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Auditing and Assurance Standards Board

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February 1, 2021

Mr. Willie Botha
Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue
New York, NY 10017
U.S.A.

Dear Mr. Botha,

Re: IAASB Discussion Paper, *Fraud and Going Concern in an Audit of Financial Statements*

The Canadian Auditing and Assurance Standards Board (AASB) is pleased to provide its comments on the IAASB's discussion paper, *Fraud and Going Concern in an Audit of Financial Statements* (Discussion Paper). The AASB is an independent body with the authority and responsibility to set standards and guidance for quality control, audit, other assurance, and related services engagements in Canada.

We undertook consultations with a wide range of Canadian stakeholders to obtain their views regarding the Discussion Paper. The feedback we received is reflected in this letter and following is a summary of the groups consulted during the Canadian consultations:

- Practitioners (large firms, small-medium firms and public sector);
- Management
- Board/Audit Committee Members;
- Regulators;
- Users; and
- Academics

In our response, "stakeholders" refers to Canadian stakeholders who provided us with input and "we" refers to the AASB.

Our comments are set out under the following main headings:

A. Overall Comments; and

B. Responses to Specific Questions.

We hope that these comments will be useful to the IAASB in determining the appropriate next steps for these topics. If you have any questions or require additional information, please contact me at kcharbonneau@aasbcanada.ca.

Yours very truly,

Ken Charbonneau FCPA, FCA, ICD.D
Chair, Auditing and Assurance Standards Board (Canada)

c.c. Canadian Auditing and Assurance Standards Board members

Julie Corden, CPA, CA, IAASB Member

Eric Turner, FCPA, FCA, IAASB Member

OVERALL COMMENTS

Expectation Gap

We support the IAASB initiative to address the important and timely issues described in the Discussion Paper. The expectation gap is a long-standing issue, however the impact of the global pandemic on many entities has heightened attention on this topic.

All parties in the financial reporting ecosystem are responsible for delivering financial information to meet stakeholder expectations. An expectation gap is created when the ecosystem fails to meet users' expectations for the delivery of credible, adequate, and timely financial information. This is often the case when there is an unexpected entity failure or scandal.

Many stakeholders do not understand the different but interconnected roles and responsibilities of all the parties in the ecosystem. Following an unexpected entity failure or scandal, stakeholders try to determine who is to blame and for decades have focused mainly on the role of the auditor. Perhaps this is why the expectation gap has always been labeled as an audit issue.

In our view the expectation gap is not solely an "audit" expectation gap. Shifting the discussion about the expectation gap from an audit focus will help all parties to accept they are part of the solution. It will also help stakeholders understand there are several parties responsible for preparing and delivering financial reports.

The IAASB, alongside national audit standard setters such as the AASB, play an important role in narrowing the expectation gap. This includes an ongoing commitment to continuous improvement of audit quality and auditing standards in an ever-changing environment. However, we are of the view that all the parties in the financial reporting ecosystem that are responsible for delivering credible high-quality information, and users, have a role to play.

We believe it is important that the IAASB, and others, work collectively to address the expectation gap as the impact of the efforts of a single party within the financial reporting ecosystem will be limited.

Fraud and Going Concern

The Discussion Paper considers several possible enhancements to the auditor's role related to fraud and going concern. As discussed in our response to the specific questions, we support the IAASB exploring the following:

For fraud:

- developing guidance related to use of forensic specialists;
- making certain revisions to ISA 240; and
- developing application material or non-authoritative guidance to support the application of professional skepticism.

For going concern:

- encouraging accounting standard setters, including the International Accounting Standards Board (IASB), to clarify what is meant by "material uncertainty relating to going concern" in their financial reporting frameworks; and

- developing guidance for the auditor to enhance their ability to identify and assess going concern risks.

Finally, the IAASB will need to consider how any future enhancements are scalable for audits of less-complex entities (LCE). In doing so, we encourage the IAASB to carefully consider potential implementation challenges for LCE audits.

RESPONSES TO SPECIFIC QUESTIONS

Q1. (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?

What our stakeholders told us

Fraud

Our stakeholders had mixed views on the main cause of the expectation gap as it relates to fraud. They identified causes within each of the Discussion Paper's defined sub-components of the expectation gap (knowledge, performance, and evolution) and in many cases they were of the view that the cause related to more than one sub-component.

Knowledge gap

Many stakeholders were of the view the expectation gap was primarily driven by a lack of understanding by financial statement users of the role of each party in the financial reporting ecosystem, including that of the auditor.

Performance gap

Some stakeholders, primarily those that were not practitioners, indicated the expectation gap was caused by the auditor failing to fulfill the requirements in audit standards, or that the requirements in ISA 240 are not robust enough. In one instance, a financial statement user pointed to findings from fraud scandals that they believe indicate the auditor failed to perform their responsibilities.

