Deloitte.

Deloitte LLP
Hill House
1 Little New Street
London
EC4A 3TR

Phone: +44 (0)20 7936 3000
Fax: +44 (0)20 7583 1198
www.deloitte.co.uk

Direct phone: [redacted]

1 February 2021

Keith Billing
Project Director
Financial Reporting Council
8th Floor
125 London Wall
EC2Y 5AS

By email only to: AAT@frc.org.uk

Dear Mr. Billing

Proposal to revise ISA (UK) 240 (Updated January 2020) The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements

We welcome the opportunity to comment on the FRC's proposal in this area as part of the FRC starting to implement the recommendations of Sir Donald Brydon's review on the quality and effectiveness of audit ('the Brydon review').

In responding to the FRC's proposal, we would like to make the following key comments:

Wider package of necessary reforms

It is equally important to consider the changes proposed by the FRC alongside the wider package of necessary reforms to respond to the recent high profile corporate failures, including the responsibility of companies and their boards in vital areas such as high quality and transparent corporate reporting and ensuring an effective control environment.

Where a fraud has been identified subsequent to an audit, there can be a correlation with poor corporate controls. As a result, we firmly support the adoption of a form of Sarbanes-Oxley in the UK, where for larger listed entities, directors or boards of directors, management and auditors are required to report publicly on the internal control environment.

In addition to working on the other actions for auditors, we request that the FRC works with the Department for Business, Energy and Industrial Strategy ('BEIS') as changes to auditing standards and to the responsibilities of management and those charged with governance need to be made in a unified way. For example, the Brydon review also recommended implementing a requirement (in section 14.2.2) for the directors to report on the actions they have taken to fulfil their obligations to prevent and detect material fraud.

If actions are not implemented in a coordinated manner, then it could mean that requirements are being inappropriately imposed on company directors indirectly through auditing standards rather than directly on the directors through changes to their own obligations implemented by BEIS. There is also a risk that the expectation gap of auditors' responsibilities in relation to fraud could be widened if the impression is given that only auditors have increased responsibilities in this area.

We also request that the FRC proceed on further actions recommended in the Brydon review, such as maintaining an open access case study register detailed corporate frauds (section 14.4.3).

As the other recommendations in the Brydon review in relation to auditor's responsibilities are implemented, these may result in further revisions to ISA (UK) 240. If, for example, the auditor is required to audit alternative performance measures and key performance indicators (as recommended in sections 20.1.5 and 20.2.8), then further clarification may be needed on the implications for auditors' fraud risk assessment procedures and audit response.

Need for global consistency

We have some concerns about the changes the FRC have proposed in the standard, mainly where we consider the proposed wording to be unclear (which we have detailed in appendix 1). However, we consider that it would be better for the FRC to influence new and revisions to existing standards through the International Auditing and Assurance Standards Board ('IAASB') rather than amending those standards and adding further UK-specific requirements.

As the UK is a key global capital market, consideration needs to be given to the fact that the updated ISA (UK) 240 will only apply to entities incorporated in the UK. There are increasing numbers of entities who are incorporated overseas and seek to raise money on the London capital markets who will not be subjected to these additional auditing requirements as their auditors will follow the standards issued by the IAASB.

The expectation gap is not just an issue for the UK, but a global concern and one for which a consistent, global approach should be taken. We also note that in September 2020 the IAASB issued a discussion paper, *Fraud and Going Concern in an Audit of Financial Statements: Exploring the Differences Between Public Perceptions About the Role of the Auditor and the Auditor's Responsibilities in a Financial Statement Audit*.

We therefore encourage the FRC to work more together with the IAASB and other national auditing standard setting bodies to reduce the expectation gap and so that the number of differences between the UK and IAASB standard is kept to a minimum. This will mean that guidance is developed that is consistent across multiple jurisdictions and will reduce confusion and inconsistency in execution.

If the timetable is such that the FRC would prefer to make changes in advance of the IAASB then we recommend this be achieved through issuing UK Guidance Notes to published ISAs rather than rewriting the IAASB standards.

We have set out our responses to the feedback questions in the attached appendix 1 together with detailed drafting comments in appendix 2.

If you would like to discuss any of our responses in more detail, please do not hesitate to contact Alan Chaudhuri (achaudhuri@deloitte.co.uk or 020 7303 5066) or Philip Lenton (plenton@deloitte.co.uk or 020 7007 1772).

Yours faithfully

[redacted]

Deloitte LLP

Deloitte.

Appendix 1 – Responses to consultation questions

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.

