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Dear Board Members

Fraud and Going Concern in an audit of financial statements: Discussion Paper

We are pleased to have the opportunity to respond to the Discussion Paper on *Fraud and Going Concern in an audit of financial statements*. We set out below our overall comments on the proposals followed by detailed responses to the questions raised.

General Comments

We support the IAASB's initiative to gather perspectives from stakeholders on the auditor's role in fraud and going concern. However, it is difficult to see how a consensus view is expected to emerge from the variety of stakeholders who will hopefully respond to the discussion paper. We would also urge the IAASB and others to be very mindful of the risks of widening the expectation gap by taking actions that might be perceived to address issues but may not be entirely successful without the full support of all parties.

We are pleased to see the IAASB stressing the importance of all parties involved in the "financial reporting ecosystem". Successful development and implementation of any future improvements in fraud and going concern can only be achieved through a concerted effort on behalf of all the key players in the financial reporting ecosystem, as set out in the Background section of the discussion paper. It is not possible for any one constituency to effect substantial change without all parties' support and collaboration.

We are pleased to see the expectation gap analysis reflecting that of the ACCA which we believe summarises the complexity of the "gap" into a series of different issues along a spectrum. It is clear that there is a broad spectrum of:

- what the "public" thinks auditors do and what they are required to do ("Knowledge")
- what auditors are required to do and what they do in practice ("Performance")
- what auditors do in practice and what the users would like the auditor to do ("Evolution")

Only by understanding the complexity of the expectation gap can we hope to address it. Part of that understanding lies in identifying who can make a difference to address the elements of the gap.

A significant aspect of auditor behaviour underpinning the work on fraud and going concern is the application of professional scepticism. In particular challenge of management, including challenging assumptions in estimates may indicate management bias or the basis of the going concern assessment. We believe that the IAASB, and other stakeholders, can do much more to assist auditors in effectively challenging management through better standards, application material, training and guidance. A key part of such materials would be clarity for auditors on the different types of bias, how they manifest themselves during an audit and how they can be mitigated when undertaking audits.

Response to Questions

Expectation gap
1 In regard to the expectation gap (See section1)

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?*

Response:

We believe that there are multiple causes of the expectation gap, reflecting the different elements of the gap, and indeed that these causes are different for fraud and going concern. We discuss each in turn below.

Fraud expectation gap
Each of the three "gaps" is relevant to fraud. There is a clear knowledge gap as the extent of the auditor's responsibilities is not clearly understood by to the users and the public. This is, at least partly, explained by the lack of clarity of wording in the standards – for example, the words highlighted in bold/italics in the extract below are all open to interpretation and potential misunderstanding by different parties:

> *An auditor is responsible for obtaining **reasonable assurance** that the financial statements, **taken as a whole**, are free from **material misstatement**, whether caused by fraud or error.*

The Performance Gap is all too obvious in some, but not necessarily all, of the high-profile cases, leading to concerns over audit quality. There are examples where some of the more basic audit tasks have not been carried out to the quality required, for example, obtaining of bank confirmations. It should be noted that it can be challenging to identify more complex, sophisticated frauds under existing auditing standards.

We believe that a key aspect of the fraud expectation gap relates to the evolutionary gap due to how fraud is perpetrated. Even though the motivation to commit fraud has not changed, the use of new technology is making fraud more sophisticated and challenging to identify. The business environment has evolved, including sudden changes arising from the COVID-19 pandemic, the volume of data used and the use of different technological factors such as social media, digital assets, cybersecurity, to name but a few. These, we believe, have contributed to the increase in the evolutionary gap.

Going Concern expectation gap
Similarly, the Going Concern gap relates to a greater or lesser degree in all three aspects of the gap. The expectation gap relating to what users/the public think the auditor does and reports on compared to the expectations on auditors set out in standards. In our view, issues around going concern are linked to the current limitations on auditor's responsibilities, i.e., how much more auditors can do or should do in relation to going concern.

Regarding the Performance Gap, there are examples of auditor's not sufficiently challenging management's assessment of going concern. It should be noted that management does not always perform the assessment to the standard required. Furthermore, there is an evolutionary gap as more expectation is placed on the assessment of going concern and wider auditor consideration of disclosures and qualitative information, including the impacts of climate change, sustainability, ESG and one-off events like the current pandemics. Although we believe that stakeholders expect the auditor to do more here, a wide range of stakeholders will need to be fully engaged in driving any solution to this evolution gap.

We are pleased that the UK Financial Reporting Council has taken steps to address the performance gap by enhancing the requirements on auditors around challenge of management's assessment of going concern and auditor reporting in the newly revised ISA (UK) 570.

b) *In your view, what could be done, by the IAASB and/or other (please specify), to narrow the expectation gap related to fraud and going concern in an audit of financial statements?*

While we accept that auditors can do more and that IAASB can contribute to this through standard setting, the expectation gap cannot be addressed by any one or a small number of players in the financial reporting ecosystem. It will require a fully joined up, intelligent response from all stakeholders involved to ensure that all aspects of the expectation gap can be effectively addressed. Therefore, the IAASB must ensure that it is engaging with all the relevant communities to ensure successful changes are introduced.

