

# Fraud and Going Concern Discussion Paper

**Question (1a)-1. What do you think is the main cause of the expectation gap relating to fraud in an audit of financial statements?**

**Q1a-1.1 - Combination of one or more components (evolution gap, knowledge gap, or performance gap)**

## 1. Monitoring Group

### Basel Committee on Banking Supervision (BCBS)

Fraud

The Committee understands that there may be gaps between what the users expect from the auditor and the financial statement audit. As noted in the discussion paper, 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).

### International Organization of Securities Commissions (IOSCO)

We believe that there are, broadly, two potential issues at play with respect to the auditor's detection of fraudulent financial reporting. First is the potential that some auditors have failed to conduct audits in accordance with the existing requirements of professional standards – though the standards are clear (we refer to this as failures in performance). Second is the potential that there should be incremental requirements (or clarifications) in the professional standards to mitigate the risk that material misstatements, whether due to fraud or error, go undetected when auditors are providing reasonable assurance on the financial statements. We believe it is important to distinguish these two because we are concerned about standard-setting responses to failures in performance rather than in response to the need for enhancements or clarifications of extant standards.

What are causes of the expectation gap?

We appreciate the discussion on the audit expectation gap included in the Paper on page 11, “which described three components of the expectation gap: the “knowledge gap”, the “performance gap”, and the “evolution gap”.

In our view, there is an overlap between the knowledge and evolution gaps, in terms of financial statement users' expectation of auditors. This relates to not only what auditors' current responsibilities are today based upon the existing standards, but what the users expect they should be. We believe the IAASB should consider as part of its information gathering activities what, if any, expectations that 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.

The last component of the expectation gap outlined in the Paper is the performance gap, where we believe a critical activity for the IAASB during the information gathering phase is to analyze the root causes of recent events, in order to determine the cause(s) of the performance gap.

## 2. Regulators and Audit Oversight Authorities

### Canadian Securities Administrators (CSA)

#### Fraud

Within the knowledge gap component of the expectations gap, we agree that the current wording prescribed for an auditor's report does not clearly explain the nature, extent and limitations of the auditor's responsibilities in relation to fraud. The statement "the risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control," (per Appendix C1 of ISA 700 – Forming an opinion and reporting on financial statements) does not explicitly state that the standards do not require the auditor to detect fraud. Related to this knowledge gap, in response to the evolution gap, the IAASB should consider expanding the requirements and enhancing procedures in the auditing standards targeted at the identification of risks relating to fraud for better detection of fraud. However, the IAASB should ensure that the costs to implement and apply any new requirements do not outweigh the benefits. It appears auditors themselves are considering changes to address the evolution gap, as highlighted by the response to the Wirecard scandal by EY Global Chairman Carmine Di Sibio, where he noted: "Many people believe that the fraud at Wirecard should have been detected earlier and we fully understand that. Even though we were successful in uncovering the fraud, we regret that it was not uncovered sooner".

With respect to the performance gap, page 11 of the Discussion Paper states that for the purposes of the Discussion Paper, the IAASB is limiting its consideration of the performance gap to issues resulting from an auditor not doing what is required because the requirements are not clear or leave room for misinterpretation. We agree that the performance gap may be the result of auditors not having sufficient understanding in the area of fraud. However, in the table on page 13, the examples in the first and fourth bullets of "aspects that require further consideration" relating to the performance gap are where the auditors do not meet the existing standards due to time and client pressures. These bullets raise additional considerations (e.g., quality control procedures, audit fee pressures) that are not within the scope of this Discussion Paper, and therefore we have not commented on these issues even though we agree these are concerns. We note that if an auditor knowingly does not meet existing standards, changing the terminology used in the audit standard (as proposed in the Discussion Paper) or changing the requirements in the audit standards will not address this type of performance problem. We recommend to the Board to pursue these types of performance concerns separately.

Relating to the evolution gap, we agree that users of financial statements are looking for enhanced procedures in relation to fraud that are not currently required by auditing standards. Based on the public response to the high-profile corporate failures highlighted in the Discussion Paper, we think users expect the auditor to more rigorously identify, assess, and carry out audit procedures responsive to, the risks of material misstatement due to fraud. Technological advances have contributed to the evolution gap and we think stakeholders expect auditors to be able to leverage new technologies in the financial statement audit. We recommend the IAASB consider modernising the standards to reflect technological advances, for example where an auditor can use technology (e.g., data analytics, data mining, or other forensic techniques) for fraud detection, to increase the coverage of audit samples or to reduce some of the more mundane or routine procedures that have to be done so that auditors can focus on the areas of greatest risk and on key judgments that management is making.

## **Committee of European Auditing Oversight Bodies (CEAOB)**

We would like to emphasize the fact that difficulty in detecting material misstatements in the financial statements resulting from fraud (rather than error) does not reduce the auditor's responsibility. Similarly, difficulty in assessing the management's use of the going concern assumption and whether a material uncertainty exists related to future events or conditions that may cause an entity to cease to continue as a going concern does not reduce the auditor's responsibility.

