

**Please note: This is the IAASB Fraud Issues Paper that was discussed by the Board at the April 2021 IAASB virtual meeting (Agenda Item 3). This paper is provided to the IAASB CAG Representatives in September 2021 for reference purposes.**

## Fraud in an Audit of Financial Statements

### Objectives of Agenda Item

The objectives of this Agenda Item are to:

- (a) Provide an overview of the feedback received related to fraud in an audit of financial statements from the Discussion Paper (DP), [\*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\*](#); and
- (b) Obtain Board views on the proposed possible way forward on the matters relating to fraud that have been identified.

### Format of the Board Discussion

The Fraud Working Group (WG) Chair will walk through the matters in the order of this Agenda Item. The slide presentation in **Agenda Item 3-B** illustrates the order of discussion, as well as those topics that will be grouped together for Board discussion.

The NVivo reports (attached as **Agenda Items 3-A.1 through 3-A.10**) have been presented as supplements to this Agenda Item and are for reference purposes.

### Summary of IAASB Possible Actions

This Agenda Item summarizes feedback from the DP responses and other information-gathering activities performed to date and provides a possible way forward for each theme or issue identified. The WG has grouped the proposed possible actions, where relevant, by five types of activities. These activities include detailing those that are for the IAASB (i.e., consistent with activities that would be within the remit of the IAASB), and activities for others, as follows:

- Standard-setting (this could involve changes to the requirements or application material);
- Development of non-authoritative materials;
- Education (both by the IAASB and others);
- Further IAASB and WG discussions needed to determine an appropriate way forward; and
- Actions for others.

This approach will assist with developing the draft project proposal later in 2021. For a summary of the themes identified and the related possible way forward, see **Appendix C**.

#### Matters for IAASB Consideration

1. Board members are asked, for each of the themes set out below in this Agenda Item, whether they agree with the proposed possible actions, and if not, why not.
2. Board members are asked whether there is anything further that the WG should consider as it develops the project proposal.

## I. Introduction

1. At the December 2020 IAASB meeting, the WG Chair provided the Board with an update on the information-gathering activities performed through that date regarding identified issues and challenges related to fraud in an audit of financial statements. Information-gathering activities have continued to progress since that meeting. In particular:
  - (a) Additional outreach meetings were held between the IAASB and various stakeholders.
  - (b) Responses to the DP were due on February 1, 2021.
2. This Agenda Item sets out:
  - (a) A summary of outreach meetings held since the December 2020 IAASB meeting (See **section “II. Update on Outreach”** below).
  - (b) A summary of the broad range of stakeholders who responded to the DP as well a summary of the process undertaken to analyze responses (See **section “III. Analysis of Responses to DP”** below).
  - (c) A summary of feedback from DP respondents, together with the other information-gathering activities, organized by broad themes identified. A possible way forward is also included for each theme identified (See **section “IV. Summary of Feedback”** below).

## II. Update on Outreach

3. Since the December 2020 IAASB meeting, the following outreach was performed:

Outreach Group	Date Held	Details
Auditing Section of the American Accounting Association (AAA)	January 15, 2021	Participation by a WG member in a panel discussion focused on fraud and the expectation gap.
European Audit Committee Leadership Network (EACLN) of the Tapestry Network	February 5, 2021	IAASB Chair and staff provided the EACLN with a brief explanation of the IAASB's work on fraud in an audit of financial statements. The EACLN provided their views on concepts discussed in the DP.

Outreach Group	Date Held	Details
<b>Representatives from the Chartered Institute of Public Finance and Accountancy (CIPFA) and the European Court of Auditors (ECA)</b>	February 22, 2021	IAASB staff provided an explanation of the IAASB's work on fraud in an audit of financial statements. The representatives from CIPFA and the ECA provided perspectives relevant to fraud in the public sector.
<b>China Auditing and Assurance Standards Board (including official representatives from the Ministry of Finance and China Securities and Regulatory Commission)</b>	March 13, 2021	A WG member provided an update on the IAASB fraud initiative and high-level observations from the DP responses.
<b>Accountancy Europe</b>	March 22, 2021	IAASB staff provided an update on the fraud and going concern initiatives, including an update of high-level themes from the discussion paper responses. Accountancy Europe representatives provided an update on their fraud and going concern initiatives, noting their recently published publications on these topics and asked stakeholders to respond by April 30, 2021.
<b>Forum of Firms</b>	March 24, 2021	The WG Chair participated as panellist in discussion about fraud and provided brief high-level observations from DP response analysis. Other panellists included representatives from Accountancy Europe, the UK FRC, and a corporate governance representative from Australia.
<b>International Organization of Securities Commission (IOSCO)</b>	March 24, 2021	Board members and IAASB Staff provided IOSCO with high-level observations from the DP response analysis. IOSCO expressed their support for this project and noted the IAASB should consider all possible actions to address issues (whether standard-setting or other actions, such as education or non-authoritative guidance).
<b>International Forum of Independent Audit Regulators (IFIAR)</b>	April 8, 2021	Board members and IAASB Staff provided IOSCO with high-level observations from the DP response analysis. IOSCO expressed their support for this project.
<b>Leadership Team of the Shenzhen Stock Exchange</b>	March 13, 2021	A WG member provided an update on the IAASB fraud initiative and high-level observations from the DP responses.

### III. Analysis of Responses to DP

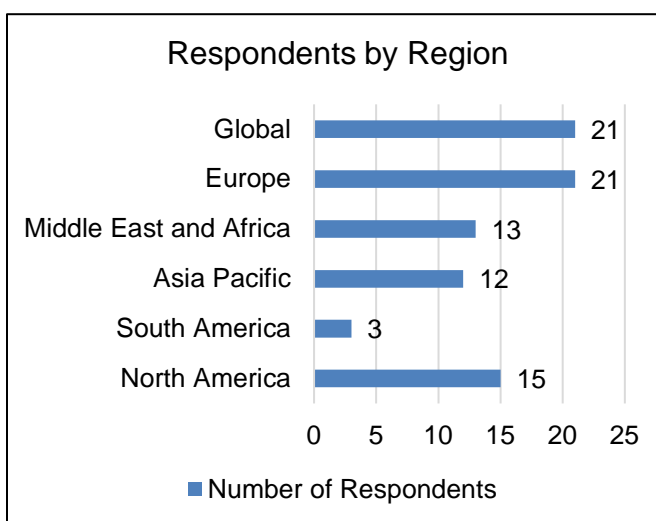
- The DP was published on September 15, 2020 with a response deadline of February 1, 2021.

5. NVivo, a qualitative data analysis tool, was used to assist with the analysis of responses to the DP. The following sets out how the comments have been assimilated to present the matters in section “IV. Summary of Feedback.”
6. The NVivo analysis is provided in nine separate Microsoft Word files (which contain the detailed comments pertaining to each question and broad themes in the DP) (see Supplements to Agenda Item 3-A.1 through 3-A.9) and one Microsoft Excel spreadsheet (see Supplement to Agenda Item 3-A.10) that summarizes the number of responses related to each question and theme.
7. The Excel summary spreadsheet includes separate tabs for each question related to fraud from the DP and summarizes the list of respondents who provided a response related to that question, as well as broad themes. Each Excel tab links back to a Microsoft Word report generated using NVivo (i.e., Agenda Items 3-A.1 through 3-A.9). The Excel document provides context about the amount of respondents who commented related to each broad theme, organized by stakeholder group.
8. Each NVivo Microsoft Word report contains the respondents’ answers relating to a specific question from the DP. Matters noted within this Agenda Item summarized from respondents’ comments can be traced back to the individual comments made in the NVivo Microsoft Word report. References to the corresponding NVivo reports are included for each theme discussed in “section IV. Summary of Feedback.”
9. A listing of the relevant individual NVivo reports and the corresponding Excel spreadsheet can be found in **Appendix A**.

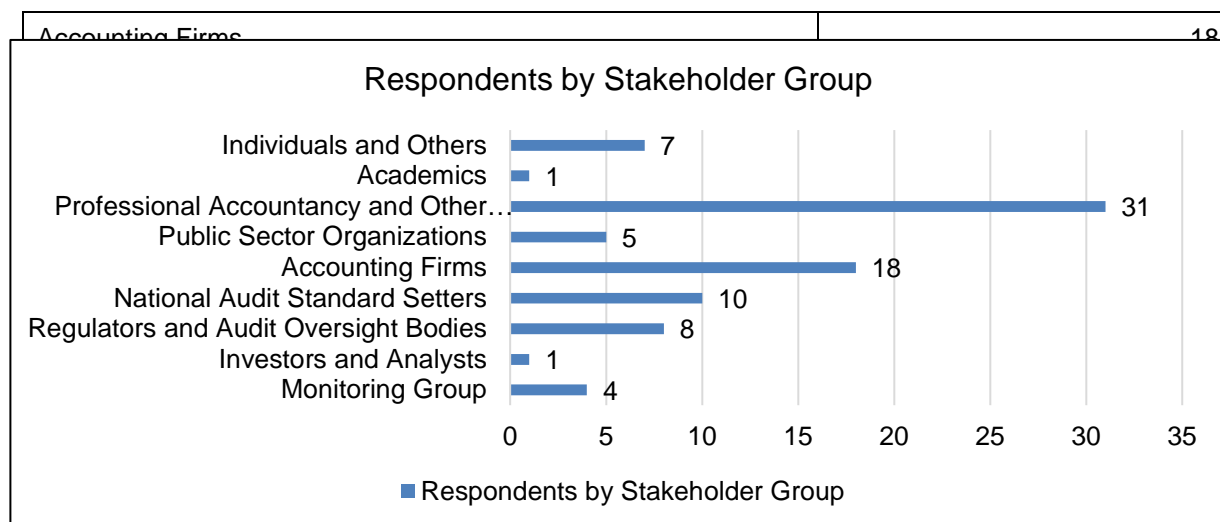
#### *Summary of DP Respondents*

10. The IAASB received 85 responses from a broad range of stakeholders, summarized by geographical area and stakeholder group below:

Respondents by Region	
Global	21
Europe	21
Middle East and Africa	13
Asia Pacific	12
South America	3
North America	15
<b>Total</b>	<b>85</b>



Respondents by Stakeholder Group	
Monitoring Group	4
Regulators and Audit Oversight Authorities	8
National Audit Standard Setters	10



11. The respondents represent a wide cross-sectional representation, both in terms of stakeholder group and geographical distribution.
12. **Appendix B** to this paper includes the full list of respondents to the DP.

#### IV. Summary of Feedback

13. The purpose of this section is to summarize responses from the DP, together with feedback from outreach to date, by themes identified. These themes, are organized into broad areas as follows:
  - (a) Areas where the WG recommends standard-setting (modifications to requirements or application material) (see **Section A** below);
  - (b) Areas where further WG (and Board) discussion is needed to determine the appropriate way forward (see **Section B** below);<sup>1</sup>
  - (c) Areas where the WG recommends non-authoritative guidance (see **Section C** below);
  - (d) Areas where no further action is recommended by the WG (see **Section D** below); and
  - (e) Other matters and general comments from respondents (see **Section E** below).
14. The WG has provided a possible path forward for each theme at the end of each sub-section. A symbol is denoted at the top of each sub-section which indicates the various Board activities that could be undertaken on that theme. The symbols are as follows:

<sup>1</sup> It is intended that the matters within this section will be further explored for an appropriate way forward and brought to the IAASB for discussion in June and July 2021.

Symbol	Description
<b>R</b>	<b>Standard-Setting (Requirements)</b> – New or changed requirements in the ISA(s).
<b>A</b>	<b>Standard-Setting (Application Material)</b> – Changed or additional application material to clarify or further explain application of the relevant requirement.
<b>G</b>	<b>Non-Authoritative material</b> – Supporting materials and guidance developed outside of the ISAs.
<b>E</b>	<b>Education</b> – Educational initiatives or outreach (where within the remit of the IAASB)
<b>O</b>	<b>Actions for others</b> - Where an issue or challenge has been identified, but it does not relate to actions that are within the IAASB's remit and will need efforts from another participant in the financial reporting ecosystem to address it.
<b>D</b>	<b>More discussion needed</b> – Further WG and Board discussions needed to explore the path forward

## A. Standard-Setting

15. The following section summarizes the feedback from DP respondents about possible areas for enhancement where the possible actions are likely to include standard-setting (modifications to requirements or application material). Where further exploration of an aspect of a topic is needed before standard-setting is proposed, this has been specifically noted.
16. The WG will consider scalability and proportionality in accordance with the principles and guidelines that are being developed by the IAASB CUSP<sup>2</sup> workstream.

### General Feedback about Whether Enhancements Should be Required for All Audits or in Certain Circumstances

#### *What We Heard from DP Respondents:*

17. In response to specific DP questions about whether changes should apply to all audits or only in specific circumstances, there were mixed views as to whether any enhanced or additional requirements should be required for all audits or only for certain entities or in specific circumstances. Where respondents commented on this issue for a specific proposed enhancement (e.g., forensic specialists), this is detailed further in subsequent sections as appropriate.
18. Where respondents commented more generally on the applicability of enhanced requirements, the following themes were noted:
  - (a) Where there was support for conditionality of enhanced requirements based on the nature of the entity, respondents commented that enhanced requirements should be required for listed entities or other public interest entities, certain regulated entities (e.g., financial institutions), public sector entities, or entities determined to be high risk.

<sup>2</sup> Complexity, Understandability, Scalability and Proportionality (CUSP)

- (b) Other respondents expressed support for requiring certain enhanced procedures only when fraud is suspected or identified or where there is a high risk of fraud. For example, it was suggested that a requirement may be added to require the use of forensic specialists only when fraud is suspected or identified.
  - (c) Where respondents commented that enhancements should be required for all audits, the reasons expressed were that fraud occurs at all types of entities, and therefore requirements should be written in a scalable and proportionate manner that can be applied to all entities. These respondents noted that the standard should allow for flexibility so that judgment can be used to determine if additional procedures are warranted based on the circumstances of the entity and the audit. Respondents also commented that requiring different levels of procedures for different entities may widen the expectation gap, further contributing to a knowledge gap around the scope of a financial statement audit.
19. Respondent feedback about whether possible enhancements should be required for all audits or only in certain circumstances was considered by the WG for each individual theme identified.

### **Stronger Linkages to Risk Identification and Assessment (ISA 315 (Revised 2019)<sup>3</sup>)**



#### **Risk Assessment Procedures and Related Activities**

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-07 - Yes - Linkages to ISA 315 (Revised 2019)”):*

20. Respondents supportive of enhancements suggested:
- (a) More robust risk assessment procedures, in addition to inquiry (e.g., requirements to perform specific observations and inspection).
  - (b) Emphasizing the importance of making inquiries of individuals within the internal audit function (if the function exists).
  - (c) Emphasizing the importance for the auditor to follow up when responses to inquiries of management and those charged with governance (TCWG) are implausible or inconsistent (e.g., business rationale behind transactions).

#### **Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity's System of Internal Control**

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-07 - Yes - Linkages to ISA 315 (Revised 2019)”):*

21. Respondents supported enhancements to emphasize the importance of obtaining and documenting a thorough understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control (which impacts the identification and assessment of material misstatements due to fraud and specific responses to those assessed fraud risks):

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<sup>3</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

- (a) The entity and its environment, and the applicable financial reporting framework:
  - (i) It was noted that an in-depth knowledge of the entity, its industry and environment are required to effectively identify fraud risk factors (i.e., fraud-indicators or “red flags”).
  - (ii) The importance of understanding the entity’s financial reporting policies in connection with the applicable financial reporting framework was highlighted.
  - (iii) It was suggested that the auditor engage with senior personnel from other relevant business units of the entity and assign more senior members of the engagement team when obtaining the necessary understanding. The respondent observed that the seniority of the engagement team member and the entity personnel involved greatly affects the quality of insights gained towards the necessary understanding.
  - (iv) Respondents encouraged an emphasis on the information from the auditor’s procedures regarding acceptance or continuance of the client relationship or the audit engagement may include information directly relevant to the identification of fraud risks.
  - (v) A respondent suggested expanding on how the understanding of the elements of the business model (as outlined in Appendix 1 of ISA 315 (Revised 2019)) can give rise to fraud risk factors that may need to be considered by the auditor.
- (b) The entity’s risk assessment process and the entity’s process to monitor the system of internal control:
  - (i) It was encouraged to consider clarifying that the understanding obtained under ISA 315 (Revised 2019) includes how such processes of the entity address fraud risks, and how the auditor’s evaluation of such processes impacts the identification and assessment of risks of material misstatement due to fraud.
- (c) The entity’s information system and communication:
  - (i) It was observed that ISA 315 (Revised 2019) is not sufficiently clear to enable the auditor to identify instances of management override of controls, such as the integration between sub-ledgers and general ledgers, the sources of the types of different journal entries, as well as the access and authorization rights of different individuals that post journal entries.
  - (ii) It was suggested that the linkage between paragraph 18 of extant ISA 315 (Revised) (which relates to the understanding of the information system, including related business processes, relevant to financial reporting) and paragraph 33 of extant ISA 240 (which relates to the audit procedures responsive to risks related to management override of controls) is clarified.
- (d) The entity’s control activities:
  - (i) It was suggested controls designed to prevent or detect fraud (e.g., fraud risk management programs and controls that operate above the transactional level such as whistleblower programs, internal audit departments, or controls similar to those set out in the Committee of Sponsoring Organizations of the Treadway Commission (COSO)



fraud risk management guide) are more explicitly identified or focused on (e.g., add specific requirement to evaluate the design and implementation of such controls).

*Input from Other Information-Gathering Activities:*

22. The following input was gathered from other information-gathering activities:

- (a) Expectation Gap Roundtable – During a roundtable facilitated by the IAASB in September 2020, participants noted that the IAASB should consider more robust requirements around testing internal controls but acknowledged this would also require increased requirements for management around internal controls.
- (b) Association of Certified Fraud Examiners (ACFE) [Report to the Nations 2020](#):
  - (i) This report summarizes the results of a study on the costs and effects of occupational fraud based on data from 2,504 of cases of fraud across 125 countries. Based the results of the study:
    - a. A lack of internal controls contributed to nearly one-third of frauds.
    - b. The presence of anti-fraud controls is associated with lower fraud losses and quicker detection.
    - c. Smaller companies are more likely to lack internal controls, while larger companies are more likely to have controls overridden.
    - d. Poor tone at the top was the primary risk factor in 22% of all financial statement frauds.
    - e. 51% of frauds were committed by two or more fraudsters working in collusion. Losses tended to increase with multiple perpetrators—particularly when three or more individuals conspired to commit fraud.
- (c) Fraud Canadian Public Accountability Board (CPAB) Publication - CPAB Exchange: “[An auditor’s responsibilities related to fraud in an audit of financial statements](#)”
  - (i) CPAB notes that evaluating the effectiveness of whistleblower hotlines contributes to an auditor’s understanding of the tone at the top of the company, including the importance placed on ethical conduct.
- (d) Academic report, “Internal Control Weaknesses and Financial Reporting Fraud” - Donelson, D. C., Ege, M. S., & McInnis, J. M. (2017)
  - (i) This academic study finds a statistically and economically significant association between material weaknesses in internal controls over financial reporting (as defined under PCAOB Auditing Standard No. 5) and the future revelation of fraud. This association is driven entirely by instances where the internal control issue reflects a general opportunity to commit fraud (as captured by entity-level material weaknesses) rather than account- or process-specific control deficiencies.
- (e) Academic report, “Financial Reporting Fraud: Public and Private Companies” - Fleming, A. S., Riley Jr., R. A., Hermanson, D. R., & Kranacher, M.-J. (2016)

- (i) This academic study reveals that public companies have stronger anti-fraud environments, are more likely to have frauds that involve timing differences, tend to experience larger frauds, have frauds that involve a larger number of perpetrators, and are less likely to have frauds that are discovered by accident. It states that overall, it appears that the stronger anti-fraud environment in public companies leads public company financial reporting fraud perpetrators to use less obvious fraud methods (i.e., timing differences) and to involve larger fraud teams to circumvent the controls. These public company frauds are larger than in private companies, and their larger size may make them more likely to be detected through formal means, rather than by accident.
- (f) Academic report, “A Synthesis of Fraud-Related Research” – Trompeter, Carpenter, Desai, Jones and Riley (2013)
  - (i) This report synthesizes academic research related to fraudulent financial reporting. It references one study (Van De Bunt 2010) that argues there are three major factors that adversely affect fraud detection: lack of supervision, successful concealment efforts, and silence maintained in social environments. These factors suggest the importance of tone-at-the-top, strong oversight, segregation of duties, and a healthy corporate culture with an emphasis on openness and transparency. Further, anti-fraud professionals must rely on detection controls and oversight mechanisms to reduce the risk of collusive fraudulent behavior (Dorminey et al. 2012).
  - (ii) The report also references a study (Hogan et al. 2008) that finds weak corporate governance is associated with a greater likelihood of fraudulent reporting.

