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Ref:EY/R&PP  
Your ref: FRC

Dear Mr Billing

## Proposed revisions to ISA (UK) 240

We support the FRC's initiative to revise ISA (UK) 240 (Updated January 2020) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("the Consultation"), because the obligations of auditors towards the detection of fraud are unclear. This is borne out of the findings of various independent reviews<sup>1</sup> and commentary<sup>2</sup> which can be distilled into three core issues where some stakeholders are either: unclear about the requirements of these obligations, doubtful about their adequacy, and/or uncertain as to whether these obligations are being met.

In recognition of these issues we hope the FRC will be able to meet its deadline and ensure the revised standard is effective from 15 December 2021. This timing is also important because it coincides with the effective date of the complementary ISA (UK) 315, which focuses on risk assessments, including the risk of fraud.

### The responsibilities of stakeholders

As noted in paragraph four of ISA (UK) 240: 'The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.' Whilst the presence of an audit may go some way towards the prevention of fraud, its focus is currently on the detection of material fraud.

Material fraud often involves the override of controls and collusion with others inside the company being audited, and/or third parties. This means improvements in preventing and detecting fraud have to be achieved holistically involving various stakeholders, which in addition to the auditor should include company directors and audit committee chairs. Relying solely on making revisions to an auditing standard is not going to make fraud a thing of the past, but if it's complied with effectively it should go some way towards improving the detection of fraud in the future.

<sup>1</sup> 'In particular, there continues to be a difference between public perceptions about the auditor's ability to detect financial statement fraud and the auditor's responsibilities relating to fraud under the existing professional standards. *Independent Review of the Financial Reporting Council*, December 2018, page 28, paragraph 2.7.

<sup>2</sup> Nigel Sleigh-Johnson, Head of ICAEW's Audit and Assurance Faculty, stated that: 'improving the effectiveness of audit in relation to fraudulent financial reporting will do much to restore trust in the profession.' *Fraudulent Financial Reporting*, March 2020, [ICAEW's website promotion](#).

## The development of current audit practice

As a profession we need to evolve our approach to fraud for two main reasons:

- as a response to changes in the way fraud is perpetrated; and
- to reflect the growing concerns and expectations of stakeholders.

Even without changes in auditing standards, as a global organisation we are committed to addressing the questions that many stakeholders ask about the role of the auditor in fraud detection. The objectives we have set in this regard will help our procedures to exceed current professional standards e.g:

- mandating annual fraud training;
- mandating the use of data analytics for fraud testing;
- using additional internal and external data and information to enable more appropriate responses to external risk indicators such as short sellers and whistle-blowers;
- using electronic confirmations for audit evidence wherever possible;
- developing a proprietary fraud risk assessment framework; and
- requiring the use of our forensic specialists in the audit on a targeted-risk basis.

As explained above, auditing is an important check against fraud, but it is not the only one and so we believe adopting a 'three lines of defence' approach, as referenced by the European Commission<sup>3</sup>, is important i.e: corporate governance; the auditor; and capital markets supervision. The evolving external environment, increasingly complex business models and the sophistication of fraudsters requires nothing less.

## Next steps and revising ISA (UK) 240

The audit profession must re-examine how audit procedures approach the risk of fraud, and underpinning this is the auditing standard itself, ISA (UK) 240. It's the common denominator that helps to unify the auditing profession in its approach toward the detection of fraud: driving a level of consistency and transparency, by defining the auditor's obligations and how they should be reported respectively. Revising this standard now might go some way towards assuaging the concerns of some stakeholders who believe that auditors are not doing enough to detect fraud<sup>4</sup>.

We have summarised above our overall perspective on the long overdue need to address the issues related to the role of audit and fraud detection, which to some degree may also be covered in the anticipated consultation from BEIS covering earlier reviews and inquiries into governance, reporting and auditing. In the appendix we have responded to your specific questions and we would be very pleased to discuss our answers with you. We also recently published a paper on the prevention and

<sup>3</sup> Public Internal Control Systems in the EU, Discussion Paper No. 9, February 2017.

<sup>4</sup> 'ISA (UK) 240 appears to be a balancing act between managing, or possibly lowering, expectations whilst seeking to avoid going so far as to affect significantly users' perceptions as to the value of audit. The messaging in this standard is therefore somewhat ambiguous, in my view, contributing to a lack of clarity as to what exactly is expected of auditors in this area. Indeed, a number of respondents called for auditors' responsibilities to be clarified, whether or not they believed there is or may be a case for increasing them.' *Assess, Assure and Inform, Improving Audit Quality and Effectiveness*, December 2019, page 65, paragraph 14.0.2.

detection of fraud ([LINK](#)) which you might find useful. Please do not hesitate to contact me using the details provided.

Yours sincerely



Christabel Cowling

EY UK Partner, Head of Regulatory & Public Policy

## Appendix

- 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.**

Yes, the revisions are appropriate on two counts. Firstly, they reflect the FRC's intention to clarify the current role of the auditor relating to fraud, rather than fundamentally changing it. Secondly, they also address the concern raised in the Brydon review that: 'ISA (UK) 240 should be amended to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways.'<sup>5</sup>

- 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.**

Yes, the enhancements are appropriate. In particular, the new references (paragraphs 24-1 and 27-1) to risk assessment procedures and related activities are helpful (e.g., 'that the auditor shall determine whether the engagement team requires specialised skills or knowledge, and if a misstatement due to fraud is suspected or detected, the auditor shall determine whether a forensic expert is needed'). We also commend the FRC for introducing examples to show how and when specialised skills should be brought into the audit team. It's important for the auditor to report when a particular specialist was brought into the team, to undertake specific tasks (e.g., forensics).