In certain cases involving fraud, even where the fraud was very significant or where the auditor's report did not highlight concerns regarding the situation of an entity which collapsed shortly after its issuance, the "expectation gap" has been put forward by auditors to explain that no material misstatements or uncertainties were identified during the audit. However, in instances where auditors have not complied with the requirements of the ISAs, including ISA 240 (on fraud) and ISA 570 (on going concern), putting forward the "expectation gap" alone is not an appropriate explanation to justify the failure.

The DP provides some examples of corporate failures and scandals. However, there is limited information presented on their detailed circumstances. Performing a root cause analysis on such recent corporate failures or scandals would be highly beneficial to understand the roles of the different parties and, in any cases involving audit failure, the reasons for that failure. This analysis should be carried out as a prerequisite before discussing which aspects of the audit engagement to change in the auditing standards.

In the light of these recent corporate failures and scandals, the CEAOB encourages the IAASB to further explore the role of the auditor in relation to fraud and going concern in an audit of financial statements to ensure that the public interest is appropriately served and best promoted.

## **Financial Reporting Council (FRC)**

In relation to both fraud and going concern, we agree with the description of the three components of the expectation gap that are described on page 11 of the Discussion Paper. We also broadly agree with the examples of aspects that could be better addressed by standard setting, including supporting materials, and aspects that require further consideration. The extent to which these different components and the related aspects exist will vary across and within jurisdictions. For example, in any one jurisdiction there may be stakeholders who have a very good understanding of what auditors do and others who do not. Similarly, different stakeholders may have different views as to how they would wish audit to evolve, and the level of assurance they want that audit to provide. While audit inspections and investigations into corporate failures and major frauds have revealed audit performance failures and inconsistency of application, there is no evidence of general performance failures in all audits.

In light of this, we would not suggest that, from a global perspective, there is one particular "main cause" of an expectation gap.

## **Independent Regulatory Board for Auditors (IRBA)**

The consolidated view of the stakeholders consulted (see the cover letter) is that each component – the "knowledge gap", the "performance gap" and the "evolution gap" – contributes to the audit expectation gap in a significant manner.

The "evolution gap" is a common concern shared by regulators and those charged with governance. Concerns raised include whether the audit product and, consequently, the standards that support the audit product are evolving at the same pace as business; and whether they can keep up with the evolving

business models, information systems and accounting standards that are more judgement and estimation based today than they were a few years ago.

We have learnt – from our discussions with the Audit Committee and CFO forums, as well as from what is being reported in the media – that the public is expecting auditors to do more in relation to preventing corporate failures caused by undetected fraud and unidentified risks to the financial stability and the long-term going concern of corporations.

### **Irish Auditing and Accounting Supervisory Authority (IAASA).pdf**

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### **National Association of State Boards of Accountancy (NASBA)**

(a) NASBA believes the expectation gap relating to fraud and going concern in a financial statement audit may be caused by a few factors: lack of understanding by the public as to what an audit is and what auditors do; inconsistent audit execution in these areas by some auditors due to lack of understanding and, in some cases, competence; and the inherent limitations of a financial statement audit.

## **3. National Audit Standard Setters**

### **Australian Auditing and Assurance Standards Board (AUASB)**

#### **Knowledge Gap**

Contention persists around the expectation gap between what users of financial statements expect an auditor to provide and what auditors are required to provide under statutory obligations when it comes to the auditor's role in preventing and detecting fraud. In part the knowledge gap exists because users of the financial statements (e.g. investors) believe that auditors should be able to detect all material fraud. That is, they do not have enough understanding of the complexities (i.e. intentional behaviours, collusion) that usually exist when a sophisticated fraud is perpetrated, and therefore the difficulties encountered by auditors in detecting fraud. The IAASB could work with the international investor community to further educate both institutional and retail investors in this area.

Most stakeholders agreed that the knowledge gap contributes significantly to the expectation gap, but it is not the only factor to consider. Other auditing and assurance concepts relating to fraud, such as the different levels of assurance (i.e. reasonable and limited), materiality, risk-based auditing, and sampling can be very difficult for users to comprehend. Understanding these concepts and the implications of them for audit engagements requires in-depth technical knowledge of auditing. This contributes to the knowledge gap of what the public expects from auditors. The knowledge gap is always going to be challenging to

address, however through improved communication of these concepts in the audit report (for example, using Key Audit Matters (KAMs)) and other communication strategies there are other ways this could be addressed by the IAASB.

Another factor that may contribute to the knowledge gap is that some of the public's expectations of auditors in relation to fraud are developed without any consideration of a cost-benefit analysis. Without determining the true cost of meeting any increased expectations, and who is expected to address them, it is difficult to talk about the expectation gap in a practical sense. To enable meaningful discussions about practically addressing user expectations, a proper cost-benefit analysis is required for any additional measures to address the fraud knowledge gap.

