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International Auditing and Assurance Standards Board
529 Fifth Avenue
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Invitation to Comment: Discussion Paper Fraud and Going Concern in an Audit of Financial Statements

Dear Sir/Madam,

Nexia International supports the IAASB in its efforts to ensure that the ISAs continue to provide a foundation for high-quality global audits.

We appreciate the opportunity to comment on the IAASB Discussion Paper. Our comments are set out in the accompanying attachment.

Yours faithfully

Paul Ginman

COO & Global Head of Quality

DISCUSSION PAPER FRAUD AND GOING CONCERN IN AN AUDIT OF FINANCIAL STATEMENTS

RESPONSE TO QUESTIONS

1. *In regard to the expectation gap (see Section I):*

   a) *What do you think is the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements?*

The "expectation gap" in general terms is the difference between what the financial statement users expect from the auditor and the audit, and the reality of what an audit actually is. The ITC discusses three components of the expectation gap: the knowledge gap, the performance gap and the evolution gap. We believe that the knowledge gap is the most significant of these to be addressed.

Under the current auditing standards, an audit provides ***reasonable assurance*** about whether the financial statements as a whole are presented fairly, in all material respects, in accordance with an applicable financial reporting framework. Today's audit standards include materiality considerations, sample size determination (not 100% audit) and the concept of professional scepticism. Based on these concepts, it is simply not possible to design an audit to detect all forms of fraud. An audit does not provide absolute assurance.

We also think part of the problem is the users' belief that frauds can always be detected in a timely manner. This is simply not true. Sophisticated fraud (often involving collusion with external parties) is very difficult to detect with the limited power, access to data and time constraints that auditors have. Using a forensic expert as referred to in the ITC will is unlikely to change this outcome without change to the other constraints.

There is also an expectation gap regarding going concern. Here the gap lies in user's reliance on the auditors to tell the story of a company's strategic and operational plans to continue as a going concern. In the past, too much emphasis is placed on the auditor as it relates to this topic. Much of what is provided by management to support going concern assumptions are related to future or projected events and transactions. Management is in a better position to tell users this story than the auditor. The expectation can simply not be that the auditor is responsible for the viability of a company's operations.

The directors do not guarantee an entity is a going concern, and there is no basis for the auditor, who is not responsible for the management or operation of the entity, to be held to a higher threshold.

However, although this gap has narrowed in recent years as accounting standards rather than only audit standards, address this topic, we do believe that IAS 1 could be much more detailed on when and how management report issues around going concern. The auditing standards provide more guidance, but this does not apply to management.

In practice, many entities have poor and/or unstructured fraud risk assessment processes and monitoring of controls (even some of the larger entities). Making public statements around fraud risk management and adopted controls will assist in entities placing more focus on the risk of fraud.

The IAASB should work with regulators to encourage better communication to manage stakeholder expectations, rather than increasing the scope of audit.

This entails more consistent and more transparent communication of the work performed by auditors to address significant matters (e.g., fraud and going concern). While ISA 260 Communication with Those Charged with Governance may have set down the framework on how significant matters are communicated by the auditors to TCWG, there may not be similar requirements to ensure that there is a similar information flow from the TCWG to other stakeholders.

Closing this gap requires the joint efforts of various parties including:

- Standards setters who should ensure that standards are clear and understandable and should provide adequate and appropriate guidance on their implementation. In particular, more examples could be provided on how complex fraud risks, such as external collusion, can be addressed.
- More stringent requirements for training auditors through education and examination and on the job training.
- Robust supervision/monitoring by the firms, national professional bodies and regulators.

The improvements in quality arising from the new Quality Management Standards may help narrow the performance gap.

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

Some of this expectation gap is perpetuated by litigators and regulators looking to assign blame for a perceived shortcoming, such as a high-profile restatement. We encourage the IAASB to work with regulators to narrow this gap. We believe an advocacy effort by the IAASB targeted to management, investors, regulators and governments may be appropriate.

We also believe that changes to the auditor's report may help narrow the expectation gap related to fraud and going concern:

- We believe users of ISA reports may benefit from a more-clear indication about the risk of not detecting a material misstatement from fraud. This could be achieved by incorporating the requirements in AU-C 700.35 and related application guidance (ADDENDUM 1) into ISA 700 thus providing a more transparent description for users of ISA reports.
- We believe that the requirement for the auditor's responsibility section of the auditor's report to include the statement in respect of going concern contributes to the expectation gap by implying negative assurance about the entity's ability to continue as a going concern for a reasonable period of time. That is, by indicating that if the auditor had drawn attention to disclosures in the financial statements, that a material uncertainty exists, but if the auditor does not discuss a material uncertainty in the report, then a material uncertainty does not exist.

