



Financial Reporting Council

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By email to: AAT@FRC.org.uk

For the attention of Keith Billing

28 January, 2021

Dear Mr Billing,

Proposed International Standard on Auditing (UK) 240 (Revised) The auditor's responsibilities relating to fraud in an audit of financial statements

PricewaterhouseCoopers LLP (We) welcome the opportunity to respond to the FRC's exposure draft on the proposed International Standard on Auditing (UK) 240 (Revised) The auditor's responsibilities relating to fraud in an audit of financial statements (ISA (UK) 240).

We recognise that change is needed, and we are committed to improving audit quality, including, where necessary, as it relates to our audit responsibilities with respect to fraud.

In our view, audit operates as part of an inter-connected corporate reporting "ecosystem". This ecosystem has several different members - preparers, those charged with governance, investors, other users, regulators, as well as auditors. As in any ecosystem, effective functioning of the whole depends on each member operating effectively. We fully recognise the need for auditors to embrace change, but the effectiveness of any changes will depend on the evolution of the roles of all ecosystem members.

In particular, ecosystem changes we believe are needed in the area of fraud are:

- (a) Development of greater stakeholder understanding and clarity of directors' and auditors' responsibilities in the area of fraud;

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- (b) Directors taking clearer responsibility for identifying fraud risks and designing and testing responsive controls;
- (c) Continued focus by auditors in improving the quality of audit work in this area, with particular focus on mindset, challenge and training with reference to experience of fraud; and
- (d) Careful and targeted use of forensic expertise in response to areas of heightened risk.

We support many of the proposed revisions to ISA (UK) 240 and believe they go a long way towards addressing part of (a) above. However, it is equally as important to address the other areas for change to ensure the entirety of the ecosystem is aligned.

In giving our views, we are conscious of the other reviews that are being undertaken in the UK, in particular, the Brydon Review on the Quality and Effectiveness of Audit¹, which has made a number of recommendations relating to directors' and the auditor's responsibilities around fraud. The FRC's proactiveness in acting now to add enhanced requirements and guidance to ISA (UK) 240 and in proposing a response to the Brydon recommendation that ARGA amends ISA (UK) 240 to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways (14.1.5), is a reasonable first step. Although we would recommend that the FRC consider how "all" reasonable ways should be defined. What is seen as reasonable could change over time and in addressing this recommendation there needs to be a consistent benchmark for clarity of expectation and consistent application.

More broadly, consideration should be given to how these recommendations will fit into the overall package of reform. In particular, we note that the FRC has deferred to the BEIS consultation on overall reform to consider Sir Donald Brydon's recommendation 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 (14.2.2). As we note above, more needs to be done around directors' responsibilities in this area and although it may not be in the FRC's gift at the moment to increase these responsibilities, one way to drive change through the auditing standard would be for the auditor to have a greater focus on assessing and challenging the directors/those charged with governance on their fraud risk assessment. At the moment, the changes being proposed seem to be primarily focused on the auditor's fraud risk assessment, rather than that of the directors' and in our experience, the depth and quality of the directors' own risk assessment is variable.

Clarifying auditor responsibilities

There is one proposed revision that does raise a significant concern and which, in our view, could lead to a widening of the expectation gap around auditors' responsibilities and extend those responsibilities beyond those of management. This is the revision to paragraph 3 that:

"... a fraud or suspected fraud by a key member of management may be considered qualitatively material, even if the potential misstatement is less than materiality determined in quantitative terms."

¹https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/794244/brydon-review-call-for-views.pdf



We agree that when assessing identified intentional misstatements, we would consider both the qualitative and quantitative impact of those misstatements, including whether it calls into question the integrity of key management. We also agree that when performing a risk assessment, it is important to also consider the risk of qualitatively material misstatement. However, if this revision to paragraph 3 is suggesting that any fraud committed by key members of management should always be considered material, it implies that all audits will need to be planned so as to detect all fraud by key management, no matter what the value. This would be a significant departure from current auditing standards and would, in our view, require disproportionate cost and effort when compared to the benefit to the public interest. As always, we'd be happy to discuss any of our comments with the FRC, but would, in particular, appreciate the opportunity to discuss the potential implications of this additional language before the changes are implemented. If we are not interpreting the FRC's intention correctly, it is possible that some clarification in the additional wording could be helpful.

