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29 January 2021

Dear Willie,

Discussion Paper – Fraud and Going Concern in and Audit of Financial Statements

The Financial Reporting Council (FRC) welcomes the opportunity to reply to this Discussion Paper. As the UK's Competent Authority for Audit, our mandate includes: the setting of auditing, assurance and ethical standards; inspection of public interest entity audits and enforcement action against auditors. We also oversee the accountancy profession in regulation of its members and take public interest misconduct cases where conduct falls below expected standards (e.g. where practitioners fail to comply with the fundamental principles and requirements set out in the Code of Ethics). The FRC also is responsible for setting the UK Corporate Governance Code and its associated guidance.

On 20 October 2020, we issued a consultation[1] on the proposed revision of ISA (UK) 240. While it remains based on ISA 240, it includes proposed new supplementary material to provide increased clarity as to the auditor's obligations together with enhancements to the requirements for the identification and assessment of risk of material misstatement due to fraud and the procedures to respond to those risks. These are designed to address stakeholders concerns that have been raised in the UK, including by Sir Donald Brydon in his review of the quality and effectiveness of audit. The consultation closes on 29 January and we will be happy to feedback to you information that may be relevant to your revision of ISA 240.

In September 2019, we issued a revision of ISA (UK) 570[2] which remains based on ISA 570. However, it includes a significant amount of supplementary material that increases the work auditors are required to undertake in respect of going concern, including enhanced risk assessment procedures, drawing on a wider range of available information to obtain sufficient appropriate audit evidence, enhancing professional scepticism, and more transparency in communications and reporting. It is clear that going concern isn't a matter to be focussed on just towards the end of the audit. The revisions were made in response to stakeholder concerns and issues identified in our audit inspections, and a number of significant enforcement cases.

Further, we are currently consulting[3] on revisions to ISRE (UK) 2410 to address a potential lack of clarity in relation to going concern when performing a review of interim financial information. We undertook this to ensure that the level of work carried out by auditors reflects wider expectations on going concern, particularly given recent high- profile corporate failings, and

1 https://www.frc.org.uk/consultation-list/2020/consultation-on-revised-auditing-standard-(isa-(uk

2 https://www.frc.org.uk/getattachment/13b19e6c-4d2c-425e-84f9-da8b6c1a19c9/ISA-UK-570-revised-September-2019-Full-Covers.pdf

3 https://www.frc.org.uk/consultation-list/2020/consultation-on-revised-review-standard-(isre-(uk)

aligns with the requirements of revised ISA (UK) 570.

We therefore encourage the IAASB when strengthening ISAs 240 and 570 to take account of the enhancements we have made in the standards. This will help address the identified expectation gaps in relation to fraud and going concern and enhance the quality and rigour of audits.

We set out below our responses to questions in the request for specific comments. Further comments on the matters the IAASB has said it is interested in perspectives about are set out in the Attachment to this letter.

Responses to request for specific comments

1. *In regard to the expectation gap:*

   (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?*

In relation to both fraud and going concern, we agree with the description of the three components of the expectation gap that are described on page 11 of the Discussion Paper. We also broadly agree with the examples of aspects that could be better addressed by standard setting, including supporting materials, and aspects that require further consideration. The extent to which these different components and the related aspects exist will vary across and within jurisdictions. For example, in any one jurisdiction there may be stakeholders who have a very good understanding of what auditors do and others who do not. Similarly, different stakeholders may have different views as to how they would wish audit to evolve, and the level of assurance they want that audit to provide. While audit inspections and investigations into corporate failures and major frauds have revealed audit performance failures and inconsistency of application, there is no evidence of general performance failures in all audits.

