FRAUD ADVISORY PANEL REPRESENTATION 01/21

RESPONSE TO THE FINANCIAL REPORTING COUNCIL CONSULTATION ON THE PROPOSAL TO REVISE THE AUDITING STANDARD FOR THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD, PUBLISHED ON 20 OCTOBER 2020

The Fraud Advisory Panel welcomes the opportunity to comment on the consultation on the revision of the International Standard on Auditing (UK) ISA (UK) 240 (updated January 2020): *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, published by the Financial Reporting Council on 20 October 2020, a copy of which is available from this link.

We are happy to discuss any aspect of our comments and to take part in all further consultations on the issues we've highlighted to the FRC.

For more information, please contact info@fraudadvisorypanel.org

www.fraudadvisorypanel.org

GENERAL COMMENTS

1. The Fraud Advisory Panel welcomes the opportunity to respond to the Financial Reporting Council (FRC) consultation on the proposal to revise ISA (UK) 240 (updated January 2020): *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

2. Our response has been prepared by a small steering committee of our members and has also been informed by a series of short surveys we conducted with our wider membership in the second quarter of 2020 on Sir Donald Brydon's recommendations.

3. The Fraud Advisory Panel (the 'Panel') is the UK's leading counter fraud charity. We act as the collective voice of the counter fraud profession and provide practical support to almost 300 corporate and individual members. Our members come from a wide range of professions and sectors but are united in their determination to counter fraud.

Aims and timing of the consultation

4. We agree with the aim and timing of the consultation (ahead of the IAASB's review) to clarify auditor's responsibilities relating to fraud in an audit of the financial statements and to provide further supplemental requirements and guidance. However, we note that this means that the revised standard is being taken forward ahead of the rest of Sir Donald Brydon's recommendations and is therefore a little bit out of sync.

5. In our view a more joined up and holistic approach could have achieved a more immediate practical benefit in addressing the public expectation gap, particularly in respect of the recommendations relating to directors' statements, and the auditor's assessment of these and the effectiveness of relevant fraud controls. Surveys of our members last year found overwhelming support for these proposals as follows.

    a. Company directors should be required to explain the actions they have taken to prevent and detect material fraud in the statutory report and accounts (97% of members who responded to our survey agreed with this proposal).

    b. The auditor's report should state the work they have performed to conclude whether the directors' statement (on the actions taken to prevent and detect material fraud) is appropriate (80% agreed).

    c. The auditor's report should explain the steps they've taken to assess the effectiveness of relevant fraud controls and to detect fraud (80% agreed).

6. Taken together, these requirements and the revised standard, will not only improve transparency and accountability in respect of fraud, but also address the existing expectations gap in respect of the auditor's role in detecting fraud.

The revised standard

7. Consequently, while we broadly support the proposed revisions to ISA (UK) 240 (the 'revised standard') we recognise that there is still much more to be done to address the wider issues of corporate failure and to clarify the responsibilities of other stakeholders (particularly management and those charged with governance) within the wider corporate ecosystem to prevent and detect fraud. The revised standard alone will not do this.

8. Because the standard is aligned with other recommendations in the Brydon review consideration also needs to be given to addressing the issues of training and capacity of auditors the interim. This may also necessitate transitional arrangements to address the different levels of competency between newly qualified auditors (who have received appropriate training) and those who have been working in the field for many years. Upskilling experienced auditors may be challenging in practical terms in the short-term.

9. It is also worth noting that there seems to be a recognition that these proposals will mean that the cost of audit will increase and may result in some auditors seeking to exit clients deemed too high risk. This may make it more difficult for some companies to appoint auditors in future.

Examples of fraud

10. We note throughout our responses below that the revised standard may be further strengthened with the addition of examples. The Fraud Advisory Panel would be pleased to assist in the identification and articulation of appropriate examples if this would be of assistance to the FRC.

RESPONSES TO SPECTIFIC 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 <u>do not</u> consider this to be the case, please set out why and how you believe those obligations should be clarified.

11. Overall, we believe that the revised standard strikes a good balance without being overly prescriptive.

12. As previously worded the standard was commonly perceived to emphasise the directors' responsibilities in respect of fraud over the auditor's responsibilities and to perpetuate the expectation gap between auditors and users of the financial statements.

