

ISA 240 Consultation

Dear Keith,

Please find below my response to the consultation questions. I hope you will find my comments useful. I've attached to my email some articles that could be useful to this call. If you seek any further clarifications, do not hesitate to contact me on rasha.kassem@coventry.ac.uk

1. Has ISA (UK) 240 been appropriately revised to give increased clarity as to the auditor's obligations relating to fraud in the audit of financial statements. If you do not consider this to be the case, please set out why and how you believe those obligations should be clarified.

No, the statement about materiality and fraud is still unclear. ISA 240 should clearly state that fraud risk should be identified regardless of materiality. Materiality is highly subjective, and in some cases, auditors tend to ignore fraud risk based on materiality.

It is also important to advise the auditors to consider the following fraud factors when assessing fraud risk: Motives to commit fraud; Opportunity to commit fraud; Management integrity; and Fraud perpetrators' capabilities. ISA 240 currently focuses only on three factors: Motives, opportunities, and rationalisation. Rationalisation is more likely to be known during fraud investigations when the suspects are interrogated. Thus, it is unrealistic to require auditors to consider this fraud factor. Academic research asserts that assessing management integrity and commitment to ethical values should replace rationalisation as it could be easily assessed. Although significant in fraud perpetration, fraud perpetrators' capabilities are currently ignored by the standard. Not everyone can exploit opportunities of fraud which usually comes about weaknesses in an organisation's internal control system. Some individuals are more capable of committing fraud than others. The traits that enhance fraudsters' capabilities include power within the organisation; good knowledge of accounting; good knowledge of internal control weaknesses in an organisation; confidence that the perpetrator will get away with their crimes even if caught; and the ability to overcome stress. Auditors need to be aware of these fraud factors. Besides, these fraud factors should be placed at the top of the standard and straight after auditor's responsibility to detect fraud. This will help in alerting auditors to the fraud factors that must be considered in fraud risk assessment. Management motives and management integrity are key factors in fraud perpetration. This was evident in recent and past corporate fraud cases. Auditors also need to be aware of the significance of these two fraud factors to avoid overlooking them.

Additionally, it is not clear why FRC has restricted auditors' responsibility to two types of insider fraud? Corruption is also a type of corporate fraud and falls under "fraud by abuse of position" and "fraud by false representation" under the UK Fraud Act 2006. Corruption could impact the reliability of financial statements and thus should be considered by external auditors. For example, corrupt employees can cause employers to overpay for goods and services bought by a company where the employees have a hidden interest. This form of corruption is called

"conflict of interest." These conflicts of interest can also lead to writing off sales through the use of discounts or allowances. Inadequate disclosure of conflicts of interest and related parties transactions could also impact the financial statements and may mislead shareholders. Corrupt payments could be made by business checks. Disguised payments on the payer's accounting records might appear as legitimate business expense such as consulting fees. Loans and credit card expenses could also be used as a form of bribe.

I recommend clarifying auditor's responsibility to detect fraud by considering the following:

Auditors are responsible for detecting material misstatements in the financial statements, whether due to errors or fraud. However, auditors are obliged to assess and respond to fraud risk, whether the misstatement is material or not. The types of fraud that auditors should consider including fraudulent financial reporting, asset misappropriation, and corruption. In assessing fraud risk, auditors need to consider the following fraud factors: Motives to commit fraud; Management integrity and commitment to ethical values; opportunity for fraud; and fraud perpetrators' capabilities. Although all these fraud factors are essential, management motives and integrity are key fraud factors and shall not be overlooked in fraud risk assessment.

2. Have appropriate enhancements been made to the requirements for the identification and assessment of risk of material misstatement due to fraud, and the procedures to respond to those risks, to promote a more consistent and robust approach to the auditor's responsibilities in relation to fraud? If you do not consider this to be the case, please set out why and how you believe the requirements should be enhanced.