### Performance Gap

The view of the AUASB and its stakeholders is that the current fraud standard, ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report, remains fit for purpose and does not require a fundamental overhaul. Enhancing the requirements of this standard is one possible course of action the IAASB could take to address the drivers of the performance gap, but our consultations on this topic did not see it as the only approach. Feedback we received indicated the responsibility to address issues associated with the performance gap spreads across multiple parties in the financial reporting ecosystem.

In particular, a key part of addressing the fraud performance gap lies with management and those charged with governance (TCWG) and their role to implement and manage relevant governance, culture, risk management and internal control requirements that fulfil their obligations to prevent and detect fraud. The AUASB's outreach noted that any changes to the auditor's responsibilities to respond to fraud risk needed to be aligned to commensurate responsibilities for management and TCWG. This could also be supported through further reporting by TCWG on fraud in their attestation requirements, such as the Directors' Declaration which accompanies an entity's financial report and is audited as part of the financial statements in Australia, or similar Director responsibility statements used in other jurisdictions.

Stakeholders agreed that corporate culture has a significant impact on the likelihood of fraudulent financial reporting. Further consideration on governance and integrity around internal controls and the impact on culture and behaviour, as lines of defence in the prevention and detection of fraud should be given high priority. Of equal importance is TCWG's responsibility for creating and maintaining a corporate culture and identity conducive to integrity, as well as implementing and overseeing adequate controls to mitigate the risk of management override.

### Evolution Gap

The AUASB and its stakeholders noted that the expectations of users and entities relating to fraud may have changed due to the increased use of specialist technological tools and techniques (e.g. data analytics and other data mining tools). Considering how the use of technology is now more likely to be included in a firm's audit methodology and the way firms use technology on an audit has evolved, then this is an area which could be better reflected through a modernisation of ISA 240.

However, our outreach noted that the adoption of specialist technological tools and techniques by auditors when it comes to addressing fraud prevention and detection is not as widespread as many may believe, as the investment in infrastructure and training to effectively apply technology on audits is still significant. Accordingly, any suggestion that the better adoption of technology is the sole solution to address the evolution gap is misplaced.

## Canadian Auditing and Assurance Standards Board (AASB)

### Other comments

Our stakeholders cautioned against putting too much emphasis on any one sub-component of the expectation gap. In their opinion, some actions focused on narrowing the evolution gap may result in an increase in the knowledge gap. For example, expanding the involvement of forensic specialists may result in users having heightened expectations of the audit which may widen the expectation gap.

We used the Discussion Paper's breakdown of the expectation gap by sub-components (i.e., knowledge, performance, evolution etc.) when engaging with our stakeholders during consultations. However, we did not find the sub-components helpful in developing our views and recommendations. The sub-components were interpreted by stakeholders based on their understanding of the role of each party in the financial reporting ecosystem and therefore lacked consistency.

In our view, there is no one main cause of the expectation gap, but rather, several inter-connected factors/causes.

This view is evidenced by the fact that our stakeholders did not agree on a main cause, expressing varying views. The only item our stakeholders all agreed on was that it is not just the auditor that needs to implement actions to narrow the expectation gap.

We believe that all parties within the financial reporting ecosystem must contribute to narrowing the gap through undertaking actions such as those outlined in our response to Q1(b). In our view, a collective effort by all parties is the only way to make a meaningful impact to narrow the expectation gap.

### Fraud

Our stakeholders had mixed views on the main cause of the expectation gap as it relates to fraud. They identified causes within each of the Discussion Paper's defined sub-components of the expectation gap (knowledge, performance, and evolution) and in many cases they were of the view that the cause related to more than one sub-component.

### Knowledge gap

Many stakeholders were of the view the expectation gap was primarily driven by a lack of understanding by financial statement users of the role of each party in the financial reporting ecosystem, including that of the auditor.

### Performance gap

Some stakeholders, primarily those that were not practitioners, indicated the expectation gap was caused by the auditor failing to fulfill the requirements in audit standards, or that the requirements in ISA 240 are not robust enough. In one instance, a financial statement user pointed to findings from fraud scandals that they believe indicate the auditor failed to perform their responsibilities.

### Evolution gap

The majority of stakeholders felt auditors could do more in response to the ever-changing tools and techniques that fraudsters use in perpetrating fraud, including new technologies. They indicated that fraud was the area with the most opportunity, and in some cases, most need, for the auditor's role to evolve.

## Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC)

### Expectation gap relating to fraud

We are of the view that the question of fraud is one of the most complex and probably one of the most misunderstood issue in relation to the auditor's duties. We believe that the main causes of expectation gap relating to fraud in an audit of financial statements could be analysed as follows:

#### Misunderstanding about the role and responsibilities of the auditor on fraud

Public opinion considers that auditors play a role that extends beyond providing the provision of such reasonable assurance.

Stakeholders seem to expect auditors to detect and communicate all significant frauds and errors committed within an entity. Some stakeholders think even that the role of the auditor is to detect all error and fraud cases, i.e. material and non-material frauds. This is due to the fact that some users of financial statements do not understand what an audit entails (i.e., nature, extent and limitations of the auditor's procedures) and may have unreasonable expectations of what auditors ought to do compared to what auditors are actually capable of doing due to the inherent limitations of an audit.