Evolution gap

The majority of stakeholders felt auditors could do more in response to the ever-changing tools and techniques that fraudsters use in perpetrating fraud, including new technologies. They indicated that fraud was the area with the most opportunity, and in some cases, most need, for the auditor's role to evolve.

Going Concern

Like the views expressed for fraud, stakeholders acknowledged that there was a lack of understanding by users of the role of each party within the financial reporting ecosystem.

Stakeholders emphasized that the role of certain parties in the financial reporting ecosystem, specifically the entity and its management, cannot be ignored. They expressed a view that management's role and responsibilities need to evolve before more can be expected of the auditor.

As it relates to the role of the auditor, they believed that limited revisions to audit standards are needed, and such revisions would mainly be responsive to changes in management's role and responsibilities, and changes to requirements in accounting frameworks.

Other comments

Our stakeholders cautioned against putting too much emphasis on any one sub-component of the expectation gap. In their opinion, some actions focused on narrowing the evolution gap may result in an increase in the knowledge gap. For example, expanding the involvement of forensic specialists may result in users having heightened expectations of the audit which may widen the expectation gap.

AASB views and recommendation

We used the Discussion Paper's breakdown of the expectation gap by sub-components (i.e., knowledge, performance, evolution etc.) when engaging with our stakeholders during consultations. However, we did not find the sub-components helpful in developing our views and recommendations. The sub-components were interpreted by stakeholders based on their understanding of the role of each party in the financial reporting ecosystem and therefore lacked consistency.

In our view, there is no one main cause of the expectation gap, but rather, several inter-connected factors/causes.

This view is evidenced by the fact that our stakeholders did not agree on a main cause, expressing varying views. The only item our stakeholders all agreed on was that it is not just the auditor that needs to implement actions to narrow the expectation gap.

We believe that all parties within the financial reporting ecosystem must contribute to narrowing the gap through undertaking actions such as those outlined in our response to Q1(b). In our view, a collective effort by all parties is the only way to make a meaningful impact to narrow the expectation gap.

Q1. (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?

What our stakeholders told us

As it relates to a lack of understanding by financial statement users of the role played by each party in the financial reporting ecosystem, our stakeholders struggled with what actions, if any, could be taken to make meaningful progress.

Regulators questioned the value of focusing efforts on this lack of understanding, expressing concerns that it would be a distraction from actions which could be taken to support the evolution of the auditor's role. Other stakeholders felt this lack of understanding by users cannot be ignored as it will continue to hurt the audit profession. They also had the view that without addressing the lack of understanding, it may undermine efforts for the profession to evolve (i.e., widen the expectation gap).

On balance, stakeholders agreed that it was worthwhile that additional effort be put into educating financial statement users on the roles of all parties in the financial reporting ecosystem. This includes a role for the accounting profession to assist in educating stakeholders on each party's respective role.

In addition to the role of education in narrowing the expectation gap, our stakeholders raised certain other specific actions that they felt could be taken by each of the parties within the financial reporting ecosystem.

<u>Entity and its Management</u>

Our stakeholders acknowledged that the entity and its management play a foundational role for both fraud prevention and assessing and disclosing the entity's ability to continue as a going concern. As such, many felt that management's actions could have the most significant impact in narrowing the expectation gap.

When asked about the entity and management's role regarding going concern, stakeholders were of the view that management should be required to conduct a more in-depth going concern analysis, which would in turn support more robust disclosure within financial statements.

As it relates to fraud, stakeholders emphasized the importance of an entity's anti-fraud procedures/controls and the overall tone at the top of the organization in reducing the opportunity for fraud and improving fraud detection. As such, stakeholders supported additional requirements for management to develop and implement anti-fraud procedures and controls within their organization.

Finally, some stakeholders highlighted that the Discussion Paper did not include internal audit in the financial reporting ecosystem discussion. Internal audit plays a unique role within some organizations. Several stakeholders felt internal audit could be a starting point in addressing the need for enhancements as it relates to fraud controls and detection. For example, an entity's internal audit function could include enhanced responsibilities to review and assess anti-fraud procedures and controls.

<u>Boards and Audit Committees</u>

Our stakeholders emphasized the important leadership role that boards and audit committees (also referred to as those charged with governance) have over the entity and its management.

Stakeholders raised concerns over a perceived lack of accountability of those in oversight roles as to whether they are appropriately fulfilling their responsibilities. Some possible actions to address the lack of accountability include:

- <u>Composition and training</u> – Introducing requirements for minimum skills and training to ensure boards and audit committees have the appropriate knowledge and expertise to perform their responsibilities; and
- <u>External reporting</u> – Exploring whether those charged with governance should externally report on their actions to fulfill their obligations.

External Auditors

Please refer to responses to questions 2 and 3 for ways in which our stakeholders felt the expectation gap could be narrowed by external auditors.