Our views on the other key changes in the exposure draft are included in Appendix 1 to this letter and our responses to the questions in the exposure draft are included in Appendix 2.

Forensic initiatives

A forensics investigation is and will remain different to an audit - the level of materiality and detailed testing, the fact that a fact pattern may already be known or suspected, the laser focus on specific points rather than the overall picture. However, we do believe there are ways in which drawing on forensic skills can still improve the audit approach and have recently undertaken a number of initiatives to use forensic skills and experience to enhance the quality of our audit work around fraud. This includes specific training of all qualified staff in developing a forensic mindset; launching a repository of real-life fraud case studies to assist engagement teams in having more robust discussions around fraud risk; and piloting the increased involvement of forensic experts at the planning stage of certain engagements. We would be happy to share the results and insights from these initiatives with the FRC. Our Forensics experts have also developed a tool for companies to use to discuss and assess the maturity of their organisation in relation to fraud risks and the controls and processes in place to address them. Companies that we've shared this tool with have found it a very useful part of their risk assessment and governance responsibilities by enabling them to focus on the risks that need most attention. We'd also be happy to demonstrate this tool for the FRC.

We hope our comments are helpful and if you have any questions or require any further information, please do not hesitate to contact me at [REDACTED]

Yours sincerely,

[REDACTED]

Hemione Hudson
UK Head of Audit, PricewaterhouseCoopers LLP



Appendix 1 - Our views on the key changes in the exposure draft

Directors' responsibilities

1. We agree with the addition of a requirement in paragraph 21-1 that *"if the responses to inquiries of those charged with governance, or others within the entity, are inconsistent with the responses to the inquiries of management, the auditor shall determine the implications for the audit in accordance with ISA (UK) 500."* However, we think more needs to be done in this area to ensure that those charged with governance are more engaged in the first place. In our experience, the discussions we have with those charged with governance in which we get their views on the risk of fraud at the company and whether they are aware of any suspected or actual frauds can often be somewhat perfunctory.

We recognise that the FRC is not in a position at the moment to enhance directors' responsibilities but we suggest that clearer guidance for directors could be published about the FRC's views of directors' responsibilities in this area, how they should be exercised and what supporting evidence is needed. Once ARGAs is created and assuming it has more direct responsibility for supervising directors and audit committees, this could be more directly prescriptive.

As mentioned in our cover letter, one specific area where we believe directors should also be taking clearer responsibility is in designing and testing responsive controls to fraud risks. This could be through a strengthening of the UK internal controls framework, as recommended by Sir Donald Brydon, including a specific focus on the internal controls around the prevention and detection of fraud and the directors' responsibilities for certifying the effectiveness of those controls.

Clarifying the auditor's responsibilities

2. We support the existing requirements in paragraph 41-1 that, if the auditor suspects fraud, they are to inform the entity and invite it to investigate the matter and in paragraph 43-1 that the auditor inform the relevant authorities if the entity does not investigate. However, we suggest the FRC consider whether it would make sense to extend this requirement beyond PIE audits, for example to OEPs. Please note that there is a reference to A63-2 in paragraph 41-1 and A63-2 doesn't exist.
3. We note that the following words have been added to paragraph 3: *"Judgements about whether a misstatement is material involves both qualitative and quantitative considerations. For example, a fraud or suspected fraud by a key member of management may be considered material even if the potential misstatement is less than materiality determined in quantitative terms."* In practice, auditors consider whether identified misstatements are qualitatively material, even if not quantitatively material.