Auditing standards and the EU legislation define the purpose of audit as to enhance the intended users' confidence in financial statements. The objective of the auditor is to obtain a reasonable assurance about whether the financial statements, as a whole, are free from material misstatement. A misstatement can arise from fraud or error. The distinguishing factor between these two is that the action which results in the misstatement is intentional in the case of fraud. Not all instances of fraud will result in a misstatement of financial statements (for example if there has been a misappropriation of assets which has been identified and is properly booked in the financial statements), and when they do, the misstatement may not be material. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement (whether caused by fraud or error) when it exists.

A lack of knowledge about what an audit is generates confusion about the nature of the auditor's responsibilities: does the auditor have an obligation of result (i.e. identifying all frauds) or of means (i.e. performing procedures designed to identify frauds) in terms of detecting fraud?

Auditors apply a risk-based approach and their main responsibility with regards to fraud is to identify, assess and respond to risks of material misstatements. In doing so, they consider fraud risk factors which are the events or conditions that indicates an incentive or pressure or provide an opportunity to commit fraud. In practice, an auditor may have performed a good and efficient audit without having detected any of the existing frauds. In all audits there is an unavoidable risk that some material misstatements in the financial statements may not be detected. This risk is higher for misstatements resulting from fraud than for one resulting from error. Fraud usually involves sophisticated schemes designed to conceal it, such as collusion with third parties or forgery of third-party evidence, intentional omissions, misrepresentations. Detecting fraud can be particularly difficult when committed by management, since management is in a position to override internal control procedures.

#### Term fraud and its scope not clearly defined

As mentioned hereabove, the auditor's responsibility is to plan an audit to obtain reasonable assurance that there are no material misstatements that are resulting from fraud and error.

Furthermore, fraud is a legal concept and the definition of fraud in the law is very broad and includes, without any materiality threshold, any accounting, tax and social security fraud, any internal and external fraud and any embezzlement organised for a moral or financial advantage.

The same term (fraud) used in two different contexts with different objectives is a source of misunderstanding and increases expectation gap.

We therefore consider that the term fraud in the context of audit should be further clarified and explained to the third parties. For example, it is unclear whether or not the term Fraud includes client's non-compliance with laws and regulations (NOCLAR), corruption, money laundering and the financing of terrorism, internal or external fraud. We are also conscious that there is not always a clear distinction between these two categories and that one may lead to another. Moreover, a matter of non-compliance with laws and regulations may also be a matter of fraud. When committed intentionally, such non-compliance or irregularity may be considered as fraud by stakeholders.

### **Hong Kong Institute of Certified Public Accountants (HKICPA)**

Based on our outreach to stakeholders, we believe that the expectation gap is mainly a combination of the knowledge gap and the evolution gap. For the knowledge gap, it is observed that the general public and audit report users may not have a thorough understanding or knowledge of the role of auditors and the approaches used and procedures carried out by auditors under the current auditing standards. Hence, the public may over-expect what auditors actually do during an audit of financial statements.

Though we believe the extant auditing standards remain robust and fit for purpose, stakeholders who are preparers of financial statements expressed observations that the current auditing standards may not have kept up with the rapid changes in financial markets and technological advancements. This lag in the development of new standards is identified as the evolution gap.

Based on the feedback from stakeholders, we recommend that the IAASB work with local professional accountancy bodies and standard setters to educate the general public through discussion forums or publications. A full understanding of the work performed by auditors and its limitations and the responsibility of those charged with governance (TCWG) related to fraud and going concern would be helpful to narrow the expectation gap. The HKICPA is willing to work with the IAASB to organise discussion forums or develop publications.

The expectation gap is mainly due to the general public and financial statement users not fully understanding the work performed by auditors during an audit, referred to in the DP as the knowledge gap.

### **Japanese Institute of Certified Public Accountants (JICPA)**

We think that the main causes of the expectation gap relating to fraud in an audit of financial statements are as follows:

There are actual cases in which the auditor was unable to detect material misstatement of the financial statements due to fraud.

An auditor 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, and expressing an opinion. However, there are actual cases in which material misstatement of the financial statements due to fraud is subsequently discovered although the auditor expressed an unmodified opinion. This has triggered discussions as to whether the audit was properly conducted.

The roles of management, those charged with governance, and auditors in the financial reporting ecosystem need to be reaffirmed.

In order to achieve fair financial reporting, it is essential that all participants in the financial reporting ecosystem, in particular management, those charged with governance, and auditors, fulfil their respective roles. The extant International Standard of Auditing (ISA) 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” (ISA240) paragraph 4 states “the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.” ISA240 paragraph 5 also states “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.” Under the current financial reporting system, it is considered that the social consensus is to set the objectives and scope of an audit of financial statements as obtaining “reasonable assurance” that the financial statements are free from material misstatement, taking into account social benefits and costs. Detecting non-material fraud committed by employees and responding to cyber risks that do not cause material misstatement of the financial statements, which are described in the discussion paper, should not be included within the scope of an audit of financial statements, taking into account social benefits and costs.