Regulators

Our stakeholders acknowledged that regulators, including auditor oversight bodies, play a key role in ensuring the accountability of entity management and directors, and auditors. Stakeholders emphasized that regulators need to consider whether additional or enhanced rules and regulations are necessary to narrow the expectation gap.

Standard-Setters

Stakeholders believe there are actions that accounting standard setters could take in enhancing management's going concern analysis and disclosure, as noted above and in the response to question 3(a).

Please refer to responses to questions 2 and 3 for ways in which our stakeholders felt the expectation gap could be narrowed by the IAASB.

AASB views and recommendation

We believe that all parties within the financial reporting ecosystem have a role to play in narrowing the expectation gap.

Many of our stakeholders acknowledged the long-standing challenges around the expectation gap. We believe this is largely because all parties need to recognize that they not only have a role to play but also need to commit to working collaboratively towards a solution.

As a first step, we believe all parties can assist in the education of users of financial information on the role of each party within the financial reporting ecosystem. In our view, if we are unable to help users better understand everyone's role, there will be a limit in the progress that can be made in narrowing the expectation gap.

For example, as it relates to the IAASB's role, we support its continued efforts, including through the Discussion Paper, to highlight and discuss the expectation gap and the roles of each of the parties in the financial reporting ecosystem. As a next step, the IAASB could consider whether there is further outreach it can undertake to educate financial statement users.

In addition to educating financial statement users, we recommend the following additional actions which could be explored by each of the parties within the financial reporting ecosystem. However, in doing so, we acknowledge that each stakeholder group may wish to perform their own analysis to determine if these actions will be effective in narrowing the expectation gap.

The Entity and its Management

We agree with our stakeholders that an entity and its management play a foundational role for fraud prevention and assessing and disclosing an entity's ability to continue as a going concern.

We encourage the IAASB to consider working with relevant parties to promote more robust going concern assessments and financial statement disclosures by management, through financial reporting framework requirements.

In our view, an entity's internal controls are an important first line of defense in the prevention and detection of fraud. We support exploring whether additional requirements should be imposed on management and directors to enhance the entity's anti-fraud procedures and controls. This could include consideration by regulators of whether internal control reporting requirements, similar to the Sarbanes Oxley Act in the United States, should be required.

Finally, we agree with our stakeholders that the role of internal audit in narrowing the expectation gap should be explored. The IAASB could consider whether there are internal audit organizations they could engage to discuss what specific enhancements could be made to the roles and responsibilities of the internal auditor, and where appropriate, how those actions might be leveraged by the external auditor.

Boards and Audit Committees

We think it is important that additional requirements be put in place around board and audit committee composition and training. In our view, there should be minimum requirements in these areas to ensure that all boards/audit committees have the appropriate skills to fulfill their responsibilities.

Additionally, we support exploring a requirement for those charged with governance to externally report how they met their oversight responsibilities.

External Auditors

Please refer to actions set out in response to questions 2 and 3.

Regulators

All regulators have an important role in establishing and enforcing their requirements.

Consistent with the view of our stakeholders, regulators need to consider whether additional or enhanced rules and regulations are required that will assist in narrowing the expectation gap. For example, securities and prudential regulators may conclude there is merit in establishing requirements for entities to implement additional procedures and controls to prevent and detect fraud.

Standard-Setters

We support accounting standard-setters exploring the development of additional requirements or guidance around management's going concern analysis and disclosure, including those outlined in our response to question 3(a).

As it relates to the role of the IAASB, please refer to actions set out in response to questions 2 and 3.

Additionally, should stakeholders action the enhancements proposed in the above paragraphs, there may be a follow-on action for the IAASB to develop or amend standards to enable external auditors, where requested, to provide assurance on additional information, processes and controls. For example, if regulators require management to design, implement and report on compliance with a system of internal controls for the prevention and detection of fraud, there may be a need for assurance to be provided on the compliance report.

Q2. (a) Should the auditor have enhanced or more requirements with regard to fraud in an audit of financial statements? If yes, in what areas?

Increased Use of Forensic Specialists or Other Relevant Specialists

What our stakeholders told us

Practitioners and those charged with governance believe a requirement to use forensic specialists on all audit engagements may increase the expectation gap because users may believe that a forensic audit was conducted. While practitioners agree that involving forensic specialists in the audit would enhance audit procedures related to fraud risks, they support the flexibility provided in the extant standard where this decision is left to the practitioner's professional judgment, rather than such involvement being mandated. Scalability concerns were also raised by practitioners since there are limited forensic specialists available and their cost may be difficult to rationalize on small audits.

Regulators were the only group that supported requiring involvement of forensic specialists. They believe this specialized skillset is needed on the audit team and since audits already involve many experts, this is another area where an expert should be required to be involved.

AASB views and recommendation

We support the flexibility currently provided in the standard for the auditor to apply their professional judgment when determining how to respond to identified fraud risks. As is the case for the involvement of any expert in an audit, involvement of forensic specialists should not be mandated. The involvement of a fraud specialist should be based on the fraud risks identified in the engagement and potential consequences of a fraud.