In light of this, we would not suggest that, from a global perspective, there is one particular "main cause" of an expectation gap. But there are clearly some identified aspects that the IAASB could seek to address that would help reduce expectation gaps generally, particularly where the cause(s) relate to a knowledge or performance gap. For example, during our consultation for the revision of ISA (UK) 570, some respondents expressed concern that the proposals would require auditors to go further than management are required to in making their going concern assessment, despite this already being the case. As paragraph 6 of ISA 570 sets out, the auditor's responsibilities include to obtain sufficient appropriate audit evidence and conclude whether a material uncertainty related to going concern exists even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Problems in this area were not a failure in the standard, but instead a failure caused by a performance gap in the application of the standard, namely auditor failure to implement the existing requirements appropriately. We have emphasised the message in paragraph 6 in our revised standard.

With regard to evolution gaps, we believe that the IAASB should address only matters for which there is a general global consensus. Expectations of how audit should evolve in the public interest, especially in relation to its scope and how much stakeholders are willing to pay for any extension thereof, may vary significantly across and within different jurisdictions and may be more appropriately and better addressed by national standard setters and regulators.

   (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?*

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Fraud

ISA 240 contains a significant number of requirements, with related application material, designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement. However, there is ongoing concern that auditors are not doing enough to detect material fraud and that this may, at least in part, be due to a lack of clarity as to their obligation to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud. Sir Donald Brydon's report identified that he "found the question of fraud and auditors' related responsibilities the most complex and most misunderstood in relation to auditors' duties". He commented that "[ISA 240] appears to be a balancing act between managing, or possibly lowering, expectations whilst seeking to avoid going so far as to affect significantly users' perceptions as to the value of audit. The messaging in this standard is therefore somewhat ambiguous, in my view, contributing to a lack of clarity as to what exactly is expected of auditors in this area. Indeed, a number of respondents called for auditors' responsibilities to be clarified, whether or not they believed there is or may be a case for increasing them."

Sir Donald's concern is shared by other stakeholders who believe that the introductory text in the standard places <u>too much emphasis on the inherent limitations of an audit and that this may lead to auditors not planning and performing appropriate procedures to detect material misstatements due to fraud</u>.

The overall objectives of the auditor, as set out in ISA 200, include "to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, <u>whether due to fraud or error</u>". This responsibility is reiterated in paragraph 5 of ISA 240. Both ISA 200 (paragraph A49) and ISA 240 (paragraph 6) identify that fraud may involve sophisticated and carefully organised schemes to conceal it. ISA 200 goes on to say "Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents". There is no suggestion that the auditor should, for example, assess whether there are fraud risk factors and design appropriate audit procedures to respond to those. The impression, unfortunately, is given that auditors should not concern themselves very much about trying to find material misstatement due to sophisticated fraud, which is unacceptable to stakeholders.

ISA 240 does not repeat the statement that "audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement" but rather identifies that the risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.

We agree that the circumstances of some frauds may make them difficult to detect. Nonetheless, it remains the case that the objective of the auditor is to obtain "reasonable assurance" about whether the financial statements as a whole are free from material misstatement, "whether due to fraud or error". Reasonable assurance is defined as a high but not absolute level of assurance and accordingly it follows that the auditor should seek to obtain a high level of assurance that the financial statements are free from material misstatement due to fraud. Unfortunately the text in paragraph A49 of ISA 200 and paragraph 6 of ISA 240 can give the impression that is not the case.

We have sought to address this in our proposed revision of ISA (UK) 240 by adding the following statement in the Introduction after paragraph 7:

> "While, as described above, the risk of not detecting a material misstatement resulting

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> from fraud may be higher than the risk of detecting one resulting from error, that does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Reasonable assurance is a high, but not absolute, level of assurance."

We have also supplemented the ISA 240 objectives of the auditor to clarify they include "To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud" which is consistent with the overall objectives set out in ISA 200.

In addition, we have supplemented the text in paragraph 3 of the Introduction to clarify that the evaluation of whether suspected or identified fraud is material takes into account the qualitative as well as quantitative characteristics of the fraud. For example, if a fraud was undertaken by a member of senior management it would likely be regarded by stakeholders as material regardless of the amount.

Proposing supplementary text, and not completely rewriting parts of the standard, reflects our continuing support for the underlying international standard. However, we recommend that the IAASB undertakes a more fundamental review of the standard.

