Canadian Public Accountability Board
Conseil canadien sur la reddition de comptes

January 21, 2021

Submitted electronically

Mr. Thomas R. Seidenstein
Chair
International Auditing and Assurance Standards Board

Dear Mr. Seidenstein:

Response to the International Auditing and Assurance Standards Board's (IAASB) discussion paper – Fraud and Going Concern in an Audit of Financial Statements

The Canadian Public Accountability Board (CPAB) is Canada's independent audit regulator responsible for overseeing firms that audit Canadian listed entities. Our mandate is to promote high quality, independent auditing that contributes to public confidence in the integrity of financial reporting.

CPAB is pleased to respond to the IAASB's discussion paper: Fraud and Going Concern in an Audit of Financial Statements.

Overall comments

Fundamental changes to the fraud and going concern standards are necessary to protect the public interest. High-profile corporate failures around the world are eroding trust in the audit profession because the auditor failed to detect material fraud or identify the existence of a material uncertainty about an entity's ability to continue as a going concern. We commend the IAASB for looking to obtain a better understanding of the public's expectations of auditors related to fraud and going concern in audits of financial statements. A lively debate about what else can be done by auditors is timely.

CPAB carried out thematic reviews on fraud and going concern in 2019 to evaluate auditors' compliance with International Standards on Auditing (ISA) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and ISA 570, *Going Concern*. Insights from these reviews, extensive dialogue with investors and audit committee chairs and our inspections of audit engagement files have informed our views about how the fraud and going concern auditing standards should be revised to enhance audit quality.

It is our view that the IAASB should strengthen the requirements in the fraud and going concern auditing standards related to how auditors exercise professional skepticism. In addition to the specific observations outlined below, this could be accomplished by adding requirements similar those recently added in ISA 315 (revised), specifically, requirements to:

- Evidence how contradictory evidence was considered and concluded on.
- Stand-back and consider all audit evidence obtained in forming conclusions.

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Fraud

Responsibilities of the auditor

Auditors are required to obtain reasonable assurance about whether the financial statements are free from material misstatement due to fraud or error (ISA 200). Yet the emphasis in ISA 240 on the limitations of the audit when it comes to detecting fraud has contributed to a lack of clarity about what exactly is expected of auditors in this area. The IAASB should revisit whether the limitations described continue to accurately reflect the capabilities of auditors in today's world, including considering advancements in audit technology over the past few years. Supplemental text should be added to emphasize that the limitations do not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud.

Auditor mindset

We welcome a reconsideration of which auditor mindset is most conducive to enhancing an auditor's ability to assess and respond to fraud risks in the public interest. We continue to observe a high rate of audit deficiencies in our inspections that are attributable to a lack of professional skepticism related to conditions that could be indicative of fraud. Examples include acceptance by auditors of less persuasive audit evidence when responding to identified fraud risks and insufficient evaluation of contradictory audit evidence during the audit.

The prevailing auditor mindset in the ISAs has been characterized as neutral: one that neither assumes the honesty nor dishonesty of the preparers of financial information. The question posed in the discussion paper is whether this mindset remains appropriate, or whether requiring auditors to adopt a suspicious mindset would enhance an auditor's ability to detect fraud.

A suspicious mindset may in fact enhance an auditor's ability to detect fraud. It is the mindset that is applied by forensic specialists and is, accordingly, well suited to fraud detection. However, additional research is needed to evaluate whether the benefits to stakeholders outweigh the incremental costs and this is likely to unnecessarily delay exposure of changes that are urgently needed to ISA 240.

A more pragmatic solution would be to use stronger language in the ISAs, such as challenge, question, and re-consider, to strengthen definitions and application guidance related to exercising professional skepticism. It is surprising to us that the concept of auditors challenging management only appears once in the ISAs. The reference is in the application guidance of ISA 540, *Auditing Accounting Estimates and Related Disclosures*, paragraph A95 which deals with situations when auditors identify changes in estimation methods, significant assumptions and the related data from prior periods.

Integrating the concept of effective challenge of management in application guidance in each of the relevant ISAs on how to apply professional skepticism, including ISA 240, would require auditors to assume a more active stance when critically evaluating the evidence obtained from management. This contrasts to the more passive definition of professional skepticism in ISA 200 which requires auditors to remain alert to, among other things, audit evidence that contradicts other audit evidence obtained. Effective challenge of management may also be more closely aligned with how the public perceives the role of the auditor.

Risk Assessment

Understanding management's process for identifying and responding to fraud risks

Effectively designed anti-fraud controls by management act as a strong deterrent to fraud. Conversely, poorly designed controls create opportunities for fraud to occur and to remain concealed. When obtaining an understanding of the entity and its environment, including the entity's internal controls, auditors are required to make inquiries of management regarding, among other things, management's process for identifying and responding to the risks of fraud in the entity. However, how can auditors be expected to understand management's process through inquiry alone? The standard should be strengthened to require auditors to evaluate the design and implementation of that process, including the related anti-fraud prevention and detection controls, to better understand whether the process is effectively designed to prevent/detect fraud.