In order to ensure that the financial reporting ecosystem as a whole responds more appropriately to fraud, we believe that there should be sufficient dialogue and reaffirmation among the participants on their roles and responsibilities of management, those charged with governance, and auditors.

#### **Korean Institute of Certified Public Accountants (KICPA)**

(KICPA response) The gap between what the general public expects from audit and what the auditor actually provides is mostly about the knowledge gap, and the gap is mostly associated with the hindsight gap, a gap between expects of stakeholders on auditors prior to a negative event and those after that event occurs, due to the lack of understanding on the inherent limitations of audits, thereby giving rise to the overestimation of the government, regulators and media about the extent to which audit services could provide, which could mislead investors, consumers and other financial statement users about the limitation of auditors’ responsibilities.

In addition, auditing standards and practical guidance relating to fraud and going concern issues have difficulties with providing clear guidelines fit for each case. Therefore, in most of the parts, these standards and guidance require that the auditor exercise “professional judgment” throughout the audit procedures, thereby bring about differences in their understanding and application. While the public expectation level and fraud scheme, in particular, have continuously evolved, driven by technological transformation, specified audit methodologies have not advanced in a timely manner, in response to the public expectation and fraud scheme changes, but lagged behind the changes, all of which have resulted in the expectation gap.

#### **New Zealand Auditing and Assurance Standards Board (NZAuASB).pdf**

The NZAuASB considers the analysis of the various causes of the expectation gap to be helpful and that the knowledge gap, performance gap, evolution gap and hindsight gap are all causes of the expectation gap. However, the Board considers the main causes of the expectation gap relating to fraud and going concern differ.

Fraud

At our roundtable event, most participants, from all stakeholder groups, noted the knowledge gap is a key contributor to the expectation gap. Concepts such as reasonable assurance, materiality, risk-based auditing etc can be very difficult to explain. Understanding the ambiguity in these concepts and the implications of such ambiguity for audit engagements require in-depth technical knowledge of auditing. This contributes to the knowledge gap of what the public expects from auditors. This knowledge gap is difficult to reduce, and cannot be addressed by amending the role and responsibilities of the auditor alone. Some of the participants, primarily academics, further believed that auditors cannot clearly explain what their role is in detecting fraud, and this may also contribute to the knowledge gap.

Another factor that may contribute to the knowledge gap is that some of the public expectations of auditors in relation to fraud are made in a vacuum of a cost-benefit analysis. Without knowing the cost of meeting these expectations, and who is expected to meet them, it is difficult to talk about the expectation gap in a realistic sense. A cost-benefit analysis is needed to enable meaningful discussions about user expectation.

The roundtable participants, from all stakeholder groups, also agreed that there is an evolution gap in relation to prevention and detection of fraud. There may be a place for evolution about what is meant to be reported on, as the economic environment changes. However, it is not solely the responsibility of external auditors. It is vital that all those within the financial reporting ecosystem do their part to meet evolving expectations.

Management and those charged with governance, who hold the primary responsibility for preventing and detecting fraud, have a particularly significant role to play. It would be impractical for auditors to meet these expectations without specific disclosures and statements regarding management's responsibilities for implementing systems that are adequate to prevent and detect fraud. Of equal importance is those charged with governance's responsibility for creating and maintaining a corporate culture and identity conducive to integrity, as well as implementing and overseeing adequate controls to mitigate the risk of management override of controls.

At our roundtable event, participants' views were that there is also a performance gap in case of financial reporting fraud perpetrated by senior members of management. ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, clearly stipulates that such instances of fraud should be a key focus for auditors. Instances of major financial reporting frauds must be duly studied, and the lessons learned shared between both auditing standard setters and audit practitioners.

Views were mixed about whether the expectation gap relating to auditor's identification of instances of misappropriation of assets can be attributed to the knowledge gap or performance gap.

It was also noted that audit procedures may not be targeted at detecting fraud. Auditors rarely come across instances of fraud perpetrated by employees in their auditing careers and external audit procedures rarely find actual instances of fraud. This makes training auditors to be good at detecting fraud difficult. Furthermore, most instances of fraud perpetrated by employees are discovered by an entity's system of internal controls (e.g., Internal auditors), not by external auditors and their audit procedures. This is to be expected as detecting small scale frauds requires in depth knowledge of and continuous involvement in the day-to-day activities of the entity. External auditors seldom have such knowledge or involvement in the day-to-day activities of the entity. It may be unreasonable to expect auditors to be more successful at identifying actual instances of misappropriation of assets by employees (other than senior management) than an entity's internal controls.