However, we believe involvement of forensic specialists in risk assessment should be encouraged. Initial academic research shows that involving forensic specialists in the risk assessment process helps the auditor focus their efforts and leads to efficiency gains which largely compensate for the increased cost associated with consulting a forensic specialist[1].

Also, we believe audit quality could be enhanced through fraud training for auditors, and guidance on the use of forensic specialists. We encourage the IAASB to consider:

- Developing guidance on when it is appropriate to involve forensic specialists and what type of procedures they can assist with - Academic research indicates that auditors

[1] Stephen Kwaku Asare and Arnold M. Wright (2018) Field Evidence about Auditor's Experiences in Consulting with Forensic Specialists; Behavioral Research in Accounting Vol. 30(1) pp.1-25.

could benefit from some assistance with identifying risk factors related to fraud[2], and as well, auditors struggle with how to respond to those risks[3]. Using forensic specialists to assist auditors with these steps would enhance the audit procedures related to fraud risks conducted on the engagement. Providing guidance on when to involve forensic specialists in the audit would aid in building consistency in the type of audit procedures conducted and encourage their use at appropriate phases of the audit; and

- Encouraging educational institutions and professional bodies to require additional fraud training for auditors – Requiring specific fraud training, as well as how to utilize data analytics to conduct audit procedures related to fraud would enhance an auditor's skillset. There is also an opportunity for auditors to learn how to utilize forensic tools and techniques on financial data since there are similarities in application. The IAASB should encourage educational institutions and professional bodies to add fraud courses to certification requirements for auditors.

Enhanced Quality Control Requirements

What our stakeholders told us

Although practitioners are cautious of adding another "checklist" type procedure, they are willing to explore enhancing quality control review requirements. Evidence is required from jurisdictions that have enhanced procedures to demonstrate there has been a positive impact on the auditor's ability to identify and address fraud risks in the audit. Practitioners recognize this enhancement could be easier to implement compared to the other suggested enhancements discussed in the Discussion Paper since it enhances an existing process rather than creating a new process. Regulators were also supportive of this option since the framework already exists to incorporate additional quality control review procedures and they can be targeted based on the fraud risk profile of the entity.

AASB views and recommendation

It is not clear whether introducing specific quality control review requirements related to fraud would result in better identification of fraud risks and appropriate design of procedures to respond to those risks. However, in principle, quality control review requirements could enhance the audit, for example, through focused discussions about the judgments made in developing appropriate responses when fraud risks are identified. The engagement quality reviewer could hold discussions about the engagement team's conclusions regarding fraud risk areas and the audit procedures planned to address those risks, including the decision of whether to use a forensic specialist. In exploring this enhancement, we recommend the IAASB examine whether the Japanese fraud standard has enhanced audit quality.

2 Jacqueline S. Hammersley, Karla M. Johnstone, and Kathryn Kadous (*2011*) How Do Audit Seniors Respond to Heightened Fraud Risk? AUDITING: A Journal of Practice & Theory 30(3) pp. 81-101.

3 Bauer, Hillison, Peecher, and Pomeroy *(2019*) Revising Audit Plans to Address Fraud Risks: A Case of "Do as I Advise, Not as I Do"?

Revisions to ISA 240

What our stakeholders told us

During our outreach, we heard concerns regarding several sections and requirements in ISA 240.

Responsibility for the prevention and detection of fraud

Regulators are concerned that the tone set in the introduction of ISA 240 negates the auditor's responsibilities related to fraud. Specifically, paragraph 5 of ISA 240 notes the inherent limitations of an audit, stating that while the audit may be properly planned and performed, some material misstatements may not be detected. Regulators believe this statement and others in the introduction section of ISA 240, downplay the responsibility that auditors have for the detection of fraud by stating right from the beginning that fraud may go undetected.

Rebuttable presumption related to fraud risks over revenue

Practitioners questioned whether the presumption of fraud over revenue continues to be appropriate. Some practitioners commented that in many cases, this presumption results in auditors spending an undue amount of time designing and performing fraud procedures in areas where for many entities the risks are not high because of the nature of the business. On the other hand, regulators are concerned that auditors are rebutting this presumption too often.

Unpredictability of audit procedures

Regulators expressed concern that auditors tend to use the same audit procedures year over year when addressing fraud. They believe that when audit procedures become predictable, they may be ineffective in identifying efforts to conceal fraudulent financial reporting. Practitioners are concerned that if the standard provides a list of procedures to explain how to introduce unpredictability, it may result in a checklist approach and negate the purpose of the procedures.