#### Identifying and Assessing the Risks of Material Misstatement

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-07 - Yes - Linkages to ISA 315 (Revised 2019)”):*

##### Monitoring Group Member

- 23. A Monitoring Group member was supportive of enhancements focusing on fraud risk factors, questioned whether the extant requirement to determine that a risk of material misstatement due to fraud as a significant risk is understood correctly in practice, and whether the current practice when responding to a significant risk of material misstatement due to fraud focuses too much on journal entry testing.

##### Other Respondents

- 24. Respondents supportive of enhancements to strengthen the link between ISA 315 (Revised 2019) and ISA 240 suggested enhancing the requirements for identifying and assessing risks of material misstatement due to fraud, for example, by:
  - (a) Emphasizing that the auditor should focus on fraud risk factors specific to the entity and its circumstances (e.g., management compensation tied to financial metrics meeting analysts' expectations), as well as consider fraud risk factors in all areas (not just in the areas of revenue recognition and / or journal entries).

- (b) Updating Appendix 1: Examples of Fraud Risk Factors in ISA 240 using insights obtained from recent corporate failures, academic analysis and research, emerging fraud schemes and considerations related to evolving technology, or elevating the importance of fraud risk factors by relocating to include the fraud risk factors in the application material of ISA 240.
- (c) Considering whether the connection between fraud risk factors and the identification and assessment of risks of material misstatement at the financial and assertion levels is adequate.
- (d) Clarifying when indications for material misstatements due to fraud in the financial statements or fraud risk factors are strong enough for auditors to need to take further measures.
- (e) Requiring the participation of more experienced personnel when identifying and assessing areas more prone to fraud risk, in the documentation of the fraud risk identification, and in the design and execution of procedures addressing such risks.

*Input from Other Information-Gathering Activities:*

25. The following input was obtained from other information-gathering activities related to the auditor's fraud risk assessment:

- (a) May 2020 National Standard Setters (NSS) Meeting
  - (i) Participants noted that greater clarity is needed on how to appropriately assess and respond to risks from different revenue streams.
  - (ii) Participants noted there should be improved connection between the identification of fraud risk factors and the identification and assessment of risks of material misstatement due to fraud.
  - (iii) Participants noted that there should be better integration of the consideration of fraud risk into all aspects of the audit.
- (b) Clarity Post-Implementation Monitoring Project
  - (i) Respondents expressed concern with the effectiveness of both the design and performance of audit procedures intended to respond to an identified risk of material misstatement due to fraud at the assertion level. In many cases auditors do not clearly link the fraud risks identified to the specific procedures intended to respond to those fraud risks.
  - (ii) Respondents noted that there is a tendency to raise significant risks around all assertions of provisions, estimates and revenue streams as opposed to designing audit procedures to test areas where significant risks truly exist. It was noted that more guidance is needed to strike a balance and ensure auditors respond appropriately to the identified risk of management override of controls.
- (c) Less Complex Entities (LCE) Roundtable – On October 7, 2020, the IAASB facilitated a roundtable with global experts to discuss challenges related to fraud and going concern procedures in audits of LCEs. Further details about the take-aways from the discussion were published in a document titled “[Summary of Key Take-aways: IAASB Fraud and Going Concern Roundtables](#).” Participants discussed the nature of fraud perpetrated in LCEs, for which the key take-aways are detailed below:

- (i) While both types of fraud are committed in LCEs, fraud related to misappropriation of assets is more commonly seen in practice in LCEs than financial reporting fraud.
- (ii) Certain fraud risk factors may be more prevalent in LCEs because pressures, opportunities, and rationalizations are different as compared to more complex entities. Fraud is not unique to LCEs, but the circumstances giving rise to fraud may be. The following points were discussed related to each component of the fraud triangle:
  - a. Opportunities
    - i. LCEs often have less anti-fraud controls (e.g., whistleblower hotlines, internal audit function, etc.). They also typically have less employees and therefore less segregation of duties. As such, there may be greater opportunity to commit fraud than in more complex entities.
  - b. Pressures/Incentives
    - i. Owner-managers may have different pressures than management of more complex entities.
    - ii. For example, in LCEs, owner-managers may feel pressure to understate revenue in order to reduce tax liabilities (as compared to more complex entities, where earnings may be tied to performance metrics and the resulting incentive is to overstate revenue).
    - iii. In other cases, there may be pressure to renew, or obtain additional, financing from stakeholders and therefore there may be pressure to overstate revenue in order to demonstrate profitability and long-term viability.
  - c. Rationalization
    - i. Owners of LCEs often take a lot of pride in their companies and in their employees as they may have started the company from the ground up. Therefore, if the company is going through a difficult time, they may rationalize the perpetration of fraud to help the company survive.
- (iii) Similarly, certain fraud risk factors may be less prevalent in LCEs as compared to more complex entities. For example, certain characteristics that may indicate fraudulent activities, such as journal entries posted outside normal business hours, may be normal operating practices for certain LCEs.
- (iv) Frauds may be perpetrated by trusted employees.
- (d) LCE Discussion Paper
  - (i) Respondents commented that Management of an LCE may not have structured fraud risk assessments or even processes for identifying and responding to fraud risk. In those cases, this imposes a challenge on the auditors to respond to the assessed risk of material misstatement due to fraud.
- (d) CPAB Exchange Publication titled “An auditor’s responsibilities related to fraud in an audit of financial statements”

- (i) CPAB noted that “In more than half of the audits we inspected, auditors evaluated aspects of the company’s fraud risk management program to inform their fraud risk assessments. Procedures included evaluations of code of conduct, communications and related sign-offs by employees, processes in place to investigate fraud and take corrective action, and the quality of oversight exercised by audit committees over the program. These procedures assist auditors to obtain an understanding of the strengths and weaknesses of a company’s fraud risk management and where opportunities exist for internal controls to be circumvented and for fraud to occur.”
- (e) Academic report, "The Role of Power in Financial Statement Fraud Schemes" - Albrecht, C., Holland, D., Malagueño, R., Dolan, S., & Tzafrir, S. (2015)
  - (i) While the fraud triangle explains why a single individual becomes involved in financial statement fraud, the theory does not inform us as to how large groups of individuals become involved. The fraud triangle is limited in that it only provides a psychological glimpse of a single person’s perceptions, and why he or she may choose to participate in fraudulent behavior through pressure, opportunity, and rationalization. This academic report presents the following propositions which link types of power to the components of the fraud triangle:
    - a. Personal Power and its Relation to the Fraud Triangle:
      - (i) The more personal power that an individual has, the less likely he or she is to perceive external pressure to perpetrate a financial statement fraud.
      - (ii) The more personal power that an individual has, the more likely he or she is to perceive an opportunity to perpetrate a financial statement fraud.
      - (iii) The more personal power that an individual has, the more likely he or she will develop rationalizations for perpetrating a financial statement fraud.
    - b. Types of Social Power Most Effective to Drive Collusion in Each Component of Fraud Triangle
      - i. Reward power (ability to convince potential co-conspirator that he or she will be rewarded for participation) and coercive power (ability to make the potential co-conspirator perceive punishment if they do not participate) are the most effective forms of social power that may be used to apply pressure on potential co-conspirators.
      - ii. Expert power (ability of the conspirator to use influence through means of expertise or knowledge) and legitimate power (ability of Person A to convince Person B that A truly does have real power over them) are the most effective forms of social power that may be used to increase the perception of opportunity for potential co-conspirators.
      - iii. Referent power (ability of the conspirator to relate to the target of influence (co-conspirators)), legitimate power, and expert power are the most effective forms of social power that may be used to help potential co-conspirators form satisfactory rationalizations regarding fraudulent behavior.

- (f) Academic report, “Detecting and Predicting Financial Statement Fraud: The Effectiveness of the Fraud Triangle and SAS No.99” - Skousen, C. J., Smith, K. R., & Wright, C. J. (2009)
  - (i) This academic study examines the fraud risk factor framework adopted in SAS No.99 in detection of financial statement fraud. The following were found to be significantly related to detecting fraud:
    - a. Five financial ratios used as proxies for pressure (ratios that indicate external pressure, for example, the need for external financing, or ratios that indicate personal financial need, such as cumulative percentage of ownership in the firm held by insiders)
    - b. Two measures used as a proxy for opportunity:
      - i. The percentage of audit committee members who are independent of the company.
      - ii. Indicators that the chairperson of the board holds the position of CEO or president.
- (g) Academic report, “Framework for Detecting Risk of Financial Statement Fraud: Mapping the Fraudulent Environment” - Murcia, F. D.-R., & Borba, J. A. (2007)
  - (i) This academic study constructs a framework of “red flags” to detect the risk of financial statement fraud.

#### Understanding the Control Environment, Including Corporate Culture

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.8, Subheading “Q4.1 - 13 Fraud - Corporate culture”):*

##### Monitoring Group Member

- 26. A Monitoring Group member noted that it may be helpful for auditors to consider the extent to which there might be signs in governance, internal controls or corporate culture that might point to the increased risk of both financial and non-financial fraud that are material.

##### Other Respondents

- 27. The following include other respondents’ suggestions and observations on the entity’s control environment, including corporate culture:
  - (a) It was strongly suggested that more attention be paid by auditors to the entity’s control environment (i.e., culture and behavior (e.g., values and ethical behaviors), ‘soft controls,’ ‘tone at the top’ and programs that are fraud related such as whistleblower programs). The importance of understanding these aspects of the control environment at the acceptance of an engagement was also highlighted.
  - (b) It was noted that assessments of corporate culture are critical to informing management, internal audit, the audit committee, and the external auditor in their assessments of fraud risk, but it was also recognized that the subtler aspects of culture make it hard to audit in a more formal way.

- (c) It was suggested that the auditor adapt the nature, timing and extent of the fraud risk identification and assessment procedures directly in response to their understanding of the control environment.
  - (d) The IAASB was encouraged to explore whether auditors may need to consider certain kinds of corporate cultures (or aspects thereof) as potential fraud risk factors.
  - (e) The IAASB was encouraged to consider additional procedures in response to the possible impact of corporate culture on fraudulent financial reporting, including using computer-assisted audit techniques to identify conflict of interest due to relationships between management and suppliers or customers.
  - (f) It was suggested that auditors may benefit from guidance on:
    - (i) The aspects of an entity's culture to specifically consider in order to perform a more effective evaluation of whether management, with the oversight of TCWG, has created and maintained a culture of honesty and ethical behavior (as required by ISA 315 (Revised 2019)); and
    - (ii) How auditors should respond, including communication with TCWG, when weaknesses in the control environment are identified in conjunction with a required evaluation of the entity's culture for the risk of management override and the identification of other fraud risks.
  - (g) It was suggested developing guidance on corporate culture including consideration of:
    - (i) "Definition of the desired culture – has the desired culture been communicated?
    - (ii) Embedment– has the desired culture been embedded into every part of the organization? What evidence supports this?
    - (iii) Monitoring and measurement – how are the board and senior management monitoring culture? What evidence supports this?
    - (iv) Governance – how does the board and TCWG oversee this? What evidence supports this?"
  - (h) Enhancements to auditor's procedures relating to corporate culture were suggested to complement enhancements to the requirements of preparers and TCWG.
  - (i) It was noted that corporate culture would be more effectively addressed as part of a separate assurance engagement on internal controls, rather than specific additional procedures within the audit (although it is not the role of the IAASB to mandate such an engagement).
28. There was also a respondent who does not believe that additional procedures on corporate culture should be considered by the Board at this time.
29. It was encouraged that the new requirements in ISA 315 (Revised 2019) on the control environment are implemented before deciding if further action is needed.

*Input from Other Information-Gathering Activities:*

30. The following input was obtained through other information-gathering activities performed:

- (a) Academic report, “Corporate Culture and the Occurrence of Financial Statement Fraud: A Review of Literature” - Omar, N., Johari, Z. A., & Hasnan, S. (2015)
  - (i) Culture refers to values that are shared by the people in a group and that tend to persist over time even when group membership changes.
  - (ii) All firms have corporate cultures, although some have much “stronger” cultures than others. These cultures can exert a powerful effect on individuals and on performance, especially in a competitive environment.
  - (iii) Employees take their cues from the top. The character of the CEO and other top officers is generally reflected in the character of the entire company. (Biggerstaff, Cicero and Puckett 2014)

**Possible Actions #1—Strengthening the Auditor’s Consideration of Fraud when Identifying and Assessing the Risks of Material Misstatement**

Although consequential and conforming amendments were made to ISA 240 when revising ISA 315 (Revised), there were many areas enhanced in ISA 315 (Revised 2019) to make the standard more robust that may not have been replicated for fraud-specific considerations in ISA 240. The WG is of the view that those enhancements in ISA 315(Revised) should be the focus for any revisions to ISA 240, in particular how to better integrate the auditor’s considerations relating to fraud in the risk identification and assessment process. The WG has the view that such changes could be made through standard-setting by modifying or enhancing the requirements and application material, as necessary, in ISA 240 for the following:

- (a) Making risk assessment procedures more robust by specifically including fraud considerations (e.g., requiring corroborative evidence for inquiries related to fraud).
- (b) Clarifying that risk assessment procedures in ISA 240 are not separate from those in ISA 315 (Revised 2019) (and therefore, should not be performed in ‘silos’).
- (c) Strengthening the link between ISA 240 and the acceptance and continuance process, and linking the information obtained during that process with the auditor’s understanding of the entity and its environment (in particular its corporate culture), and system or internal control, when identifying risks of material misstatement from fraud.
- (d) Describing the auditor’s specific considerations relating to fraud when obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity’s system of internal control in accordance with ISA 315 (Revised 2019), with an emphasis on, for example:
  - (i) The entity’s corporate culture, including for example, how the general business environment impacts the corporate culture when obtaining an understanding of the control environment.
  - (ii) Measures used by management to assess the entity’s financial performance (e.g., key performance indicators (KPIs)).



- (iii) Employee performance measures and incentive compensation policies (e.g., how the CEO, CFO and other executives are paid; whether they are compensated based on stock performance and other KPIs).
- (iv) The entity's risk assessment process for identifying and analyzing fraud risks to achieving the entity's objectives, which forms the basis for how management or TCWG determine how fraud risks are to be managed.
- (v) Specific control activities that management has designed and implemented to prevent and detect fraud, such as the entity's whistleblower programs or other fraud specific controls.
- (e) Updating the fraud risk factors currently included in the Appendix of ISA 240 and considering whether the fraud risk factors should rather be included in the application material to the standard, and how their use can be clarified when performing risk assessment procedures.
- (f) Fraud considerations when identifying and assessing the risks of material misstatement due to fraud, with emphasis on:
  - (i) How fraud risk factors influence the auditor's assessment of the likelihood and magnitude of misstatement for the identified risks of material misstatement due to fraud at the assertion level.
  - (ii) How the degree to which fraud risk factors affect the susceptibility of an assertion to misstatement assists the auditor in appropriately assessing inherent risk for risks of material misstatement due to fraud at the assertion level, and therefore in designing a more precise response to such a fraud risk.
  - (iii) Strengthening the link between the identified and assessed risks of material misstatement due to fraud to further audit procedures addressing those risks.
- (g) Considering examples to illustrate the scalability of the requirements, for example by providing examples that are more relevant to LCEs.

#### Enhanced Transparency with TCWG and Enhanced Linkage to ISA 260<sup>4</sup>



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-05 - Yes - Linkages to ISA 260 (Revised) - Communication with TCWG” and Agenda Item 1-A.7, Subheading “Q2d.1 - Yes - 09 TCWG - Enhanced communications with TCWG”):*

#### Monitoring Group Member

31. A Monitoring Group member supportive of enhancements questioned whether auditors appropriately engage with TCWG. This includes the application of appropriate rigor in determining whom to speak to, whether meetings should include management, whether the auditor is sufficiently considering management bias, and whether the auditor appropriately communicates to TCWG how fraud risks were addressed and results of the relevant audit procedures.

<sup>4</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

## Other Respondents

### 32. Other respondents supportive of enhancements suggested:

- (a) Enhancing the linkages to ISA 260 (Revised) when fraud or suspected fraud is identified.
- (b) Greater two-way communication with TCWG and management by:
  - (i) Requiring the auditor to have a specific discussion with TCWG about the risks of material misstatement arising from fraud in the entity, including those with business sector specific relevance, and including:
    - a. Fraud risks identified and the audit strategy to respond to the identified fraud risks.
    - b. Views of TCWG about fraud risks specific to the entity (including the effects of the entity's corporate culture on fraud risks), and their knowledge of fraud, alleged fraud, or suspected fraud affecting the entity.
    - c. Views of TCWG about management's controls to address fraud risks.
    - d. Inquiries of TCWG whether they are aware of tips or complaints regarding the entity's financial reporting, as well as whether the entity has entered into any significant unusual transactions.
  - (ii) Strengthening the standard by requiring the auditor to evaluate the design and implementation of management's process for identifying and responding to fraud risks and report such evaluation to TCWG.
  - (iii) Requiring the auditor to report to TCWG any potential indicators of management bias.
  - (iv) Requiring the auditor to report all instances of fraud to TCWG, including non-material fraud. Other respondents noted that professional judgment should be applied by the auditor in determining whether other instances of identified or suspected fraud (i.e., fraud not meeting the materiality threshold) should be communicated.
  - (v) For public interest entities (PIEs), requiring the auditor to inform the entity of identified or suspected irregularities, including frauds in connection to the financial statements, and invite the entity to investigate the matter and take appropriate measures to deal with such irregularities in the future. Where the entity does not investigate the matter, requiring the auditor to inform the authorities responsible for investigating such irregularities (e.g., regulatory and / or enforcement authorities).
  - (vi) Requiring the auditor to assess whether fraud remediation measures taken by management are appropriate, and evaluate the impact on the auditor's relationship with the entity.

### *Input from Other Information-Gathering Activities:*

### 33. The following input was obtained from other information-gathering activities performed:

- (a) Expectation Gap Roundtable –Participants highlighted the importance of robust two-way communication between the auditor and TCWG throughout the audit. It was highlighted that communications with TCWG were often only done as the end and may be perceived as 'an

afterthought" when it should be integral to the auditor's procedures throughout. Participants expressed that more effective engagement between these parties would help inform auditors and TCWG in their duties so that they may better challenge management as needed.

- (b) EACLN Outreach Meeting: EACLN representatives expressed that more transparency with TCWG would be a welcome enhancement. However, they cautioned against changing the role of TCWG to a more 'executive type function' through expanding the auditor's requirements to communicate and cooperate with TCWG.

#### **Possible Actions #2—Enhancing the Auditor's Communications with TCWG**

Enhancements could be made through standard-setting by modifying or enhancing the requirements and application material in ISA 240, as well as possible targeted enhancements in ISA 260 (Revised), for communications with TCWG on fraud, with emphasis on the following:

- (a) Greater two-way communication with TCWG and management throughout the audit engagement by:
  - (i) Requiring, in ISA 240, that the auditor has a specific discussion with TCWG (who are independent of management) about the entity's risks of material misstatement due to fraud, including susceptibility to misstatement due to management bias, and corroborating with TCWG inquiries of management regarding:
    - a. Management's assessment of the risk that the financial statements may be materially misstated due to fraud.
    - b. Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to management's attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.
    - c. Management's communication, if any, to TCWG regarding its processes for identifying and responding to the risks of fraud in the entity.
  - (ii) Requiring, in ISA 240, that the auditor assess whether the remediation measures taken by management and TCWG for identified or suspected fraud are appropriate. This assessment will assist in the auditor's conclusion as to whether the auditor has obtained reasonable assurance about whether the financial statements are free from material misstatement due to fraud.
  - (iii) Requiring, in ISA 260 (Revised), that the auditor communicate in writing with TCWG the auditor's responsibilities specific to fraud.
  - (iv) Requiring, in ISA 260 (Revised), that the auditor communicate in writing with TCWG any potential indicators of management bias identified during the audit (for example when dealing with accounting estimates) to allow TCWG to monitor the bias and take appropriate actions, as needed.
- (b) Clarifying in the application material of ISA 240 that effective participation by TCWG is influenced by their independence from management and their ability to evaluate the actions of management, and highlighting the factors that should be considered by the auditor that may

affect the auditor's assessment of risks of material misstatement due to fraud and the associated audit response.

### Closer or Enhanced Linkage to ISA 550<sup>5</sup>



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-14 - Yes - Linkages to ISA 550 - Related parties):*

34. Respondents supportive of enhancements in the standards to strengthen the link between ISA 240 and ISA 550 suggested:
- (a) Including a cross reference to ISA 550 in ISA 240 to emphasize that in obtaining audit evidence regarding the risks of material misstatement due to fraud, the auditor also includes specific consideration of the susceptibility of the financial statements to material misstatement due to fraud that could result from the entity's related party relationships and transactions as noted in paragraph 12 of ISA 550.
  - (b) Enhancing the work performed in ISA 240 to address risks related to related party transactions as it relates to the auditor's responsibilities for fraud.

*Input from Other Information-Gathering Activities:*

35. The following input was obtained from other information-gathering activities.
- (a) Independent Regulatory Board for Auditors' staff Audit Practice Alert 4: A South African Perspective on the Auditor's Considerations Relating to Fraud
    - (i) IRBA published this document which serves to provide auditors with implementation guidance in responding to the risks of material misstatements due to fraud and/or non-compliance with laws or regulations. The document notes that auditors should focus on related party transactions as part of their considerations pertaining to fraud – for example, when performing the audit risk assessment and when considering the nature of journal entries to test – since the risk of fraud between related parties is high.