The above revisions should help reduce both a knowledge gap and performance gap. But there is still more that could be done by the IAASB as we have. For example, increased transparency in the auditor's report about the auditor's responsibilities in relation to fraud and what the auditor has done in the circumstances of a particular audit may help further reduce the knowledge gap. Clarifying and enhancing the requirements and application material in the standard could help reduce performance gaps. We comment further on these possibilities in our responses to the other questions below.

Going concern

Since the beginning of the IAASB's auditor reporting project, the FRC has strongly encouraged the IAASB to make significant revisions to ISA 570. We supported proposals for auditors to make positive statements on going concern and were disappointed when the IAASB did not pursue those proposals. More recently, we requested that the IAASB seek to revise ISA 570 further when responding to the IAASB's Proposed Strategy and Work Plan. We are pleased that IAASB is now undertaking initiatives in relation to going concern but, given the timing, the FRC believed that it was in the public interest to move forward and revise the UK standard as a matter of importance. Accordingly we have introduced extensive enhancements and new requirements supplementing the standard as issued by the IAASB.

We feel the more robust process set out in the revised UK standard will help address performance gaps, such as that described in our response to Q.1(a), as it is clearer what the standard requires from an auditor when considering going concern. Upon the issuing of the revised ISA (UK) 570 in September 2019, the FRC stated that UK auditors would now follow significantly stronger requirements than those required by current international standards and we hoped that the UK experience would lead to further strengthening of requirements at the international level. Our position remains the same and we encourage the IAASB to consider the enhanced UK auditor requirements further explained in response to Q3, and introduce them in the international standard for global benefit.

In the UK, under the applicable accounting frameworks, directors are required to make an assessment of going concern. However, these frameworks provide little guidance on how this assessment should be made or the level of detailed analysis that may be required to make the assessment. We have heard stakeholder concerns that accounting standards need to give more guidance to the preparers of financial reporting. In 2014, the FRC was in favour of IASB

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proposals to amend IAS 1 to provide guidance concerning disclosures around material uncertainties about going concern, and convergence of accounting and auditing standards to provide a common understanding of material uncertainties relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern. The FRC was disappointed that these proposals were abandoned but are encouraged, given recent stakeholder concerns and the extension of accounting and disclosure requirements in Australia and New Zealand, that the IASB may revisit this. We strongly encourage the IAASB to seek to liaise with the IASB to achieve consistency in the international auditing and accounting standards.

2. *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?*

Yes. We have made a number of enhancements in our proposed revision of ISA (UK) 240, which are summarised in the FRC's Consultation Paper and that we encourage the IAASB to take account of. These include enhancements in relation to:

Professional scepticism – reflecting changes made in the recent revisions of ISA 540 and ISA 315 to enhance the application of professional scepticism, including emphasising that risk assessment and further audit procedures are designed and performed in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. We have also clarified that the auditor shall remain alert for conditions that indicate a record or document may not be authentic; and require the auditor to investigate responses to inquiries of management, those charged with governance or others in the entity that appear implausible.

Discussion among the engagement team – specifying more matters to be covered in the discussion and adding more examples in the application material. Requiring that the engagement partner shall determine whether further discussion(s) among the engagement team be held at later stages in the audit to consider fraud risk factors that have been identified and the implications for the audit.

Risk assessment procedures and related activities - requiring that the auditor shall determine whether the engagement team requires specialized skills or knowledge to perform particular procedures. Application material has been added giving examples of matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge, including a possible need for forensic skills as part of the risk assessment process, and to follow up on identified or suspected fraud. We have added a specific requirement that, if the auditor identifies a misstatement due to fraud or suspected fraud, the auditor shall determine whether a forensic expert is needed to investigate further.