Nature and extent of journal entry testing

Feedback from stakeholders suggests some auditors do not understand the purpose of journal entry testing. Practitioners indicated that there is inconsistency in practice in how journal entry testing is tailored based on the fraud risks identified in the audit, and the extent of testing required. Practitioners are seeking clarity regarding these matters, including whether a risk-based approach is appropriate when conducting journal entry testing. Stakeholders also believe the standard could be updated to recognize the use of audit analytics when conducting journal entry testing.

Updates to the Appendices

Stakeholders believe Appendix 1 and 2 in ISA 240 should be updated to better reflect current business practices. Also, practitioners believe examples of how audit analytics could be used to address fraud risks should be added to Appendix 2.

AASB views and recommendation

Responsibility for the prevention and detection of fraud

We recognize it is important for ISA 240 to outline the challenges auditors face in identifying fraud, however the introduction to the standard could be enhanced to explain how the requirements provide the basis for the auditor to fulfill their responsibilities related to fraud. This could be achieved by clearly articulating the auditor's responsibilities related to material fraud in the introduction. The extant material explaining what difficulties the auditor may face could be moved to application material. This would help to strengthen the tone of the standard.

Rebuttable presumption related to fraud risks over revenue

Based on stakeholder feedback, we believe research is needed to determine whether the fraud presumption related to revenue continues to be appropriate. Focusing time on this area when it is not always relevant to an audit leads to inefficiencies.

Also, additional application material is needed to clarify how auditors determine when it may be appropriate to rebut this presumption, for example, by providing factors to consider. Use of these factors to decide when to rebut the presumption will help to build consistency. The standard could also provide more and better examples of when it may be appropriate to rebut this presumption since the current example in paragraph A31 of ISA 240, in our view, is simplistic.

Unpredictability of audit procedures

We recognize that paragraph A37 of ISA 240 explains why elements of unpredictability are important. However, we believe that application material could be added to explain how audit procedures can be modified to introduce unpredictability based on the fraud risks identified at the financial statement or assertion level. For example, adding application material related to auditing accounting estimates, since they can often represent fraud risks when significant judgment is involved. Also, examples should be added to highlight how auditors of smaller entities can tailor audit procedures to make them less predictable. Generally, there is less opportunity to introduce unpredictability on smaller audits given there is less opportunity to adjust the timing of audit procedures or perform procedures at different locations, as suggested in paragraph A37 of ISA 240.

While we agree that auditors would benefit from examples that incorporate an element of unpredictability, we also share our stakeholders' view that providing a list of procedures may result in a checklist approach and reduce the element of unpredictability. It may be constructive to expand on the examples in the standard, as well as develop non-authoritative guidance that contains case studies. Fraud cases could be used to illustrate how unpredictability can be introduced in audit procedures. Academic research has shown that reading fraud stories can help auditors develop better knowledge of fraud versus using checklists[4]. Use of examples and case studies can help to build this knowledge.

Nature and extent of journal entry testing

We and our stakeholders believe ISA 240 could better explain the objective of journal entry testing and how it can be used to address fraud risks in addition to those involving management override.

In addition, auditors are using technology to analyze large sets of financial data, as well as exploring the application of artificial intelligence in their audit procedures. The IAASB should consider developing non-authoritative guidance to explain how audit analytics may be used in journal entry testing and provide examples to illustrate how testing can be tailored to address identified fraud risks.

Updates to the Appendices

We support our stakeholders' recommendation that Appendix 1 and 2 in ISA 240 should be updated. Appendix 1 should consider whether some fraud risk factors, such as management incentives, require additional emphasis in order to help auditors focus their work. Also, new examples could be added to Appendix 2 to illustrate how audit analytics can be used to address fraud risks.

Additional Focus on Non-material Fraud

What our stakeholders told us

Stakeholders reinforced that preventing, detecting, and investigating fraud is the responsibility of the entity. The extant requirement for the auditor to evaluate all misstatements identified during the audit for whether there is any indication of fraud continues to be appropriate and sufficient. Stakeholders pointed out that it would not be appropriate to expect the auditor to conduct audit procedures to identify non-material fraud since this does not align with the objective of the audit.

AASB views and recommendation

We support the requirements in paragraphs 36 and 37 of ISA 240. Under these requirements, an auditor is required to evaluate whether identified misstatements are indicative of fraud; and when misstatements are identified, whether material or not, to reevaluate the assessment of the risks of material misstatement due to fraud and the resulting impact on the nature, timing and extent of audit procedures. We do not support additional focus on the auditor identifying non-material fraud during the audit because we believe paragraphs 36 and 37 are sufficient to guide auditors in assessing identified misstatements for fraud.

4 James L. Bierstaker, Denise Hanes-Downey; Jacob M. Rose and Jay C. Thibodeau (2018); Effects of Stories and Checklist Decision Aids on Knowledge Structure Development and Auditor Judgment; *Journal of Information Systems*; v32, Issue2: p.1–24.