#### **Possible Action #3—Enhancing ISA 240 to Make the Link to Related Parties Stronger**

Possible actions to strengthen the link to ISA 550 include:

- (a) Standard-setting by enhancing the requirements in ISA 240 to promote the auditor's consideration of related parties when undertaking audit procedures related to fraud.
- (b) Considering what other NSS have done to strengthen the relationship between fraud and related parties, for example in PCAOB Auditing Standard No. 2410: Related Parties.
- (c) Exploring what more can be done to encourage auditor's consideration of related parties when undertaking fraud procedures, for example, through non-authoritative guidance.

<sup>5</sup> ISA 550, *Related Parties*



## Suspicious Mindset and Professional Skepticism

### Suspicious Mindset

*What We Heard from DP Respondents (See NVivo – Agenda Items 1-A.5 and 1-A.6):*

#### Monitoring Group Members

36. A Monitoring Group member suggested performing further research to understand the root causes of the issues that the IAASB expects to be addressed by the introduction of the “suspicious mindset.” Clear linkage to the root cause of the underlying issues will help the IAASB to evaluate whether the introduction of this new concept could result in meaningful improvements to audit quality.
37. Other Monitoring Group members did not support a suspicious mindset but suggested enhancing the existing concept of professional skepticism.
  - (a) It was noted that the difference between a suspicious mindset and a skeptical one is not adequately explained, and so it is not clear that this is a helpful or necessary distinction. Although the auditor mindset is important, it was suggested that this issue might be better addressed through clarification and training on the application of existing requirements rather than the creation of a new concept.
  - (b) Noted that there may be unintended consequences when introducing new terminology (especially if similar in nature to professional skepticism that is universally accepted), which could widen the expectation gap or create confusion for auditors of when and how to apply a suspicious mindset versus professional skepticism during the course of an audit.

#### Other Respondents

38. Other respondents did not generally support a suspicious mindset but suggested enhancing the existing concept of professional skepticism (see suggestions relating to professional skepticism below). Respondents noted the following reasons for not supporting a suspicious mindset:
  - (a) Professional skepticism is adequate and appropriate to describe the quality auditors must possess to be able to respond competently to risks of fraud.
  - (b) While a suspicious mindset may contribute to enhanced fraud identification, the respondent did not believe that this will overcome the practical challenges or the inherent limitations auditors are facing in applying an appropriate mindset.
  - (c) Introducing a new term could exacerbate the expectations gap. It is unclear how using the term “suspicious mindset” would contribute to enhanced fraud identification or add value when planning and performing every audit.
  - (d) Introducing a new concept parallel with that of professional skepticism in ISA 240 might be a source of confusion and translation issues, cause a disproportionate amount of effort on fraud at the expense of consideration of error, be negatively perceived by the management and employees of the audited entity, or could damage the auditor-client relationship.
  - (e) Moving to a concept where the auditor starts from a base of suspicion (or presumptive doubt) could move the financial statement audit toward that of a forensic audit and may not be timely

or cost-effective. This likely requires the traits of a forensic auditor which an external auditor may not be appropriately trained in.

- (f) The standard should rather be clearer about how the auditor responds if they identify or suspect fraud, for example:
  - (i) A specific requirement to determine whether a forensic expert is needed to investigate further.
  - (ii) Enhancing communication requirements, including inviting the entity to investigate further, and informing relevant authorities if the entity does not investigate further. This is an aspect of the auditor's responsibilities that should be considered further in a more fundamental review and revision of the standard.

39. Respondents supportive of a suspicious mindset, including those with specific comments, provided the following views:

- (a) For all audits, the respondents:
  - (i) Suggested enhancing the auditor's considerations with regards to certain accounts of auditees where due to the nature of their business these accounts could be more prone to fraudulent reporting. Examples of procedures to be carried out with a suspicious mindset could be looking for sources of contradictory information which could bring into question certain estimates made by management. This could be required for all audits, but with consideration of whether the accounts and nature of the auditee's business could be indicative of an inherent fraud risk.
  - (ii) Suggested enhancing the auditor's considerations around fraud to include a "suspicious mindset" for all audits. However, the extent and level of application should be based on the risk and materiality assessment of the underlying accounts and assertions. In other words, enhanced procedures should be more extensive for high risk and material items, and less extensive for low-risk items.
  - (iii) Suggested that considerations on professional skepticism and suspicious mindset should be applied consistently across all audits. It was noted that when there is sufficient clarity as to how the auditor navigates between professional skepticism and suspicion, enhanced considerations and / or procedures will then be applied to those instances where there is merit for suspicion.
  - (iv) In the case of identified fraud risks, suggested that auditors should be more suspicious of the authenticity and reliability of audit evidence obtained. It was highlighted that the audit evidence obtained must clearly show how the auditor has implemented the suspicious mindset.
- (b) Only in some circumstances, the respondents:
  - (i) Suggested that a suspicious mindset be applicable only for listed entities that offer their shares publicly and for those that make up lists of public interest entities, in the countries that have this categorization defined.

- (ii) Suggested that a suspicious mindset be applicable based on the nature and circumstances of the entity (e.g., behavior of executives, history of suspicious operations).
- (iii) Noted that it is impossible for the auditor to have a suspicious mindset about all information. Rather, the auditor should act upon contradictory information received and/or when the auditor has doubts about the authenticity of documents.
- (iv) Noted that in the event of suspicion of fraud that could lead to misstatement, the auditor needs to exercise a more suspicious mindset when engaging in audit work. In such a case, it may be determined that there is a high possibility of fraud, and the auditor has to engage in an audit on the premise that the management is dishonest or TCWG are uncooperative.
- (v) Noted that the introduction of a different set of terminology from that used in the past (i.e., skeptical versus suspicious) ensures that auditors' attention is drawn to this matter. There are however downsides to the constructive working relationships needed for an effective audit and should a "suspicious mindset" not be handled correctly this could actually impede the effectiveness of the audit.

*Input from Other Information-Gathering Activities:*

40. The following input was obtained through other information-gathering activities performed.
- (a) Expectation Gap Roundtable – During the roundtable facilitated by the IAASB in September 2020, there was encouragement by some for a move towards a more suspicious or doubtful mindset as opposed to a neutral mindset. However, other participants cautioned the need to also consider how this may impact the auditor-client relationship and did not encourage introduction of a new concept.
  - (b) EACLN Outreach Meeting - EACLN representatives expressed concern with the concept of a suspicious mindset. They commented that this may imply every company is guilty and it cause strained auditor-client relationships that impede the flow of information. In addition, it could create a heightened burden for the auditor with limited potential return.

**Professional Skepticism**

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings "Q2a.1-10 - Yes - Professional skepticism," "Q2a.2 – Mixed response – 03 Professional skepticism," "Q2a.3 - No - 05 Professional skepticism," "Q2a.1-04-07 - Yes - Linkages to ISA 315 (Revised 2019) - Risk assessment," "Q2a.1-04-11 - Yes - Linkages to ISA 500 - Audit evidence," and "Q2a.1-04-13 – Yes – Linkages to ISA 540 (Revised) – Accounting estimates"):*

*Monitoring Group Members*

41. Monitoring Group members supportive of enhancements suggested:
- (a) Considering the use of stronger language (e.g., "challenge, question and reconsider") in ISA 240.

- (b) Considering the use of a “stand-back” requirement by taking into account all evidence obtained in forming conclusions at the end of the audit.
- (c) Considering whether requirements and guidance are sufficiently clear around the exercise of professional skepticism by auditors, including when there are signals that indicate an elevated risk of material misstatement due to fraud.
- (d) Enhancing how professional skepticism is applied in practice throughout the audit.
  - (i) Specific suggestions include:
    - a. Emphasizing in the standard the importance of having the right attitude and a willingness to challenge management. This is especially important for those in charge of the audit to set the tone at the top for their engagement teams. The auditor’s attitude including their willingness to challenge management should become more heightened as risks are identified during the planning and performance of an audit.
    - b. Including in application material “triggering events” where an auditor’s skepticism should be elevated and therefore the nature, timing, and extent of audit procedures are tailored in response to the risk identified.
    - c. Heightening focus in light of how audits are performed in the current virtual environment.
    - d. Encouraging the IAASB to consider how we can work with other stakeholders in the financial reporting system to collectively reinforce the need for, and enhance, professional skepticism throughout an audit (e.g., International Ethics Standards Board for Accountants (“IESBA”) Role and Mindset of a Professional Accountant project).

#### Other Respondents

#### 42. Other respondents supportive of enhancements to professional skepticism suggested:

- (a) Adding a requirement in ISA 240 (similar to those added in ISA 315 (Revised 2019) and ISA 540 (Revised)) to design and perform audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory, including evidencing how contradictory evidence was considered and concluded on.
- (b) Considering a “scaled, spectrum or continuum” approach when exercising professional skepticism (similar to the “spectrum of inherent risk” concept in ISA 315 (Revised 2019)).
  - (i) Where a neutral mindset may be appropriate in certain low-risk circumstances, but presumptive or complete doubt may be warranted in other higher-risk circumstances.
  - (ii) Where it may be appropriate for an auditor and engagement team to apply a heightened level of professional skepticism that treats what they are being told or the information provided by the entity with suspicion – but it is not the starting point for every engagement.



- (c) Adding a “stand-back” requirement in ISA 240 (similar to that included in ISA 315 (Revised 2019)). Specific suggestions included:
- (i) Including in ISA 240 a “stand-back” requirement to evaluate whether the assessment of risks of material misstatement at the assertion level due to fraud remain appropriate and whether sufficient appropriate audit evidence has been obtained regarding the assessed risks of material misstatement due to fraud; and a conclusion of whether the financial statements are materially misstated as a result of fraud.
  - (ii) Clarifying that the “stand-back” requirement in ISA 315 (Revised 2019) to evaluate whether the audit evidence obtained from risk assessment procedures provides an appropriate basis for identification and assessment of the risks of material misstatement also applies with respect to fraud risks.
- (d) Emphasizing the concept of professional skepticism when fraud or suspected fraud is identified and when:
- (i) Auditing areas involving significant judgments (e.g., management estimates relating to future cash flow relevant to the entity’s ability to continue as a going concern).
  - (ii) Evaluating the authenticity of audit evidence (e.g., external confirmations).
- (e) Clarifying the appropriate experience requirements for high-risk areas with consideration that a skeptical mindset is a behavior that comes with experience and application in challenging, not just corroborating the evidence.
- (f) Enhancing how professional skepticism is applied in practice throughout the audit by:
- (i) Further investigating the underpinning issue (i.e., whether the issue is technical clarity that can be addressed through introducing additional requirements around how to apply professional skepticism consistently in practice, or behavioral that can be addressed through additional monitoring and enforcement).
  - (ii) Highlighting the challenges to the application of professional skepticism in practice observed by the Professional Skepticism Working Group, for example:

Environmental factors that influence the ability of the auditor to exercise professional skepticism, for example, tight deadlines, resource constraints and culture.
Personal traits and biases (e.g., independence, confidence, an inquisitive nature and an individual’s response to stress).
Lack of business acumen in a complex and ever-changing business environment.
  - (iii) Looking into the update to AU-C Section 500, Audit Evidence, with various mentions and examples of the concept.
  - (iv) Emphasizing that auditors should bring effective challenge to bear and not accepting explanations at face value.

- (v) Explaining different types of bias, how they manifest themselves during an audit and how they can be addressed when undertaking audits.
  - (vi) Linking from the standard to the Examples of Circumstances that Indicate the Possibility of Fraud, set out in Appendix 3 of ISA 240
43. Other respondents with mixed responses on, or not supportive of, enhancements:
- (a) Did not believe that simply adding further references to professional skepticism in the ISAs will serve to improve auditor performance with respect to its exercise. Whether or not additional requirements or procedures are needed or not ought to be based upon an evidence-based analysis.
  - (b) Noted that extant requirements relating to professional skepticism are sufficient but highlighted that technological transformation could change procedures applying professional skepticism.
  - (c) Observed that using terms such as “enhanced professional skepticism” are not very meaningful.

*Input from Other Information-Gathering Activities:*

44. The following input was obtained from other information-gathering activities performed:
- (a) Expectation Gap Roundtable – During the roundtable facilitated by the IAASB in September 2020, participants called for more robust requirements to encourage auditors to exercise enhanced professional skepticism when undertaking procedures related to fraud in an audit of financial statements. Also, the introduction of a stand-back requirement was encouraged to emphasize that auditors must consider cumulative audit evidence obtained in formulating their conclusions.
  - (b) IAASB Consultation on Proposed Strategy for 2020-2023 and Work Plan for 2020-2021
    - (i) One Monitoring Group respondent commented that there should be clear requirements and guidance in ISA 240 and throughout the standards regarding the exercise of professional skepticism by auditors.
  - (c) Consultation for Proposed ISA 540 (Revised)
    - (i) One commentor noted the IAASB should consider adding a stand back requirement to other ISAs where complexity, judgment and uncertainty come into play, such as ISA 240.
  - (d) Academic report, “Professional Skepticism: The Effects of a Partner’s Influence and the Presence of Fraud on Auditors’ Fraud Judgments and Actions” – Carpenter and Reimers (2011)
    - (i) This academic study concludes that partner emphasis on professional skepticism significantly influences auditors’ fraud risk assessments.
  - (e) Academic report, “The Effect of Fraud Risk Assessment Frequency and Fraud Inquiry Timing on Auditors’ Skeptical Judgements and Actions” - Brasel, K. R., Hatfield, R. C., Nickell, E. B., & Parsons, L. M. (2019)
    - (a) This academic study found that participants exhibited heightened skepticism when re-evaluating fraud risk for a second time. The study also found that fraud inquiries prior to substantive procedures improves skeptical evaluation of evidence, but only if the

auditors also exhibited higher levels of trait skepticism (an individual characteristic, acknowledging that some individuals may be inherently more or less skeptical than others).

- (f) Publication titled "[Enhancing Auditor Professional Skepticism](#)", commissioned by the Global Public Policy Committee (GPPC)
- (i) In this publication, the authors recommend that "Standard setters could work in concert with other key stakeholders to develop a globally recognized framework, together with practical implementation guidance, illustrations, and best practices for the appropriate application and documentation of professional judgment and skepticism across different risk settings."
- (ii) The authors also note that "Current standards are largely written in a positive or confirmatory frame of reference to gather sufficient appropriate evidence to provide support for an assertion. Research in judgment and decision making over the last few decades has demonstrated the power of judgment frames. Standard setters should consider infusing standards with a skeptical frame to encourage an appropriately skeptical mindset on the part of auditors—for example, a standard could encourage auditors to consider "what could go wrong," to make the "opposing case" to management's view, or to seek potentially disconfirming evidence."

**Possible Action #4—Enhancements for Professional Skepticism, Including Views about Suspicious Mindset**

The WG is of the view that:

- (a) The concept of a "suspicious mindset" not be further pursued more broadly in the ISAs, but rather the existing concept of professional skepticism is enhanced as detailed below.
- (b) Further exploring whether limited circumstances may necessitate the use of a 'suspicious mindset,' i.e., determining whether there are elements of the audit that may benefit from a suspicious mindset (This matter will be brought to the IAASB for discussion at the June / July 2021 IAASB meetings).
- (c) There should be no further consideration of a scaled approach to professional skepticism (this has previously been discussed by the IAASB and not further pursued).

Possible actions to enhance the auditor's considerations on professional skepticism include:

- (a) Enhancing the auditor's exercise of professional skepticism in undertaking fraud procedures by exploring whether standard-setting (i.e., requirements and / or application material) is needed and appropriate (e.g., using stronger language such as "challenge," "question," "reconsider" and focusing on management bias). Further consideration of the changes made in ISA 315 (Revised 2019) and ISA 540 (Revised) relating to professional skepticism (i.e., introducing a requirement to consider contradictory and corroborative evidence) could also be considered.
- (b) Developing non-authoritative guidance to illustrate how the specific requirements in the ISAs addressing professional skepticism can be applied. For example, the guidance can illustrate

how to apply the requirement to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory through example scenarios.

- (c) Explaining in ISA 240 how the existing stand back requirements in ISA 220 (Revised) and ISA 315 (Revised 2019) are performed for the auditor's considerations about fraud.

## Journal Entry Testing



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Journal entry testing”):*

45. Respondents commented that further clarity is needed on the objective of journal entry testing, and commented that the IAASB should consider enhancements to improve the consistency with which these procedures are performed.
46. Specific suggestions for enhancements to journal entry testing included:
- (a) Enhancing the linkage to the concepts in ISA 315 (Revised 2019) and emphasizing that the auditor's risk assessment and understanding of management's journal entry process drives the journal entry testing approach. For example, it was noted that the auditor's understanding of the interfaces between sub-ledgers and general ledgers, the sources and types of different journal entries, and restrictions to access should all be considered in determining the nature, timing and extent of journal entry testing to perform.
  - (b) Modernizing ISA 240 to include consideration of recent technology often employed by practitioners to perform journal entry testing (e.g., data analytics):
    - (i) A respondent questioned whether it is feasible to get sufficient appropriate audit evidence over the risk of management override of controls in the absence of being required to obtain and analyze the entire journal entry data set (through data analysis) in these circumstances.
  - (c) Adding an explicit requirement around checking the completeness of the journal entry data population before selecting journal entries for further testing.
  - (d) Considering if the journal entry testing requirements remain fit for purpose. For example, it was noted that the standard requires the auditor to select journal entries and other adjustments made at the end of the reporting period, but only requires consideration of the need to test journal entries and other adjustments throughout the period. Commenters questioned whether it is still appropriate that the requirement is focused on year-end entries and noted the IAASB should consider adding a requirement to test journal entries and other adjustments throughout the period.
  - (e) Considering enhancements to prescribe minimum documentation requirements for journal entry testing procedures.

*Input from Other Information-Gathering Activities:*

47. The following input was obtained from other information-gathering activities performed:

- (a) Clarity Post-Implementation Monitoring Project:
  - (i) Respondents commented that clarity is needed to explain how auditors should apply a risk-based approach to identify the nature of journal entries to test. It was noted that clarity is also needed around the work effort required to test the completeness of journal entries.
  - (ii) Respondents commented that there is inconsistency in how auditors interpret the extent of journal entry testing required – some auditors will test full populations of journal entries at year-end and throughout the year, while others might select only one or two journal entries to meet the requirement.
- (b) LCE Roundtable:
  - (i) Participants questioned whether the minimum requirements in ISA 240 are appropriate in all circumstances for LCEs. While it was acknowledged that certain procedures should be required to ensure an appropriate focus on fraud, the procedures currently required in the standard may not be as effective in all circumstances for LCEs. For example, in certain audits of LCEs, there are so few journal entries throughout the year that all journal entries may have already been captured in other audit procedures. In those circumstances, performing additional journal entry testing to fulfill the requirements of ISA 240 may not be the most effective way to respond to the risk of management override of controls.
- (c) LCE Discussion Paper
  - (i) Respondents commented that it can be challenging to determine an appropriate extent of journal entries testing in LCE audits when there are limited fraud risk criteria identified and non-complex systems are used. It was noted that additional guidance and/or illustrative examples would be helpful to clarify the extent of journal entry testing required in these types of circumstances that are often present in audits of LCEs.
  - (ii) Respondents questioned if the same level of journal entry testing should be mandatory in audits of LCEs, particularly when auditors take a largely substantive approach where journal entries are already tested as part of other audit procedures.
- (d) May 2020 NSS Meeting
  - (i) One participant commented that the requirements for journal entry testing should be revisited to determine if it remains fit for purpose. They also commented that at a minimum, practical guidance should be provided to auditors to clarify the requirements for the nature, timing and extent of testing of journal entries and other adjustments.

### **Possible Action #5—Making the Journal Testing Requirements More Robust**

Possible actions to make journal testing more robust include:

- (a) Standard-setting in ISA 240 (requirements and/or application material) to:
  - (i) Better link the auditor's risk assessment procedures (performed as part of ISA 315 (Revised 2019)) and the approach to journal entry testing.
  - (ii) Modernizing journal entry testing for current circumstances, taking into account how journal entry testing is currently performed and considering the impact of technology on journal entry testing.
  - (iii) Test journal entries throughout the period.
- (b) Consideration of enhancing the application material or non-authoritative guidance to clarify what the auditor's objectives are when testing journal entries, and help auditors understand how to determine the nature, timing and extent of the auditor's procedures related to journal entry testing.
- (c) Consider the impact of any proposed changes being made to ISA 500<sup>6</sup> (for example for testing the completeness of the population of journal entries).

## **Technology**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheadings “Q1b-1 - IAASB - 05 Consider impact of technology” and “Q2a.1-04-11 - Yes - Linkages to ISA 500 - Audit evidence\03 - Yes - Linkages to ISA 500 - Increasing use of data analytics and other automated techniques in audits”):*

### **Monitoring Group**

- 48. One Monitoring Group respondent encouraged the IAASB to explore whether technology has an impact on the ability of management of the entity or others to perpetrate fraud and whether the standard provides sufficient guidance to the auditor about the resulting risks of technology, as well as the opportunities offered by technology to respond to risks.