The auditing standards recognise that management of an entity may conclude that it is not cost effective to implement certain controls (e.g., management accepts the higher risk associated with a lack of segregation

of duties). The auditing standards require auditors to mitigate this increased risk of fraud by adjusting their risk assessment. However, it is unclear if it is reasonable to expect auditors to be able to compensate for the inadequate controls with cost-effective audit procedures. Clear communication of such strategic choices and the associated risks by management to those charged with governance, and where appropriate, to users is required if the expectation gap relating to these types of fraud is to be meaningfully narrowed.

#### Royal Netherlands Institute of Chartered Accountants (NBA)

The various components of the expectation gap each play a role. Regarding the knowledge gap, we should not act defensive as auditors, but see what we can contribute ourselves to improve in this area. We believe that the main reason for the expectation gap is that auditors are insufficiently transparent in their communication and that auditors should report more clearly and specifically about the audit procedures performed and the outcomes thereof.

Furthermore, the performance gap also plays a role. Both the complexity of the standards including interpretation thereof as well as appropriate application thereof are causing difficulties in practice, the latter being the most important.

Finally, the evolution gap is also relevant. The public expects that technology such as data analytics is used to further improve the audit.

#### 4. Accounting Firms

##### MHA Macintyre Hudson (MHA)

We believe that there are multiple causes of the expectation gap, reflecting the different elements of the gap, and indeed that these causes are different for fraud and going concern. We discuss each in turn below.

##### Fraud expectation gap

Each of the three "gaps" is relevant to fraud. There is a clear knowledge gap as the extent of the auditor's responsibilities is not clearly understood by to the users and the public. This is, at least partly, explained by the lack of clarity of wording in the standards – for example, the words highlighted in bold/italics in the extract below are all open to interpretation and potential misunderstanding by different parties:

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

The Performance Gap is all too obvious in some, but not necessarily all, of the high-profile cases, leading to concerns over audit quality. There are examples where some of the more basic audit tasks have not been carried out to the quality required, for example, obtaining of bank confirmations. It should be noted that it can be challenging to identify more complex, sophisticated frauds under existing auditing standards.

We believe that a key aspect of the fraud expectation gap relates to the evolutionary gap due to how fraud is perpetrated. Even though the motivation to commit fraud has not changed, the use of new technology is making fraud more sophisticated and challenging to identify. The business environment has evolved, including sudden changes arising from the COVID-19 pandemic, the volume of data used and the use of different technological factors such as social media, digital assets, cybersecurity, to name but a few. These, we believe, have contributed to the increase in the evolutionary gap.

## MNP LLP (MNP)

We are of the view that the three components of the expectation gap, as stated in a May 2019 publication by the Association of Chartered Certified Accounts (ACCA): knowledge gap, performance gap and evolution gap, are all causes of the expectation gap relating to fraud and going concern in an audit of financial statements. In the context of the IAASB's workplan, we have focussed our comments on the knowledge gap and evolution gap.

As stated in the DP, some users of the financial statements do not understand what an audit entails and may have unreasonable expectations of what an auditor ought to do in comparison to what they are reasonably capable of doing due to the inherent limitations of an audit. That is, such investors may believe that the role of the auditor is to detect fraud, material or otherwise, and conflate resilience statements with the going concern concept.

In contemplating amendments to audit standards and broader deployment of newer audit techniques, we are conscious of their impact on cost-effective timely financial information. We are mindful of the ability of emerging growth public companies and small and medium sized enterprises (SMEs) to support such audit changes. In Canada, this would represent an extremely significant portion of the marketplace. Moreover, certain changes may deepen the expectation gap. For example, audit tools that test the internal integrity of 100% of a client's transactions may still not connect to external evidence nor necessarily detect fraud or management bias, despite a potential undue reliance by financial statement users on these technologies

## Moore (MGN)

Notwithstanding all this, we do strongly agree that the audit profession has a role to play in helping to resolve disconnects through, among other things, considering:

What could be done better than is being done now (improving or extending current performance in compliance with existing standards);

What isn't being done now that should be (addressing non-compliance with existing standards);

What additional steps could and/or should be taken (improving standards, potentially extending the scope of an audit or considering whether there are additional complementary engagements that could be triggered by the audit (as a result of audit findings, perhaps)).

As suggested above, while we recognise there are, in some cases, significant disconnects between expectations relating to the audit of fraud and the audit of going concern, we do not think the disconnects are necessarily identical, nor do we think they necessarily stem from the same root causes.

With regard to Fraud, it is clear that many stakeholders expect auditors to detect all major fraud, some expect auditors to detect all fraud no matter the financial impact, and some expect auditors to prevent fraud from having occurred in the first place. Some stakeholders believe the key purpose of audit is to detect or prevent fraud.

With regard to going concern, some stakeholders appear to expect auditors to be able to predict with certainty an entity's financial and economic viability and resilience. Some of these expectations are reasonable, to an extent, many are not.