Auditor’s Responsibilities with Respect to Third-party Fraud

We understand third-party fraud can refer to:

- fraud involving third parties that is material to the financial statements (e.g., supplier sending invoices that add up to a material amount for services not rendered);
- fraud involving third parties that is not material to the financial statements (e.g., supplier sending an invoice that is not material for services not rendered); and
- fraud involving third parties that does not have a direct impact on the financial statements but may have a reputational or operational risk to the entity (e.g., cyberattack to steal customer data).

What our stakeholders told us

We and our stakeholders focused on the first type of third-party fraud noted above since this is within the current scope of ISA 240. Practitioners believe the requirements of the extant standard adequately consider the risks of third-party fraud as part of the risk assessment process. Practitioners explained that while ISA 240 does not contain specific requirements related to third-party fraud, it does include third-party fraud as part of the definition of fraud, and hence it should be considered by the auditor.

Those charged with governance were the only stakeholder group that supported exploring whether additional procedures should be considered related to third-party fraud that is not currently considered in the audit (third-party fraud that is not material or that does not have a direct impact on the financial statements). They believe there is an increased risk of third-party fraud due to changes in the business environment as a result of the COVID-19 pandemic and therefore additional focus by auditors on this risk area should be required.

AASB views and recommendation

We do not believe the IAASB should explore further requirements related to the auditor’s responsibilities for third-party fraud outside of that which is material to the financial statements. Primary responsibility for preventing and detecting fraud resides with management and those charged with governance. This responsibility includes safeguarding against cyber-attacks and other third-party fraud schemes.

From an auditor’s perspective, the risk assessment process under ISA 315 requires the auditor to identify and assess risks of material misstatement due to error or fraud, including understanding the entity’s system of internal controls. We believe the risk assessment process is sufficient and appropriate to identify fraud risks that are to be considered in relation to the audit of the financial statements. We believe it would be inappropriate to expand the scope of the financial statement audit by requiring the auditor to consider third-party fraud that is not material or does not have a direct impact on the financial statements.

However, practitioners have expressed the need for non-authoritative guidance to clarify the auditor’s responsibilities in relation to third-party fraud, as required in the extant standard.

Auditors struggle with how to address fraud risks that involve third parties and what audit procedures they can perform.

Q2. (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.

What our stakeholders told us

Stakeholders indicated that they need more information on enhanced procedures before they are able to form a view as to their applicability to certain entities/specific circumstances and whether they would be within or outside the scope of an audit.

AASB views and recommendation

We agree with our stakeholders that more information is needed on the enhanced procedures before we can form a view on how they should be applied. However, to the extent that the enhanced procedures fall within the scope of the audit, we are of the view that such procedures would need to align with the risk-based audit approach and the requirements of ISA 315.

Q2. (c) Would requiring a "suspicious mindset" contribute to enhanced fraud identification when planning and performing the audit? Why or why not?

What our stakeholders told us

Stakeholders struggled to understand how the application of a "suspicious mindset" would enhance fraud identification. Stakeholders are concerned that having a suspicious mindset would mean a greater burden of proof when collecting audit evidence, and it could lead to onerous information demands on entities. There is also concern that a suspicious mindset would lead to an adversarial auditor-client relationship which would not be conducive to conducting an effective and efficient audit.

Stakeholders supported the concept of professional skepticism but were of the view that practitioners struggle with how to apply and document it.

AASB views and recommendation

We do not support the concept of a "suspicious mindset". In our outreach, there was inconsistent interpretation by stakeholders as to what the concept meant since it has not been defined. We believe the concept of professional skepticism is appropriate when conducting an audit of financial statements.

We recommend the IAASB consider:

- Adding application material to ISA 240 to explain how auditors can apply and document their application of professional skepticism in the audit - Professional judgment is required to appropriately apply professional skepticism in response to specific audit circumstances. Professional skepticism is a mindset held by the auditor and is used in assessing audit evidence. Additional training and guidance to assist auditors in developing this mindset would be beneficial.
- Developing non-authoritative guidance on how to apply professional skepticism in remote audits (when an audit is completed offsite) **-** The importance of professional skepticism is heightened in a remote audit environment because certain indicators of potential fraud (e.g., uncommon behaviour displayed by management) may be less apparent to the auditor.

Q2. (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.)?

What our stakeholders told us

As mentioned in Question 1(b), stakeholders emphasized that an entity's anti-fraud procedures and controls and the tone at the top of the organization play an important role in reducing the opportunity for fraud and improving detection. Those charged with governance can demonstrate greater leadership by overseeing the implementation of and actively monitoring anti-fraud controls. Stakeholders were supportive of enhanced communications between the auditor and those charged with governance to promote a better understanding of each party's role and responsibilities related to fraud. Our stakeholders indicated that the auditor's report adequately describes the roles and responsibilities of management and the auditor, as related to fraud.