### **Other Respondents**

- 49. Other respondents commented that ISA 240 should be modernized to consider how technology may be used by the auditor to assess risks of material misstatement due to fraud and perform fraud-related procedures. Respondents noted the increasingly widespread use of data analytics or other technologies to analyze complete sets of data, analyze trends and identify anomalies.
- 50. Respondents emphasized that technology does not replace the human element of an audit. It was noted that professional judgment and professional skepticism will always remain critical components in the execution of audit procedures.
- 51. Respondents also commented that ISA 240 should be modernized to consider how technology may result in additional fraud risks for an entity. Respondents commented that entities are implementing

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<sup>6</sup> ISA 500, *Audit Evidence*

new technology applications at an increasing pace, and without proper governance and controls, this may create further opportunities for fraud. Further, fraudsters have increased opportunities to commit fraud through the use of advanced technologies.

52. Respondents suggested to coordinate with the IAASB Technology Working Group to provide more specific guidance and support materials related to this topic.

*Input from Other Information-Gathering Activities:*

53. The following input was obtained through other information-gathering activities performed:

(a) Technology Roundtable: On September 2, 2020, the IAASB facilitated a roundtable with global experts focused on technology and fraud. Below are the key take-aways from the discussion. In addition, the IAASB published a document "[Summary of Key Take-aways: IAASB Fraud and Going Concern Roundtables](#)" that provides further details.

(i) How Technology is Used to Perpetrate Fraud:

- a. While the nature of many frauds committed today have not significantly changed (e.g., invoice and check tampering), as technology evolves fraudsters are using more sophisticated means to commit those frauds.
- b. Artificial intelligence (AI), robotic processing automation (RPA) and other forms of advanced technology can help detect fraud, but fraudsters can also use them to perpetrate fraud. The impact of these advanced technologies may make companies more vulnerable to fraud. For example, the use of AI or RPA may reduce the number of employees necessary to perform tasks, which may cause issues related to lack of segregation of duties.
- c. Fraudsters disregard relevant regulations when implementing technology and, as such, have greater flexibility in applying it to perpetrate fraud.
- d. Technology used by fraudsters may be specifically designed to evade detection.
- e. Cybersecurity and data security are increasingly important topics in today's environment due to the rise in cybercrime, which can exploit weaknesses in a system of internal control and cause severe reputational damage.

(ii) Technology Used by Financial Statement Auditors

- a. Data extraction and analytics are common types of technology used today for fraud-related procedures in financial statement audits, with other emerging technologies on the way.
- b. With these new tools, auditors are able to more effectively profile the journal entries and target populations to test based on certain risk characteristics (e.g., unusual or seldom-used accounts, entries with a debit to revenue, key word searches, duplicate entries, etc.).
- c. AI and machine learning algorithms can provide auditors with opportunities to review an entire population for anomalies.

- d. Once the technology is in place, auditors can perform procedures faster and more efficiently across many audits and can also run the analysis more frequently as needed or desired (e.g., quarterly instead of annually, thereby increasing effectiveness).
  - e. There are challenges associated with advanced technologies used in financial statement audits, including verification of relevance, reliability, completeness and accuracy of data. Also, automated tools and techniques provide useful insights, but it may be difficult to use as audit evidence if it does not meet the requirements for audit evidence described in ISA 500.
  - f. While technology offers useful tools, it does not replace the human element of an audit.
- (iii) Technology Used in Forensic Audits
- a. Forensic auditors use similar types of advanced technologies as financial statement auditors and use some additional types of technologies used as well, such as predictive coding to automatically review large volumes of documents.
  - b. Similar to financial statement audits, determination of the completeness and accuracy of the data that is used can be challenging.
  - c. Also similar to financial statement audits, technology can help identify anomalies and 'red flags' that require further investigation. However, technology cannot replace professional judgment and professional skepticism that is necessary for auditors to undertake their work and draw conclusions.

#### **Possible Action #6—Enhancing ISA 240 for Advancements in Technology**

Possible actions to modernize ISA 240 for advancements in technology include:

- (a) Modernize and enhance application material in ISA 240 to reflect and describe fraud risks presented by use of modern technology as well as the auditor's use of technology to perform fraud-related procedures (such as more advanced and robust analytical procedures using modern technologies). In doing so, remaining mindful of maintaining a balance of not 'dating' the standard by referring to technologies that may change and evolve;
- (b) Working collaboratively with the Technology Working Group to determine if non-authoritative guidance could be used to support the application of ISA 240; and
- (c) Monitoring technology-related developments in the ISA 500 project.

#### **Non-Material Fraud and Linkage to ISA 320<sup>7</sup>**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-09 - Yes - Non-material fraud,” “Q2a.3 - Mixed response - 02 Non-material fraud,” “Q2a.2 - No - 04 Non-material fraud,” and “Q2a.1-04-08 - Yes - Linkages to ISA 320 - Materiality in planning and performing the audit”):*

<sup>7</sup> ISA 320, *Materiality in Planning and Performing an Audit*



#### Monitoring Group Members

54. A Monitoring Group member noted that it would be helpful for the IAASB to consider whether increasing the responsibility of the auditor is warranted regarding fraud that is not related, or immaterial, to the financial statements, or fraud that seems unrelated but could potentially have a material impact when discovered (e.g., fraudulent product quality certification).
55. A Monitoring Group member, as well as other respondents, suggested clarifying whether the standard provides sufficient guidance to auditors for considering the qualitative and quantitative aspects of fraud (including identified or suspected fraud below the auditor's materiality threshold) when identifying and assessing risks of material misstatement due to fraud.

#### Other Respondents

56. Other respondents supportive of enhancements related to non-material fraud:
  - (a) Noted that it is also important for auditors to communicate with appropriate stakeholders (e.g., TCWG) when non-material fraud is identified.
  - (b) Highlighted that when the auditor identifies a non-material fraud or a circumstance that indicates the possibility of a non-material misstatement due to fraud, auditors are required to determine whether there is a suspicion of material misstatement due to fraud by understanding the (possible) fraud, its causes and relevant internal control, and performing additional audit procedures even if the fraud itself is not material.
57. Other respondents with mixed responses on enhancements for non-material fraud:
  - (a) Noted that the cost of requiring auditors to plan and perform an audit to detect non-material frauds would likely outweigh the benefits in most cases. However, these respondents suggested that should the auditor identify actual or suspected non-material fraud during the audit, they should be required to investigate further (unless clearly inconsequential), with aid of a forensic expert if needed, and determine the implications for the audit.
  - (b) Noted that if the auditor is required to perform audit procedures on non-material fraud, this would be in direct contrast with ISA 320, which requires the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. However, this respondent noted that if the auditor is responsible for non-material fraud, the guidance under ISA 240 would need to be reconsidered to address such a responsibility.
58. Other respondents not supportive of enhancements for non-material fraud:
  - (a) Noted that the extant requirements (e.g., paragraphs 36-37 of ISA 240) are sufficient to guide auditors in assessing identified misstatements for fraud and therefore no further changes are needed.
  - (b) Noted a requirement for auditors to identify non-material fraud in general is too onerous and the benefits of doing so would outweigh the costs, which is not in the public interest.
  - (c) Noted that the resources and time needed to seek to detect immaterial frauds would make audits prohibitively expensive and would cause them to be completed at a time at which the results of the audit would no longer be relevant to users.

- (d) Highlighted that not having a concomitant requirement for management and TCWG to prevent and detect such frauds would cause the responsibilities of auditors to exceed that of management and TCWG. It was further noted that the cost of controls to have an entity prevent and detect all non-material frauds would vastly exceed the benefits.

*Input from Other Information-Gathering Activities:*

59. The following input was obtained from other information-gathering activities performed:

- (a) LCE Roundtable: Participants expressed there is not enough distinction between fraud within the entity and frauds perpetrated by third parties. While some frauds may seem to be non-material when first identified, further investigation may reveal more complicated and material fraud schemes involving people inside the entity and/or third-parties (i.e., the non-material fraud may just be the “tip of the iceberg” in an environment that fosters fraudulent behavior).
- (b) Academic report, “A Synthesis of Fraud-Related Research” – Trompeter, Carpenter, Desai, Jones and Riley (2013)
  - (a) This report synthesizes academic research related to fraudulent financial reporting. It references one study (Bowlin 2011) which suggests that while risk-based auditing directs more attention toward high-risk accounts, this may allow strategic managers engaged in fraud to take advantage of the fact that less attention is directed toward “low-risk” accounts.

**Possible Actions #7—Considering Whether Further Action is Needed for Non-Material Fraud**

The WG:

- (a) Does not recommend expanding the scope of the auditor to detect all non-material fraud.
- (b) Recommends standard-setting (enhanced requirements and/or application material) to clarify the auditor’s responsibilities when a possible non-material fraud is identified (for example, that more work is required to conclude that it is a non-material fraud, taking into account the quantitative and qualitative characteristics of the misstatement).
- (c) Recommends that further consideration could also be given to developing non-authoritative guidance to help auditor’s understand what actions are necessary when a possible non-material fraud is identified, including clarifying the roles and responsibilities of TCWG, management and the auditor with respect to the possible non-material fraud.

**Unpredictability Procedures**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1.16 – Yes - Unpredictability Procedures”):*

**Monitoring Group**

- 60. One Monitoring Group respondent encouraged the IAASB to explore whether auditors are appropriately incorporating elements of unpredictability in audit procedures when addressing risks of material misstatements.

#### Other Respondents

61. Other respondents noted that enhancements to application material to emphasize the importance of unpredictability procedures and provide guidance or examples on how auditors can vary procedures from year to year would be helpful.

#### *Input from Other Information-Gathering Activities:*

62. The following input was obtained from other information-gathering activities performed:

- (a) LCE Roundtable:
  - (i) Participants noted the requirement to incorporate unpredictability in the selection of the nature, timing and extent of audit procedures can be difficult to apply in audits of LCEs where procedures are already performed in most or all areas of the financial statements, and additional guidance in this area may be helpful.
- (b) LCE Discussion Paper
  - (i) Respondents commented that incorporating unpredictability can be challenging when taking a fully substantive audit approach where many (or all) transactions and balances are examined. Further guidance would be helpful to provide clarity on the nature of unpredictable procedures that may be performed in LCEs.
- (c) Academic report, “Increase your fraud auditing effectiveness by being unpredictable” – McKee (2006)
  - (i) This academic report provides examples of unpredictability procedures, as summarized below:
    - a. Random sampling.
    - b. Unannounced inventory observation.
    - c. Changing the timing of audit procedures.
    - d. Changing the audit technique from prior years.
    - e. Test some low-risk accounts.
    - f. Test some small accounts.
    - g. Apply Benford’s Law (a statistical law which evaluates the frequency of certain numbers occurring).
    - h. Observe operations discretely.
    - i. Sample “Whistleblower” files.
    - j. Use technology such as data analytics to test large amounts of data.
    - k. Apply detailed analytical analysis.
    - l. Embed a software monitor in the auditee’s system.
    - m. Visit internet chat groups for the auditee’s stock.

- n. Obtain relevant external data.
- o. Examine auditee customer correspondence files.

**Possible Actions #8—Enhancing the Auditor’s Consideration of Unpredictability Procedures in an Audit**

Possible actions to further explain the types of unpredictability procedures can be incorporated in the application material to help auditors understand how these procedures can be done. Consideration could also be given to further developing non-authoritative materials on this topic.

**Audit Documentation and Closer or Enhanced Linkage to ISA 230**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-02 - Yes - Audit documentation”)*

63. Respondents supportive of enhancements suggested:
- (a) Requiring documentation in ISA 240 of fraud risk factors. It was observed that extant documentation requirements in ISA 240:
    - (i) Requires auditors to document identified and assessed fraud risks but not the judgments made in reaching their conclusions including their consideration and assessment of fraud risk factors.
    - (ii) Are inconsistent with ISA 230 because it does not enable the engagement team to be accountable for their work, retain a sufficient record of matters of continuing significance for future audits and support the conduct of quality control reviews and inspections.
  - (b) Enhancing documentation in ISA 240 of specific inquiries of TCWG, management and other appropriate individuals within the entity, including individuals within the internal audit function and how the responses inform and impact the audit approach and assessment of entity’s processes for identifying and responding to the risk of fraud.
  - (c) Emphasizing that, as required by ISA (UK) 230, if the auditor identified information that is inconsistent with the auditor’s final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.
  - (d) Include minimum documentation requirements for journal entry testing procedures.

*Input from Other Information-Gathering Activities:*

64. The following input was obtained from other information-gathering activities.
- (a) LCE Discussion Paper: Respondents commented that the extent of work and audit documentation required by ISA 240 is challenging in audits of LCEs. Guidance or examples to illustrate the required level of documentation would be helpful for practitioners.

#### **Possible Actions #9—Enhancing and Clarifying the Documentation Requirements in ISA 240**

Possible actions to enhance or clarify the documentation requirements in ISA 240 include:

- (a) Considering whether additional fraud-related specific documentation requirements are needed, including documentation of the fraud risk factors considered as well as the auditor's actions if a fraud is identified.
- (b) Considering whether there are changes arising out of the work on documentation from the CUSP Drafting Principles and Guidelines and working with the CUSP Working Group to consider whether further non-authoritative guidance specific to the auditor's documentation on fraud is needed.

The WG will also consider the scalability and proportionality of any additional documentation requirements, and will coordinate with the LCE Task Force as appropriate.

#### **Analytical Procedures and Closer or Enhanced Linkage to ISA 520<sup>8</sup>**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-01 - Yes - Analytical procedures”):*

Monitoring Group Member

65. A Monitoring Group member supportive of enhancements suggested clarifying how required analytical procedures in the planning and closing stages of an audit are being dealt with, since high level year-on-year analytics are unlikely to support the identification of fraud risks.

Other Respondent

66. A respondent supportive of enhancements suggested adding a requirement to perform more robust analytical procedures (i.e., beyond analytics performed at the financial statement level, as the auditor is unlikely to identify unusual or unexpected relationships in the absence of a more detailed analytical review). This is in the context that even small companies these days have hundreds and thousands of data lines, given the automation of the general and subledger entries.

#### **Possible Actions #10—Making Analytical Procedures at the Planning and Closing Stages of the Audit More Robust**

Possible actions to enhance the requirements and application material or developing non-authoritative guidance to address issues identified for analytical procedures, include:

- (a) Requiring analytical procedures at the appropriate level of disaggregation at the planning and closing stages of the audit, with supporting application material to help implement such a revised requirement in the context of the auditor's fraud considerations.
- (b) Developing non-authoritative guidance, in coordination with the Technology Working Group, in using ATT when performing analytical procedures.

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<sup>8</sup> ISA 520, *Analytical Procedures*



## Linkage to Other ISAs

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3 with specific subheadings noted below):*

67. In addition to the ISAs discussed in previous sections, respondents also suggested enhancing the linkage between ISA 240 and the following ISAs:

*Q2a.1-04-03 - Yes - Linkages to ISA 220 (Revised) - Quality management at the engagement level*

- (a) ISA 220 (Revised), *Quality Management for an Audit of Financial Statements* – Emphasizing how resources, tone at the top, professional skepticism and significant judgments impact the auditor's considerations of fraud.

*Q2a.1-04-06 - Yes - Linkages to ISA 265 - Communicating deficiencies in internal control to TCWG*

- (b) ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – Enhancing the communication requirements to TCWG in ISA 240 to explicitly refer to reporting of any identified significant deficiencies in the context of the auditor's fraud considerations. Enhanced guidance may be provided on what constitutes significant deficiencies that could have fraud implications.

*Q2a.1-04-09 - Yes - Linkages to ISA 330 - Auditor's responses to assessed risks*

- (c) ISA 330, *The Auditor's Responses to Assessed Risks* – More robust responses to assessed fraud risks. Specific suggestions and observations include:
- (i) Adding a stand-back requirement to evaluate, taking into account all relevant audit evidence obtained, whether corroborative or contradictory, whether the assessments of the risks of material misstatement at the assertion level due to fraud remain appropriate and sufficient appropriate audit evidence has been obtained regarding the assessed risks of material misstatement due to fraud; and conclude whether the financial statements are materially misstated as a result of fraud.
  - (ii) Clarifying when auditors may need to be required to engage an expert with expertise not normally within an engagement team, such as forensic specialists, due to the assessed risk of material misstatement in the financial statement due to fraud.

*Q2a.1-04-15 - Yes - Linkages to ISA 580 - Written Representations*

- (d) ISA 580, *Written Representations* – It was suggested clarifying that written representations by management do not relieve the auditor from the requirement to obtain sufficient and appropriate audit evidence, to avoid overreliance, by the auditor, on management representations. It was also noted that the UK proposed revisions to ISA 240 suggests an extension of the existing management representation on fraud. Other respondents also suggested specific written representation regarding fraud, including:
- (i) More specificity on the policies and procedures established by management to identify and address fraud risks.

- (ii) Specific conclusion of management's assessment of compliance with the fraud policies and procedures that have been established, and explicitly stating that as a result of their assessment they did not identify instances indicative of fraud.

*Q2a.1-04-16 - Yes - Linkages to ISA 600 (Revised) - Group audits*

- (e) ISA 600, *Special Considerations –Audits of Group Financial Statements (Including the Work of Component Auditors)* –It was noted that further consideration be given to addressing frauds that arise at components and highlighting the importance of involvement of component auditors, given their greater knowledge of the component environment, including local language, prevailing business culture, risks, laws and regulations, ethical standards, corporate governance standards, and established business customs / practices.

*Q2a.1-04-17 - Yes - Linkages to ISA 610 (Revised 2013) - Using the work of internal auditors*

- (f) ISA 610 (Revised 2013), *Using the Work of Internal Auditors* – Further consideration of the use of internal auditors in understanding the risks of material misstatement due to fraud.

*Q2a.1-04-18 - Yes - Linkages to ISQM 1 - Quality management at the firm level*

- (g) International Standards on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* – Emphasizing linkages to relevant components or aspects of ISQM 1 on resources, tone at the top and firm culture.

**Possible Actions #11—Enhancing the Linkages in ISA 240 to Other ISAs**

Possible actions include change to the requirements and/or application material in ISA 240 to:

- (a) More effectively enhance linkages between ISA 240 and ISA 220 (Revised), and ISQM 1 about resources, tone at the top and firm culture.
- (b) Require a more specific link between the assessed risks of material misstatement and the responses to those risks in accordance with ISA 330.
- (c) Enhance the requirements for specific written representations relating to fraud.
- (d) Further considering whether changes are needed to strengthen the links to ISA 265 and ISA 610 (revised 2013).

The WG will also continue to coordinate with to the Group Audits and Audit Evidence Task Forces as needed.

Another suggested possible action is to add an appendix or issue non-authoritative guidance to show the interconnectivity between ISA 240 and other ISAs (e.g., through a diagram).

## **B. Areas Where Further WG and Board Discussion Needed**

- 68. The following section summarizes feedback from DP respondents related to areas where further WG (and Board) discussion is needed in order to determine an appropriate way forward (such as standard-setting actions to modify requirements or application material, issuance of non-authoritative

guidance, educational efforts, and/or encouraging others to act). It is intended that these topics are further discussed with the IAASB at the June and July 2021 IAASB meetings to determine an appropriate direction for any Board action.

## Forensic Specialists



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-07 - Yes - Forensic specialists”, “Q2a.3 - Mixed response - 01 Forensic specialists” and “Q2a.2 - No - 03 Forensic specialists”):*

### Monitoring Group

69. The Monitoring Group respondents that commented on the use of forensic specialists supported the IAASB's further consideration of whether requiring targeted use of forensic specialists will achieve the right outcomes. These respondents support further exploring the benefits, particularly in the risk assessment and fraud risk brainstorming phases of the financial statement audit. They also support further exploring whether forensic specialist involvement in other phases of the audit depending on risk is appropriate.
70. One Monitoring Group noted the IAASB needs to be proportionate in any final proposals, noting that forensic expertise is unlikely to be necessary on all audits.

### Other Respondents

71. Other respondents including regulators, national audit standard setters, public sector organizations and member bodies or other professional organizations, expressed support for enhanced requirements related to the use of forensic specialists. Where respondents expressed support, it was not to require forensic specialists in all audits. Rather, the majority of respondents who supported requirements for the use of specialists commented that the IAASB should consider enhanced requirements in the following circumstances:
  - (a) Audits of entities with high-risk profiles, for example, taking into consideration the complexity of the business model, information systems, transactions, data flows, estimation models, related party transactions and fraud risks associates with the industry, and countries where the entity operate.
  - (b) Audits of entities where fraud is identified or suspected.
72. Respondents also thought the use of forensic specialists would be beneficial in the following areas:
  - (a) Assist in performance of the fraud risk assessment, including participation in the engagement team discussion (i.e., fraud risk brainstorming with the engagement team).
  - (b) Conduct further investigation when fraud is identified or suspected.
  - (c) Consider use of forensic specialists to perform unpredictability procedures.
73. Other respondents, including national audit standard setters, accounting firms, public sector organizations, member bodies and other professional organizations did not support enhanced requirements around the use of forensic specialists. Reasons cited included:
  - (a) The scope of a forensic engagement is very different to an audit.