Ultimately, it is our view that the future of the audit will involve management reporting on the strength of their internal controls related to fraud, and auditors providing assurance over those controls. There is some evidence that this requirement in the US under the *Sarbanes-Oxley Act* has had a positive effect in deterring fraud. Other jurisdictions around the world are also considering similar requirements. We recognize that the requirements for management, including related reporting, are outside the remit of the IAASB. Nevertheless, we encourage the IAASB to explore the benefits and constraints of developing an international standard for auditors to assess and report on internal controls over financial reporting.

Use of forensic and other specialists

ISA 240 only requires auditors to consider engaging forensic and IT specialists as a response to suspected fraud or assessed risks of material misstatement due to fraud. This use of forensic specialists is consistent with what we saw in our thematic review. For example, we identified forensic specialists engaged in five per cent of audits in response to a trigger event including a suspicion about the integrity of management or an allegation about misappropriation of assets.

Given the increasing complexity of entities' business models and sophistication of fraud schemes, we believe that auditors should be required to involve forensic and IT specialists more frequently during risk assessment and throughout the audit. That determination should be based on an evaluation by the engagement team of the specialized skills or knowledge needed to perform fraud risk assessments based on some of the following factors including complexity of the business model, information systems, transactions, data flows, estimation models, related party transactions and fraud risks associated with the industry, and countries where the entity operates.

Fraud brainstorming meeting

ISA 240 would be enhanced by expanding the list of matters that auditors are required to cover in their meeting to discuss where the entity's financial statements may be susceptible to material misstatements due to fraud, including how fraud might occur. To emphasize that risk assessment is an iterative process that occurs during all phases of the audit, auditors should be required to determine if there is a need to have another fraud brainstorming meeting later in the audit to confirm that identified and assessed fraud risks remain appropriate. Finally, specialists engaged in the audit should be required to attend fraud brainstorming meetings. We were surprised to learn in our thematic review that specialists engaged by the engagement team only participated in the fraud brainstorming meeting in two thirds of audits inspected. Specialists' perspectives are relevant to these discussions because of their involvement in complex areas of the audit, including accounting estimates with elevated levels of estimation uncertainty and subjectivity that are particularly susceptible to fraud.

Prescribed risk assessment procedures

Although we support a principles-based approach to auditing standards, we believe the following procedures should be required as part of an auditor's fraud risk assessment:

- Understanding the entity's whistleblower programs: We noted in our thematic review that 40 per cent of occupational fraud is detected through tips from employees, customers, vendors and other anonymous sources according to The Association of Certified Fraud Examiners' 2018 Global Study. Yet, we only identified auditors engaging with the entity's whistleblower program in about one quarter of audits inspected. Fraud risk assessments would be strengthened if auditors were required to test the design and implementation of whistleblower hotlines and to review complaints received through those hotlines.
- Understanding management compensation arrangements and analysts' expectations: CPAB recently hosted a roundtable to hear institutional investors' expectations of auditors related to fraud in financial statement audits. Participants commented that financial reporting frauds tend to cluster around financial metrics that are tied to management compensation. For listed entities, compensation arrangements for management are often tied to meeting analysts' expectations. Fraud risk assessments would be strengthened by requiring auditors to obtain an understanding of managements' compensation arrangements and the metrics that analysts are focused on for listed entities, when applicable.

Responses to Assessed Risks

Incorporating an element of unpredictability

Research suggests that when auditors use consistent procedures year over year, those procedures become predictable and, accordingly, less effective at detecting fraud in the financial statements. Too often we see auditors adhere to the requirement to incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures as a check-the-box exercise. The requirement could be enhanced by providing more examples in the application guidance on how auditors could design procedures to incorporate unpredictability in audits to respond to financial statement level fraud risks.

Presumed fraud risk in revenue recognition

Revenue and revenue growth are often key performance measures for entities. ISA 240 would be enhanced by including more application guidance on how to attribute the presumed fraud risk in revenue recognition and when it's appropriate to rebut it.

ISA 240 requires auditors to evaluate which types of revenue, revenue transactions or assertions give rise to presumed risk of fraud in revenue recognition. However, we often see auditors limit their attribution of the presumed risk to the revenue cut-off assertion without evidencing a critical evaluation of whether the presumed risk also applies to other assertions or revenue transactions. More application guidance will help improve audit quality in this area.

We also continue to identify a high rate of rebuttals in our inspections with a 25 per cent rebuttal rate identified in our thematic review. We consider that rate to be too high based on the risk profiles of the audits we typically select for inspection. Including additional examples in ISA 240 that illustrate when it is appropriate to rebut the fraud risk presumption in revenue recognition will help improve audit quality.

Communication with those charged with governance

Effective, two-way communication between auditors and those charged with governance is a cornerstone of high-quality audits. We believe that auditors should be reporting to those charged with governance how they discharged their responsibilities related to fraud in all audits. We propose that auditors be required to report to those charged with governance their evaluation of the design and implementation of management's process for identifying and responding to fraud risks. This requirement would be consistent with the recommendation described earlier to require auditors to evaluate the design and implementation of that process.