However, as noted in our cover letter, we think the additional wording could be open to misinterpretation. Arguably, any intentional misstatement, for example, a fraudulent expense claim by key management, could be considered to be qualitatively material by nature,



regardless of its size. In fact, in today's political/social environment, there is a heightened risk that a stakeholder could respond this way. It is reasonable to expect that an auditor will respond differently to a quantitatively immaterial intentional misstatement by a member of key management when identified. However, the change to the auditing standard could be interpreted as requiring what appears to be a forensic approach to audit testing which would entail extremely significant cost and disruption. For example, in the expense testing scenario mentioned above, this revision would suggest that, in testing expense claims of key members of management, all must be tested, including quantitatively immaterial claims. If this is what is being suggested, we would not support such a change as, in our view, it would be disproportionate and the cost/benefit imbalance would not be in the public interest.

Notwithstanding our view expressed above that we do not support this proposal, if it goes ahead, clear definitions would be needed of what are regarded as "qualitative" and "quantitative" considerations as well as who is determined to be "key management" and how far down the organisation this goes. Without this clarity, there is a risk that this paragraph of the standard could be misinterpreted.

4. We understand the rationale for adding the language in paragraph 7.1 to reinforce the auditor's responsibility for obtaining "reasonable assurance", i.e. *"While, as described above, the risk of not detecting a material misstatement resulting 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."*

However, we are concerned that this reinforcement could appear to contradict or at least negate the inherent limitations referred to in paragraph 6 (specifically that the *"fraud may have involved sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false"*) and possibly even lead to increased expectations that the audit will identify fraud from collusion or carefully organized schemes (which will always be difficult given inherent limitations).

We would recommend modifying the wording in paragraph 7.1 to clarify that within the context of fraud, reasonable assurance does not mean overcoming the limitations that are inherent to an audit and the unavoidable risk that some material misstatements may not be detected. For example (additional language underlined):

~~"While, as described above, the risk of not detecting a material misstatement resulting from fraud may be higher than the risk of not detecting one resulting from error. While 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 from material misstatement due to fraud, the auditor is not expected to overcome the limitations that are inherent to an audit (as described in ISA (UK) 200.A47). Reasonable assurance is a high, but not absolute, level of assurance"~~



5. The additional language in paragraph 10, which appears to have been added to address Sir Donald Brydon's recommendation that the responsibilities of the auditor around fraud be clarified, does add some clarity, but we would suggest it is also important to outline what the audit is NOT capable of doing if we are to fully manage expectations. At a minimum, adding the following words would be helpful: "The objective of an audit is not to obtain absolute assurance that all material misstatements, or reasonable assurance that all immaterial misstatements, due to fraud have been identified".

In addition, we believe that the word "*including*" in part (a) should be replaced with "*by*" so as not to give the impression there are other parts to this objective.

6. The examples of tampering with information in paragraph A9-1 are helpful, but we would also appreciate further guidance on how, practically, we should evidence our adherence to the new requirement in paragraph 13-1 that the auditor should "*remain alert*" for conditions that indicate a record or document may not be authentic".

Use of forensic experts

7. We are pleased to see the FRC recommending a requirement to determine whether specialised skills are needed in assessing the risk of material misstatement due to fraud in paragraph 24-1 and involvement of forensic experts when a fraud is suspected or identified in paragraph 27-1 (although see comment below). We also welcome the examples in paragraph A27-1 of matters that might affect the auditor's determination of whether this involvement is necessary. As outlined in our cover letter, we have implemented a number of recent initiatives in this area and would be happy to share the results with the FRC.

However, clarity is needed on what is the expected nature and extent of those specialised skills and, where circumstances require a "forensic expert", how much training and experience would they be expected to have? Care also needs to be taken that this does not lead to an overreliance on experts that, as well as being impractical, especially on smaller engagements or when the identified fraud is relatively straightforward, could appear to take some of the responsibilities away from the engagement team for developing their own "forensic mindset". (We also note that the last bullet point in the list in A27-1 could be clearer and in line with the rest of the list (i.e. possible "*need for forensic skills as part of the risk assessment process, and to follow up on identified or suspected fraud*").

