Audit Scotland response to proposed amendments to ISA(UK) 240

Audit Scotland has noted with interest your proposals to enhance ISA(UK)240. We hope you find our responses to your questions helpful. We have also provided a brief overview of public audit in Scotland, particularly auditors' responsibilities for fraud which are wider than in the private sector.

Public audit in Scotland - overview

Audit Scotland, working closely with the Accounts Commission and Auditor General, is responsible for the audit of over 200 bodies in the Scottish public sector with total audit fees of over £20 million.

Public bodies in Scotland within our audit regime include central government bodies, councils, health boards, and colleges, as well as more diverse entities such as charities, companies limited by guarantee, and public interest entities. Collectively these bodies spend over £40 billion of public money each year. Some of the larger more significant bodies include the Scottish Government (£34 billion net expenditure), NHS Greater Glasgow & Clyde (£4.6 billion gross expenditure), Glasgow City Council (£2.7 billion gross expenditure), Scottish Water (£1.4 billion revenue).

Auditors are appointed to audit these public bodies by the Accounts Commission and by the Auditor General, supported by Audit Scotland. In most cases, staff in Audit Scotland's inhouse audit practice are appointed as auditor but private sector accountancy firms are appointed to around a third of the bodies.

All audits are governed by a Code of Audit Practice which requires the audit of the financial statements to be undertaken in accordance with international standards on auditing in the UK (ISAs). Auditors are also required to follow practice note 10 which applies certain ISAs in a public sector context.

However, the responsibilities of auditors under the Code go beyond identifying misstatements in the financial statements and include considering and reporting conclusions on the arrangements for financial sustainability, governance and transparency, value for money, and financial management.

Public audit in Scotland - fraud

Key features of public audit in Scotland relevant to fraud are as follows:

- The nature of public sector bodies means that there are specific fraud risk factors which should be considered when applying ISA(UK)240. These include taxation receipts, welfare benefits, grants and other claims made by individuals and organisations on the public purse.
- Auditors report conclusions on whether the public body has established appropriate and effective arrangements for the prevention and detection of fraud and corruption. This involves auditors assessing whether the arrangements are operating effectively, and recommending improvement when they are not.
- When auditors are advised by internal audit of a fraud or suspected fraud (in accordance with paragraph 19 of the ISA) involving the misappropriation of assets, the auditor reports the case to Audit Scotland. Audit Scotland then disseminates information to all other auditors who consider whether any action is required in relation to their own audit appointments. The most recent annual fraud report is available here.
- Audit Scotland coordinates the participation of public bodies in Scotland in the National Fraud Initiative. This is a data-matching exercise which matches data within and between other public bodies to identify potentially fraudulent transactions or claims and errors. More information is available here.
- Audit Scotland also carries out other thematic work where particular fraud risks emerge. For example, this includes emerging fraud risks caused by COVID-19 and red flags in procurement fraud.

Contact

If you would find further information useful, please contact Paul O'Brien – [redacted]

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.

We believe that most proposed revisions have increased clarity in respect of auditors' obligations regarding fraudulent reporting. However, we offer the following observations on specific revisions:

- Paragraph 2 now refers to fraud not only being intentional but also requiring deception. As errors are unintentional, this change would appear to exclude misstatements that are intentional but do not involve deception (for example the disclosure of an inappropriate accounting policy) from being classified as either fraud or error.
- The words 'actual or suspected' have been added before 'fraud' in paragraph 3. This results in the sentence now reading that the auditor is concerned with actual fraud. The explicit reference to actual fraud would appear to be inconsistent with the final sentence of that paragraph; the sentence states that it would be rare for auditors to identify the occurrence of fraud, and even then the auditor does not determine whether it actually legally is fraud. Other references in the standard are perhaps more appropriately to 'fraud or suspected fraud' and we suggest that phrase is also used in paragraph 3.
- We also suggest that clarity could be improved in respect of fraud caused by the misappropriation of assets. Often, the amounts involved in such misappropriations are below materiality. Paragraph 3 suggests, by way of an example, that fraud perpetrated by management may be considered material in qualitative terms. This example presumably applies to the misappropriation of assets, but we suggest that the linkage be more explicit.

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.

We believe that appropriate enhancements have been made to requirements.

However, we consider one specific proposed addition would create an inconsistency with an existing standard. Paragraph 39-1 has been added to refer to the requirements in ISA (UK) 700 for the auditor's report to explain the extent to which the audit was considered capable of detecting irregularities, including fraud.

Paragraph 39-1 then goes on to require the above explanation to be specific to the circumstances of the audited entity. However, the inclusion of specificity as a requirement is inconsistent with ISA (UK) 700 as the latter standard merely includes it as application material rather than as a requirement.

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.

We believe that appropriate enhancements have been made to application material.

We note that paragraph A11 recommends that the engagement team considers any material frauds of which team members have experience in companies in the same industry and whether there are similar risks. While we agree with that addition, its effectiveness is limited by the experience of specific team members. Audit Scotland goes further by collecting information on frauds in a sector and disseminating the information to all other auditors to act as prompts. We recommend that each firm be encouraged to disseminate information on identified frauds throughout the firm.

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.
We consider that the proposals sufficiently support the appropriate exercise of professional scepticism.
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.
As the public sector generally has relatively stable and predictable funding models, the presumption of fraud in revenue recognition can often be rebutted in public bodies. However, as public bodies exist predominantly to deliver services rather than to generate income, practice note 10 extends the rebuttable presumption to expenditure. This rebuttable presumption in respect of expenditure may have application to certain entities in the private sector where there is a risk that expenditure may be manipulated, such as service-based businesses.
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.
We have identified a risk in the public sector of IT controls being overridden by management to allow an individual, for example, to set up a fictitious supplier, invalidly change a supplier's bank account number or to authorise and pay an invalid invoice. Audit procedures aimed at confirming the validity of suppliers can address that risk. We do not believe that there are other risks of material misstatement due to fraud that should be required for all audits. We consider that the emphasis should be on the importance of the assessment performed by auditors in respect of identifying applicable risks at each body rather than a central prescription.
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?
We consider the interaction between these standards is clear.
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.
Audit Scotland is responsible for the audit of a wide range of public bodies. We do not envisage any difficulties in applying the requirements of the standard to all audited bodies.
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.

Audit Scotland coordinates the participation of public bodies in Scotland in the National Fraud Initiative. This is a UK-wide data-matching exercise ran by the Cabinet Office which matches data within and between other public bodies to identify potentially fraudulent transactions or claims and errors. The NFI is available to private sector organisations and so there may be scope for the existing exercise to be extended and/or for a similar exercise to be carried out in the private sector.

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.

We agree with the proposed effective date.

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?

While we consider there may well be benefit in such a discussion, to allow a more flexible and proportionate approach, we consider this should be included in application material rather than as a requirement.