The phrase 'Expectation Gap' was coined many years ago in an attempt to succinctly summarise disconnects between members of the financial reporting ecosystem. Over time the phrase has become many things to many people and there are likely many competing visions of what the phrase actually

means. We do not believe there is a single (expectation) disconnect between auditors and other individuals/groups – other disconnects that appear evident include knowledge/understanding gaps, and performance gaps. Neither do we believe that disconnects only exist between auditors/non auditors. We do not believe that there is one ‘main cause’ for any of the disconnects which exist, including for any universally agreed ‘expectation gap’. In particular, we do not necessarily believe that the gaps in expectation (and other factors) arising in relation to fraud and going concern are the same or have identical causes (although there may be similarities both between the various disconnects and the reasons for those disconnects).

In our view a key to resolving disconnects is to recognise not just that they are nuanced but that there can be no meaningfully effective solution that does not address and include all the members of the ecosystem. Nevertheless, we appreciate that IAASB has the role of determining audit standards and therefore will primarily be addressing issues relevant to the auditor piece – but this should be considered in the context of the nature and circumstances of the issues as a whole.

We believe that any meaningful attempt to address disconnects including expectation gaps must start from the position of developing and promoting understanding from all parties as to what their expectations and roles actually are. In particular, the roles of audit committees and management cannot be ignored.

### **PricewaterhouseCoopers (PWC)**

We believe that the components described in the Discussion Paper (DP) – Knowledge Gap, Performance Gap and Evolution Gap – are a reasonable way to articulate the expectation gap.

It is not always clear which of these components is the main driver of the expectation gap relating to fraud and going concern in an audit of financial statements. In reality, it is often a combination thereof.

In addition, perceptions of the expectation gap at any point in time are likely to vary depending on recent events or conditions as well as contextual factors including the local jurisdictional legal and regulatory regime, and the corporate reporting and governance model in place. This complicates finding solutions that are applicable and equally effective globally.

As we explain in our cover letter, while it is appropriate to consider whether there are ways in which the current auditing standards can be improved, the root causes of the expectation gap and solutions to it are unlikely to be a function of the financial statement audit alone.

In addition to possible changes to auditing standards, we encourage the Board to take the lead in exploring what additional actions could be taken across the ecosystem to provide the insight stakeholders are seeking in relation to fraud and going concern. That involves looking at the responsibilities of management and those charged with governance in relation to risk assessment, controls, disclosure and transparency, as well as the legal and regulatory infrastructure needed to underpin them, in addition to the role of the auditor.

Reflecting on the experiences of other jurisdictions, we believe that solutions that are capable of meaningfully addressing the expectation gap will need to involve changes to the responsibilities of not only auditors but also others in the corporate reporting ecosystem.

Our response to part (b) explores further the interaction of the roles of others in the ecosystem and the IAASB, and our responses to other questions explore the types of broader responses that may be needed.

## 5. Public Sector Organizations

### New Zealand Auditor General (NZAG)

We have referred to the Association of Certified Chartered Accountants' analysis of the audit expectation gap in responding to these questions. That analysis breaks the audit expectation gap into:

The knowledge gap;

The performance gap; and

The evolution gap.

We note that the way the performance gap has been described in the discussion paper does not address auditors' failure to do what standards or regulations require. We believe that there is merit in considering why this occurs and whether there is anything the IAASB could do to facilitate improvement.

#### Causes of the expectation gap relating to fraud

We consider that there is a genuine knowledge gap among many stakeholders about what an audit involves. Additionally, parties who have suffered loss because of material fraud that has not been detected and reported by the auditor will almost always assert that there has been audit failure through the benefit of hindsight. Their assertion of audit failure may or may not have validity.

When the auditor considers the risk of material misstatement due to fraud, financial reporting fraud is generally the auditor's primary concern. However, when the general public think of "fraud" they are likely to have misappropriation in mind.

We consider that a performance gap also exists in relation to fraud. In our view, auditors do not always do everything that is required by existing auditing standards and regulations in relation to fraud. This is borne out by the examples on page 9 of the IAASB Discussion Paper. Although this may be in part because of a failure to meet expectations that are clear, it is also true that in many areas the existing standards allow room for differing interpretations. Improving the clarity of expectations may help.

The auditing standards correctly recognise that management and those charged with governance are responsible for the prevention and detection of fraud. However, when fraud occurs, it is often the auditors who are blamed. There is an argument that the attribution of blame (a significant component of the expectation gap) is unfairly directed to auditors, with those who are responsible for the prevention and detection of fraud (management and those charged with governance) getting off relatively lightly. If there is a fault that can be levelled at auditors, it may be that they are not demanding enough in holding management and those charged with governance to account for not meeting their responsibilities in respect of fraud.

Furthermore, we consider that an evolution gap has emerged, including:

The auditor's responsibility for non-material fraud.

We do not believe that there should be any expansion of the auditor's current responsibilities for non-material fraud. The current responsibilities include identifying and reporting on any significant deficiencies in internal controls that might present an opportunity for even non-material fraud to occur. It would be also helpful to be explicit in communication to stakeholders about the auditor's responsibilities for non-material fraud.

What constitutes non-material fraud.

