Quoted Companies Alliance

6 Kinghorn Street
London EC1A 7HW

T +44 (0)20 7600 3745
mail@theqca.com

www.theqca.com

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

AAT@frc.org.uk

Friday 29 January 2021

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 respond to your consultation on the revisions to the auditing standard on the auditor's responsibilities relating to fraud.

The Quoted Companies Alliance *Accounting, Auditing and Financial Reporting Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

The QCA is the independent membership organisation that represents the interests of small to mid-sized quoted companies. As part of this, the QCA seeks to support smaller listed entities as preparers of financial statements. From the perspective of these preparers, it is important to consider the balance between the additional costs to the preparers of a more robust audit regime, on the one hand, and the benefit to investors, on the other hand.

Therefore, and whilst we support a more robust audit regime, it is important to ensure that sufficient guidance is put in place in order to assist the auditors of smaller listed entities in achieving these objectives in a more cost-effective and scalable manner.

Furthermore, it is important that the FRC does not inadvertently widen the expectations gap with the proposed amendments. For instance, the proposed involvement of forensic experts risks creating an impression that turns an audit into a fraud-detecting mission, which it can never be.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

[redacted]

Tim Ward
Chief Executive

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.

No – we do not consider that the revisions to the auditor's obligations relating to fraud in the audit of financial statements go far enough.

We acknowledge that the proposed changes do provide an element of clarity to the auditor's obligations in respect of fraud within the financial statements. However, the recommendation raised by Sir Donald Brydon should be taken as a whole rather than piecemeal. To fully address the lack of understanding on the auditor's responsibilities in this regard will need more than just clarification paragraphs added to a Standard which only auditors will read and apply. It needs a clear understanding to be obtained by all relevant stakeholders, including the audited entity itself, to fully address the expectations gap of what an auditor is obliged to do in respect of fraud, what that actually entails and the level of assurance that can be attributed to it. It appears from the changes proposed to date that the clarifications are more a reminder of the expectations of auditors in performing their audit work (i.e. stand back requirement, greater discussions with management and between the audit team) rather than additional tests that need to be performed.

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.

No – we do not believe that appropriate enhancements have been made in order to promote a more consistent and robust approach to the auditor's responsibilities in relation to fraud. We are of this opinion because the insertions by the FRC – in relation to the requirements for the identification and assessment of risk of material misstatement due to fraud, and the procedures to respond to those risks – are generic. The enhancements also fail to include an element of scalability for the differing levels of complexity of the entities subject to audit, especially in the SME space.

As a result of the auditor's external position to the company, it is not possible to expect an auditor to understand and have the same knowledge of a company as the directors and management who are responsible for running the entity. For this reason, the auditor is required to obtain an understanding of the fraud risk factors relevant to an entity and will have to acquire this information principally from the management of that entity. However, it is not acknowledged by the FRC that the person who is responsible for dealing with allegations of fraud raised by employees may also be the same individual the FRC would attribute to be a key person within the management framework who could perpetuate a fraud. There appears to be no acknowledgement of this within the revisions.

It is imperative that the FRC demonstrates its understanding of the differing structures of small and mid-sized entities compared to larger entities, such as those in the FTSE 100, and ensure an element of scalability is reflected within the 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.

No – we do not believe that appropriate enhancements have been made to the application material.

Given that there have only been minor additions to the application material supporting the requirements, since the standard underwent a major revision in 2004, enhancements to this material are much needed in order to help the auditor identify and assess the risks of material misstatement due to fraud.

However, in expanding the application material from the previous version of ISA (UK) 240, we believe it fails to go far enough to clarify the requirements of the body of the Standard. For instance, the inclusion of the comments on automated analytical procedures does not address this emerging area of technology for the performance of audits.

Additionally, the FRC should have taken the opportunity to enhance the requirements of paragraph 32 on journals testing based on their findings from its AQR inspections. For example, explaining exactly how the completeness of journals should be achieved and what constitutes sufficient testing of "unusual journals". Other standard setters (namely those in the US and Canada) provide much more detailed guidance in this regard, and, despite the AQR finding failures, especially in the lower end of the audit firm market, the FRC has missed an opportunity to expand upon the application guidance in this regard as part of the revision.

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.