- (b) Requiring the use of forensic specialists on all audits is not scalable and would be challenging for smaller practitioners to implement.
  - (c) The cost does likely does not outweigh the benefit to the entity.
  - (d) Whether forensic specialists or other specialists are needed should be a decision for the engagement partner based on the circumstances of the engagement.
  - (e) Upskilling auditors in forensic techniques is a better alternative.
  - (f) Requiring the involvement of forensic specialists may become perfunctory or less effective over time.
  - (g) Requiring the involvement of forensic specialists may widen the expectation gap.
74. Other respondents had mixed views, commenting that they do not think forensic specialists should be required in all audits, but the IAASB may possibly consider adding enhancements to require use of forensic specialists in response to identified risks. Commenters noted that if the IAASB pursues enhancements that require the use of forensic specialists, the following should be considered.
- (a) Considerations around the nature, extent and timing of required use of forensic specialists.
  - (b) The use of a forensic specialists does not affect the extent of the auditor's responsibility for the audit.
  - (c) If requirements are added to involve forensic specialists, it should not be for all audits. It should be in response to identified risks or trigger mechanisms.
  - (d) Use of forensic specialists may be beneficial in the risk assessment phase of the audit.
  - (e) Guidance may be useful to assist engagement teams navigate when it is appropriate to involve forensic specialists and what types of procedures they can assist with.
  - (f) An alternative approach may be to focus on providing forensic-type training for auditors.

*Input from Other Information-Gathering Activities:*

75. The following input was obtained from other information-gathering activities performed:
- (a) Expectation Gap Roundtable – During the roundtable facilitated by the IAASB in September 2020, participants noted the following in regard to the use of forensic specialists:
    - (i) It was noted that a financial statement audit should not be expanded to be forensic in nature, but there may be a role for forensic-type procedures or mindsets in various stages of the audit, such as planning or high-level analytic procedures.
    - (ii) Participants noted there may be benefits to incorporating forensic interview skills when performing inquiries with management.
    - (iii) Participants also noted it may be beneficial to consider requiring forensic-type procedures but only in certain circumstances or in audits of certain types of entities. There was, however, a caution as to maintaining balance, scalability, and proportionality in the procedures required given the scope and purpose of an audit.

- (b) Technology Roundtable (held on September 2, 2020) – For further details about this roundtable, refer to section titled “Technology”:
- (i) Forensic audits differ from financial statement audits. In a financial statement audit, the role of the auditor is to identify risks of material misstatement arising from error or fraud. The purpose of a forensic audit is generally to investigate suspected or known fraud (i.e., a targeted examination focused on, for example, gathering evidence for legal proceedings). Accordingly, the objective, depth and breadth of the work of forensic auditors is different to that of a financial statement audit. The mindset, questions and interview techniques of a forensic auditor are different to that of a financial statement auditor. Forensic auditors hone in on a very specific set of known or suspected circumstances.
- (c) LCE Roundtable: Participants noted it may be effective to require that auditors of LCEs apply more forensic type interview skills when performing inquiries of management. However, participants noted there is a need to maintain balance, scalability and proportionality in the procedures required for the purpose of an audit.

**Possible Action #12—Determining Whether, and How, Forensic Type Procedures May be Appropriate in an Audit**

The WG notes this area had significantly mixed views with respondents who were supportive and respondents who were opposed to requirements around the use of forensic specialists. On balance, the WG has the view that there was not a call for forensic type procedures for *all* audits, however the WG noted further analysis and discussion on the options for where forensic type procedures may be appropriate in an audit would be beneficial. This would include exploration of possible alternatives that consider the feedback from both those that were opposed and those that were in favor of enhancements to specific requirements in this area.

The WG therefore recommends further exploration of the responses in this area and will develop a deeper analysis and matters for Board consideration at a future Board meeting.

**Definition of Fraud**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-05 - Yes - Definition of fraud” and “02 - Yes - Linkages to ISA 250 - Clarify definition of fraud versus NOCLAR”):*

76. Respondents noted that the term “fraud” is used in many contexts, which is sometimes not the same as the way that fraud is ‘defined’ in ISA 240 (this was also highlighted as one of the reasons for the increasing expectation gap). Respondents encouraged that further consideration be given to whether changes need to be made to:
- (a) Revise the definition to include other definitions that may include, for example, bribery, corruption, money laundering, financing of terrorism, internal or external fraud (or what may commonly be used by forensic specialists, public sector or others). In doing so, it was also noted that the difference between theft, embezzlement and fraud should be clarified.

- (b) Clarify the relationship with non-compliance with laws and regulations (NOCLAR) as it is not clear what the distinction is and whether NOCLAR can also be fraud (also see section on stronger linkage to ISA 250 (Revised)).

*Input from Other Information-Gathering Activities:*

77. EACLN Outreach Meeting: Participants commented that fraud comes in many forms and that many stakeholders associate all “bad” corporate behavior with fraud. They noted the importance of properly defining the term “fraud” in the auditing standards and making efforts to ensure there is a common understanding of what auditors’ responsibilities are in terms of what they are required to do.
78. During a meeting with representatives from the ECA and CIPFA, it was noted that it is difficult to distinguish between fraud and corruption (or other terms commonly considered with fraud in the public sector) as there is often overlap in these concepts and suggested that further clarification of the definition of fraud is needed.

**Possible Action #13—Further Consideration About Whether a Change to the Definition of Fraud is Needed**

The WG recommends that further exploration of whether changes are needed to the definition of fraud to determine if, and what, changes may be needed. In addition, further consideration of what is needed to help clarify the auditor’s responsibilities regarding fraud in an audit of financial statements. For example, the Working Group could also consider whether, and what, more may be needed, such as education on the auditor’s role and responsibilities in an audit of financial statements or non-authoritative material to describe the interactions of fraud for the purpose of an audit and other relevant terms used.

The WG recommends exploring whether changes to the definition of fraud or other actions are needed, and bring it to a future Board meeting for discussion.

**Enhanced Transparency in the Auditor’s Report**



79. The following sections summarize the feedback from DP respondents related to whether more transparency is needed about the auditor’s work on fraud in an audit of financial statements.

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.7, Subheadings “Q2d.1 - Yes - XX Auditor’s report”):*

**Monitoring Group**

80. A Monitoring Group respondent commented that it may be helpful for the auditor to clearly communicate any specific or general limitations in their audit, so that financial statement users understand the likelihood of fraud detection. They cautioned, however, that such communication is less likely to be useful if it is “boilerplate” in nature and that it should not be viewed as an alternative to carrying out appropriate audit procedures.
81. A Monitoring Group respondent commented that the IAASB should consider whether enhancements to communications with TCWG are needed. This includes the application of appropriate rigor in determining who to speak to, whether meetings should include management, whether the auditor is

sufficiently considering management bias and whether the auditor appropriately communicates how fraud risks were addressed and results of relevant audit procedures.

#### Other Respondents

82. There were mixed views from other respondents on whether enhancements are needed to improve transparency in the auditor's report related to fraud.

(a) Respondents who favored enhancements to improve transparency in the auditor's report commented on the following themes:

(i) More transparency is needed around the procedures the auditor performed in response to risks of material misstatement due to fraud. This may include a dedicated section of the auditor's report with a description of the most significant assessed risks of material misstatement due to fraud, a summary of the auditor's response to those risks, and where relevant, key observations from procedures performed. Respondents commented that the IAASB could consider whether to extend key audit matter (KAM) requirements from ISA 701<sup>9</sup> to the work effort on addressing fraud risk.

a. Respondents noted that transparency around fraud-related procedures performed would help reduce the knowledge gap by better informing stakeholders as to the work the auditor has done. It may also help reduce the performance gap as auditors will be held more accountable for the procedures performed if they are required to be made public.

(ii) If key audit matter requirements are not extended to the auditor's work regarding fraud in all audits, the IAASB may consider enhanced material to assist practitioners in determining whether fraud, or fraud risk, may be considered a key audit matter (KAM).

(iii) The standard should be enhanced to require the auditor to report to what extent the audit was considered capable of detecting irregularities. This requirement currently exists in certain jurisdictions.

(iv) Respondents commented that enhancements to the auditor's report around auditor's procedures related to fraud should not be "boilerplate" in nature.

(v) The section in the auditor's report related to the auditor's responsibilities should be expanded to elaborate on the auditor's role, responsibilities, and limitations regarding fraud in an audit of financial statements.

(vi) Respondents proposed greater transparency in the auditor's report regarding identified significant control deficiencies and weaknesses related to fraud. Respondents acknowledged that greater disclosure may first be needed by management around their responsibilities and controls over fraud (i.e., changes may need to be made by other stakeholders to add management requirements in this regard).

(b) Respondents who commented that enhancements to the auditor's report are not needed noted the following reasons:

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<sup>9</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

- (i) Increasing the length and complexity of the auditor's report may reduce user understandability.
  - (ii) Requiring additional disclosures in the auditor's report may become perfunctory and boilerplate over time, and therefore will not hold informational value for users.
  - (iii) The extant standards provide for sufficient transparency.
  - (iv) Investors do not always read the auditor's report in detail, and therefore, enhanced requirements in the auditor's report may not be effective in narrowing the knowledge gap.
- (c) Other respondents had mixed views about whether more transparency is needed in the auditor's report, noting a combination of views held by respondents who were in favor and those who were opposed as described above.

*Input from Other Information-Gathering Activities:*

83. The following input was obtained through other information-gathering activities performed:

- (a) Expectation Gap Roundtable – During the roundtable facilitated by the IAASB in September 2020, participants noted the following regarding more transparency related to fraud in the auditor's report:
  - (i) Participants called for more bespoke information to be disclosed by the auditor in the auditor's report regarding the work performed and findings in respect of fraud.
  - (ii) The need to maintain balance as to how much information is disclosed was emphasized; the information must remain meaningful.
  - (iii) Participants noted that greater transparency in the auditor's report would likely lead to different behaviors. For example, greater transparency can lead to higher accountability pressure as managers may expect their judgments to be scrutinized more comprehensively.
  - (iv) Participants also noted that greater transparency may also help demonstrate the value of an audit.
- (b) Brydon Review and the UK Department for Business, Energy, & Industrial Strategy (BEIS) [Consultation on "Restoring trust in audit and corporate governance"](#) published in March 2021:
  - (i) In addition to recommendations for additional director requirements, the Brydon Review in the UK recommended that the auditor's report state explicitly the work performed to conclude whether the directors' statement regarding the actions they have taken to prevent and detect material fraud is appropriate. Furthermore, the auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.
  - (ii) In line with the Brydon Review's recommendation, as noted in the BEIS consultation, the UK Government intends to legislate to require the directors of Public Interest Entities to report on the steps they have taken to prevent and detect fraud. Also, they intend to legislate to require auditors of Public Interest Entities, as part of their statutory audit, to

report on the work they performed to conclude whether the proposed directors' statement regarding actions taken to prevent and detect material fraud is factually accurate, report on the steps taken to detect any material fraud and assess the effectiveness of relevant controls. This consultation is currently open and will close on July 8, 2021.

- (c) Auditor Reporting Post-Implementation Review (AR PIR) Survey
  - (i) Respondents to the AR PIR survey indicated some support for inclusion of further insight about the auditor's procedures with respect to fraud.
- (d) EACLN Outreach Meeting: One participant cautioned against unintended consequences of requiring additional information related to fraud in the auditor's report for every audit. Particularly, they noted that extensive information about fraud procedures may mislead users into thinking there are issues related to fraud at that entity, when that may not be the case.

**Possible Action #14—Exploring Whether to Consider Requiring More Transparency in the Auditor's Report about Fraud**

The WG acknowledges there was a mix of respondents who were supportive and opposed to additional transparency in the auditor's report about the auditor's procedures on fraud.

The WG recommends that further analysis of the responses is needed, including further discussion about whether standard-setting, or other appropriate action, is necessary in this area. In addition, further coordination with the AR PIR Working Group is needed to understand the direction of any further work arising from the recent post-implementation review of the new and recently revised auditor reporting standards. The WG recommends that this topic be brought for further discussion at a future IAASB meeting.

**Revisit Introductory Language in ISA 240 About Inherent Limitations of an Audit**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-03 - Yes - Clearer description of auditors responsibility and objectives” and “Q2a.1-14 - Yes - Revisit how inherent limitations are described in standard”):*

**Monitoring Group Members**

- 84. All Monitoring Group members who commented on this theme noted that the IAASB should consider whether the introductory language in ISA 240 around inherent limitations of an audit, in the context of fraud, undermines or adds confusion around the objective of an audit (which is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error).

**Other Respondents**

- 85. Respondents commented that the limitations of an audit described in the introductory paragraphs of ISA 240 may diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement due to fraud.

86. Respondents also commented that the IAASB should revisit whether the limitations described in the introductory paragraphs of ISA 240 continue to accurately reflect the capabilities of auditors in today's world, including considering recent advancements in audit technology.

*Input from Other Information-Gathering Activities:*

87. The following input was obtained from other information-gathering activities performed.

- (a) Expectation Gap Roundtable: Participants noted that the role of the auditor may be misunderstood in some cases – the expectation of what the auditor does regarding fraud needs to be better understood by all. Also, it was highlighted that the auditor's procedures are meant to address 'error and fraud' but many of the procedures undertaken focused on finding material misstatements arising from 'errors.' Fraud procedures sometimes appeared to be an "add-on" and there was insufficient focus by auditors on procedures targeted at identifying fraud in some cases.
- (b) LCE Roundtable: Participants noted the fraud-related responsibilities of the auditor may need to be more clearly emphasized. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. However, in practice, auditors spend most of their time on procedures to identify material misstatements due to error. It was also emphasized that the responsibilities of the auditor regarding fraud and the procedures the auditor is required to perform related to fraud for the purpose of an audit may need to be clarified to stakeholders.
- (c) Brydon Review and the UK BEIS Consultation on "Restoring trust in audit and corporate governance" published in March 2021:
  - (i) In his report, Sir Donald Brydon notes that the messaging in ISA (UK) 240 is somewhat ambiguous on what exactly is expected of auditors in the area of fraud. He states "Some of this ambiguity stems from the introductory section of the standard. As well as stating that directors and management have primary responsibility for preventing and detecting fraud, it stresses that the auditor is less likely to detect a material misstatement due to fraud as a result of sophisticated efforts to conceal fraud. It also stresses that there is a higher risk of not detecting management fraud because of their ability to override controls and directly or indirectly manipulate accounting records. It is consequently understandable that there is both confusion and a gap between the reality and the expectations of performance of auditors in this area. If an auditor is giving an unmodified opinion, then he or she is stating effectively that they have obtained a "high level" of assurance that the financial statements are "true and fair" or "presented fairly in all material respects." But some would ask: how can this be so, if there has been a material fraud that the auditor has failed to detect? Relying on users fully understanding that auditors may have done enough work to reach a reasonable expectation of the financial statements being free of material misstatement is not a satisfactory answer."
  - (ii) The BEIS consultation notes that the FRC considered Brydon's recommendation "to make clear that it is the obligation of an auditor to endeavor to detect material fraud in

all reasonable ways” as part of a wider review of the UK auditing standard on fraud. The UK FRC’s consultation on proposed ISA (UK) 240 (Revised 2021) includes an additional paragraph in the section related to responsibilities of the auditor that states:

*“While...the risk of not detecting a material misstatement resulting from fraud may be higher than the risk of detecting one resulting from error, that does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Reasonable assurance is a high, but not absolute, level of assurance”.*

**Possible Action #15—Exploring Whether Changes are Needed to the Introductory Paragraphs of ISA 240 About Inherent Limitations of an Audit**

The WG recommends further exploration about whether the introductory material used to describe inherent limitations of an audit and the auditor’s responsibility for fraud in ISA 240 should be modified, and if so, how. The WG also questioned whether further changes are needed in ISA 200<sup>10</sup> (e.g., paragraphs A53 and A54 that explain “Other Matters that Affect the Inherent Limitations of an Audit” and that are referenced in ISA 240) and / or whether more is needed to help balance the paragraphs in the introductory material in ISA 240. The WG remains mindful of the possible consequences of a change in this area and therefore considers it necessary to further explore those consequences.

The WG recommends that this topic be brought for further discussion at a future IAASB meeting. .

**Making the Fraud Brainstorming (Engagement Team Discussion) More Robust**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-07 - Yes - Linkages to ISA 315 (Revised 2019)”):*

Monitoring Group Member

88. A Monitoring Group member supportive of enhancements to make the auditor's fraud brainstorming more robust suggested that the required engagement team discussion should sufficiently focus on broader aspects of the entity’s system of internal control, risks related to management override of controls and inherent risks before delving into more specific fraud risks.

Other Respondents

Enhance the rigor of the engagement team discussions

89. Respondents supportive of enhancements suggested enhancing the rigor of the engagement team discussions by specifying more matters to be covered in the discussion and adding more examples in the application material. For example, it was noted that this could be done by further focusing the discussions on:

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<sup>10</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*



- (a) The entity's control environment (corporate culture) (e.g., how TCWG and management promote a culture of honesty and integrity; what policies they have in place to facilitate and encourage reporting of wrongdoing; and how they respond to any such reports). It was highlighted that where the auditor identifies a control weakness as a result of these discussions, it would provide the opportunity for the auditor to develop further audit procedures responsive to the control weakness.
- (b) Entity-specific fraud risk factors such as incentives for TCWG, management or others within the entity to commit fraud, how they could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

Consider timing of engagement team discussions throughout the engagement

90. Respondents supportive of enhancements also suggested emphasizing that risk assessment is an iterative process that occurs during all phases of the audit, and to determine if there is a need to have another fraud brainstorming meeting later in the audit to confirm that identified and assessed fraud risks remain appropriate (i.e., consideration of the timing of engagement team discussions throughout the engagement).

Require attendance of specialists engaged in the audit during engagement team discussions

91. Respondents supportive of enhancements also suggested requiring all specialists (i.e., not just forensic specialists) engaged in the audit (if any) to attend engagement team discussions. It was emphasized that specialists' perspectives are relevant to these discussions because of their involvement in complex areas of the audit, including accounting estimates with elevated levels of estimation uncertainty and subjectivity that are particularly susceptible to fraud.

*Input from Other Information-Gathering Activities:*

92. The following input was gathered from other information-gathering activities:

- (a) Expectation Gap Roundtable – During the roundtable facilitated by the IAASB in September 2020, participants noted the IAASB should consider enhancing the standard to require a more robust discussion about the fraud risk factors that are relevant to the nature and circumstances of the audit engagement.
- (b) Fraud CPAB Exchange
  - (i) CPAB observed that specialists engaged in audits participated in the audit team's fraud brainstorming meeting in two thirds of the audits inspected. They note that they think it is beneficial for specialists engaged in audits to participate in fraud brainstorming meetings.
- (a) ACCA publication titled "Closing the expectation gap in audit"
  - (i) This publication notes that "sometimes the way standards are written may exacerbate bias. For example, the engagement team meeting to discuss areas of risk of material

misstatement can be susceptible to ‘groupthink.’ It is important that standard-setters draft standards as clearly as possible and avoid creating requirements that may introduce judgement biases or which are hard to implement in an objective way.”

- (b) Academic report, “A Synthesis of Fraud-Related Research” – Trompeter, Carpenter, Desai, Jones and Riley (2013)
  - (i) This report synthesizes academic research related to fraudulent financial reporting. It references one study (Brazel et al. 2010) that finds brainstorming quality is higher when the brainstorming session occurs early in the audit process and when IT specialists attend the session. They further suggest that brainstorming quality moderates the link between auditors’ fraud risk assessments and fraud-related testing, suggesting that the benefits of brainstorming do not apply uniformly: low-quality brainstorming sessions are likely incurring significant costs without attendant benefits.

**Possible Actions #16—Making the Engagement Team Discussion More Robust for the Auditor’s Considerations Around Fraud**

Possible actions to make the engagement team discussion more robust on fraud considerations include:

- (a) Standard-setting by modifying or enhancing the requirements and application material in ISA 240 on specific matters covered during the engagement team discussion.
- (b) Exploring a requirement in ISA 240 to determine whether additional engagement team discussions are needed, including when the auditor becomes aware of or obtains new information, which is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement.
- (c) Considering a requirement in ISA 240 for specialists (who are already engaged in the audit) to participate in the engagement team discussion, and if necessary, in what circumstances.

There are mixed views about whether a requirement for the auditor to hold more than one engagement team discussion during the audit is needed.

The WG recommends that further exploration and discussion on this aspect will help determine whether changes are needed in the requirement for the engagement team discussion. The WG recommends that this topic be brought for further discussion at a future IAASB meeting.

**Clarifying the Relationship Between ISA 240 and ISA 250 (Revised)<sup>11</sup>**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-04-04 - Yes - Linkages to ISA 250 – NOCLAR”):*

93. Respondents supportive of enhancements suggested:

- (a) Clarifying, within ISA 240, the relationship between responding to non-compliance with laws and regulations and responding to instances of fraud, considering that fraud is a matter that is

<sup>11</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*

often inter-related with non-compliance with laws and regulations and often constitutes an illegal act.