13. While the revised standard certainly provides greater clarity on the auditor's responsibilities (for example see new paragraph 7.1), we believe this could be further strengthened through the inclusion of the following.

a. Examples of financial statement fraud that the auditor might typically come across in the course of their work that might not be readily identifiable, such as those set out in paragraph 6 of the revised standard. It should be made clear that the inclusion of such examples are for illustrative purposes only and are not exhaustive. The appendices (which are currently limited to fraud risk factors and indicators) could be expanded to include these.

b. A clear explanation on what the auditor is – and is not – capable of doing in respect of preventing and detecting fraud (so to better manage public expectations). One of the limitations of the audit process is the reliance on the explanations provided by management and the inherent difficulty in challenging these in an appropriate and proportionate manner. While the auditor can test some transactions to corroborate the information provided by management, they will never know the business to the same extent as their client and can therefore only assess whether the explanations provided are reasonable given their limited knowledge about the company.

14. Otherwise, there is a risk that there will continue to be a perception by users of the financial statements that the auditor can – and should – uncover all types of fraud (rather than material misstatement of the financial statements due to fraud). This may be more of a public education point about the auditor being one line of defence against fraud in a much wider corporate ecosystem in which responsibility for the prevention and detection of fraud is shared amongst a variety of stakeholders.

15. Some benefit might be derived from involving a forensic professional in the early audit planning stage to help inform discussions with the audit team about fraud risk factors, and especially in audit engagements for companies that might operate in a particularly high-risk fraud environment or otherwise be more susceptible to fraud. This would need to be proportionate.

16. It is important to encourage professional scepticism and a general form of fraud awareness training as part of the auditor's foundation training and continuing professional development could go a long way towards assisting the auditor to understand what fraud looks like in practice and to identify it.

17. Ninety-three percent of respondents to our members survey agreed that auditors of the financial statements should receive fraud awareness training, ideally as part of continuous learning requirements (80%).

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.

18. Please see our comments in paragraphs 11 and 13(a) above.

19. We are concerned that organisational culture is emphasised and considered as part of the application material and appendices but does not appear to be treated with the same priority within the standard itself. We believe that this is a significant omission given the central role that organisational culture plays in many corporate frauds and failures. Auditors should be encouraged to think about the client's culture as a potential risk factor and to objectively seek to understand, assess and corroborate it. This could potentially be included within the risk assessment section of the revised standard.

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.

20. We believe that some further enhancements could be made to the application material.

21. Overall A9-1 is a helpful addition to the revised standard, but we are concerned that it may become outdated as the sophistication of materials used in fraud schemes continue to increase in line with technological advancements. (We consider that while the underlying characteristics of fraud tend to remain the same, it is the 'vehicle' for conducting the fraud that changes.) For example, as new developments in blockchain begin to impact accounting records, auditors will need to incorporate this new technology into their identification of risks. We appreciate the practical difficulties in ensuring that the standard is broad enough to capture both low- and high-tech frauds.

22. In our view the inclusion of more illustrative examples (on either a fictional or non-fictional basis) to highlight the principles set out in the standard would be useful and may also go some way toward addressing Brydon's recommendation for a repository of case studies (which almost two-thirds of our members support).

23. We also feel that further consideration needs to be given to the concept of materiality in the context of a fraud to ensure that the auditor is not expected to identify all non-material fraud. The public impact of a fraud becoming known may mean that the reputational impact becomes qualitatively material. This is quite problematic; how can an auditor predict this and how a fraud might be perceived if it hits the press? For example, a minor expense fraud perpetrated by senior management at a charity receives high profile media exposure that leads to a significant impact on the charity's ability to generate income through donations and grants and to continue as a going concern.

24. It is unclear whether this consideration applies at the risk assessment stage, in which case it could make the financial statements inauditable if any potential fraud – however small – by key management is considered material.

25. Instead, we would recommend that the focus should be on how the auditor responds when a potential fraud by a key member of management has been identified and their assessment of whether an identified fraud is material.

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

<u>not</u> consider this to be the case, please give reasons and describe how you consider the exercise of professional scepticism could be better supported.

26. In our experience a sceptical mindset is developed through a combination of training, experience and from having appropriate discussions and the right mix of skilled and experienced people on the team. The question is how to embed professional scepticism within the team and take time to step back and reflect?

27. This means that outside of ISA (UK) 240 more needs to be done to encourage auditors to develop their professional scepticism and to consider and evaluate the internal and external factors (for example, bonuses or market expectations) that might make the providers of information to the auditor manipulate the figures. Specific training may assist in demonstrating an 'enhanced sceptical' approach rather than through other means.

28. It might be helpful to include some guidance on the importance in maintaining a sceptical mindset in considering the potential bias on the part of management, particularly with regard to judgemental areas. Management can be subject to a variety of pressures and incentives, such as a need to achieve market expectations or bonus KPIs which can increase the risk of fraudulent financial reporting. The auditor should bear this in mind when considering representations from management.

29. In addition, if management responds to audit requests on key audit risk areas late and close to deadline, then the auditor should consider the reasons behind this. It is our members experience that this is a common factor in cases where an entity has been involved in fraudulent financial reporting.