AASB views and recommendation

We are supportive of enhanced communications between the auditor and those charged with governance to promote a better understanding of each party's role and responsibilities related to fraud. In addition, we recommend that auditors be encouraged to communicate with those charged with governance to emphasize the responsibilities of management and those charged with governance related to fraud. These additional communications could be encouraged through non-authoritative guidance.

One area where clarity is needed in the auditor's report is in relation to the following statement:

> "The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentation, or the override of internal controls."

This statement could be interpreted in two ways:

- The risk remains higher, notwithstanding all the work that was done in the audit; or
- The risk is higher and therefore the auditor performed additional work.

Clarification should be added to the auditor's report to explain what this statement is trying to communicate.

We believe the expectation gap cannot be addressed in the auditor's report, but rather through continued education. While we recognize that these education activities are outside of the IAASB's mandate, we would encourage the IAASB to work with other parties to increase awareness of these issues and develop educational materials as required.

Q3. (a) Should the auditor have enhanced or more requirements with regard to going concern in and audit of financial statements? If yes, in what areas?

<u>**Material Uncertainty related to Going Concern**</u>

What our stakeholders told us

Our stakeholders supported clarifying the concept of "material uncertainty relating to going concern" for the following reasons:

- There is a lack of clarity and inconsistent practice as to what constitutes "material uncertainty relating to going concern". Stakeholders indicated there are often varying interpretations as to whether a particular set of events and circumstances constitute material uncertainty relating to going concern. We note that this point is supported by an academic study[5] suggesting that management has a higher substantial doubt threshold than auditors.
- The term "going concern" is not well-understood by stakeholders outside of the accounting profession.
- Management's assessment of going concern is often limited to solvency and liquidity indicators. There may be other factors such as losing key personnel or technological developments that may result in material uncertainty relating to going concern.

AASB views and recommendation

We support the clarification of material uncertainty relating to going concern in financial reporting frameworks. We recommend that the IAASB work with the IASB and other accounting standard setters to consider:

- <u>Supplementing the current binary approach of disclosing material uncertainty related to going concern, with additional going concern disclosures</u> – The IAASB may work with the IASB and other accounting standard setters to explore the merits of additional disclosures relating to management's going concern assessment, even when there is no

[5] Bierstaker, J. and DeZoort, T. (2019) The effects of problem severity and recovery strategy on managers' Going Concern judgments and decisions, *Journal of Accounting and Public Policy*, 28 (5): 1-12

material uncertainty about the entity's ability to continue as a going concern. For example, management may disclose identified significant risks (or lack thereof) to the entity's ability to continue as a going concern, the entity's susceptibility to such risks, and how management reached the conclusion that material uncertainty does not exist. We also emphasize that the existing required disclosures of material uncertainty relating to going concern in many financial reporting frameworks should be retained as they continue to serve as a warning to financial statements users.

- <u>Exploring whether there is merit in replacing "going concern" with terminology that is more easily understood</u> – Exploring other concepts such as resiliency, as discussed in the following section, may help inform the development of more understandable terminology.
- <u>Providing guidance on specific industry going concern factors beyond generic financial measures and indicators</u> – This could be achieved through collaboration with other parties such as industry associations.

Addressing these issues within financial reporting frameworks would increase clarity in going concern assessments and disclosures, which would in turn enhance the auditor's ability to evaluate management's going concern assessments.

<u>Going Concern and Other Concepts of Resilience</u>

What our stakeholders told us

Many of our stakeholders were interested in the IAASB's exploration of this area. However, some stakeholders expressed hesitancy over moving away from the concept of going concern to resiliency concepts until there is greater clarity about these concepts.

Stakeholders from the legislative auditor community indicated that public sector accounting standards and non-authoritative guidance in some jurisdictions already deal with financial conditions that involve certain resiliency concepts. For example, the Canadian Public Sector Accounting Board's Statement of Recommended Practice (SORP) 4[6] includes descriptions of elements indicating an entity's financial condition such as flexibility, sustainability, and vulnerability.

AASB views and recommendation

We support an initiative to explore whether resiliency concepts other than going concern might be useful to financial statements users. Such an initiative should include collaboration with the IASB and other accounting standard setters as well as other parties in the financial reporting ecosystem such as regulators. If a regime to report resiliency information is developed, the IAASB could provide input on whether the information is verifiable so that auditors can provide assurance on it.

[6] SORP 4, Indicators of Financial Condition

Guidance to Enhance the Ability of Auditors to Identify and Assess Going Concern Risks

What our stakeholders told us

During our consultations, we heard many suggestions on how auditors can better identify and assess going concern risks such as:

- Firm monitoring of publicly available information pertaining to risks of going concern in its client portfolio – For example, as part of a firm's system of quality management, the firm may establish a process for monitoring media releases, industry outlooks and other sources of information for potential going concern risks, and providing relevant information to engagement teams.
- Auditors being more cognizant of going concern considerations throughout the audit - For example, through:
  - More in-depth understanding of the entity and its environment, for example, by performing analytical procedures at the risk assessment stage that include specific considerations relating to going concern;
  - More robust discussions with management and those charged with governance with a focus on going concern risks; and
  - Considering whether to involve a specialist when going concern risks are identified.