No, it is essential to advise the auditors to consider the following fraud factors when assessing fraud risk: Motives to commit fraud; Opportunity to commit fraud; Management integrity; and Fraud perpetrators' capabilities. ISA 240 currently focuses only on three factors: Motives, opportunities, and rationalisation. Rationalisation is more likely to be known during fraud investigations when the suspects are interrogated. Thus, it is unrealistic to require auditors to consider this fraud factor. Academic research asserts that assessing management integrity and commitment to ethical values should replace rationalisation as it could be easily assessed. Although significant in fraud perpetration, fraud perpetrators' capabilities are currently ignored by the standard. Not everyone can exploit fraud opportunities, which usually comes about weaknesses in an organisation's internal control system. Some individuals are more capable of committing fraud than others. The traits that enhance fraudsters' capabilities include power within the organisation; good knowledge of accounting; good knowledge of internal control weaknesses in an organisation; confidence that the perpetrator will get away with their crimes even if caught; and the ability to overcome stress. Auditors need to be aware of these fraud factors. Besides, these fraud factors should be placed at the top of the standard and straight after auditor's responsibility to detect fraud. This will help in alerting auditors to the fraud factors that must be considered in fraud risk assessment. Management motives and management integrity are critical factors in fraud perpetration. This was evident in recent and past corporate fraud cases. Auditors also need to be aware of the significance of these two fraud factors to avoid overlooking them.

Besides, I think it is not enough to require auditors to consider the above fraud factors without explaining "HOW" they could incorporate them into the audit process. The audit standard is a benchmark for auditors and should provide sufficient guidance to auditors on fraud risk assessment. Leaving this matter to fraud firms will lead to inconsistencies among audit firms in their fraud risk assessment efforts. Besides, auditors are more likely to overlook fraud risk assessment with the absence of adequate guidance. Therefore, auditors need guidance on how to assess motives/incentives to commit fraud and management integrity.

3. Have appropriate enhancements been made to the application material? If you do not consider this to be the case, please set out why and how you believe the application material should be enhanced.

I think it is not enough to require auditors to consider the above fraud factors without explaining "HOW" they could incorporate them into the audit process. The audit standard is a benchmark for auditors and should provide sufficient guidance to auditors on fraud risk assessment. Leaving this matter to fraud firms will lead to inconsistencies among audit firms in their fraud risk assessment efforts. Besides, auditors are more likely to overlook fraud risk assessment with the absence of adequate guidance. Therefore, auditors need guidance on assessing motives/incentives to commit fraud, assess management integrity; and prove the intent to commit fraud. Intent is the only factor that differentiates between fraud and error.

4. Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk assessment procedures, the procedures to respond to those risks and the evaluation of audit evidence obtained? If you do not consider this to be the case, please give reasons and describe how you consider the exercise of professional scepticism could be better supported.

No, I think critical thinking needs to be introduced to the definition of professional scepticism. Besides, suppose you want the auditors to be sceptical and more curious. In that case, you need to emphasise the importance of anti-fraud education and the use of forensic accounting techniques in enhancing auditors' professional scepticism. Research asserts that auditors are more likely to improve their fraud detection skills through education and training than experience. Knowledge is power. If auditors are knowledgeable about the nature of fraud and how it is committed and concealed, they are more likely to be sceptical and have a forensic accountant mindset.

5. ISA (UK) 240 establishes a rebuttable presumption that there are risks of fraud in revenue recognition (paragraph 26). Are there other account balances, transactions or disclosures for which such a rebuttable presumption should be established? If you consider there are, please identify them and set out why.

The accounts that are also vulnerable to fraud include assets; expenses; and disclosures. Assets misappropriation is the most common type of fraud, and manipulations often accompany it in the financial statements to conceal the theft. Similarly, payroll expenses and consultancy fees are among the most commonly manipulated accounts in past and recent fraud cases. Improper disclosure especially omission of directors' remuneration and related party transactions, are also very common and should be considered by the auditors.