- (b) Clarifying the inter-relationship between identified fraud risk indicators and identified or suspected non-compliance with laws and regulations (NOCLAR).
- (c) Having an overall definition which includes material fraud and non-compliance and considering integration of ISA 240 and ISA 250 (Revised). It should be clear which actions need to be taken in the various circumstances as to when ISA 240 applies and when ISA 250 (Revised) applies (e.g., a decision tree might be useful).

**Possible Actions #17—Clarifying the Relationship between ISA 240 and ISA 250 (Revised)**

The WG recommends further exploration of possible changes to ISA 240 and/or ISA 250 (Revised) to clarify how the two standards interrelate by:

- (a) Exploring the implications and the response required in ISA 240 when non-compliance with laws and regulations is identified or suspected in accordance with ISA 250 (Revised).
- (b) Exploring the implications and the response required in ISA 250 (Revised) when fraud is identified or suspected in accordance with ISA 240.

The WG recommends that this topic be brought for further discussion at a future IAASB meeting.

**Rebuttable Presumption of Fraud Risk in Revenue Recognition**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-12 - Yes - Rebuttable presumption of fraud risk in revenue recognition” and “Q2a.2 - Mixed response - 05 Rebuttable presumption of fraud risk in revenue recognition”):*

**Monitoring Group Member**

- 94. A Monitoring Group member supportive of enhancements suggested clarifying how the rebuttable presumed fraud risk in revenue recognition is understood in practice.

**Other Respondents**

- 95. Other respondents supportive of enhancements suggested:
  - (a) Considering whether certain criteria indicating when and how to rebut the presumption that there is a risk of material misstatement due to fraud in revenue recognition should be included in ISA 240.
  - (b) Emphasizing the risks of material misstatement in revenue (e.g., simple frauds in revenue recognition facilitated by collusion with third parties).
  - (c) Exploring other areas for a rebuttable presumed fraud risk in addition to revenue, for example, expenditure which particularly in light of Covid-19 may be more susceptible to fraud.
- 96. Other respondents with mixed responses for enhancements:
  - (a) Suggested considering whether it remains appropriate to specify a rebuttable presumption of risks of fraud solely for revenue recognition.

- (i) It was noted that there are other areas that are also susceptible to fraudulent misstatement, such as inventory and property valuations.
- (ii) It was highlighted that the focus on revenue recognition may result in insufficient attention being given to the many other ways fraud may be perpetrated.
- (b) Questioned whether the presumption of fraud over revenue recognition continues to be appropriate.
  - (i) It was noted that auditors are spending an undue amount of time designing and performing fraud procedures in areas where for many entities the risks are not high because of the nature of the business.
  - (ii) It was noted that regulators are concerned that auditors are rebutting this presumption too often.
  - (iii) It was suggested that additional application material is needed to clarify how auditors determine when it may be appropriate to rebut this presumption, for example, by providing factors to consider.
  - (iv) It was suggested that the standard could also provide more and better examples of when it may be appropriate to rebut this presumption.

*Input from Other Information-Gathering Activities:*

97. The following input was obtained from other information-gathering activities performed:

- (a) May 2020 NSS Meeting
  - (i) Participants commented that there is inconsistency around the interpretation of when it is appropriate to rebut the presumption that there is a material risk of misstatement due to fraud in revenue recognition.
- (b) Clarity Post-Implementation Monitoring Project
  - (i) Respondents noted there is inconsistency around the interpretation of when it is appropriate to rebut the presumption that there is a material risk of misstatement due to fraud in revenue recognition. It was also noted that further clarity is needed around whether the rebuttal should address all assertions.
- (c) LCE Discussion Paper
  - (i) Respondents noted that the current examples in the standards for rebuttal of the presumption of fraud in revenue recognition are restrictive and may need revision in the context of LCEs.

### **Possible Action #18—Further Considering the Presumed Risk of Fraud in Revenue Recognition and What Changes Are Needed**

This is an area where there are mixed views about what further changes, if any, are needed in ISA 240. On balance, the WG does not intend to remove the rebuttable presumption but recommends that further analysis of the responses is needed to determine appropriate actions in this area. Changes could include:

- (a) Clarifying when it is appropriate to rebut the presumption of fraud risk in revenue recognition, whether through standard-setting (i.e., application material) or non-authoritative guidance, with emphasis on:
  - (i) Distinguishing the entity's different revenue streams (e.g., product and service revenues).
  - (ii) Considering whether there are other areas beyond revenue recognition that should have increased focus in ISA 240 (e.g., cash, impairment, provisions, off-balance sheet arrangements).
  - (iii) Focusing on the importance of the appropriateness of risk assessment procedures to identify and assess fraud risk in revenue recognition and not just solely focusing on the rebuttal itself.
  - (iv) Enhancing the application material in ISA 240 for public sector considerations, i.e., revenue is likely not a focus in public sector audits.

The WG recommends that this topic be brought for further discussion at a future IAASB meeting.

### **Requirements for when Fraud is Detected or Identified**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-13 - Yes - Requirements for when fraud is detected or elevated risk of fraud exists”):*

Monitoring Group Member

98. A Monitoring Group member supportive of enhancements suggested considering whether the requirements and guidance sufficiently convey the message that the exercise of increased professional skepticism and further audit procedures (such as varying the nature, timing and extent) are necessary if there are signals that indicate an elevated risk of a material misstatement due to fraud.

Other Respondents

99. Other respondents supportive of enhancements:
- (a) Suggested that the standard should mandate an investigation be performed where fraud is suspected. This is because it is only possible to design an appropriate audit response when the issue is properly understood. It was noted that, in the absence of an investigation, it may be impossible to get to a “sufficient appropriate audit evidence” conclusion. If the investigation is refused, the auditor may then be able to modify the opinion, based on a scope limitation or take other appropriate action.

- (b) Suggested adopting a more robust approach when there are signals that indicate the possibility of a material misstatement due to fraud. Such signals could include, for example, lack of appropriate “tone at the top” at the audited entity’s management level, relevant information received through whistle-blowing systems or public information.
- (c) Suggested that it would be useful for the firm to establish policies and procedures for consultation so that the members of the engagement team undertake consultation with others at the appropriate level within or outside the firm, as necessary, when the auditor has identified a circumstance that indicates the possibility of a material misstatement due to fraud or the auditor has determined that a suspicion of a material misstatement due to fraud exists.

*Input from Other Information-Gathering Activities:*

100. The following input was obtained from other information-gathering activities performed:

- (a) May 2020 NSS Meeting
  - (i) Participants noted there should be further requirements and guidance in situations where there is a possible fraud identified, including considerations about withdrawing from the engagement or the impact on the auditor’s report.

**Possible Actions #19 – Further Considering What Changes are Needed Related to Procedures when Fraud is Detected or Identified**

The WG recommends further exploring whether the requirements and application material for when fraud is detected or identified in ISA 240 are sufficient or whether enhancements are needed to provide clarity. The WG recommends that this topic be brought for further discussion at a future IAASB meeting.

**External Confirmations and Closer or Enhanced Linkage to ISA 505<sup>12</sup>**



*What We Heard from DP Respondents (See NVivo – Agenda Item A-1.3, Subheadings “Q2a.1-04-12 - Yes - Linkages to ISA 505 - External confirmations” and “Q2a.1-06 - Yes - External confirmations”):*

Monitoring Group Member

101. A Monitoring Group member supportive of enhancements suggested:

- (a) Developing guidance on how to assess the reliability of external confirmations received having regard to the possibility of fraud.
- (b) Adding specific requirements on how to respond where there is no reply to a confirmation request.
- (c) Strengthening ISA 505 to adapt to the complexities and technological advances that exist in today’s global business environment (e.g., paper versus electronic confirmation) and considering whether further guidance is needed in evaluating evidence received from external sources.

<sup>12</sup> ISA 505, *External Confirmations*

## Other Respondents

102. Other respondents supportive of enhancements suggested:

- (a) Enhancing guidance in ISA 240 or ISA 505 to set stronger expectations for obtaining external confirmations in certain circumstances (e.g., existence of cash or other assets with higher assessed risks of material misstatement).
- (b) Requiring auditors to be more skeptical when evaluating audit evidence (including external confirmations) of crucial importance for obtaining reasonable assurance on specific issues.

## *Input from Other Information-Gathering Activities:*

103. The following input was obtained from other information-gathering activities performed.

- (a) IAASB Consultation on Proposed Strategy for 2020-2023 and Work Plan for 2020-2021
  - (i) A Monitoring Group respondent noted there should be guidance for auditors on how to assess the reliability of external confirmations received having regard to the possibility of fraud. There should also be more complete requirements on how auditors should respond when there is no reply to a confirmation request.

### **Possible Actions #20—Strengthening Requirements About the Auditor’s Considerations for External Confirmations**

Possible actions to address the issues and challenges identified for external confirmations include standard-setting to enhance the requirements and application material, and/or developing non-authoritative guidance addressing external confirmations, with an emphasis on:

- (a) Considering the implications and further audit procedures when external confirmations are not reliable (e.g., in certain jurisdictions where there are no structured systems or regulations addressing external bank confirmations).
- (b) Considering the implications and further audit procedures when there are no replies to external confirmations or when contradictory evidence is obtained through external confirmations.
- (c) Considering a requirement for using external confirmation procedures to obtain audit evidence regarding specific elements, accounts or items of a financial statement.
- (d) Considering an FAQ, in coordination with the Technology Working Group, on the advent of open banking where the auditor can directly obtain audit evidence.

In addition, the WG will explore whether enhancements are needed for the requirements and/or application material in ISA 505. The WG recommends that this topic be brought for further discussion at a future IAASB meeting.

## **c. Non-Authoritative Guidance**

104. The following section summarizes feedback from DP respondents related to areas where the WG recommends non-authoritative guidance is issued.



## Development of Non-Authoritative Materials

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheading “Q2a.1-18 - Enhanced guidance or application material instead of changes to requirements”):*

105. There were respondents that questioned the need for changes to the standards, with encouragement to rather issue non-authoritative materials (examples, staff alerts, questions and answers (Q&A's) etc.).
106. There was a call from firms for more ‘implementation’ guidance to assist with some of the areas that had traditionally been difficult to implement. Other respondents had the view that it should be a combination of standard-setting and non-authoritative materials. Where respondents noted specific examples of non-authoritative guidance needed, this has been presented within the relevant areas above.
107. General areas where the IAASB has been encouraged to issue guidance:
  - (a) To help explain widely misunderstood and related concepts, including the scope and purpose of an audit, inherent limitations of an audit, and materiality.
  - (b) To explain common fraud schemes (with a suggestion that this could be maintained in a global digital repository and updated annually, as well as populated with examples and information from others in this area).
  - (c) On fraud risk factors, to update for current circumstances, and to consider specific circumstances for LCEs. It was also highlighted that guidance on fraud risk factors specific to public sector would be helpful.
  - (d) That helps apply the standards in the context of the current environment, in particular to highlight the impact of technology on fraud (both in how frauds are perpetrated as well as the more sophisticated procedures auditors are using). It was highlighted that it would be helpful to help auditors understand how they could better employ emerging technologies to enhance auditor performance regarding fraud (e.g., continuous auditing, artificial intelligence, enhanced audit data analytics etc.) and the impact of cybercrime.
  - (e) That highlights the application of professional skepticism through examples of specific circumstances.
  - (f) About what the audit steps are when a fraud is suspected.
  - (g) To clarify the auditor’s responsibilities on third-party fraud.
  - (h) About when it is appropriate to involve forensic specialists and what type of procedures they could assist with.
  - (i) To share leading practices in areas that are difficult to implement such as testing journal entries for evidence of possible management override of controls.
  - (j) To help illustrate how auditors can use key performance indicators in the procedures they are required to undertake (such as risk assessment procedures, fraud brainstorming session and refining journal testing). It was noted it may also be helpful to distinguish between listed entities and less complex entities.



- (k) To assist with implementation, including fraud inquiries and how these are best tailored, to help the efficacy of the fraud brainstorming session and the use of internal and external information and analytics.
- (l) To provide guidance on when a fraud-related item is a key audit matter.
- (m) Issuance of periodic staff audit practice alerts that highlight common fraud schemes and other potential fraud risk factors.

*Input from Other Information-Gathering Activities:*

108. The WG met in October 2020 to brainstorm possible actions related to identified challenges within ISA 240 based on information-gathering activities performed up to that date. The Board was provided an update on the results of that brainstorm session during the December 2020 IAASB meeting, which included the WG's preliminary views on directions forward for the identified issues (standard-setting changes to requirements or application material, non-authoritative guidance, further outreach, or actions for others). See [December 2020 Agenda Item 6 - Fraud](#) for details.

**Possible Actions #21—Development of Non-Authoritative Materials**

The WG believes that this will be an integral part of any project to revise ISA 240, and recommends further exploration of what non-authoritative materials are needed during the course of the project, as well after changes have been made, as appropriate. The form and timing of any non-authoritative materials also needs to be considered. Further matters for Board consideration on specific non-authoritative materials will be brought to a later IAASB meeting.

**Third-Party Fraud**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-15 - Yes - Third party fraud,” “Q2a.2 - Mixed response - 04 Third party fraud” and “Q2a.3 - No - 06 Third party fraud”):*

**Monitoring Group**

109. One Monitoring Group respondent encouraged the IAASB to consider whether increasing the responsibility of auditors is warranted regarding fraud that is immaterial but could potentially have a more material impact when investigated, which could include third-party fraud. This respondent noted that even if the IAASB determines the auditor requirements and responsibilities are sufficient under the current standards, it would be helpful to be definitive and clear on this topic.

**Other Respondents**

110. Respondents who supported additional requirements related to third-party fraud that is material to the financial statements commented that there should be additional emphasis on the nature of fraud risks specific to third parties and highlighted that the auditor's response to risks of material misstatement due to fraud involving third parties may need to differ from those that are internal to the entity. Specific suggestions included:

- (a) As part of obtaining an understanding of the entity and its environment and the entity's internal control, and determining the significant classes of transactions, the auditor should consider whether and where third parties are involved and where fraud could possibly be perpetrated.
  - (b) Expanding the auditor's understanding to include understanding management's processes and controls over the involvement of third parties, when such involvement could lead to a risk of material misstatement arising from fraud. In addition, the auditor could also consider the third party's objectivity and integrity, including whether the third party is a related party.
  - (c) Consideration of audit evidence obtained from third parties, including evaluating the validity of the evidence received. It was also noted that the Fraud WG should collaborate with the ISA 500 Task Force on this topic.
111. Other respondents commented that the requirements in extant ISA 240 are sufficient, but it may be beneficial to provide non-authoritative guidance to provide clarity around how auditors should assess and respond to the risk of material misstatement due to third-party fraud.
112. Respondents commented that third party fraud that does not result in a material misstatement of the financial statements but that may still have a severely negative impact on the entity (e.g., cybercrime attacks) falls outside the scope of the financial statement audit. Respondents noted that broadening auditor requirements in this area may widen the expectation gap relating to the scope of a financial statement audit. However, respondents acknowledged there may be a point of convergence where the potential impact from cybercrime (e.g., fines, penalties, impact on business operations and cash flows) is material, this should be assessed as part of the auditor's risk assessment and internal controls evaluation under ISA 315 (Revised 2019).

*Input from Other Information-Gathering Activities:*

113. The following input was obtained through other information-gathering activities performed:
- (a) Article, "Financial Statement Fraud by External Parties" - Carmichael, D. R. (2020)
    - (i) This article reviews real fraud cases and presents the following list of lessons learned related to third party fraud:
      - a. Auditors may not be giving adequate attention to the serious risks that external parties pose for unauthorized acquisition, use or disposition of an organization's assets that have a material effect on its financial statements.
      - b. Auditors should identify and evaluate country, business and entity risks.
      - c. Auditors should not ignore the prominence of the potential perpetrator.
      - d. Auditors should recognize the limitations of the fraud triangle. Even if only one or two conditions of the fraud triangle are present, this may be enough to trigger an audit response.
      - e. Auditors should focus on the opportunities for fraud created by control deficiencies.
      - f. Auditors should brainstorm fraud potential and challenge quality of evidence from confirmations.

### **Possible Actions #22—Addressing Auditor’s Considerations Relating to Third-Party Fraud**

The WG does not recommend standard-setting to expand the role of the auditor to detect third-party fraud that is not directly related to a material misstatement in the financial statements (i.e., operational or reputational risk without financial risk). However, further consideration could be given to non-authoritative guidance to clarify the auditor’s responsibilities regarding the risk of material misstatement due to third-party fraud, and further implications for auditors. In addition, the WG will collaborate with the Technology Working Group to determine if non-authoritative guidance on cybercrime would be useful.

## **D. No Further Action Recommended**

114. This section summarizes feedback from respondents to the DP related to matters where the WG does not recommend further action is taken.

### **Engagement Quality Reviews**

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.3, Subheadings “Q2a.1-04-19 - Yes - Linkages to ISQM 2 - Engagement quality reviews,” “Q2a.1-11 - Yes - Engagement quality review procedures,” “Q2a.2 - Mixed response - 06 Engagement quality review procedures” and “Q2a.3 - No - 02 Engagement quality review procedures”):*

115. Respondents supportive of enhancements suggested:
- (a) Requiring an engagement quality review when the auditor has determined that a suspicion of a material misstatement due to fraud exists.
  - (b) A specific requirement for the engagement quality reviewer to evaluate judgments made regarding fraud risks and any instances of identified or suspected fraud.
116. Respondents with mixed responses on, or not supportive of, enhancements:
- (a) Noted that it is not clear whether introducing specific engagement quality review requirements related to fraud would result in better identification of fraud risks and appropriate design of procedures to respond to those risks. However, further noted that in principle, engagement quality review requirements could enhance the audit. It was suggested that further examining whether the Japanese fraud standard has enhanced audit quality may be helpful to determine if further changes are needed.
  - (b) Noted that quality management might help but cannot fix issues that are not detected at the start of the audit.
  - (c) Noted that the ISQM standards are fit for purpose, but supportive of enhancements to more explicitly clarify that ‘significant matters’ subject to engagement quality reviews would include significant matters in regarding fraud.
  - (d) Expressed concern about the efficacy of the enhanced engagement quality review procedures described in the DP but noted support for requirements or application material relating to ‘hot’ reviews and / or engagement quality reviews for audits in which the risk of fraud is heightened

or in which potentially material fraud is alleged, suspected or detected - regardless of the size of the audit.

- (e) Agreed with the statement that “a material misstatement arising from fraud would likely be considered a significant matter or an area requiring significant judgment,” and that it therefore already falls within the scope of the engagement quality review.
- (f) Noted that the current requirements are appropriate and sufficient to cover issues relating to fraud and cautioned the IAASB that being overly prescriptive in the requirements could perpetuate a “checklist mentality” and thus erode audit quality, which would not be in the public interest.

#### **Possible Actions #23—Enhancing Requirements for Engagement Quality Reviews**

Based on the comments received, on balance the WG does not recommend further actions related to engagement quality reviews in ISQM 1 and ISQM 2 as the requirements and application material in the recently approved ISQM standards on this topic are considered sufficiently robust.

### **Expectation Gap**

- 117. The DP described the expectation gap, in general terms, as the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is. It went on further to reference a May 2019 publication by the Association of Chartered Certified Accountants (ACCA) titled “[Closing the Expectation Gap in Audit](#),” which describes three components of the expectation gap: the “knowledge gap,” the “performance gap,” and the “evolution gap.”
- 118. Respondents commented to provide views on the primary cause of the expectation gap to help inform the IAASB what may cause the underlying issues.

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.1):*

#### **Monitoring Group Members**

- 119. The Monitoring Group members who commented on this topic recognized that the knowledge gap, performance gap, and evolution gap contribute to the overall expectation gap. A Monitoring Group member commented that there may be gaps between what the users expect from the auditor and the financial statement audit and noted this could include a misunderstanding of the role of auditors (knowledge gap), unclear or inconsistently applied requirements (performance gap) or the need for enhancements to add more value (evolution gap).

#### **Other Respondents**

- 120. Respondents commented that the three-component framework used in the DP to describe the expectation gap, was helpful to understand the issues.
- 121. There were comments from respondents who used different terminology to describe the primary causes of the expectation gap and there was a respondent who commented that there is no expectation gap.

122. Respondents noted that all three components described in the DP (the “knowledge gap”, the “performance gap”, and the “evolution gap”) contribute to the expectation gap. Other respondents, while acknowledging all three components contribute to the expectation gap, emphasized the knowledge gap as a primary driver.
123. Where respondents indicated the knowledge gap as the primary driver, the suggested solutions were not always limited to possible actions to address the knowledge gap. Solutions were suggested to address all three components of the expectation gap.

*Input from Other Information-Gathering Activities:*

124. Expectation Gap Roundtable - On September 28, 2020, the IAASB facilitated a roundtable among global experts about the expectation gap related to fraud and going concern. Further details about the take-aways from the discussion were published in a document titled “[Summary of Key Take-aways: IAASB Fraud and Going Concern Roundtables](#).” Participants commented that the expectation gap related to fraud can be attributed to various elements of a knowledge gap, performance gap, and evolution gap. There were mixed views as to which elements more prominently drive the expectation gap.