Fraud detection, through the conduct of an audit, is the most effective when everyone in the team is alert to the risks of fraud. This requires ongoing discussion between team members throughout the audit cycle, bringing together insights and experience which enables more scepticism when executing audit procedures, including the evaluation of any inconsistencies in audit evidence.

We also think it's highly appropriate that the FRC has included references to other ISAs, specifically ISA (UK) 540 (Revised December 2018), and ISA (UK) 700. It's important to obtain and evaluate audit evidence regarding possible management bias in making accounting estimates, and the auditor should explain to what extent the audit was capable of detecting such irregularities, including fraud. These references show how different standards connect together, and where else auditors' responsibilities around fraud are addressed which may have previously been overlooked.

We add a note of caution though on the use of cross references. For stakeholders less familiar with UK ISAs, but who may nevertheless wish to read ISA (UK) 240 given its significance, the FRC should make sure that such references are as specific as possible, with an appropriate level of context to explain what each standard includes. Some references are made to individual paragraphs, others to a whole standard (e.g., paragraph 32-1 in ISA (UK) 240 could be more

<sup>5</sup> Assess, Assure and Inform: Improving Audit Quality and Effectiveness, December 2019.

specifically linked to paragraph 21-21D-1 in ISA 540, rather than ISA 540 as a whole).

- 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.**

The enhancements to the application material (e.g., see response to Q 2) are highly appropriate.

- 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.**

The references to professional scepticism are sufficient, although it would be helpful if the importance of a 'culture of challenge' amongst auditors (e.g., when considering the judgements and estimates of management) could be reinforced. It's equally important to refer to scepticism in the context of reasonable assurance, and that although such assurance can be driven by professional scepticism - and it's a high level of assurance - it's not absolute assurance.

There remains a perception amongst some stakeholders that an audit provides absolute assurance, and that the financial accounts are free from any misstatement due to fraud or error. So regardless of how scepticism is applied and reported upon, the standard should also ensure there is no ambiguity as to the limits of what an audit can achieve, and that all stakeholders should be left in no doubt about what those limits are.

- 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.**

In the current climate, especially when businesses and individuals are under extreme financial pressure, it's reasonable to assume that the accounts of some companies may be more susceptible to material irregularities as a consequence of error and/or fraud. Which accounts are likely to be manipulated will vary by business. The key is to ensure that teams do not develop a tunnel vision and focus too much on revenue, given the rebuttable presumption described in the ISA (UK) 240, but they look at a broad range of risks relevant to the entity being audited.

- 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.**

Management override with collusion is difficult to detect when only using information from the entity being audited, so accessing information from outside the entity may also be helpful. In this context, additional audit procedures might include ratio analysis/competitor comparisons for business performance. These may identify where a company being audited is out of line with industry/past performance: the auditor needs to ask if the company's performance is too good to be true.

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, the “interaction” between ISA (UK) 250 and ISA (UK) 240 (the current Exposure Draft) is sufficiently clear.

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.

We believe the application material is sufficiently scalable at the present time. However, we encourage the FRC to keep this under review, especially under the current circumstances (see response to question 5) and because the IAASB will be reviewing its equivalent standard on fraud i.e., ISA 240. We also note that ISA (UK) 240 has not been reviewed and revised for 16 years. Given the number of high-profile and damaging cases of accounting fraud in recent years, we encourage the FRC to review this standard more frequently in the future.

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.

For the most part the technology that we and other firms use is bespoke, and accordingly the guidance is generated and used within the respective networks of these firms, EY included. There is however one piece of guidance that could apply universally across firms, and it relates to the use of meta data as a means to check the veracity of electronic audit evidence (e.g., online documents, reports, emails) which link to para 13-1 and A9-1 on the authenticity of evidence.

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.

We think it's appropriate to align the implementation date of ISA (UK) 240 with that of ISA (UK) 315, given its focus on risk assessments, which is critical in the determination of the risks of fraud.

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, as referenced in the ISA (UK) 240 Exposure Draft, and in relation to ISA (UK) 250, additional and specific discussions with those charged with governance seems highly appropriate. It will help to reinforce their responsibilities to prevent and detect fraud. Gathering further insight from

those charged with governance will also allow a cross-check to explanations provided by others within the organisation, to help identify inconsistencies which need further investigation.

However, we are reminded of a comment made by Sir Donald Brydon in his independent review of auditing<sup>6</sup>, when he wrote that there is a: 'deep anxiety that, as the role of the auditor explicitly involves increased focus on fraud detection, failure to find fraud is judged in hindsight in a prejudiced manner. It is all too easy to see the unravelling of collusion laying bare what with hindsight is obvious, but in real time was not.'

Further discussions, as explained in the question above, may help with the detection of some frauds, but how you determine whether a fraud is material, and if/when/how such a fraud can be stopped in its tracks, or prevented from being committed in the first place, is never going to be easy, whether the business eco-system is finely tuned or not.

<sup>6</sup> Assess, Assure and Inform: Improving Audit Quality and Effectiveness, December 2019.