As we set out in our covering letter, we welcome the FRC clarifying the responsibilities of auditors. However, it is important that the FRC works with BEIS so that at the same time as the responsibilities of auditors are strengthened and clarified, similar consideration is given to the responsibilities of management and those charged with governance.

If these actions are not done in a coordinated manner, then it could mean that requirements are being imposed on companies indirectly through auditing standards rather than directly through recommendations implemented by BEIS. There is also a danger that the expectation gap of auditors' responsibilities in this area could be widened if the impression is given that only auditors have additional responsibilities in relation to fraud.

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 have set out below areas where we consider that the enhancements proposed by the FRC need further clarification or in certain cases where we consider them unnecessary.

Paragraph 3

The proposed wording in paragraph 3, which states that "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", needs further clarification.

It is unclear whether this consideration applies at the risk assessment stage, in which case it could make the financial statements unauditable if any potential fraud, however small, by key management is considered material. Instead, we recommend that the focus should be on how the auditor responds when a potential fraud by a key member of management has been identified.

Paragraph 12-1

We are concerned about the phrase "in a manner that is not biased towards obtaining audit evidence that may be corroborative". While we understand the intent behind the wording the FRC is proposing, there may be circumstances where this is not possible. For example, when testing the accuracy of an expense, the auditor may request to see the invoice supporting that expense. By its very nature, this could be interpreted as being biased toward corroborative evidence but may nonetheless be the appropriate response to that risk.

We also question whether ISA (UK) 240 is the right ISA to be introducing such a concept, as it applies more broadly than when responding to potential risks of fraud. We consider that the existing requirements and guidance in ISA (UK) 500, such as the consideration of internal versus external evidence and contradictory evidence, already provide sufficient guidance to auditors.

Paragraph 15

The FRC have added the words "including the individual financial statements and the disclosures", which we consider unnecessary given the requirement in paragraph 15 already refers to "financial statements" and this would clearly cover individual financial statements and disclosures. This proposed wording could also potentially cause confusion where consolidated financial statements are required, as it could be interpreted as referring to the individual financial statements of each component.

Paragraphs 15-3 and 27-1

Paragraphs 15-3 and 27-1 imply that it is the auditor's responsibility to investigate fraud. It should be management who determine "how to investigate and respond to the allegations," not the auditors. There are existing requirements in the ISAs on procedures to perform, including communications to management and those charged with governance, when any fraud is alleged, suspected, or identified. The auditor considers the effect of the allegations on the audit, but they should not be responsible for "investigating" any such allegations. We also consider that requiring the auditor to investigate fraud could give rise to an independence and self-review threat.

In addition, there is no concept of materiality in paragraph 15-3 or consideration given to the type of fraud identified and its potential significance in the context of the financial statements. As an example, for a retailer, given the nature of the operations, there may be an unavoidable level of theft. Where this is wholly immaterial, that should not necessarily require an audit response. Such an example would contrast with a possible accounting fraud where there was a suspicion of the deliberate manipulation of some element(s) of the financial statements.

Paragraph 15-4

We understand that the intent of paragraph 15-4 is to reinforce the need to revisit the risk assessment throughout the audit and that the fraud discussion is not a single, one-off event at the commencement of the audit. However, as currently drafted, the requirement is unclear on this point and whether the determination for further discussion later in the audit needs to be made during the initial fraud discussion or only when new factors become known in the course of the audit.

Paragraph 18-1

The application material in paragraph A16-1 makes clear that this is intended to apply where entities have whistleblowing policies for employees to disclose concerns. However, the requirement in paragraph 18-1 has no conditionality clause to make clear that it only applies where the entity has such whistleblowing policies in place. If the wording is not amended, then this could be interpreted as imposing policies on the entity through the auditing standards.

Paragraphs 24-1 and 27-1

We do not consider that paragraph 27-1 is necessary given the proposed additional requirement in paragraph 24-1 to evaluate whether the engagement team requires specialised skills or knowledge to perform the risk assessment procedures, identify and assess risks, design and perform audit procedures or evaluate the evidence obtained.

If the FRC does retain paragraph 27-1, we recommend that it uses the terms "specialised skills or knowledge" rather than specifically refer to a "forensic expert" as other ISAs (UK) are not as specific on the type of expert or specialist required. It is also unclear what is meant by the term "forensic expert" as that is not defined. This requirement could also prevent an issue in terms of scalability; the larger firms may have such specialists in house, albeit outside the ring-fenced audit business. However, for smaller firms they may have to hire an external forensic expert.

Finally, we recommend that if the wording in paragraph 27-1 is retained, it be amended to refer to "material" misstatements due to fraud or suspected fraud.

Deloitte.