Responses to the assessed risks - emphasising that, in obtaining and evaluating audit evidence regarding possible management bias in making accounting estimates, the auditor shall also comply with the relevant requirements in ISA (UK) 540. Adding a stand-back requirement to evaluate, taking into account all relevant audit evidence obtained, whether corroborative or contradictory, whether the assessments of the risks of material misstatement at the assertion level due to fraud remain appropriate; and sufficient appropriate audit evidence has been obtained regarding the assessed risks of material misstatement due to fraud; and conclude whether the financial statements are materially misstated as a result of fraud.

The auditor's report - emphasising that, as required by ISA (UK) 700, the auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including

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fraud[4]. To clarify that this is not intended to be 'boilerplate', it is required that this explanation shall be specific to the circumstances of the audited entity and take account of how the auditor planned and performed procedures to address the identification and assessment of the risks of material misstatement. This ISA (UK) 700 requirement was originally introduced to reflect EU law in relation to the audit of public interest entities (PIEs). We have widened the scope of the requirement to apply for all audits. Currently there is no equivalent requirement in the IAASB's ISA 700.

Communications to management and those charged with governance - requiring that in communicating matters related to fraud, the auditor shall consider the matters, if any, to communicate regarding management's process for identifying and responding to the risks of fraud in the entity and the auditor's assessment of the risks of material misstatement due to fraud.

While not included in the proposed revisions in the exposure draft, in the consultation we ask whether the auditor should be required to have a specific discussion with those charged with governance about the risks of material fraud in the audited entity, including those with business sector specific relevance. The purpose of this discussion would be to enhance risk assessment procedures related to material misstatement of the financial statements due to fraud

Documentation - emphasising that, as required by ISA (UK) 230, if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

Non-compliance with laws and regulations - . A matter that is often closely related to fraud is non-compliance with laws and regulations, particularly where that non-compliance is intentional as it is often also fraudulent in nature. We have therefore asked respondents for their views on whether more could be done to clarify the links between ISA 240 and ISA 250.

Possible further UK revisions

Sir Donald's recommendations also included that directors should report on the actions they have taken to fulfil their obligations to prevent and detect material fraud against the background of their fraud risk assessment; and that the auditor's report state explicitly the work performed to conclude whether the directors' statement regarding the actions they have taken to prevent and detect material fraud is appropriate. Furthermore, the auditor should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.

The UK Government's Department for Business, Energy and Industrial Strategy (BEIS) is likely to consult on statutory requirements for directors to report on the actions they have taken to fulfil their obligations and for auditors to report in relation to such a director's statement. We will address these recommendations in due course, taking account of the outcome of the BEIS consultation. With regard to Sir Donald's recommendation that auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud, we intend to address that separately from this proposed revision of ISA (UK) 240 as it relates to auditor reporting and we will consider it holistically with other recommendations in relation to the content of the auditor's report.

The IAASB cannot introduce in ISAs requirements for management and those charged with governance. However, it should consider whether the transparency of auditor reporting in

[4] ISA (UK) 700 (Revised November 2019), *Forming an Opinion and Reporting on Financial Statements*, paragraph 29-1.
https://www.frc.org.uk/getattachment/0b1f9783-42a8-44f5-ae4b-d4fcd4b538db/ISA-(UK)-700_Revised-November-2019_Updated-January-2020_final-With-Covers.pdf

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relation to fraud could be improved as is being proposed in the UK.

Possible further considerations for the IAASB

In addition to the matters we are addressing in our proposed revision, we strongly support the IAASB considering the impact of technology, both in relation to how frauds are committed and methods available to auditors to detect them.

We recommend that the IAASB consider whether it remains appropriate to specify a rebuttable presumption of risks of fraud solely in relation to revenue recognition. While we agree that revenue recognition can be susceptible to fraudulent misstatement there are other areas that are also susceptible to fraudulent misstatement, such as inventory and property valuations. Further, the evolving financial reporting frameworks since ISA 240 was issued, including the need for significant judgments and, in some industries, complex processes for making estimates, have increased fraud risk factors. The focus on revenue recognition may result in insufficient attention being given to the many other ways fraud may be perpetrated.