In addition, although, as noted above, we support the appropriate use of experts when a fraud is suspected or identified, the new requirement in paragraph 27-1 that "*if an auditor identifies a misstatement due to fraud or suspected fraud, the auditor shall determine whether a forensic expert is needed to investigate further*" is out of place in the risk assessment section of the standard. At this stage, the auditor may identify risk factors or identify a risk of material misstatement, but is unlikely to have identified any actual misstatement. If the intent of this paragraph is to involve forensic experts to assist in the identification and assessment of the risks of fraud then this should be clarified and combined with paragraph 24-1. If the intention is to use forensic experts to address responses to assessed risks then, again, this should be clarified and moved to the next section of the standard on responding to risks.



Finally, paragraph 27-1 seems to suggest that if *any* misstatement due to fraud or suspected fraud is identified the auditor should determine whether a forensic expert is needed, rather than only if the misstatement is material. We suggest this should say “*material*” misstatement (taking into account the previous revisions to make it clear that materiality could be quantitative or qualitative).

Engagement team discussions

8. As noted above, paragraph A10-1 states that “*All members of the engagement team, including specialists, participate in the [engagement team] discussion.*” We agree that it is very important to have a broad range of engagement team members participate in the discussion and given what we’ve learned over the last year about the effective use of virtual meetings, we think this should be largely possible for firms that have access to good remote working technology. However, we suggest that the language in the requirement be amended to allow for the fact that, although every attempt should be made to get the whole team together, this may not be possible. For example, there may be changes in engagement personnel as the engagement progresses, who are not part of the team at the time of the discussion. Or for larger, multinational engagements, it may not be possible to get all team members together at the same time and as an alternative (only where getting all members of the team together is not possible) the standard could refer to a need to communicate the outcome of the discussion with all members of the engagement team, to cover situations where team members were unable to attend.
9. We welcome the additional requirements in paragraph 15-1 and the additions to the application material in paragraph A11, which we think will help teams to have more robust fraud risk discussions. We do question whether it would be possible for teams to openly discuss fraud allegations as required in paragraph 15-3, so suggest some limitation is put around this requirement due to confidentiality.
10. We suggest that the new language in paragraph 15-4, that the “*engagement partner shall determine whether further discussions among the engagement team should be held at a later stage in the audit*” be changed to make it a requirement to have the discussion where certain conditions have been met i.e. those outlined in A11-1.

Audit report disclosures

11. We agree with the addition of language to paragraph 39-1, which enhances the existing requirement that the auditor describe in their audit report the extent to which the audit is capable of detecting irregularities, including fraud to say that this should be “*specific to the audited entity*” as audit report disclosures in this area have been variable in our experience. We suggest ISA (UK) 700 also be updated for this change.
12. Given the timing of the effective date and the potential implementation of the Brydon review recommendations, before finalising the change to paragraph 39-1, we suggest the FRC considers how this requirement as a whole will interact with the Brydon recommendation that the auditor state in the audit report “*the work performed to conclude whether the directors’ statement regarding the actions they have taken to prevent and detect material fraud is appropriate.*” This recommendation has the potential to be a very significant change to audit



reports and the two areas will need to come together somehow, so as to avoid duplication and confusion.

Other points

13. There is a significant degree of repetition of requirements from other ISAs in the proposed changes. While this may be helpful in reminding auditors of those requirements, we question whether simply repeating requirements that already exist is going to change practice.
14. On a related point, an additional paragraph, 14-1, has been added, presumably to conform with the requirements of ISA (UK) 550. We suggest there is more clarity here about why related parties in particular are mentioned and if there is considered to be a particular fraud risk.
15. We are interested in what information was used to conduct the FRC's impact assessment of the estimated costs of 10 hours per audit. We are concerned that it may be understated as our own pilot study of increasing the involvement of forensic experts in the group level planning process, whilst a limited sample, resulted in considerably more additional hours (in the region of 25-35 per audit).