In addition, auditors should be required to report any potential indicators of management bias identified during the audit dealing with accounting estimates to allow those charged with governance to monitor the bias and intervene, when necessary.

Documentation

Auditors should be required to document fraud risk factors. ISA 240 requires auditors to document identified and assessed fraud risks but not the judgments made in reaching their conclusions including their consideration and assessment of fraud risk factors. The limited documentation requirements in ISA 240 are inconsistent with ISA 230, *Audit Documentation* because it does not enable the engagement team to be accountable for their work, retain a sufficient record of matters of continuing significance for future audits and to support the conduct of quality control reviews and inspections.

Technology

Consistent with the IAASB's efforts to modernize other standards (i.e., ISA 315 (revised), ISQM 1, etc.) to reflect the greater use by auditors of automated tools and techniques in audits, we encourage the IAASB to evaluate whether ISA 240 also deserves some attention. Certainly, the capabilities of auditors to detect fraud in audits have increased considerably. Auditors are now able to query entire data sets and to discern anomalies, including some that indicate fraud, which were inaccessible when the standard was last revised. The lack of references to the use of audit technology in ISA 240, including how it may aid an auditor's fraud risk assessment or responses to assessed fraud risks, is conspicuous in its absence.

Going concern

The auditing standards need to be strengthened. This is irrespective of whether actions are taken by accounting standard setters and regulators to enhance requirements for management and/or those charged with governance. Several jurisdictions have amended the local auditing standards to go beyond the requirements currently set out in ISA 570 to be more responsive to the public interest.

We also encourage the IAASB to explore other possible actions to enhance the role of the auditor. For example, in other jurisdictions auditors are required to make additional communications to outside parties, including to relevant authorities, where issues related to going concern are identified by the auditor, and management and those charged with governance do not take appropriate measures, with a view to protecting the public interest.

Definitions of material uncertainty and significant doubt

Both International Accounting Standard 1 (IAS 1) and ISA 570, refer to material uncertainties related to events and conditions that may cast significant doubt about the entity's ability to continue as a going concern. More robust definitions are necessary to the concepts of material uncertainty and what constitutes significant doubt to improve consistency.

Risk assessment

There needs to be a clearer link between the requirements in ISA 315 (revised) and the auditor's evaluation of management's going concern assessment, such as understanding of the entity's business model, objectives and strategies, how the entity is structured and financed, and how the entity measures and reviews its financial performance, including its budgeting and forecasting processes. The auditor should also be required to obtain an understanding of any changes in the method or information used by management in reaching their conclusions, alternative scenarios considered, and the nature and extent of oversight and governance over management's assessment of the entity's ability to continue as a going concern.

Enhanced requirements for risk assessment procedures could result in identification of events or conditions that have not been identified by management that may cast significant doubt about an entity's ability to continue as a going concern. More robust procedures performed during the risk assessment may result in earlier identification of situations where management has not taken the appropriate steps to understand or appropriately address the basis for their assertion that the going concern assumption is appropriate. ISA 570 should require the auditor to go through a similar process as is currently required under ISA 540 (revised). Additional procedures may include requesting management to prepare a formal assessment if they have not prepared one already or requesting management to expand their cash flow forecasts to include other realistic scenarios and to perform sensitivity analyses to further support their conclusion.

To improve consistency, the requirements in ISA 570 should be applicable regardless of the financial reporting framework used in the preparation of the financial statements. Under the current standard, the auditor's evaluation of management's assessment is limited to relevant information that the auditor is aware of as a result of the audit. Increased focus on the robustness of the procedures performed as part of the risk assessment would improve auditor performance in this area.

Communication with those charged with governance

ISA 570 could be enhanced to require greater transparency in the communication of going concern to those charged with governance. Currently, the auditor is only required to communicate matters to those charged with governance when events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern or if management has refused to make or extend its assessment when requested. The auditor should be required to communicate on going concern, including commenting on the quality of management's assessment, the procedures they performed to evaluate going concern, and the conclusion reached, including whether the disclosures being made by management are appropriate given the circumstances. This could encourage early transparent dialogue among the auditor, those charged with governance and management.

Relationship between the auditing and accounting standards

A greater impact on the quality of going concern assessments and the related audit procedures will be realized when both the accounting and auditing standards have been updated. The current guidance in IAS 1 is limited and the binary nature of the disclosure requirements around going concern need to be re-evaluated. More detailed guidance within the accounting standards would improve the auditor's ability to review and independently challenge management.

We encourage the IAASB to liaise with the International Accounting Standards Board to take action to improve the accounting standards.

If you have any questions about our response or wish to discuss any of our observations in more detail please contact me (carol.paradine@cpab-ccrc.ca) or Stacy Hammett (stacy.hammett@cpab-ccrc.ca).

Very truly yours,

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