We recommend that more emphasis be given to identifying and assessing fraud risk factors specific to the entity and its circumstances.

(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.

It is important that ISAs should be proportionate and scalable. It would be appropriate to have enhanced procedures in the circumstances where fraud has been identified or is suspected – for example to determine whether a forensic expert is needed to help investigate further. However, fraud is a concern relevant to all entities and it would not be appropriate to introduce enhanced procedures only for certain entities. There are already many ways fraud can be perpetrated and new ways will continually be thought of. Over-specificity in the standard as to entities and circumstances risks auditors missing unspecified issues. As commented above, we recommend that more emphasis be given to identifying and assessing fraud risk factors specific to the entity and its circumstances.

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

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

It would not be appropriate to require a "suspicious mindset" in all circumstances when planning and performing the audit. Sir Donald's suggested principles for audit include "Auditors are appropriately qualified and exercise professional judgment and appropriate scepticism or suspicion throughout their work". But he does not suggest applying a suspicious mindset in all circumstances. Rather, his comments include "The psychology of suspicion that accompanies forensic accounting should be more widely taught, equipping auditors with the ability to <u>choose</u> between scepticism and suspicion <u>in different circumstance</u>s", "a high-quality audit is one which .... involves the application of scepticism throughout and <u>suspicion where appropriate</u>" and

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"auditors need to learn to be able to apply the same mindset as do forensic accountants in relevant circumstances [rather than a neutral mindset]".

We agree that auditors could in general be better able to spot red flags that may be indicative of fraud and give rise to suspicion. Partly that is down to training, which to some extent could be addressed in a firm's quality management procedures.. However, the IAASB could also enhance the requirements for the identification and assessment of risk of material misstatement due to fraud and the procedures to respond to those risks, particularly where a suspicion of fraud arises.

The team discussion should in effect include elements of a suspicious mindset (e.g. considering how could management perpetrate fraud if they were inclined to) and possibly it could be referred to in that context. But there should not be a requirement that "the auditor applies a suspicious mindset when planning and performing the audit", rather be clear the auditor responds appropriately when circumstances give rise to a suspicion of fraud (which is already part of the objectives). However, the standard should be clearer about how the auditor responds if they identify or suspect fraud. In our exposure draft we are proposing a specific requirement to determine whether a forensic expert is needed to investigate further. Our current standard also has further communication requirements, including inviting the entity to investigate further, and informing relevant authorities if the entity does not investigate further. This is an aspect of the auditor's responsibilities that should be considered further in a more fundamental review and revision of the standard.

(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.)?

More transparency, particularly in the auditor's report, could help reduce the knowledge gap, as stakeholders would be better informed about the auditor's work in relation to fraud in an audit of financial statements. It could also help reduce the performance gap, as having to make public what work has or has not been performed can help focus an auditor's attention on planning and performing the most appropriate procedures.

ISA (UK) 701 includes a supplementary requirement, based on European law, that the auditor's report for a PIE shall provide, in support of the audit opinion:

(a) A description of the most significant assessed risks of material misstatement, (whether or not due to fraud);

(b) A summary of the auditor's response to those risks; and

(c) Where relevant, key observations arising with respect to those risks.

In respect of all audited entities, the auditor is also required, by a supplementary requirement in ISA (UK) 700, to explain to what extent the statutory audit was considered capable of detecting irregularities, including fraud. As noted above, one of the enhancements we are proposing to ISA (UK) 240 is to re-emphasise this requirement and clarify that the explanation should not be a 'boiler plate'.

3. *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?

Yes. As explained above, we introduced extensive enhancements and new requirements in our revision of ISA (UK) 570 in 2019 that we strongly recommend the IAASB adopt when revising ISA 570. Full details can be seen in our standard (we distinguish UK text from the IAASB text by

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the use of grey highlighting). Our enhancements include, but are not limited to:

Strengthening the objectives of the auditor – the auditor must obtain sufficient appropriate audit evidence regarding, and conclude on, whether a material uncertainty related to going concern exists; and management's use of the going concern assumption is appropriate. This is important as the going concern assumption is a fundamental principle in the preparation of financial statements. The IAASB's ISA 570 only requires sufficient appropriate audit evidence to be obtained on the appropriateness of management's use of the going concern basis of accounting, but not in respect to other important aspects of going concern, including whether a material uncertainty exists related to going concern.