6. ISA (UK) 240 specifies particular audit procedures responsive to risks related to management override of controls (paragraphs 31 – 33). Are there other audit procedures responsive to those risks, or any other risks of material misstatement due to fraud, that you believe should be required for all audits? If you consider there are, please describe them and set out why.

The key in assessing management override of controls is to assess management integrity and motives to commit fraud. To assess management integrity, auditors need to consider management's commitment to integrity and ethical values and their attitude towards auditors. For example, is management imposing any limitations on the scope of the audit? Is management cooperating with the auditors? Is management honest? (This could be assessed by comparing management's assertions and inquiries with other evidence obtained by the auditors) Is management fair and treating employees with respect? Does the organisation have a code of ethics and provide staff with anti-fraud training? Does the organisation have an anonymous fraud reporting line/mechanism? Does management invest in anti-fraud controls? How did management react in past fraud cases, if any? Does management take corrective actions recommended by auditors and audit committee?

Other fraud risk factors that need to be considered include management integrity; management motives to commit fraud; and fraud perpetrators' capabilities. Guidance on the assessment of these fraud factors should be provided in ISA240.

Other audit procedures that are useful in fraud risk assessment/detection include the use of specific analytical procedures (e.g., (i) Comparing management's responses and disclosures with the responses of key employees to determine any discrepancies; (ii) using trend analysis to identify unusual transactions; (iii) using horizontal analysis), positive confirmation instead of negative confirmation, the inspection of specific documents (e.g., minutes of board meetings, asset depreciation policy, bank covenant agreements; reports from the operation and finance departments; assets ownership and lease contracts; sales contracts and proof of sales; and payroll records), assessing anti-fraud controls, assessing the tone at the top, investigating tip-offs from whistle-blowers, surprise audits, understanding the clients business environment,

checking the supplier's company location and ownership to determine if there is a shell company scheme; and paying attention to management's attitude and level of cooperation with auditors

7. In complying with the requirements of ISA (UK) 240 (Revised), the auditor may also need to consider whether there has been non-compliance with laws and regulations, and therefore that requirements in ISA (UK) 250 Sections A and B (Revised November 2019) also apply. Is it sufficiently clear in these ISAs (UK) of the interaction between them?

Yes, but it would help provide a list of all the laws and regulations that auditors need to consider and how they may relate to fraud. Anything unrelated to fraud, should be placed in a different standard to avoid confusion. For example, the bribery Act is something relevant to fraud and should be considered by auditors.

8. Are the requirements and application material sufficiently scalable, including the ability to apply ISA (UK) 240 (Revised) to the audits of entities with a wide range of sizes, complexities and circumstances? If you do not consider this to be the case, please set out why and how you believe that could be addressed. Yes

9. References to 'computer-assisted audit techniques' have been updated to 'automated tools and techniques' and we have identified that these may enable more extensive testing and assist in identifying unusual transactions or relationships (paragraphs A44, A48 and A50). Is there other guidance in relation to the use of automated tools and techniques that you believe could assist auditors in relation to their obligations with regard to fraud? If you consider there is, please give an explanation of it.

It would be useful to identify specific technologies that have proven to be effective in fraud detection. Research indicates that auditors do not consider technology in fraud detection because they do not know what technology to use and how to use it. Training on the use of technology in fraud detection and forensic accounting should be compulsory for all auditors.

10. Do you agree with the proposed effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted, which is aligned with the effective date of ISA (UK) 315 (Revised July 2020)? If not, please give reasons and indicate the effective date that you would consider appropriate. Yes

11. Should an additional requirement be placed on auditors to have a specific discussion with those charged with governance on the risks of material fraud in the business,

including those which are business sector specific, in order to further the risk assessment process in respect of the risk of material error in the financial statements relating to fraud?

Yes, absolutely. This is crucial. Auditors should also document these discussions and conduct a detailed assessment of the tone at the top (i.e., the control environment). I hope that the FRC would also consider requiring auditors to report separately on internal controls like SOX but focusing on the effectiveness of the client's anti-fraud controls.