No – we do not believe that the proposals support the exercise of professional scepticism throughout the risk assessment procedures, the procedures to respond to those risks and the evaluation of audit evidence obtained. Professional scepticism is particularly important when considering the risks of material misstatement due to fraud. It is fundamentally important for the auditor to be able to apply professional scepticism in assessing the reliability and accuracy of the information to be used as audit evidence.

For this reason, we do not believe that the FRC goes far enough. Whilst it has been stated that an auditor should apply professional scepticism, there is no explanation of how an auditor should apply this in practice and what the FRC would expect to see to ensure auditors meet the expectations. The proposals also do not take into account the differing nature and size of entities.

There is a comment included on obtaining evidence from contradictory sources that helps assist, but it is unclear to what extent this needs to be performed and there is a lack of examples from where this evidence can be obtained. The FRC should give examples of how the application of professional scepticism can be achieved in practice in order for their overall objectives in revising the standard to be met.

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.

If the FRC believes that there are other areas of the financial statements that should be subject to the same rebuttable presumption that there are risks of fraud, then the FRC should propose this.

As the rebuttable presumption has been in place for at least a decade, it is unclear why the FRC is asking this question, nor why the FRC is not using its AQR inspection findings to attribute other account balances, transactions or disclosures for which a rebuttable presumption of a fraud risk would apply.

Finally, if the FRC were to propose including other areas in the financial statements for a rebuttable presumption, they must justify this to the audit profession, as the ISAs (UK) already require the auditor to consider whether a risk of material misstatement arises due to management bias or fraud.

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.

In a similar vein to our response to Q5 above, if the FRC believes that there should be further procedures to be performed to respond to the risk of management override, the FRC should propose this based on their inspection findings.

As the FRC has not made substantive changes regarding management override of controls, it is not clear why this question has been posed, particularly when considering that this is the key testing area for a non-rebuttable presumption of a fraud risk. If the FRC's intention with this revision to the Standard is to clarify expectations and the obligations of the auditor in respect of fraud, this question raises doubt. Given that there have been no modifications to the underlying testing requirements, it would appear the FRC believes this addresses the obligations of the auditor in respect of the management override risk of fraud, but this question would suggest otherwise.

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 – we believe that the revisions have clarified the linkages to the changes that have been implemented in respect of ISA (UK) 250 Sections A and B.

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.

No – we do not believe that the requirements and application material are sufficiently scalable, including the ability to apply ISA (UK) 240 to the audits of entities with a wide range of sizes, complexities and circumstances. There appears to be no evidence of this within the guidance and application material. There is one paragraph in the application material for smaller entities (A13), but there have been no revisions made to this and it fails to provide clarity in this regard.

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.

Yes – there is additional guidance the FRC could provide regarding the use of automated tools that would assist auditors in relation to their obligations in relation to fraud. The FRC should have expanded further on what the automated tests involve and how they address the testing requirements for the Standard. This could include, for instance, how they can evidence completeness of the journal population and the testing of any outliers they identify.

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.

Yes – we agree with the proposed effective date of 15 December 2021 on the basis that the changes should be implemented at the same time as amendments to other auditing standards.

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?

Whilst we agree that an additional requirement placed on auditors to have a specific discussion with those charged with governance on the risks of material fraud in the business could enhance risk assessment procedures, we believe that a cost-benefit analysis of the value of this requirement should take place in the first instance. We strongly believe that this extension should not lead to additional costs in the audit fees for small and mid-sized audited entities when there is limited value added.

Furthermore, the FRC should acknowledge that someone charged with governance in small, non-listed businesses can also be the same person who has management responsibilities and thus it would be unclear of the benefit of having this discussion in such circumstances.

Appendix A

The Quoted Companies Alliance *Accounting, Auditing and Financial Reporting Expert Group*

Rochelle Duffy (Chair)	PKF Littlejohn LLP
Elisa Noble (Deputy Chair)	BDO LLP
Edward Beale	Western Selection PLC
Matthew Brazier	Invesco Asset Management Limited
Anna Hicks	Saffery Champness LLP
Mark Hodgkins	Trackwise Designs PLC
Matthew Howells	Smith & Williamson LLP
Michael Hunt	ReNeuron Group PLC
Clive Lovett	Bilby PLC
Laura Mott	Haysmacintyre
Giles Mullins	Grant Thornton UK LLP
James Nayler	Mazars LLP
Matthew Stallabrass	Crowe UK LLP
Helena Watson	KPMG LLP
Peter Westaway	Deloitte LLP