Paragraph 29

This has added a requirement to consider key performance indicators (KPIs), but it needs to be clear that this refers to KPIs in (or derived from) the financial statements. Auditors do not have a responsibility to audit the other information and the requirement should not extend auditors' responsibilities to other, non-financial KPIs.

Paragraph 32

One of the proposed updates in paragraph 32(a)(i) requires auditors to "[m]ake enquiries of individuals at all levels involved in the financial reporting process". The wording is unclear and could be misinterpreted. If such wording is retained we recommend this be amended to "at various levels" and the FRC considers providing application material on this additional requirement, which could also include consideration of how to incorporate unpredictability in inquiries and audit procedures.

Paragraph 32(a)(ii) adds the words "post-closing entries", but these are not defined and we know there is already inconsistent interpretation of what this phrase means by different auditors.

Paragraph 39

While we have no issue with the proposed addition requiring management to state in the representation letter that they have appropriately fulfilled their responsibilities in relation to the prevention and detection of fraud, this further stresses the importance of providing further guidance to management and those charged with governance on their responsibilities. This would include any further disclosures they may be required to provide in the financial statements (see our comment below in respect of Q11).

Paragraph 39-1

If this paragraph is retained (see our comment below on requirements repeating requirements from other ISAs (UK)), we recommend that this paragraph (or related application material) discusses the interaction with key audit matters where ISA (UK) 701 applies.

Additional requirements repeating requirements from other ISAs (UK)

The following proposed requirements do not make any changes to the procedures that an auditor performs and repeat requirements from other ISAs (UK). Given this, we recommend that they be moved to an appendix:

- Paragraph 14-1 – refers to the whole of ISA (UK) 550
- Paragraph 15-2 – repeats a requirement already in ISA (UK) 600
- Paragraph 32-1 – refers to the whole of ISA (UK) 540
- Paragraph 39-1 – repeats a requirement already in ISA (UK) 700
- Paragraph 45-1 – repeats a requirement already in ISA (UK) 230

In addition, the following paragraphs could similarly be moved to an appendix:

- Paragraph 21-1 – this requirement is already covered by the general requirement in ISA (UK) 500, so we do not consider it is necessary to make a specific requirement for this.
- Paragraph 36-1 –much of this paragraph simply restates the requirements in ISA (UK) 330 and so we do not consider it is necessary.

Putting such material in an appendix is similar to the approach taken in ISA (UK) 580 Appendix 1, where other ISAs that require written representations are listed. This would also have the advantage in that the specific paragraphs of the relevant standards could be detailed rather than references to the complete ISA (UK).

There is also a question about the completeness of the references to other ISAs (UK). Once the FRC starts adding such references without any additional requirements or guidance, there is a question of where to draw the line, as there are numerous other ISAs (UK) which refer to fraud or contain actions that would be required as part of the auditor's response to the risk of fraud. For example, ISA (UK) 505 contains a requirement to assess the risk of fraud where management refuses to allow the auditor to send a confirmation request, but there is no reference to that requirement in ISA (UK) 240.

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 have included detailed drafting comments on the application material in appendix 2.

We would also recommend that the FRC limit where possible the rewriting of existing IAASB material, especially where the wording changes are very minor. If the FRC consider that further guidance is necessary, the recommended approach would be to author a new paragraph next to the IAASB's existing material, rather than make minor amendments to the IAASB material that are less likely to influence auditor behaviour.

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 agree that the proposals further support the appropriate exercise of professional scepticism, but as the FRC has noted, the exercise of professional scepticism cannot be addressed through auditing standards alone. The FRC's letter to the heads of audit on 8 December[1] highlighted that there were a number of root causes for inspection findings where auditors had not challenged management effectively.

We have set out in our transparency report[2] that we are committed to developing a culture of challenge – where our people are trained, empowered and supported to critically question without bias or constraint. Equally, having the perspective to stand back and assess the bigger picture is just as important as close scrutiny of the detail. These are both key areas of focus where we continue to invest in our people and our processes.

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.

No, we do not consider that there are any other account balances, transactions or disclosures for which such a rebuttable presumption should be established. However, it would be helpful if there were more guidance available to auditors on why there is such a presumption in the first place, focusing on the underlying principles that led to such a presumption. This would help auditors better understand the requirement so that they would be able to apply it to other account balances where they consider there is more opportunity to

---

[1] https://www.frc.org.uk/getattachment/e297b54c-8d11-4ff7-b6c2-772b06b00c15/Challenge-of-management-Letter-Final.pdf
[2] https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/about-deloitte/deloitte-uk-annual-report-fy20-transparency-report.pdf

manipulate the financial statements instead of revenue. This would also align with the aims of the ISAs to be principles-based.