**Possible Actions #24 – Expectation Gap**

While the description used in the DP was helpful to describe the issues and foster discussion, an exact definition of the expectation gap is not necessary to explore possible future IAASB actions or necessary enhancements to address the issues identified by respondents. DP respondents provided suggested actions for the IAASB or for others which are detailed in each subsequent section of this paper.

Although there are mixed views in the WG about whether more needs to be done specifically on the expectation gap, on balance the WG recommends not to further refine the description or develop a definition of the “expectation gap” as described in the DP, or to further explore the primary causes of the expectation gap. The WG has this view because the intention had been to use the ‘expectation gap’ to facilitate obtaining input on areas for IAASB action, and not to develop a specific definition or description.

**E. Other Matters and General Comments**

125. The following section summarizes other matters and general comments for IAASB consideration.

**Root Cause Analysis**

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheading “Q1b-1 - IAASB - 02 Perform root cause analysis of recent fraud”):*

126. Respondents to the DP provided comments about what can be done, by the IAASB and/or others to narrow the expectation gap related to fraud in an audit of financial statements and encouraged the IAASB to perform a root cause analysis of recent fraud cases.

Monitoring Group Members

127. Monitoring Group Members who commented about performing a root cause analysis expressed that this exercise may help inform the IAASB's assessment of possible solutions to address the underlying issues.
128. A Monitoring Group Member expressed that the IAASB's reviews of academic research and audit quality reviews by audit regulators should help to identify sources of the problems and possible solutions.

#### Other Respondents

129. Other respondents also expressed support for the performance of a root cause analysis. Reasons cited include:
  - (a) Performing a root cause analysis will help understand the roles of different parties and the reasons for the failure. This will inform whether changes to audit standards or additional guidance will be effective in addressing the underlying issues, and if so, in what areas.
  - (b) Changes to audit standards should not be made without evidence that proposed changes will address the underlying issues.
130. Respondents recommended that the IAASB may interface with regulatory bodies to collect information on exposed corporate fraud schemes and collaborate with academia to perform root cause analysis.

#### *Input from Other Information-Gathering Activities:*

131. On March 8, 2021, the IAASB presented an update to the Consultative Advisory Group ("CAG") representatives about high-level observations from responses to the DP. At that meeting, representatives expressed support for performing activities to further understand the root cause of recent fraud cases.
132. Expectation Gap Roundtable: At the roundtable held on September 28, 2020, participants noted the following:
  - (a) Standards should only be updated if evidence and research indicate that updates are needed to address the root cause of recent issues.
  - (b) As a result of assessing fraud cases, the IAASB may identify other areas that auditors should focus on which are not currently in extant ISA 240.<sup>13</sup> For example, a participant mentioned that consideration may be given towards whether auditors should do more to confirm an entity's business relationships.
  - (c) It was noted that it would be helpful if the profession would look at 'the whole picture' in terms of corporate failures, analyze past frauds and determine whether technology could have helped identify those issues.

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<sup>13</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

- (d) One idea for improvement as a profession is development of a public database of fraud cases where characteristics could be studied and used (for example, through machine learning) to strengthen audit technologies, making them more predictive and forward-looking.

#### **Possible Actions #25 – Root Cause Analysis**

The WG noted that a variety of information-gathering activities have been performed to date related to fraud in an audit of financial statements to understand the issues and challenges, many of which were presented to the Board in December 2020. In addition to the activities summarized at that meeting, the IAASB has performed additional outreach with stakeholders and performed an analysis of the DP responses. The input received through these activities help inform and serve as evidence for possible future actions by the IAASB.

While acknowledging there are challenges in learning details of recent fraud cases which are undergoing litigation, the IAASB staff and the WG plan to perform outreach with regulators, forensic investigation specialists and crime commission representatives to better understand how frauds are being committed, including how they are executed and concealed, who is involved, what financial accounts are impacted, and how they are eventually detected. The IAASB staff and the WG also plan to perform outreach with accounting firms to understand if any recent enhancements have been made to audit methodologies related to fraud procedures.

#### **Work of Others**

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheading “Q1b-1 - IAASB - 04 Look at work done in other jurisdictions”):*

##### **Monitoring Group Member**

- 133. A Monitoring Group member suggested the IAASB look to jurisdictions that have addressed some of the issues in the DP to determine if there are standards or guidance that could be beneficial in a global context.

##### **Other Respondents**

- 134. Other respondents also suggested for the IAASB to look at work done in different jurisdictions to narrow the expectation gap related to fraud in an audit of financial statements, for example:
  - (a) American Institute of Certified Public Accountants (AICPA) Auditing Standards Board update to AU-C 500 with various mentions and examples of the concept of professional skepticism.
  - (b) AICPA's Professional Standards (Appendix B): “Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards.”
  - (c) Japan’s “Standard to Address Risks of Fraud in an Audit” that has already been introduced in an audit of financial statements of publicly traded companies in Japan (for further details, see section “*Input from Other Information-Gathering Activities*” below).
  - (d) Malaysia’s corporate liability provision (i.e., Section 17A of the Malaysian Anti-Corruption Commission Act 2009), setting out that a commercial organization is regarded as committing

an offence if any person associated with the commercial organization commits a corrupt act to obtain or retain business for the advantage of the commercial organization.

- (e) New Zealand's Office of Auditor-General [time series analysis of fraud](#) committed at public organizations, which is required to be reported to auditors (and in turn reported by auditors to the New Zealand Office of Auditor-General).
- (f) Organization for Economic Co-operation and Development (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.
- (g) South Africa's Johannesburg Stock Exchange listing requirement amendments to require the CEO and Financial Director to make a positive statement attesting that the annual financial statements fairly present the state of affairs of the company and / or group, that internal financial controls are adequate and effective and that where deficiencies and any fraud involving directors have been identified, these have been disclosed to the Audit Committee and the auditor and the necessary remedial action has been taken.
- (h) UK Financial Reporting Council's (FRC) "challenge culture" campaign in response to its audit quality inspections results analysis that identified "ineffective management challenge," in the execution of professional skepticism, as a critical root cause for poor quality results.
- (i) UK's Auditing Practices Committee's 2001 publication *Aggressive Earnings Management*, providing a simple example to demonstrate how legitimate business practices can develop into unacceptable financial reporting.
- (j) UK's Brydon Report – a review into the quality and effectiveness of the audit in the UK completed by Sir Donald Brydon, which included recommendations for improvements related to fraud and going concern (for further details, see section "*Input from Other Information-Gathering Activities*" below).
- (k) UK BEIS consultation, "[Restoring trust in audit and corporate governance: proposals on reforms.](#)"
- (l) UK's consultation on the proposed revision of ISA (UK) 240 clarifying the auditor's obligations and enhancing the auditors' procedures to identify and assess risks of material misstatement due to fraud and to plan and perform procedures responsive to those risks (for further details, see section "*Input from Other Information-Gathering Activities*" below).
- (m) UK's investor views regarding the provision of more information by the auditor as to the ability to detect fraud and other irregularities, as required by ISA (UK) 700 (revised November 2019), *Forming an Opinion and Reporting on Financial Statements*.
- (n) US PCAOB Auditing Standard (AS) 2410<sup>14</sup> in comparison to ISA 550, *Related Parties*.
- (o) US Securities and Exchange Commission's guidance for management related to management's report on internal controls, together with the 2013 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control - Integrated Framework, providing management and boards of directors a means to identify and analyze risks, and to

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<sup>14</sup> PCAOB AS 2410, *Related Parties*



develop and manage appropriate responses to risks within acceptable levels and with a greater focus on anti-fraud measures.

*Input from Other Information-Gathering Activities:*

135. The following summarizes information obtained related to work performed by other stakeholders on the topic of fraud in an audit of financial statements based on other information-gathering activities performed to date:

- (a) In Canada, the Canadian Public Accountability Board (CPAB) launched a Fraud Thematic Review to evaluate how auditors in Canada are complying with the audit standard relevant to fraud and explore what actions can be taken by all relevant stakeholders to better prevent and detect corporate fraud.
- (b) In February 2021, Accountancy Europe published "[Fraud: Recommendations to Strengthen the Financial Reporting Ecosystem](#)". The publication proposes recommendations related to fraud for key players in the financial reporting ecosystem. Accountancy Europe has asked stakeholders to share thoughts and opinions on these recommendations by April 30, 2021.
- (c) In the United Kingdom, the FRC consulted on proposed revisions to its UK auditing standard related to fraud, ISA (UK) 240 (Revised 2021). The [consultation](#) closed on January 29, 2021, and the FRC is currently analyzing responses from that process. This consultation is partly in response to a review completed by Sir Donald Brydon and published in 2019 titled the "[Report of the Independent Review into the Quality and Effectiveness of Audit](#)", which sets out recommendations for parties in the financial reporting ecosystem on several topics, including the prevention and detection of fraud.
- (d) In Japan, the Business Accounting Council established a standard in 2013 titled "[Standard to Address Risks of Fraud in an Audit](#)" to be applied to audits of publicly traded companies. This standard clarifies fraud-related audit procedures, requires more cautious performance of audit procedures in certain circumstances, particularly when the auditor has determined that any suspicion of a material misstatement due to fraud exists, and establishes additional quality control considerations. To date there has been no direct analysis of the effectiveness of the changes in Japan. However, the Certified Public Accountants and Auditing Oversight Board performs external inspections, and their inspection findings include matters relating to the new standard. Therefore, there are some that have the view that the changes have clarified what needs to be done when a fraud is suspected and believe that the more robust procedures in these instances have contributed to higher-quality audits.
- (e) In Australia, the [February 2020 Interim Report from the Parliamentary Joint Committee on Corporations and Financial Services](#) regarding the Regulation of Auditing in Australia recommended a formal review on the sufficiency and effectiveness of reporting requirements related to the prevention and identification of fraud, to be completed by the end of the 2020-2021 financial year.
- (f) In the United States, there are requirements in US GAAS Section 240 that are addition to those that exist in extant ISA 240 (or that have been elevated from application material in ISA 240). A summary of differences is published in AICPA Professional Standards Appendix B,

“Substantive differences between the International Standards on Auditing and Generally Accepted Auditing Standards.”

### Continued Outreach

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheading “Q1b-1 - IAASB - 08 Continued outreach with stakeholders”):*

#### Monitoring Group Members

136. Monitoring Group members were supportive of the IAASB’s continued engagement with stakeholders, discussions with NSS, roundtable discussions and consideration of other reviews and research. The following include specific observations and suggestions on continued outreach:
- (a) A collaborative, multi-stakeholder solution is necessary to address the challenges and achieve the desired progress to narrow (with the goal to minimize as much as possible) the expectation gap.
  - (b) Perspectives gathered from various stakeholder groups as part of the feedback to the DP can inform the IAASB about possible further standard-setting responses to narrow the expectation gap which the IAASB can begin while a more holistic multi-stakeholder solution is developed.
  - (c) The IAASB should consider as part of its information gathering activities what, if any, expectations users have of auditors beyond the core responsibilities to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error, when it pertains to undetected fraud.

#### Other Respondents

137. Other respondents were also supportive of the IAASB’s continued outreach with stakeholders. The following include specific observations and suggestions on continued outreach:
- (a) The IAASB should not “oversell” its ability to resolve these issues and to engage in a frank dialogue with its stakeholders about some of the largely intractable aspects of the fraud issues.
  - (b) It is necessary to have a public debate with all stakeholders involved to discuss what really is expected from auditors including a cost-benefit analysis. The various roles and responsibilities of the parties involved in the financial ecosystem should be clear. In this debate, it should also become clear whether additional audit costs are publicly justified. This DP might be a first step in this debate.
  - (c) Continue outreach to key stakeholders throughout the duration of these projects and work together with other national auditing standard-setting bodies to develop guidance that is consistent across multiple jurisdictions to reduce confusion and inconsistency in execution.
  - (d) Continue outreach with investors and other users to better understand and define the information that is being sought about both management responsibilities and the auditor’s work

related to fraud and going concern. This understanding is critical to determining the appropriate parties and mechanisms for providing the desired information.

- (e) Continue to collaborate with the other audit standards setters, market regulators, financial reporting standards setters, large international network firms and the various stakeholder groups to reduce the present gap between the expected role and responsibilities of the auditor for fraud and going concern in a financial statement audit and public perceptions. Many of these stakeholders have programs that include podcasts, educational initiatives, and implementation guides to support broader understanding of the issues and a consequential reduction in the expectation gap.

*Input from Other Information-Gathering Activities:*

- 138. At the December 2020 IAASB meeting, the Board was provided with an update on outreach meetings performed up until that date. For additional outreach meetings held since the December meeting, refer to earlier section titled “II. Update on Outreach.”
- 139. In addition, the following outreach meetings are currently scheduled or being planned:
  - (a) Canadian Public Accountability Board (CPAB) – Scheduled for April 23, 2021
  - (b) The Royal Netherlands Institute of Chartered Accountants (NBA) – Planning in progress.
  - (c) Outreach with regulators, forensic investigation specialists and crime commission representatives (for further details, see section above titled “Root Cause Analysis”) – Planning in progress.

## Coordination with IESBA

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.9, Subheading” 1.0 IAASB-IESBA Coordination”):*

- 140. Respondents commented about coordination between the IAASB and the IESBA and specific areas for the IAASB to consider that may overlap with concepts in the IESBA International Code of Ethics for Professional Accountants (“IESBA Code”).

### Monitoring Group Member

- 141. A Monitoring Group respondent commented about the IESBA’s Role and Mindset of a Professional Accountant project and that from a public interest perspective, it is an auditor’s responsibility to promote confidence and integrity of capital markets through the performance of high-quality audits. Therefore, auditors having a mindset with an enhanced level of vigilance for both the risk of fraud and potential signs of fraud is imperative to audit quality and ultimately investor protection.

### Other Respondents

142. Respondents emphasized the importance of appropriate coordination between the IAASB and IESBA. Themes of comments included:

- (a) Proposed changes to ISAs, if any, should be reviewed for consistency with the provisions of the IESBA code.
  - (i) One area to consider is whether any changes are necessary related to non-compliance with laws and regulations, as fraud often constitutes an illegal act and therefore is inter-related. Section 360 of the IESBA Code addresses the auditor's response to identified or suspected instances of non-compliance of laws and regulations. If any enhancements are considered, they should be consistent with the requirements of Section 360 of the IESBA Code such that there are no implementation issues for those auditors that need to comply with both the ISAs and IESBA Code.
  - (ii) To the extent enhancements are considered that will apply only to certain entities, the IAASB should monitor the IESBA's project on the Definitions of Listed Entity and PIE.
  - (iii) The IESBA Role and Mindset provisions<sup>15</sup> were recently approved and should be considered in determining whether enhancements are needed related to professional skepticism or the mindset of an auditor in performing fraud-related procedures. Respondents recommended the IAASB allow for these revisions to take effect (effective date of December 31, 2021) and monitor implementation to consider if there is a need for further guidance in this area.
- (b) The IAASB may consider issuing guidance to clarify interactions with the IESBA Code about client acceptance where fraud risk indicators may be present.

*Input from Other Information-Gathering Activities:*

143. On March 2, 2021, IAASB Staff met with IESBA staff representatives to discuss possible areas of future coordination. The following topics were discussed:

- (a) Consideration of enhancements to the concept of professional skepticism, and how it interplays with the IESBA's Role and Mindset.
- (b) Consideration of fraud risk factors detailed in ISA 240 and whether they can be enhanced with concepts from the IESBA code around behaviors, motivations, and corporate culture.
- (c) Clarification of the definition of fraud.
- (d) Consideration of technology (in particular around ethical considerations such as independence) when auditor's access client information technology (IT) systems.

## Coordination with other IAASB Projects

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<sup>15</sup> Revisions were made to the IESBA Code to promote the role and mindset expected of professional accountants. Changes were made to Sections 100, 110, 120 220 and the Glossary to the IESBA Code. For details, see section "II. Revisions to Promote the Role and Mindset Expected of Professional Accountants" in the [2020 IESBA Handbook of the International Code of Ethics for Professional Accountants including International Independence Standards](#).

144. Respondents commented about coordination with the workstreams for other current IAASB projects.

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.9, Subheading “1.001 Coordination with Other Current IAASB Project Workstreams”):*

#### Monitoring Group Members

145. Monitoring Group respondents who commented about the need for collaboration among IAASB workstreams commented on the following areas:
- (a) Audit Evidence (ISA 500): One Monitoring Group respondent encouraged the IAASB to explore how the reliability of audit evidence is required to be assessed and whether paragraph 11 of ISA 500 requiring additional procedures only when there are doubts about the reliability of information to be used, may, in practice undermine the auditor’s assessment of the reliability of evidence.
  - (b) AR PIR: One Monitoring Group respondent expressed support for the continued efforts of the AR PIR to inform and educate users as well as solicit feedback on the effectiveness of the current reporting model.

#### Other Respondents

146. Other respondents encouraged the IAASB to collaborate effectively with other current IAASB workstreams. These areas include:
- (a) Audit Evidence (ISA 500): Respondents expressed support for the IAASB’s efforts related to audit evidence and emphasized the following areas for collaboration:
    - (i) Enhanced requirements or guidance related to authenticity of documents.
    - (ii) Consideration of technology as it relates to fraud audit procedures and the audit evidence obtained.
      - (a) Respondents noted that with advances in technology, alterations to documents provided as audit evidence may be difficult to detect.
      - (b) Respondents commented that enhanced guidance around how technology may be used to obtain audit evidence directly from third parties could be helpful.
      - (c) Respondents commented that guidance may be helpful to clarify how fraud audit procedures performed using recent technologies, such as data analytics, may fit into the current evidence model under ISA 500.
    - (iii) Enhanced clarity on the required work effort related to evidence from external sources.
    - (iv) Professional skepticism: Respondents noted that the application of professional skepticism and professional judgment is pervasive across all aspects of the audit and, given the interplay between professional skepticism and obtaining sufficient appropriate evidence, will be an important aspect of the Audit Evidence project.
  - (b) AR PIR: Respondents commented that the IAASB should consider the results of the AR PIR and work collaboratively with the AR PIR workstream to solicit feedback about whether the

current auditor reporting requirements are fit for purpose. For further details on specific feedback from respondents about whether more transparency is needed from the auditor related to fraud in an audit of financial statements, refer to section titled “Transparency in the Auditor’s Report”.

- (c) ISA 540 (Revised)<sup>16</sup> Implementation: Respondent comments centered on the following themes:
- (i) Professional Skepticism: Respondents noted that the IAASB should consider making similar enhancements as those that were made recently to ISA 540 (Revised) related to professional skepticism. For further details, refer to section titled “Professional Skepticism”.
  - (ii) Closer links to ISA 540: Respondents commented that the IAASB should consider enhancing the linkage between ISA 240 and ISA 540, particularly around assessing management bias in complex accounting estimates.
  - (iii) Monitoring of Post-Implementation: The IAASB should consider performing a post-implementation review of ISA 540 (Revised) to monitor the effectiveness of the enhancements made related to professional skepticism.
- (d) LCEs: Respondent comments focused on the following themes:
- (i) The IAASB should carefully consider if possible future enhancements will be scalable and proportionate for audits of LCEs.
  - (ii) The Fraud WG should consider the work undertaken by the current IAASB project on LCEs.
- (e) Other Current IAASB Projects:
- (i) Respondents commented that the IAASB should also collaborate with other current IAASB project workstreams, including:
    - a. Group Audits (ISA 600): Respondents commented that the IAASB should consider enhancing the linkage to proposed ISA 600 (Revised), addressing fraud risks that arise at components and highlighting the importance of involvement of component auditors.
    - b. Extended External Reporting (EER): One respondent noted that over time, EER may help mitigate large, high-profile, unexpected corporate failures as a result of providing investors and stakeholders with greater transparency into the opportunities and threats to the entity’s strategy and business model.
    - c. Technology: Respondents encouraged the IAASB to work with the Technology Working Group to consider how emerging technologies may help enhance auditor performance regarding fraud and provide non-authoritative guidance on how auditors use technology to perform fraud-related audit procedures.

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<sup>16</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

- d. Professional Skepticism: One respondent encouraged expanding on the work of the IAASB Professional Skepticism Working Group to develop a framework for applying the concept of professional skepticism in practice.

*Input from Other Information-Gathering Activities:*

- 147. Audit Evidence (ISA 500): During the IAASB Technology roundtable held on September 2, 2020, participants commented that automated tools and techniques provide many useful insights that were not previously available to auditors, but it is difficult to use the insights obtained from data analysis if it does not meet the requirements for audit evidence as described in ISA 500. Therefore, collaboration with the Audit Evidence Working Group will be beneficial to understand how technology can be used to perform audit procedures while still meeting the requirements for audit evidence.
- 148. LCEs:
  - (a) LCE Roundtable: Participants discussed the following topics:
    - (i) The nature of fraud perpetrated in LCEs, and
    - (ii) Procedures related to fraud in audits of LCEs, and the specific challenges encountered by practitioners.
  - (b) In response to IAASB Discussion Paper titled "[Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs](#)" (the "LCE Discussion Paper"), one respondent expressed that clear guidance is needed to explain to what extent substantive procedures must be performed to obtain reasonable assurance in audits of less complex entities taking into consideration the circumstances of smaller entities.