For example, taking just the performance gap at a high level:

- improving auditor performance alone cannot address the expectation gap, even if audit quality were perfect, as the knowledge and evolution gaps are still relevant
- the IAASB, in combination with auditors and mature, sophisticated and balanced regulators, can help address the performance gap by setting standards which are clear, understandable and can be applied and understood consistently by both auditors and regulators without the need for extensive interpretation
- the importance of management and those charged with governance in ensuring that the auditor receives timely, effective documentation to support, for example, a going concern assessment, and in ensuring effective controls to prevent and detect fraud cannot be underestimated. For example, the lack of proper management assessment of going concern in many instances is an issue which needs to be addressed by other stakeholders (e.g. accounting standards setters, boards and management).

Other gaps will involve different parties to a greater or lesser extent.

Regarding actions that the IAASB itself can undertake regarding fraud, we believe that standards should be updated to reflect technological advancements and the reality of many audited entities, in particular SMEs. Auditors are currently required to consider management override of controls as a significant risk and undertake specific work on journal entries as part of the response to that risk. For many SMEs, where management is the control, having a significant risk of management override makes little sense. In relation to Going Concern, enhancing requirements around the challenge of management's assessment of going concern and auditor reporting will help, but again this needs to be scalable to reflect the needs of a range of entities. We are hopeful that the LCE Auditing Standard may address some of the concerns relating to SMEs relating to fraud and going concern.

There is an increasing necessity for auditors to be proficient in fraud risk assessment and the use of technology (e.g. data analytics) and we suggest that the training of auditors should be enhanced in these areas, as highlighted by Sir Donald Brydon's review in the UK. We also suggest that the IAASB considers how it can support the education of other stakeholders, helping to address the knowledge gap, including for the differences between requirements for Public Interest Entities and SME stakeholders.

We set out in responses to other questions more detailed suggestions of steps which can be taken.

2 This paper sets out the auditor's current requirements in relation to fraud in an audit of financial statements, and some of the issues and challenges that have been raised with respect to this (see sections II and IV). In your view:

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

Response
Although we can see the obvious attraction to other stakeholders of expanding auditor responsibilities, care needs to be taken that, in so doing, the expectation gap isn't widened yet further. Stakeholders need to be aware of the consequences of any extension to the auditor's remit, bearing in mind that an audit is not currently intended, nor able to, identify every fraud. For example, the time and costs involved of some of the proposals made in the discussion paper and other ongoing reviews, such as the requirement to use Forensic specialists need to be weighed against the benefits of their wider involvement.

Any revisions to ISA 240 should be aligned further with ISA 315 (Revised) with emphasis on risk assessment procedures to identify fraud, how technology may be used in identifying and responding to risks of fraud, as well as setting out clearer responses when potential fraud has been identified.

Although ISA 240 includes required procedures concerning fraud, these are a mix of high-level responses (e.g. assigning personnel, evaluating accounting policies) and procedural responses (e.g. journal entry testing and considering management bias in estimates). The current journal entry testing and data analytics procedures performed by many auditors focus on anomaly testing, rather than necessarily on identifying fraud. Greater clarity about when and where technology can and should be used in an audit will help address the gap between the complexity of fraudsters' tools and how audits are currently responding to fraud risk. For example, whether the use of Artificial Intelligence and machine learning is acceptable under auditing standards.

We believe that ISA 240 should place greater emphasis on financial reporting fraud, including considerations as to the auditor's response to potential frauds relating to accounting for complex estimates and other transactions such as off-balance sheet financing.

We do not believe that the use of forensic specialists should be routinely required by standards. However, standards should continue to provide the engagement team with the option of requiring a forensic specialist's involvement where appropriate in responding to a risk. Forensic specialists' skills are in investigating situations where fraud, or potential fraud, has been identified. Their skillset is not suited to an audit risk assessment, although we accept that their experience in how frauds occurred could be useful in training auditors. We do accept that it may be appropriate to consider a requirement, for Public Interest Entity audits only, to involve a forensic specialist in cases where fraud is suspected or identified.

As part of the IAASB's deliberations on technology, there is merit in exploring the auditor's role in third party fraud such as cybercrimes, where the IAASB as a minimum could provide additional guidance for auditors. Cyber-attacks and any associated fraud may also be linked to going concern, with auditors challenging management where operational/reputational loss has been incurred but not included in managements forecast or disclosures.