30. We note the specific reference to remaining alert to the authenticity of documents. This will have an impact on audit seniors responsible for running the audit by increasing awareness and embedding a predisposed and sceptical approach when reviewing documents supplied by management. We also note the revised standard's emphasis on whether information provided by management contradicts or confirms the auditors' knowledge and other information obtained during the audit. In our view the auditor needs to be sceptical about the internal and external influences that might impact on the providers of the information. We welcome this as we consider that more can be done to identify, document, evaluate and question potential inconsistencies.

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 disclosure for which such a rebuttable presumption should be established? If you consider <u>there are</u>, please identify them and set out why.

31. We are concerned that directing audit teams to revenue recognition may detract from other areas that may be susceptible to fraud. While we consider that revenue recognition is likely to be the one of the biggest risks in terms of financial statement fraud, there are other areas susceptible to significant fraud risk, for example related-party transactions (we note reference is made to complying with ISA (UK) 500 in paragraph 14-1 but there

is no equivalent rebuttable presumption of fraud) and off-balance sheet financing transactions, which should, in our view, be specifically and separately addressed.

32. However, we recognise that care needs to be taken to ensure the standard does not become overly prescriptive or a tick box exercise. We agree that the onus to identify and address risks and risky transactions should be part of the auditing planning process.

33. It is challenging to add further rebuttable presumptions that apply to all audits given the idiosyncrasies of individual entities and because there will be specific considerations relevant to some but not all entities.

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 do not consider there are, please describe them and set out why.

34. Please see our response to Q5 above.

35. In our view the revised standard should not be prescriptive but instead emphasise the importance of an effective fraud planning meeting at the beginning of each engagement.

36. The procedures identified in the standard are mainly related to journal entries, suspicious transactions around period ends and which are outside the normal course of business. Various audit procedures can be adopted in response to these risks, but the appropriateness of these will vary on a case-by-case basis.

37. Auditors may be assisted by the inclusion of further examples in the application material or appendices as well as procedures that may not be required but which could nonetheless be potentially useful to auditors when considering other fraud risks such as off-balance sheet financing or the capitalisation of intangible assets. Such examples should emphasise the importance of the underlying commercial substance to an arrangement or transaction, not merely its legal form.

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?

38. We believe that it is unclear what the ISA (UK) 240 triggers are for referring to ISA (UK) 250. It could be argued that any identified fraud should be regarded as non-compliance with the law and considered under ISA (UK) 250. However, is the auditor expected to make this determination and identify the suspect (for example, senior management as an individual or senior management on behalf of the organisation)? Are there certain circumstances where an auditor could fall short of ISA (UK) 250 if there has been a civil fraud that may not meet the definition of a criminal act? It would be helpful to know what

any exceptional circumstances are for withdrawing from an engagement in the context of fraud.

39. Care needs to be taken to ensure the standard does not create a perception of the auditor to be judge and jury.

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 this could be addressed.

40. Yes. The requirements and application material are, in our opinion, sufficiently scalable and applicable to most scenarios, despite different entities and industries having different risks.

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.

41. We note that this amendment seems to be little more than a search and replace of the term 'computer assisted audit techniques' with 'automated tools and techniques' and as such is unlikely to make much practical difference to how the auditor performs their work.

42. However, we consider that it may be beneficial to include some guidance in the appendices on the general principles of computer assisted audit techniques (for example, the how, when and why).

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) *Identifying and Assessing the Risks of Material Misstatement*? If not, please give reasons and indicate the effective date that you would consider appropriate.

43. No. We believe this is an unnecessarily long lead in time for what are relatively minor revisions to the standard. The effective date should be brought forward with early adoption actively encouraged.

44. While we note that this does mean that changes to the auditor's responsibilities will precede those of management and those charged with governance, it will enable the FRC to meet its stated objective 'to act now to address the immediate concerns about the auditor's responsibilities in respect of fraud'[1].

[1] Financial Reporting Council. (18 November 2020). *Consultation Paper and Impact Assessment. Proposal to revise ISA (UK) 240 (Updated January 2020) The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements.* Available from https://www.frc.org.uk/getattachment/f307003a-a7fb-4536-a864-b1e20b7021ab/-;.aspx

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?

45. This requirement already exists but could be strengthened.

46. Discussions relating to '*risks to the audited organisations*' are necessary conversations to have with those charged with governance (including audit committees). In order for such conversations to be meaningful they should be both specific to the entity itself and the sector it works within and should provide the auditor with the opportunity to challenge management about what they have done to assess the risk of fraud to their business and to prevent and detect it. These conversations could then be used by management and/or audit committees to inform wider internal discussions about the risks of fraud to the business. Such use should be encouraged by the auditor.