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.

While we do not consider that further audit procedures in relation to management override are required for all audits, it would be helpful if more guidance on recent frauds could be made available to auditors, together with some suggested procedures that might have identified such frauds. We note that Brydon review recommends in section 14.4.3 that ARGA maintains an open access case study register detailing corporate frauds that have occurred. Initially this could be shared on an anonymised basis so that potentially confidential or legally prejudicial information is not released. We consider that this would be more helpful to respond to management override than including more prescriptive, rules-based requirements in this area.

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?

Yes, subject to our comments on paragraphs 15-3 and 27-1 on whose responsibility it is to investigate fraud.

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.

Yes, subject to the comments we have raised in question 3.

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.

We recommend that the FRC emphasises in the application material that while automated tools and techniques can assist in identifying unusual transactions or relationships, this will not necessarily detect more fraud, as otherwise this could further increase the expectation gap in this area. In addition, both management and auditors need to be alert to a risk that using such tools could rapidly amplify a risk of bias if algorithms are learning from biased input data.

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 recommend that the FRC consider the IAASB's proposed actions, including the timescale for any revisions to ISA 240, from their discussion paper. It would be helpful for there to be one set of globally consistent changes to the standard, rather than the FRC making one series of changes and this be followed soon afterwards by a further set of changes from the IAASB.

If the FRC determines that it cannot wait for the outcome from IAASB's discussion paper, while we are not concerned with the proposed effective date and permitting early adoption, we recommend that:

- The effective date should be coordinated with any changes to the company's responsibilities to respond to the recommendations of the Brydon review.
- The FRC clarifies that if the changes proposed to ISA (UK) 240 are adopted early, this does not mean that the auditors are required to implement all of the changes in ISA (UK) 315, which has the same application date.
- The revised standard be published as soon as possible so that auditors have the opportunity to be trained on any of the new requirements, given that auditors typically do much of the technical update training in the summer.

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?

We do not consider that an additional requirement is necessary, as we consider that the need for such a discussion is already covered by the requirements in paragraphs 20 and 21 of ISA (UK) 240. However, more guidance could be given outside ISA (UK) 240 to those charged with governance on matters that they may want to consider when having such discussions with auditors.

This again emphasises the need for any changes to the requirements for auditors and those charged with governance to be coordinated. This is so that any additional requirements on auditors are published together with changes and clarifications to the responsibilities of directors, for example the recommendation of the Brydon review in section 14.2.2 of his report for the directors to report on how they are responding to their obligations to prevent and detect material fraud.

Appendix 2 – Detailed drafting comments

Paragraph 16
- The phrase "required by ISA (UK) 315 (Revised July 2020)" has been moved to after "risk assessment procedures and related activities" rather than remaining after "the entity's system of internal control". As this change is not in the conforming amendments to ISA (UK) 315, we recommend that the wording aligns to that proposed by the IAASB.

Paragraph 20
- The FRC has not made the following conforming amendment from ISA (UK) 315: "…responding to the risks of fraud in the entity and the ~~internal~~ controls that management has established to mitigate these risks."

Paragraph A6
- The heading before this paragraph, "Considerations Specific to Public Sector Entities", appears to have been deleted in error.

Paragraph A10-1
- This states that all members of the engagement team, including specialists, participate in the discussion among the engagement team. This could create practical difficulties, for example, for very large teams or where a member of the engagement team is unavailable or joins the audit later. We recommend that the wording clarify that if for any engagement team member who did not attend the discussion, the minutes or key discussion points of the meeting are shared with them.

Paragraph A11
- We recommend that the bullet point about the exchange of ideas be reinstated to maintain consistency with the international standard.
- In addition, to align with the change in paragraph 32(a), we recommend that the wording added to the first bullet point refer to KPIs derived from the financial statements in addition to "earnings".

Paragraph A37, footnote 21c
- We recommend that this refer to the specific requirement in ISA (UK) 530.

Paragraph A43-1
- This paragraph should be numbered A42-1 as it comes between paragraphs A42 and A43.
- We recommend that the wording be amended to state that "…controls that address risks of material misstatement at the assertion level that are expected to be identified for all audits ~~are~~ include controls over journal entries…"

Paragraph A45
- There is a reference to footnote 14a in this paragraph relating to management making a number of judgements and assumptions. As footnote 14a refers to a requirement in ISA (UK) 230, we believe that the FRC's intention was to refer to footnote 16b, which clarifies that, in the UK, those charged with governance are responsible for the preparation of the financial statements.

Paragraph A50
- This should read "Automated tools and techniques…"