An engagement quality review is an appropriate response to assessed quality risks. Under ISQC1 (or indeed ISQM1) requirements, we do not believe there is a need for additional procedures or enhancements for EQCR involvement when fraud is identified. We believe that the Engagement Partner (or the firm) may determine that fraud is a high risk and that an EQCR is an appropriate response to that risk under existing standards. However, the focus of the EQCR is on quality risk as opposed to the fraud risk, and a different approach (e.g. second partner, or technical, review) may be more appropriate depending on 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?*

Response
In general, we are concerned at the increasing complexity of auditing standards. We would urge that the IAASB uses a building block approach to any changes to ISA 240, setting out the minimum requirements for all entities. These can then be supplemented by additional requirements for Public Interest Entities, and other complex entities or circumstances where data volume is exceptionally high, leading to increased risk of fraud.

Furthermore, the standards could highlight additional requirements for circumstances where the audit is determined as high risk due to fraud.

ii) What enhancements are needed?

Response
See our comments above.

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.

Response
Any such changes should be made within the ISAs. It may also be more difficult for the IAASB to ensure consistent adoption of other engagement standards.

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?

Response

We do not believe that introducing another term, to replace professional scepticism and alongside a "questioning mindset", will be either helpful or would necessarily change behaviour significantly. A key auditor behaviour which should underpin scepticism is effective challenge of management. A greater emphasis in standards, application material, and other guidance on how auditors can challenge management (e.g. on assumptions, estimates, going concern assessment) and, equally importantly, demonstrate that challenge will be of greater value than introducing another term which is not easy to define or demonstrate. Further guidance on situations where application of a more "suspicious" approach might be appropriate and helpful (e.g. where there are indications of management bias).

d) Do you believe more transparency is needed about the auditor's work concerning fraud in an audit of financial statements? If yes, what additional information is required, and how should this information be communicated (e.g. in communications with those charged with governance, in the auditor's report, etc.)?

Response
We are generally supportive of greater transparency in audit reporting of what work was performed and the findings of auditor's work. We support the requirement introduced for PIEs in the EU Audit Regulations and ISA (UK) 700 (Revised) for all entities, to disclose the extent to which the audit was considered capable detecting irregularities, including fraud. It will be important that auditors avoid the use of "boilerplate" responses to this requirement. The IAASB should review the implementation of these requirements and assess whether such a requirement should be more widely adopted.

We believe that fraud should be a standing agenda item and key area of auditor communication with those charged with governance.

2 This paper sets out the auditor's current requirements concerning going concern in an audit of financial statements, and some of the issues and challenges that have been raised with respect to this (see Sections III and IV). In your view:

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

Response
The UK Financial Reporting Council has already introduced enhanced auditor requirements relating to going concern, which we support. Areas which we believe the IAASB and others ought to consider include:

- how better to support auditor challenge of management's going concern assessment (see our earlier comments)
- guidance on stress testing and reverse stress testing of management models to assess viability in adverse and severe conditions
- consider the appropriateness of the current definition of the 12 month period relating to going concern, and whether this is appropriate for all entities
- adopting a "stand back" approach regarding the overall reasonableness of going concern, aligned with other standards
- Requirements for management to disclose greater detail on going concern assumptions, modelling and reasoning
- ensuring that any changes to the requirements of accounting and auditing standards are fully aligned.

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.

Response
We believe that greater clarity should be provided in accounting and auditing standards when management is required to produce a detailed assessment of going concern; should this always be required? (e.g. for a cash rich, profitable company with secure revenues). Guidance on criteria indicating the need for a detailed assessment would enable auditors to require management to produce an assessment where this has not been forthcoming.

Greater clarity on the additional procedures required when events or conditions are identified, including the requirements around challenge of management (see earlier comments) on aspects such as cash flows, valuation of assets and other estimates which impact going concern.

The LCE working party should address clear guidance and requirements for Less Complex Entities.

c) Do you believe more transparency is needed:
   i) About the auditor's work about going concern in an audit of financial statements? If yes, what additional information is needed, and how should this information be communicated (e.g., in communications with those charged with governance, in the auditor's report, etc)?
   ii) About going concern, outside of the auditor's work relating to going concern? if yes, what further information should be provided, where should this information be provided and what action is required to put this into effect?

Response
We are generally supportive of greater transparency in auditor reporting and this extends also to going concern. We would support enhancement to audit reports, including potentially more nuanced reporting of the assessment of going concern. There is an understandable reluctance on behalf of management to fully disclose given the reaction of the markets and credit agencies to the merest hint of a going concern risk. Therefore, before introducing such a requirement, it will be important to ensure that users and other stakeholders (e.g. markets, credit agencies) are more mature and sophisticated in their response when potential going concern issues are highlighted in the audit report.

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

Response
It will be important that the LCE working party addresses fraud and going concern appropriately for the proposed auditing standard, and that these requirements are truly scaled to LCE stakeholder needs.

Yours faithfully

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