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Dear Keith

Consultation Paper: Proposal to revise ISA (UK) 240 (Updated January 2020)

We are pleased to have the opportunity to respond to the FRC's *Proposal to revise ISA (UK) 240 (Updated January 2020) The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements*. We set out below our overall comments on the proposals followed by detailed responses to the questions raised.

General comments

We understand the desire to enhance the requirements in ISA (UK) 240, given the current environment relating to audit quality and fraud and the associated external pressures. We also accept that there is more that auditors can do in relation to fraud, and that in many cases compliance with the current standards could be enhanced. However, we do not feel that the proposals set out in the consultation go far enough to have a meaningful impact on auditor behaviour and will, consequently, not have the desired effect. We do not fundamentally disagree with the proposed changes; indeed on many audits, much of what is proposed is already fairly common practice.

We are concerned that by introducing these amendments to ISA (UK) 240, the FRC may inadvertently widen the expectation gap further unless there is very clear and careful messaging around the limited nature of the enhancements being made. If these enhancements are purported to be in response to external factors such as the Brydon report, the users of financial statements would not unreasonably expect a step change, which is not, in our view, realistic given the nature of the proposals. We would welcome a dialogue between the FRC and Auditors to identify what more can, and should, be done, and indeed what more firms are already doing, to identify and respond to fraud risks.

We support the FRC in making enhancements to ISA (UK) 240; however, we would prefer that more time is taken to make more meaningful changes to the requirements that are more likely to achieve the desired outcomes, similarly to the approach taken to enhancing ISA (UK) 570. In the consultation paper the FRC comments on the potential for forthcoming IAASB review of ISA 240 and the upcoming BEIS consultation following the publication of the Brydon review. We would urge the FRC to delay amendments to ISA (UK) 240 until further progress in these additional projects.

Any enhancements to the auditor's responsibilities relating to fraud should form part of a wider exercise looking at the responsibilities of all parties in the Financial Reporting Ecosystem. This is likely to be the focus of the upcoming BEIS consultation and we would urge the FRC to await the outcome of that exercise before making more substantive changes to the standards.

We are pleased to see the IAASB stressing the importance of all parties involved in the "financial reporting ecosystem" in their recent discussion paper on Fraud and Going Concern. Successful development and implementation of any future improvements can only be achieved through a concerted effort on behalf of all the key players in the financial reporting ecosystem, including auditors, standard setters, regulator, company management and those charged with governance, as well as users of the financial statements. It is not possible for any one constituency to effect substantial change without the support and collaboration of all parties and merely making changes to the auditing standards in isolation is unlikely to make a significant difference, without behavioural change in other parts of the ecosystem and corresponding standards where relevant (e.g. financial reporting standards, changes to requirements in the Corporate Governance Code).

Responses to 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.

Response

As noted in our general comments, the individual proposals are reasonable, and we do not object to the proposals made which may assist in providing greater clarity. Our concern lies around whether making such limited changes will lead to different auditor behaviour and whether such restricted changes might inadvertently lead to a widening of the expectation gap.

We do not consider that the addition to Paragraph 3 is particularly helpful. There is no clear definition of what might constitute a qualitative fraud committed by management and in what circumstances this might lead to a risk of misstatement in the financial statements. This subtle, though potentially important, change needs greater explanation in the application material.

At least some of the expectation gap relating to fraud is explained by the lack of clarity and definitions in the standards – for example, the words highlighted in bold/italics in the text added to Para 10 (below) are all open to interpretation and potential misunderstanding by different parties:

> *An auditor is responsible for obtaining **reasonable assurance** that the financial statements, **taken as a whole**, are free from **material misstatement**, whether cause by fraud or error.*

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.

Response

We have no comments on the majority of the changes other than as follows:

- New Para 15-1 to 15-3: the proposed additions to the team planning meeting discussions are already commonplace and, although we don't object to their inclusion, will not have a significant impact. We are also interested to understand how the requirements in 15-2 will be impacted by upcoming changes to ISA (UK) 600
- New Para 24-1 & 27-1: we have no objection to the requirement to consider whether specialised skills are required in 24-1. However, we are concerned about the proposal in 27-1 requiring a determination as to whether a forensic expert is needed for several reasons:
    - The wording of the requirement appears presumptive, suggesting that it would be difficult for an auditor to justify, say to a regulator, why a specialist was not involved.
    - This, in turn, raises significant concern for applying this requirement in smaller and medium-sized firms that may not have access to relevant expertise.
    - Greater clarity over the definition of a "Forensic Expert" is also required.
    - Great care is needed to avoid unintended consequences in relation to the expectation gap; a forensic specialist's skills lie in the investigation of known or suspected frauds and do not extend to risk assessment and identification of fraud in the first place. It is highly unlikely that using forensic specialists will lead to the identification of more fraud.
    - were such a requirement to remain in the standard, subject to greater clarity in the requirement and application material over when involving an expert might be appropriate, we could support the requirement being restricted to Public Interest Entity engagements and only for a role in the investigation of suspected fraud, not in the risk assessment

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.

Response
See comments elsewhere where we highlight areas where greater clarity and or guidance would be helpful.

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.

Response
The new paragraphs 12-1 and 13-1 do not introduce new explanation/clarification to support the exercise of professional scepticism; the requirements in 12-1 are already in ISA (UK) 540 and IAS (UK) 315, while 13-1 merely emphasises the importance of staying alert to records or documents that may not be authentic.

We believe that auditors would benefit from assistance in effectively challenging management through better standards, application material, training and guidance, including emphasising different types of bias and how these may be manifested in an audit.

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.

Response
There are no other areas where we would suggest establishing a rebuttable presumption.

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.

Response
We believe that this is an area worthy of greater consideration and is another reason why we feel that delaying further amendments to the standard until more meaningful enhancements can be made. The requirements and application material relating to Paragraph 32(a) are somewhat dated. Many auditors have moved, or are moving, to adopting technology and new techniques of testing journal entries. We would welcome dialogue between the FRC and auditors to identify how the requirements in ISA240.31-33 can best be addressed using technology.

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?

Response
Although these two standards are closely related, we believe that the interaction between them is sufficiently 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.

Response
Scalability is an increasing challenge in a world where enhancing requirements for Public Interest Entities and larger, more complex organisations is increasingly important, whilst the majority of audit engagements are undertaken on smaller, less complex organisations. To that end, we look forward to the IAASB's LCE auditing standard proposals. In the meantime, scalability remains an issue with regard to ISA (UK) 240 in a number of areas, including that the same requirements apply to management override of controls in owner managed business and PIEs, including journal entry testing.

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.

Response
We believe that there is scope for significant additional guidance, and potential enhancements to the standards, in relation to the use of technology in the audit, both in relation to fraud and more generally. There remains a debate about the use of technology in the audit and whether technology and techniques such as data analytics represent risk assessment procedures and/or further audit procedures providing substantive

audit evidence. We would welcome a clear view within standards to what extent technology and automated tools and techniques can be used to provide substantive audit evidence. Furthermore, clarity over the acceptability of advanced technology such as Artificial Intelligence and Machine Learning as sources of audit evidence would help auditors explore the use of such technology.

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.

Response
We have no comments on the proposed effective date, subject to our concerns expressed elsewhere.

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?

Response
The addition of this requirement is reasonable. However, we would recommend that a corresponding requirement is placed on company Directors to reflect their responsibility.

Yours faithfully

[redacted]

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