**Possible Actions #26—Ongoing Activities**

Work of Others - The WG will continue to monitor initiatives performed by other stakeholders related to fraud in an audit of financial statements as this serves as an input to help inform the direction of possible future IAASB actions on this topic. The WG will further consider recommendations and changes being made by others in context of the work being undertaken in this project and further monitor all initiatives or work being done by others that were raised by DP respondents.

Outreach - Continued outreach with a broad range of stakeholders throughout each stage of the project to solicit feedback from others will help inform the direction forward.

Coordination with IESBA - Collaboration and cooperation with the IESBA at regular intervals will be continued (as appropriate) as work on fraud progresses. The WG recommends reviewing proposed enhancements to the audit standards with IESBA to agree on possible areas of collaboration or areas where alignment is necessary to ensure consistency.

Collaboration with other IAASB Workstreams – Ongoing monitoring and collaboration with other current IAASB workstreams will continue as appropriate, in particular when considering possible enhancements that (1) may overlap or link to other ISAs, or (2) are already incorporated into other ISAs (e.g., enhancements made around professional skepticism in recently issued standards).



## Education

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheading “03 Educational efforts or additional guidance “):*

149. Although the intention is to not further explore the expectation gap, there are comments that were made in the context of narrowing the expectation gap that may be further considered. It was emphasized that to narrow the expectation gap would take a collaborative and coordinated approach (from a MG member). Although not targeted at IAASB action, further consideration could be given to further communication about what was heard in the responses to the DP.
150. While education is not within the IAASB’s remit, the following comments were highlighted on the need for more education or training:
- (a) There were broad comments suggesting that each stakeholder group in the financial reporting ecosystem consider educational communications, but no specificity was provided (including from MG members). It was emphasized that coordinated efforts would be needed.
  - (b) Robust investor education to assist in enhancing investor’s understanding of current role and responsibilities of auditor’s (from a MG member) to assist with narrowing the expectation gap. It was also highlighted more education is needed about the role of others in the financial reporting ecosystem and the fraud risk triangle. It was noted that it was important that for non-listed entities it was important to continue to educate what information may not be in the purview of the auditor (because of the need to communicate less in such financial statements).
  - (c) More education is needed for TCWG on the development and execution of anti-fraud programs and controls (for example championed by accountancy organizations, board associations, shareholder groups etc.).
  - (d) Consideration is needed about whether more is needed on training about fraud in auditor’s continuing professional education, by both universities and professional accounting bodies (for example, in the areas of fraud risk assessment, forensic skills, technological competence and applying a skeptical mindset (including topics such as behavioral science, e.g., concepts of conscious and unconscious bias)).
  - (e) More training of auditors is needed on fraud (for example, forensic skills and fraud awareness, including about recent fraud cases).

The IAASB was encouraged to coordinate with the International Panel on Accounting Education (IPAE) to address issues related to education.

151. It was also highlighted that audit oversight bodies have a duty to actively participate in and feed into initiatives around enhanced education and standards (contributing to resolving the knowledge and evolution gaps).
152. Matters that may fall within the IAASB’s remit include:
- (a) Public education campaigns about what the concept of reasonable assurance means (as opposed to absolute assurance) and the impact of materiality on identifying and dealing with fraud.



- (b) Education sessions or forums (or through other forms of media) by the IAASB (which could also be coordinated with others) about the roles of each participant in the financial reporting ecosystem, in particular on the prevention and detection of fraud, as well as the inherent limitations of an audit. It was also highlighted that this could show thought leadership to explain how and when fraud may occur, the extent of the auditor's role and respective responsibilities of the auditor and others. It was noted that there was a perception that some of the responsibilities of others had been transferred to auditors.

*Input from Other Information-Gathering Activities:*

153. During the Expectation Gap Roundtable facilitated by the IAASB, participants commented that more can be done around education, by the IAASB and by others in the financial reporting ecosystem. It was noted that educational efforts can help users better understand the scope of the financial statement audit.

**Possible Actions #27—Education Activities**

Possible actions include further considering how the IAASB could use its global voice to encourage others, as appropriate, to consider the matters that have been raised. Consideration could also be given to those areas that may be within the IAASB's remit (bearing in mind that there is a balance on what the IAASB can do given its capacity), including how the messages can be disseminated in an appropriate manner. The WG recognized the importance of consistent messaging to improve the understanding of all stakeholders.

**Importance of the Role of All Stakeholders in the Financial Reporting Ecosystem**



*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheading “Q1b-1A – Suggestions for other stakeholders, and Agenda Item 1-A.8, Subheading “Q4.1 - 08 Both - Importance of role of all stakeholders in the financial reporting ecosystem”):*

**Monitoring Group**

154. Monitoring Group respondents commented that a collaborative, multi-stakeholder solution is necessary to achieve the desired progress towards narrowing the expectation gap and contribute to high-quality financial reporting. They encouraged the IAASB to continue dialogue with other stakeholders on this topic.

**Other Respondents**

155. The majority of other respondents commented that there are actions that may be taken by other participants in the financial reporting ecosystem to help contribute to narrowing the expectation gap related to fraud. Respondents commented that effectively narrowing the expectation gap will require a multi-stakeholder approach.

156. Respondents encouraged the IAASB to promote dialogue and engage in broader discussion with other stakeholders in the financial reporting ecosystem about the roles and actions each party may take to achieve narrowing the expectation gap. Stakeholders need to be aligned on the respective roles and responsibilities of each party.
157. Respondents suggested specific actions for other stakeholders (outside the IAASB), summarized below:
- (a) All or combination of stakeholders
    - (i) Respondents commented that all stakeholders can undertake educational efforts to better inform the public and other targeted audiences about their role in preventing or detecting fraud.
    - (ii) Respondents commented that multiple stakeholders (regulators, audit firms, etc.) could work to share case studies of different type of fraud and potential red flags to expand the cumulative shared knowledge of past frauds. This shared knowledge may aid in developing best practices for governance, audit committees, and auditors.
    - (iii) Respondents highlighted the importance of strengthening the “three lines of defense” as coined by the European Commission, which is made up of (1) corporate governance, (2) the auditor, and (3) capital markets supervision.
  - (b) Entity and its management
    - (i) Respondents commented that the entity and its management play a foundational role for both fraud prevention and detection as the responsibility for preventing and detecting fraud rests first and foremost with management and TCWG of an entity.
    - (ii) Respondents emphasized the importance of the entity's anti-fraud procedures and controls and the overall tone at the top and corporate culture.
  - (c) TCWG
    - (i) Respondents commented that there may need to be enhanced accountability for those in oversight roles. Possible actions proposed were requirements around the minimum skills and training for those that make up the composition of the board and exploring whether TCWG should report externally on their obligations (for example, their obligations to review anti-fraud controls and whistleblowing mechanisms).
    - (ii) Respondents commented that those changed with governance have an opportunity to focus on corporate culture and behaviors to support fraud detection.
  - (d) Accounting standard setters
    - (i) Respondents commented that accounting standard setters should consider if additional requirements are necessary for management that should be enhanced in the applicable accounting framework.

- (e) Internal audit
  - (i) Respondents commented that internal audit may consider enhanced procedures to review and assess the entity's anti-fraud procedures and controls.
- (f) Educational institutions and professional accounting bodies that set requirements for continuing education.
  - (i) Respondents noted that these parties may consider enhancements to auditor training requirements (e.g., to include enhanced training on information systems, fraud, and forensic auditing tools and techniques)
- (g) Auditors
  - (i) Respondents commented that auditors should focus on quality execution of audits and adherence to auditing standards.
- (h) Policy makers, listing exchanges, regulators and oversight bodies
  - (i) Respondents commented that regulators may consider whether enhanced or additional rules and regulations are necessary.
  - (ii) Respondents commented that regulators should participate in initiatives around enhanced education and standards and monitor the quality execution of enhanced requirements.
  - (iii) Respondents commented that policymakers and listing exchanges may consider if stricter rules are necessary for their jurisdictions, for example, requirements around internal control certifications or anti-fraud mechanisms.
  - (iv) Respondents commented that policymakers should consider if stronger national laws and regulations are needed to provide legal deterrents against fraud and prevent retaliation against whistleblowers.
  - (v) Respondents commented that regulators may be able to provide timely communication of relevant information to which they have access in order to assist auditors in the assessment of risks of material misstatement and design of responses.

*Input from Other Information-Gathering Activities:*

158. The following input was obtained through other information-gathering activities performed.

- (a) Expectation Gap Roundtable – During the roundtable held in September 2020 to discuss the expectation gap related to fraud and going concern, participants expressed that the expectation gap related to fraud will not be narrowed by standard-setting alone. It was emphasized that it will require efforts from all participants in the financial reporting ecosystem.
  - (i) Participants noted that the role of users should be further considered, and their needs understood.
  - (ii) Participants also noted that certain changes in the auditing standards will need to be considered in tandem with the relevant responsibilities of management (i.e., possible

changes to the applicable reporting framework may need to come before changes to auditing standards).

#### **Possible Actions #28—Encouraging Others in the Financial Reporting Ecosystem to Take Action**

Possible actions include:

- (a) Issuing a communication from the Chair of the IAASB briefly explaining the importance of this topic and that the IAASB is progressing its work on fraud. This communication could also emphasize the importance of others playing a role in narrowing the expectation gap.
- (b) Continued participation in the global discussion on this topic through continued outreach and interaction with others in the financial reporting ecosystem; and
- (c) Further discussion about whether there are specific actions the IAASB can take to encourage others in the financial reporting ecosystem to act on this topic.

#### **Other Suggestions**



159. The DP asked respondents to comment on any other matters the IAASB should consider as it progresses its work on fraud in an audit of financial statement. This section summarizes themes from respondent comments related to other items for consideration.

*What We Heard from DP Respondents (See NVivo – Agenda Item 1-A.2, Subheading “Q1b-1 - IAASB - 01 Add fraud as evergreen IAASB agenda item and Agenda Item 1-A.9, Subheadings “Q4.1 - 14 Fraud - Separate assurance engagement” and “Q4.1 - 01 Both - Additional guidance necessary for public sector”):*

- 160. Respondents encouraged the IAASB to continue to develop principles-based standards that are not overly prescriptive and may serve as the bases for audits of all entities internationally.
- 161. Other respondents commented that separate assurance engagements may be an effective way for practitioners to provide assurance on corporate culture and internal controls. While they acknowledged it is not the role of the IAASB to mandate such an engagement, it may be helpful to develop a standard on assurance engagements specific to internal controls for those jurisdictions that have such requirements.
- 162. A respondent commented that additional guidance is needed in areas specifically considering the public sector context.

#### *Input from Other Information-Gathering Activities:*

- 163. On February 22, 2021, WG met with Representatives from CIPFA and the ECA. Those representatives commented that it would be helpful if enhanced public-sector application material was provided.

**Possible Actions #29—Other Actions**

Actions include:

- (a) Continuing to develop standards and guidance that is scalable, proportionate, and principles based.
- (b) Monitoring developments on internal controls engagements and requirements globally; and
- (c) Enhancing application material or issuing guidance to provide public sector context as needed.

## APPENDIX A

### Listing of NVivo Reports and Excel Summary Spreadsheet Tabs

Agenda Item	Reference to Question # in the DP	NVivo Word File Reference	Excel Tab Reference
3-A.1	1(a)	20210421-IAASB-Agenda Item 3-A.1 - Fraud-Question 1(a)	Question 1(a)
3-A.2	1(b)	20210421-IAASB-Agenda Item 3-A.2 - Fraud-Question 1(b)	Question 1(b)
3-A.3	2(a)	20210421-IAASB-Agenda Item 3-A.3 - Fraud-Question 2(a)	Question 2(a)
3-A.4	2(b)	20210421-IAASB-Agenda Item 3-A.4 - Fraud-Question 2(b)	Question 2(b)
3-A.5	2(c)	20210421-IAASB-Agenda Item 3-A.5 - Fraud-Question 2(c)	Question 2(c)
3-A.6	2(c)(i)	20210421-IAASB-Agenda Item 3-A.6 - Fraud-Question 2(c)(i)	Question 2(c)(i)
3-A.7	2(d)	20210421-IAASB-Agenda Item 3-A.7 - Fraud-Question 2(d)	Question 2(d)
3-A.8	4	20210421-IAASB-Agenda Item 3-A.8 - Fraud-Question 4	Question 4
3-A.9	N/A This report contains a summary of comments where respondents referenced coordination with other workstreams and is not related to a particular question within the DP.	20210421-IAASB-Agenda Item 3-A.9 - Fraud-Reference to Other Workstreams	N/A This report contains a summary of comments where respondents referenced coordination with other workstreams and is not related to a particular question within the DP.

## APPENDIX B

### List of Respondents to the DP

#	Abbrev.	Respondent	Region
<b>Monitoring Group (4)</b>			
1	BCBS	Basel Committee on Banking Supervision	GLOBAL
2	IAIS	International Association of Insurance Supervisors	GLOBAL
3	IFIAR	International Forum of Independent Audit Regulators	GLOBAL
4	IOSCO	International Organization of Securities Commissions	GLOBAL
<b>Regulators and Oversight Authorities (8)</b>			
5	BAOA	Botswana Accountancy Oversight Authority	MEA
6	CPAB	Canadian Public Accountability Board	NA
7	CSA	Canadian Securities Administrators	NA
8	CEAOB	Committee of European Auditing Oversight Bodies	EU
9	FRC	Financial Reporting Council	EU
10	IRBA	Independent Regulatory Board for Auditors	MEA
11	IAASA	Irish Auditing and Accounting Supervisory Authority	EU
12	NASBA	National Association of State Boards of Accountancy	NA
<b>National Auditing Standard Setters (10)</b>			
13	AUASB	Australian Auditing and Assurance Standards Board	AP
14	AASB	Canadian Auditing and Assurance Standards Board	NA
15	CNCC-CSOEC	Compagnie Nationale des Commissaires aux Comptes and the Conseil Supérieur de l'Ordre des Experts-Comptables	EU
16	HKICPA	Hong Kong Institute of Certified Public Accountants	AP
17	IDW	Institut der Wirtschaftsprüfer in Deutschland e.V.	EU
18	JICPA	Japanese Institute of Certified Public Accountants	AP
19	KICPA	Korean Institute of Certified Public Accountants	AP
20	MIA	Malaysian Institute of Accountants	AP
21	NZAuASB	New Zealand Auditing and Assurance Standards Board	AP

22	NBA	Royal Netherlands Institute of Chartered Accountants	EU
<b>Accounting Firms (18)</b>			
23	BDO	BDO International Limited	GLOBAL
24	CR	CohnReznick	NA
25	CG	Crowe Global	GLOBAL
26	DTTL	Deloitte	GLOBAL
27	EY	Ernst & Young Global Limited	GLOBAL
28	GTI	Grant Thornton International Ltd	GLOBAL
29	HLB	HLB International	GLOBAL
30	KPMG	KPMG International	GLOBAL
31	MAZ	Mazars	GLOBAL
32	MAZUSA	Mazars USA	NA
33	MHA	MHA Macintyre Hudson	EU
34	MNP	MNP LLP	NA
35	MGN	Moore Global Network	GLOBAL
36	PKF	PKF International Limited	GLOBAL
37	PwC	PricewaterhouseCoopers	GLOBAL
38	RSM	RSM International Limited	GLOBAL
39	NI	Nexia International	GLOBAL
40	SRA	SRA	EU
<b>Public Sector Organizations (5)</b>			
41	AGSA	Auditor General of South Africa	MEA
42	ACAG	Australasian Council of Auditors General	AP
43	NZAG	New Zealand Auditor-General	AP
44	OAGC	Office of the Auditor General of Canada	NA
45	GAO	US Government Accountability Office	NA
<b>Member Bodies and Other Professional Organizations (31)</b>			
46	AE	Accountancy Europe	EU
47	AICPA	American Institute of Certified Public Accountants	NA
48	IBR-IRE	Belgian Institute of Registered Auditors	EU



49	BICA	Botswana Institute of Chartered Accountants	MEA
50	CAQ	Center for Audit Quality	NA
51	CFOF	CFO Forum of South Africa	MEA
52	CAANZ-ACCA	Chartered Accountants Australia and NZ and ACCA - Joint	GLOBAL
53	CII	Confederation of Indian Industry	MEA
54	CPAA	CPA Australia	AP
55	FACP	Federacion Argentina de Consejos Profesionales de Ciencias	SA
56	ICPAU	Institute of Certified Public Accountants of Uganda	MEA
57	ICAEW	Institute of Chartered Accountants in England and Wales	EU
58	ICAS	Institute of Chartered Accountants of Scotland	EU
59	IoDSA ACF	Institute of Directors in South Africa's Audit Committee Forum	MEA
60	ISCA	Institute of Singapore Chartered Accountants	AP
61	IAA	Inter-American Accounting Association	NA
62	IATA	International Air Transport Association	GLOBAL
63	IFAC	International Federation of Accountants	GLOBAL
64	KNL	Kriton	EU
65	MICPA	Malaysian Institute of Certified Public Accountants	AP
66	IMCP	Mexican Institute of Public Accountants	NA
67	NYSSCPA	New York State Society of CPAs	NA
68	PAFA	Pan African Federation of Accountants	MEA
69	PIRC	Pensions and Investment Research Consultants	EU
70	REA	REA Auditores - Consejo General de Economistas	EU
71	SAICA	South African Institute of Chartered Accountants	MEA
72	EACLN	European Audit Committee Leadership Network	EU
73	FAR	The Institute for the Accountancy Profession in Sweden	EU
74	TURMOB	Union of Chambers of Certified Public Accountants of Turkey	MEA
75	WPK	Wirtschaftsprüferkammer	EU
76	BNCTI	Belgian National Chapter of Transparency International	EU
<b>Investors and Analysts (1)</b>			
77	CRUF	Corporate Reporting Users Forum	GLOBAL

<b>Academics (1)</b>			
78	ASC	Auditing Standards Committee of the Auditing Section of the American Accounting Association	NA
<b>Individuals and Others (7)</b>			
79	AAQ	Ahmed Al-Qawasmi	MEA
80	AFV	Alvaro Fonseca Vivas	SA
81	CM	Christian Munarriz	SA
82	CC	Constantine Cotsilinis	EU
83	DT	Dmitrii Timofeev	EU
84	MB	Michael Bradbury	AP
85	TU	The Unlimited	MEA

## APPENDIX C

### Summary of Issues/Themes and Action Recommended

Issue/Theme	Standard-Setting - Requirements	Standard-Setting – App. Material	Non-Authoritative Guidance	Education	Actions for Others	Further WG and Board Discussion Needed
Stronger Linkages to Risk Identification and Assessment (ISA 315 (Revised 2019))	X	X	X			
Enhanced Transparency with TCWG and Enhanced Linkage to ISA 260	X	X				
Closer or Enhanced Linkage to ISA 550	X	X	X			
Suspicious Mindset and Professional Skepticism	X	X	X			
Journal Entry Testing	X	X	X			
Technology		X	X			
Non-Material Fraud and Linkage to ISA 320	X	X	X			
Unpredictability Procedures		X	X			
Audit Documentation and Closer or	X	X	X			X <sup>17</sup>

<sup>17</sup> This category will remain open as the project progresses because the WG will further consider whether specific documentation requirements are needed for any enhancements proposed.

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Enhanced Linkage to ISA 230						
Analytical Procedures and Closer or Enhanced Linkage to ISA 520	X	X	X			
Linkage to Other ISAs (those not already referenced in other categories)	X	X	X			
Forensic Specialists						X
Definition of Fraud						X
Enhanced Transparency in the Auditor's Report						X
Revisit Introductory Language in ISA 240 About Inherent Limitations of an Audit						X
Making the Fraud Brainstorming (Engagement Team Discussion) More Robust	X	X				X
Clarifying the Relationship Between ISA 240 and ISA 250 (Revised)						X
Rebuttable Presumption of Fraud Risk in Revenue Recognition						X
Requirements for when Fraud is Detected or Identified						X
External Confirmations and Closer or Enhanced Linkage to ISA 505	X	X	X			X

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Development of Non-Authoritative Guidance			X			
Third-Party Fraud			X	X		
Engagement Quality Reviews	N/A – No action recommended.					
Expectation Gap	N/A – No action recommended.					
Root Cause Analysis	N/A - WG recommends further outreach and discussion with others.					
Work of Others	N/A - WG recommends continued monitoring of initiatives performed by others.					
Continued Outreach	N/A - WG recommends further outreach and discussion with others.					
Coordination with IESBA	N/A – WG recommends continued collaboration and coordination with IESBA.					
Coordination with Other IAASB Workstreams	N/A – WG recommends continued collaboration and coordination with other IAASB workstreams.					
Education				X	X	
Importance of the Role of All Stakeholders in the Financial Reporting Ecosystem					X	X
Other Suggestions		X	X			