Enhancing the risk assessment procedures and related activities (see paras 10-1 to 10-5) **-** clearer links between the auditor's work effort in respect of going concern and the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control in accordance with ISA 315. This should drive the auditor to obtain information that is relevant to the identification of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and whether a material uncertainty related to going concern exists. The auditor is required to request management to make an assessment of the entity's ability to continue as a going concern where management has not yet done so. The auditor is also required to inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern and, if such events or conditions are identified, the auditor requests management to evaluate the potential significance of the event or condition on its assessment.

Obtaining sufficient appropriate audit evidence (see paras 11-1 to 15-1) **-** the auditor's evaluation of management's assessment should draw on a wider range of available information to support their work through enhanced risk assessment procedures, with a more robust evaluation of management's assessment, including a more rigorous challenge of the method, information and assumptions used by management in making their going concern assessment. In particular, applying the understanding obtained by the auditor through performing the enhanced risk assessment procedures and related activities.

Professional scepticism and management bias - additional requirements and application material designed to enhance the auditor's application of professional scepticism and consideration of the potential for management bias, including more robust risk assessment requirements for identifying events and conditions and related material uncertainty (paras 10-2 and 12-2); requirement to evaluate whether events or conditions may give rise to risk of management bias (para 10-5); requirement to evaluate whether judgments and decisions made by management, even if they are individually reasonable, are indicators of possible management bias (para 18-1); requirement to "stand back" and consider all audit evidence obtained (para 18-1).

Enhancing auditor reporting (see para 21-1) **-** requirement for the auditor's report on PIEs and other specified entities of public interest to include an explanation of how the auditor evaluated management's assessment of the entity's ability to continue as a going concern and where relevant, key observations arising with respect to that evaluation; for all entities, a conclusion that management's use of the going concern basis of accounting is appropriate (where that is the case); and, where no material uncertainty has been identified, a statement that the auditor has not identified a material uncertainty related to going concern. Where the going concern basis of accounting is appropriate but a material uncertainty exists, the auditor continues to be required to include a separate section in the auditor's report under the heading "Material Uncertainty Related to Going Concern".

Communicating with regulators (see para 25-1) **–** requirement for the auditor to determine

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whether law, regulation or relevant ethical requirements require the auditor to report to an appropriate authority outside the entity when the auditor has determined it necessary to include either a "Material Uncertainty Related to Going Concern" paragraph in the auditor's report or to issue a qualified, adverse or disclaimer of opinion in respect of going concern.

Our revisions are intended to provide a framework for the auditor to ensure that they have obtained a more robust understanding of the process management apply when assessing going concern, ensuring that the auditor is considering all aspects of the entity and its environment, the applicable financial reporting framework and the system of internal control in order to identify events and conditions. A threat to the ability to continue as a going concern should not be assessed as low based only on clearly visible factors as there may be events and conditions that are only identified through the auditor's risk assessment process.

Following our consultation, we decided against implementing a requirement for the auditor to look at a longer period than that considered by the directors, as it would be using auditing standards to indirectly change legal or current financial reporting framework requirements. However, we do require (para 14-1) that If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of approval of the financial statements as defined in ISA (UK) 560 the auditor shall request management to extend its assessment period to at least twelve months from that date. There are further requirements (para 15-1) if management is unwilling to make or extend its assessment when requested to do so'

The FRC strongly encourages auditors to challenge management where they have limited the period considered to the minimum requirement of one year where there are circumstances that indicate that a longer period would be more appropriate. In many cases, management focuses on a going concern assessment period of one year, without considering how appropriate this is. Ideally, the IASB would revisit this area to make it clearer what factors management should take into account when determining the period of assessment, but irrespective of the accounting framework, it is our belief that the auditor should also be looking at this period and assessing whether it is appropriate given the individual facts and circumstances of the entity. We require (para 13-1(a) that the auditor consider whether management's assessment includes all relevant information, including all available information about the future, of which the auditor is aware as a result of the audit. We have application material supporting this requirement, including in relation to 'relevant information'.