There are many failure prediction models which could be used to assess the going concern status; yet ISA 570 does not even mention that these models exist.

We also believe that the IAASB should encourage the IASB to enhance the requirements in accounting standards to disclose management's approach regarding the risk of fraud and the evaluation of going concern.

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:*

There should be enhanced regulatory requirements for TCWG to connect with other stakeholders to make sure that the public perception is being managed, rather than leave this responsibility to the auditors. Regulators and accounting standard setters need emphasise that this is primarily a management and corporate governance issue. There should also be requirements for TCWG to communicate significant matters from the audit to the wider stakeholder group.

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

We do not believe the auditor should have enhanced or more requirements regarding fraud in an audit of financial statements. Instead, we recommend the IAASB emphasise the concept of professional scepticism, similar to how the AICPA Auditing Standards Board did in its recent update to AU-C 500 with various mentions and examples of the concept.

Audits are not designed to detect and/or prevent a fraud from occurring. Audit procedures and rules seek to determine whether a company's financial statements are fairly stated without any material discrepancies. They are not aimed at detecting and remediating a fraudulent occurrence. Rather the focus is detecting material misstatement.

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?*

We do not believe there is a need for enhanced procedures only for certain entities in specific circumstances. Instead, we believe the ISAs should continue to be drafted in a scalable manner.

(ii) *What enhancements are needed?*

See 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.*

See above.

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

We believe the focus should still be on professional scepticism. Professional scepticism is an attitude that includes a suspicious mind. This "suspicious mind" ties in with the understanding of the business and knowing what questions to ask. Demonstrating professional scepticism will differ from auditor to auditor depending on a situation at hand and include amongst other things, a critical assessment of audit evidence, devoting special attention to inconsistencies and performing validations on evidence collected. Again, this relates to skills and competence. Skills and competence create the mindset necessary. Training plays a key role in developing a suspicious mind and giving auditors the skills to challenge a client.

Standards must emphasise the rigor component such as "robustly" challenging management's assessment of fraud.

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.)*

We believe more transparency may be appropriate and can be effectively and efficiently achieved by the IAASB adopting reporting requirements related to fraud similar to the AICPA's. See our response to 1(b) above.

Also as referred to above, we believe that the focus should be on management and those charge with governance, especially for public companies. Regulators could enhance requirements for companies to improve their internal controls on financial reporting processes, including those controls to prevent or detect fraud, and report on these matters. This would be supported by TCWG communicating to all stakeholders on management's actions as well as the auditor's role.

We do, however, believe that improvements can still be made in the manner the auditor reports and communicates potential issues. Audit reports should be less focused on what the auditor should have done (which is contained in the auditing standards) but more on potential risks and issues. Even if no issues were identified, fraud and going concern issues may exist. We believe further debate is required on how the auditor should comment on these risks and the implications of such comments.

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

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

   We believe that the inclusion in ISA 570 of provisions similar to US GAAS AU-C 570 requirement in paragraph .17 and related application guidance on "Financial Support by Third Parties or the Entity's Owner-Manager" would be appropriate for the following reasons:

   (i) AU-C 570.17 articulates the concept of obtaining sufficient appropriate audit evidence about "intent" and "ability" and the related application guidance provides context on the concept, thus provides useful guidance and some clarity to auditors, management (thus aiding the auditor in performing an effective and efficient audit) and users, thus helping to lower the expectation gap.

   (ii) Also, the requirement to obtain written evidence of third-party support when third-party support is necessary in supporting management's assertion about the entity's ability to continue as a going concern for a reasonable period of time, contributes to the rigor of the audit and, by extension, the quality.

   We also believe that IAASB should work with IASB and regulators to extend management's obligation to consider going concern to at least 12 months form their approval of the financial statements. This should also include obligations on management, at least for more complex entities, to prepare forward looking information of an appropriate standard to support the going concern assumption.

   The ISAs must emphasise the rigor required from the auditor such as "robustly" challenging management's assessment of going concern.

   b) *Is there a need for enhanced procedures only for certain entities or in specific circumstances?1 If yes:*

   We do not believe there is a need for enhanced procedures only for certain entities or in specific circumstances. Instead, we believe the ISAs should continue to be drafted in a scalable manner.