that it would be necessary to perform additional fraud audit procedures due to the occurrence of suspicious frauds or suspicions, continuous two-way communications on what is going on in forensics when forensics or the appointment of external inspection experts is demanded to the TCWG

Going concern: The extant ISA 570.25 requires auditors to communicate with the TCWG events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Along with this, the communication of whether the management presents its assessment outcomes and their details with the TCWG would contribute to narrowing performance gap, as we expect, if additionally included.

<u>The IAASB is interested in perspectives about whether more information is needed in the auditor's report regarding fraud or going concern, and if so, further details about the transparency needed.</u>

(KICPA Comment)

We believe it is sufficient with professional skepticism on frauds, as described in the extant auditing standards and law and regulation. However, the level of advancements, triggered by technological transformation, might differ, which could change procedures applying professional skepticism depending on circumstances, meaning that guidelines on specified procedures in relation to frauds need to be updated on a regular basis beyond the scope of ISAs. In addition, upon the occurrence of suspicious frauds or their signs, additional procedures to be conducted are about the scope of forensic audits on frauds, which makes it appropriate for such forensics to be performed based on a separate contract, if considered necessary.

The judgement of auditors on an entity's ability to continue as a going concern tends to contain substantial subjectivity, which could limit the usefulness of information. Therefore, the role of auditor is not about providing judgment outcomes on uncertainties related to going concern. The role should be changed into providing review opinions on the accuracy of information related to going concern and rationality of the management's judgment accordingly, with professional skepticism.

The IAASB is interested in perspectives about whether more information is needed in the auditor's report regarding fraud or going concern, and if so, further details about the transparency needed.
In addition, the IAASB is interested in perspectives about whether more transparency is needed with regard to communications with those charged with governance.

(KICPA Comment) We believe there might be unnecessary to include audit procedures on fraud and going concern, but some of the necessary items among existing audit procedures could be included in the key audit matters (or 'KAM') in relation to the close call in audit reports. In addition, the purpose of providing the above information is not about providing auditor's judgment outcomes on fraud and uncertainties related to going concern, but about providing useful, objective information to information users, as described in the 3.(c) material uncertainties related to going concern, thereby enabling users to make their own judgements.

We hope our comments would be helpful in your efforts to make standards related to fraud and going concern remain fit-for-purpose in the current environment. Please feel free to contact us via cheekim@kicpa.kr for further inquiries.