(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.

It is important that ISAs should be proportionate and scalable. In the revisions we have made, which we believe would also appropriately strengthen the underlying international standard if adopted by the IAASB, we have designed the risk assessment procedures, the procedures related to evaluating management's assessment and the procedures related to evaluating audit evidence to be scalable. As such these procedures are applicable to all entities, irrespective of size.

As described above, the requirement to provide an explanation in the auditor's report of how the auditor evaluated management's assessment of going concern applies only to PIEs and other

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specified entities of public interest. This reflected stakeholder feedback on our consultation.

(c) Do you believe more transparency is needed:

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

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

As discussed in our response to Q3(a) the revised ISA (UK) 570 places more robust transparency requirements on auditors with regards to, but not restricted to, enhanced auditor reporting and communication with regulators, which could have positive effects on narrowing knowledge and performance gaps.

ISA (UK) 260 also includes enhanced requirements for communication with audit committees of PIEs and other entities applying the UK Corporate Governance Code, including about the board's explanation in the annual report as to how it has assessed the prospects of the entity, over what period it has done so and why it considers that period to be appropriate, and their statements:

(i) in the financial statements, as to whether the Board considered it appropriate to adopt the going concern basis of accounting in preparing them, including any related disclosures identifying any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements; and

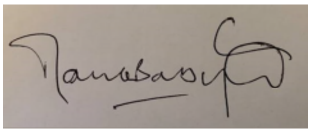
(ii) in the annual report as to whether it has a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

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?*

We support the other IAASB activities set out in Appendix A of the Discussion Paper. We were disappointed to see a delay to the work in relation to fraud and going concern in the May 2020 revision to the IAASB's work plan as these are matters of high concern to stakeholders. We strongly encourage the IAASB to expedite consideration of the other matters set out in Appendix A that are not included in the scope of the Discussion Paper in commencing the revision of ISAs 240 and 570 to address stakeholder concerns.

If you have any questions on our response or wish to discuss any of our observations in more detail please contact me at m.babington@frc.org.uk or +44 20 7492 2323.

Yours sincerely,



Mark Babington
Executive Director, Regulatory Standards

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Attachment

Comments on the matters the IAASB indicated it is interested in perspectives about

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.

A strong corporate culture committed to honesty and ethical behaviour may act as a deterrent to fraudulent financial reporting and, conversely, a weak corporate culture may give rise to increased risks of material misstatement due to fraud. We suggest the audit team discussion include consideration of how those charged with governance and management promote a culture of honesty and integrity; what policies they have to facilitate and encourage reporting of wrongdoing; and how they respond to any such reports.

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.

As identified in in our response to Q2(a), auditors should be required to determine whether the engagement team requires specialized skills or knowledge to perform particular procedures. It is not appropriate to require the use of forensic specialists in all audits. The nature of a forensic investigation into actual or suspected fraud is different to the approach of a general purpose financial statement audit. To require a 'forensic approach' to all elements of a financial statement audit, even when there is no identified risk of material misstatement due to fraud, would likely be prohibitively expensive. However, we are proposing a requirement that if the auditor identifies a misstatement due to fraud or suspected fraud, the auditor shall determine whether a forensic expert is needed to investigate further.

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 cost of requiring auditors to plan and perform an audit to detect non-material frauds would likely outweigh the benefits in most cases. However, should the auditor identify actual or suspected non-material fraud in the course of the audit they should be required to investigate further, with aid of a forensic expert if needed, and determine the implications for the audit. This is particularly important where the auditor has reason to believe management is involved.