Appendix 2 - Our responses to the questions in the exposure draft

Question	Comments
<p>Q1. 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.</p>	<p>Please see our comments in Appendix 1.</p>
<p>Q2. 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.</p>	<p>Please see our comments in Appendix 1.</p> <p>On the whole, we think the enhancements are helpful, but as noted in our comments in Appendix 1, some clarifications are needed in order for the approach to be used consistently and to truly add clarity to what the auditor's responsibilities are. Also note our suggestion in Appendix 1 that there should be more robust conversations, with a structured risk agenda, with those charged with governance over their fraud risk assessment process, potentially having forensic experts, where used, participate in these conversations - further enhancements to make sure this happens would be welcomed.</p> <p>In addition to the proposed enhancements, we note that one of the Brydon recommendations was that ARGA maintain an open access case study register detailing corporate frauds that have occurred in order that auditors can learn in real time from these frauds. We have recently launched our own internal version of this register and think this would be a really useful reference point as part of the auditor's (and directors') risk assessment process and encourage the FRC to move ahead on developing such a register, if they have not already done so.</p>
<p>Q3. 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.</p>	<p>Notwithstanding our comments on the requirements, the enhancements to the application materials are helpful.</p>



<p>Q4. 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.</p>	<p>The proposals are helpful in supporting the exercise of professional scepticism and we are particularly pleased that the focus of the changes has not been limited to adding more procedures, but also considering more behavioural and mindset changes. These include the “stand back” approach, “remaining alert” and not being biased towards corroborative evidence or excluding contradictory evidence. However, evidencing the performance of such intangible procedures can be challenging and so we would find more guidance on expectations around documentation helpful.</p>
<p>Q5. 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.</p>	<p>We don’t believe other account balances or transactions should have a rebuttable presumption. In fact, in our view, having a rebuttable presumption about a particular account balance can direct the auditor into thinking about fraud only in the context of that account balance, which could actually distract them from considering other areas of the accounts that could be at risk of fraud.</p> <p>We know that, historically, a lot of frauds have tended to involve revenue. Today, however, there is often a greater prevalence in manipulating estimates etc. or using journals to commit the fraud or to mask/hide it. We think auditors should be identifying where and how fraud could arise in any account balance, rather than being automatically driven only towards those that are presumed, rightly or wrongly, to be more susceptible.</p>
<p>Q6. 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.</p>	<p>We don’t believe that mandating more procedures is the right answer. Instead, focusing on how the current procedures are performed and documented is key, together with developing the right mindset to analyse the results and challenge where needed. The proposed enhancements, such as the involvement of experts in certain circumstances and having better, in-depth engagement team conversations about the risk of fraud are helpful in this regard, without being overly procedural.</p>
<p>Q7. 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?</p>	<p>If there has been fraud, which is ultimately determined by the courts, there has usually been breach of law. We would suggest that the requirement should be to consider the risk of non-compliance with laws and regulations in all cases of actual or suspected potential fraud rather than “may” need to consider.</p>



<p>Q8. 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.</p>	<p>On the whole, we think the requirements and application material in the existing standard are scalable. However, consideration should be given to certain of the new requirements and whether this could put an undue burden on some engagements. For example, as noted in our comments in Appendix 1, the requirements to have all members of the engagement team in the fraud risk discussion may not always be possible. Also, more clarity around who are considered to be “forensic experts” would be helpful as the availability of such expertise may not always be readily available in smaller audit firms.</p>
<p>Q9. 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.</p>	<p>The updates to paragraphs A44, A48 and A50 describe how automated tools and techniques could be used in specific situations, for example to identify trends and relationships or transactions outside the normal course of business. It would be helpful if it could also be explained, more generally, that automated tools and techniques are often used in audits to assist in the response to a specific fraud risk, or as part of the overall response to fraud risk by incorporating unpredictability into our audit procedures.</p>
<p>Q10. 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.</p>	<p>See our comments in Appendix 1. We would also suggest that early adoption be encouraged by the FRC.</p>
<p>Q11. 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?</p>	<p>As noted in our comments in Appendix 1, we suggest there is a need for much more robust conversations with those charged with governance to demonstrate how they have performed their own risk assessment and addressed the risks of fraud in the business.</p>