AASB views and recommendation

We believe guidance based on the suggestions above may help auditors better identify and assess going concern risks. On the suggestion regarding firm monitoring of publicly available information, scalability should be considered when developing guidance in this area. For example, guidance may focus on how a smaller firm can efficiently monitor information in the public domain, and how an engagement team may leverage public information that is not specific to an entity (as there is likely little publicly available information that is specific to a private enterprise).

We recommend the IAASB consider developing guidance to enhance the ability of auditors to identify and assess going concern risks. As many of the procedures discussed above were suggested by auditors (and regulators), we expect some firms are already performing many of these procedures. Guidance from the IAASB would help to promote consistency in practice.

Time Period for Going Concern Assessments

What our stakeholders told us

A few stakeholders supported extending the time period for going concern assessments, indicating that auditors currently consider longer-term information when obtaining audit evidence on non-current assets and liabilities. However, most stakeholders did not support extending the time period for going concern assessments. Concerns with extending the time period for going concern assessments include:

- As the time period for assessing going concern increases, the assessment becomes less meaningful due to the higher level of uncertainty.
- The time period for assessing going concern may be impacted by external factors beyond the control of management. For example, many non-profit organizations have a 12-month funding cycle. Management may not have sufficient information to assess going concern beyond the next funding cycle.
- Extending the time period for going concern assessment may inadvertently increase the expectation gap as financial statement users may derive unwarranted assurance about the future viability of the entity from the longer-term assessment.
- Management has primary responsibility for assessing an entity's ability to continue as a going concern. Accordingly, auditors should not be required to assess a period longer than the period required by the financial reporting framework.

We recognize that the views of the majority of our stakeholders regarding extending the time period for going concern assessments are consistent with the results from a survey on Going Concern[7] from the CFA Institute.

AASB views and recommendation

Consistent with the views expressed by most of our stakeholders, we do not support extending the time period for going concern assessments.

Q3. (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.

What our stakeholders told us

Stakeholders indicated that they need more information on the enhanced procedures before they are able to form a view as to the applicability of the enhanced procedures and whether they would be within or outside the scope of an audit.

AASB views and recommendation

We agree with our stakeholders that more information is needed on the enhanced procedures before we can form a view on how they should be applied. However, to the extent that the enhanced procedures would fall within the scope of the audit, we are of the view that such

[7] CFA Institute (2012) Survey on "Going Concern" - 63% of respondents to that survey agreed with the statements "Going concern assessments should be limited to the next 12 months from the date of the financial statements" or "Going concern assessments should be limited to the next 12 months from the date of the financial statements but also consider foreseeable events occurring shortly [thereafter]".

procedures would need to align with the risk-based audit approach and the requirements of ISA 315.

Q3. (c)(i) Do you believe more transparency is needed 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.)?

What our stakeholders told us

Key Audit Matters (KAM) reporting is not yet effective in Canada. Our stakeholders indicated that KAM reporting will likely enhance transparency on "close calls" (i.e., events or conditions that may cast significant doubt on an entity's ability to continue as a going concern, but which management and the auditor conclude do not create a material uncertainty relating to going concern).

Audit committee members indicated to us that timely communication of potential going concern issues by management and auditors is of vital importance to their role in overseeing the financial reporting process.

AASB views and recommendation

We support enhanced transparency in communications between the auditor and those charged with governance.

Some of the procedures discussed in the section "Guidance to enhance the auditor's ability to identify risks of going concern" in our response to Q3(a) may help auditors to identify indications of potential going concern issues at an early stage in an audit. IAASB guidance can encourage auditors to communicate such indications to management and those charged with governance as early as possible so as to allow all parties involved sufficient time to appropriately address such issues.

We recently completed outreach activities on the IAASB's post-implementation review (PIR) of the enhanced auditor reporting standards. Results from our PIR outreach did not identify a demand for additional communications regarding going concern in the auditor's report. Based on existing accounting and audit requirements relating to going concern, we believe the transparency provided in the going concern and KAM sections in the auditor's report to be adequate in informing financial statements users of the respective responsibilities of management and the auditor with respect to going concern assessments.

Q3. (c)(ii) Do you believe more transparency is needed about going concern, outside 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?

As indicated in our response to Q3(a), there are many areas relating to going concern outside of the auditor's work that can be enhanced with the development of new regulatory and financial reporting requirements that better meet users' needs.

Q4. 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?

We encourage the IAASB to conduct a root cause analysis of recent fraud cases and entity failures. Such an analysis will assist the IAASB in understanding what changes to standards may enable auditors to appropriately respond to such situations in the future and in addressing the expectation gap.