Whether additional audit procedures should be required when a non-material fraud is identified, and if so, what types of procedures.

As commented above, should the auditor identify actual or suspected non-material fraud in the course of the audit they should be required to investigate further, with aid of a forensic expert if needed, and determine the implications for the audit. The specific procedures will depend on the circumstances and nature of the fraud, but should be directed at identifying how the fraud occurred and the amount.

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).

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While ISA 240 highlights the difficulties in detecting fraud involving collusion, it gives relatively little specific attention to third parties, the only reference in the requirements being in paragraph 36 which, if the auditor has identified a misstatement, requires the auditor to also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. ISA 550 identifies that an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by ISA 240 because fraud may be more easily committed through related parties. It would be helpful to include a cross reference to ISA 550 in ISA 240 to emphasise that in obtaining audit evidence regarding the risks of material misstatement due to fraud the auditor complies also with the relevant requirements in ISA 550.

The ISAs are designed to provide requirements and guidance for the audit of financial statements. 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) falls outside the scope of ISAs. It is a matter more appropriately left to national standard setters and regulators to address having regard to the wishes of stakeholders in their jurisdictions.

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.

The requirements for the EQCR to perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached, should be sufficient to cover issues relating to fraud without needing to introduce requirements for specific EQCR procedures focussed on fraud. Keeping these requirements at a principles level, and avoiding specification of particular causes of risks to consider, helps avoid the possibility of an unbalanced review that does not give sufficient attention to risks that have not been specifically identified in the requirements.

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.

As identified in our response to Q1(b), the FRC believes there should be consistency in international accounting and auditing standards and strongly encourages the IAASB to liaise with the IASB to achieve that.

In the UK, the period used by those charged with governance in making their assessment is usually at least one year from the <u>date of approval</u> of the financial statements. ISA (UK) 570, paragraph 14-1, requires that if management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of approval of the financial statements as defined in ISA (UK) 560 [Subsequent Events], the auditor shall request management to extend its assessment period to at least twelve months from that date.

Whether changes are needed with regard to going concern and other concepts of resilience (within the purview of the IAASB's remit).

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We would encourage other jurisdictions to take a similar approach to the UK, which is summarised in the Discussion Paper. This is a matter that currently varies across jurisdictions and in light of that we believe more appropriately addressed by national regulators and standard setters rather than the IAASB.

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.

Clear description in the financial statements and, where appropriate, the auditor's report of the nature of the material uncertainty and its possible impact would be the most effective way of ensuring it is understood.

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.

As stated in our response to Q1(b), in 2014, the FRC was in favour of IASB proposals to amend IAS 1 to provide guidance concerning disclosures around material uncertainties about going concern, and convergence of accounting and auditing standards to provide a common understanding of material uncertainties relating to events or conditions that may cast significant doubt on an entities ability to continue as a going concern. The FRC was disappointed that these proposals were abandoned but are encouraged, given recent stakeholder concerns and the extension of accounting and disclosure requirements in Australia and New Zealand, that the IASB may revisit this. We strongly encourage the IAASB to seek to liaise with the IASB to achieve consistency in the international auditing and accounting standards.

Whether more is needed related to professional scepticism when undertaking procedures with regard to fraud and going concern and what additional procedures, if any, may be appropriate.

More could be done to support and enhance the application of professional scepticism. We have made revisions in ISA (UK) 570 and are proposing revisions in ISA (UK) 240, as described in our responses to Q2(a) and Q3(a).

Whether more information is needed in the auditor's report regarding fraud or going concern, and if so, further details about the transparency needed.

More information and transparency in the auditor's report could help address the expectations gap. As described in our responses to Q2(a) and Q3(a), the requirements in ISA (UK) 240 and ISA (UK) 570 go beyond those in the underlying international standards.

Whether more transparency is needed with regard to communications with those charged with governance.

As described in our responses to Q2(a) and Q3(c), the requirements in ISA (UK) 240 and ISA (UK) 260 go beyond those in the underlying international standards.

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