The IAASB should consider what is non-material in respect of financial reporting fraud. The ICAEW's publication Materiality in the audit of financial statements makes the statement that "fraudulent financial reporting that results in misstatements caused by management is, by definition, almost always material (regardless of the size of the misstatements) because of management's intent to influence some action or decision."

Bribery and corruption.

There is a question about the auditor's role in combatting bribery and corruption. The definition of fraud in paragraph 12 of ISA 240 could be expanded to explicitly include bribery and corruption.

## **6. Member Bodies and Other Professional Organizations**

### **American Institute of Certified Public Accountants (AICPA)**

Response: We support the IAASB's effort to assess what is meant by the expectation gap relating to fraud and the expectation gap relating to going concern and applaud their efforts to obtain feedback from stakeholders. We encourage the IAASB to continue to explore the causes of such expectation gaps to inform possible improvements to audit quality. We agree that the differences between what the public thinks auditors do and what auditors actually do, or the "knowledge gap" as described in the Discussion Paper, likely contributes to the expectation gap and believe it may be best addressed through education of the users of the auditor's report. We note that in some instances auditors may not properly implement the requirements in the auditing standards, however we believe further outreach and research are warranted to assess the extent to which that is a function of the standards being overly complex or unclear, or of auditors not exercising due professional care in interpreting or adhering to the requirements. Such outreach and research would inform decisions regarding allocation of resources to enhance auditor education and instruction and standard setting. A better understanding of the causes of an expectation gap will be helpful to determining what actions will be most effective in reducing the gap.

### **CFO Forum**

The CFO Forum believes that the expectation gap arises directly from a knowledge gap where the users of financial statements may either not fully understand or have unrealistic expectations of what an audit entails; as well as from a performance gap where there is a shortfall in the quality of the audit work performed.

The knowledge gap effectively represents the difference in knowledge between what the public assumes an auditor does during the performance of an audit together with the related level of assurance that the audit report provides, versus what auditors actually do and the level of assurance provided. This mismatch therefore stems from the public perception pertaining to the role of auditors.

For example, there is a common misunderstanding that detecting fraud is part of the auditor's role. Although audit firms do perform procedures relating to fraud, due to the nature and cost of the audit, auditors can only test a sample of transactions. In addition, fraudulent activities are often carefully planned out and well concealed making it difficult for auditors to detect. Inherent limitations may therefore further inhibit the ability for auditors to detect all fraud committed by management and/or employees. Companies are required to have their own fraud prevention and detection processes and controls, and auditors test the effectiveness of these controls through audit procedures and sample testing. Auditors may therefore detect fraud during this process; however, it is not always well understood that it is not their primary responsibility to do so.

In addition to the knowledge gap we also believe that the expectation gap results from an evolution gap and a performance gap. An evolution gap represents the fact that the planning of an audit does not always

sufficiently evolve over time to appropriately consider all the developments within an environment and industry that an audit client operates in. A performance gap relates to audit procedures (or a lack thereof) that may not always fully comply with audit quality requirements.

A performance gap may, for example, result from audit engagement team members not having sufficient and appropriate knowledge and/or understanding of the business environment, operations and the related business risks of the audit client in order to design appropriate audit procedures to address the relevant audit risks. This can also manifest in the inconsistent application of audit standard requirements where there is little guidance and/or supporting material to assist with the effective application thereof. A lack of “professional skepticism” or “suspicious mindset” further affects this performance gap.

### **Chartered Accountants Australia and NZ and ACCA - Joint (CAANZ-ACCA)**

1. In regard to the expectation gap (see Section I):

(a) What do you think is the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements?

According to feedback received in our outreach for this DP, there was a wide recognition that the expectation gap is a wider financial reporting ecosystem issue with all relevant stakeholders having a role in narrowing it, as noted in the DP. The views we've heard regarding the main cause of the expectation gap relating to fraud and going concern were mixed, with most stakeholders referring to the knowledge and evolution gaps. Some feedback was also provided for the performance gap but to a lesser extent.

#### **Knowledge gap**

We consider that there is still a lack of understanding by the general public regarding the purpose of an audit and what the respective responsibilities of auditors and those charged with governance are, in relation to the management of risks, the preparation of financial statements and the provision of assurance over those financial statements. In the case of going concern, this is exacerbated by the lack of clarity over the concept of going concern used in the accounting standards which drive preparers' responsibilities versus the auditor's responsibilities established in the auditing standards. There is also the fundamental issue that, at heart, users would like there to be no corporate failures or fraud even if this is not achievable in our current markets, regardless of how much regulation is put in place.

Furthermore, some of the feedback received emphasised that there is a general lack of knowledge regarding fraud and a confusion as to what fraud means in the context of an audit of financial statements. Recommendations suggest audit firms need to place more emphasis in educating their staff via training regarding fraud, if they are to be in a better position to detect and report fraud when it occurs and/or properly investigate suspicions.

#### **Evolution gap**

Based on the feedback received, the other primary cause of the expectation gap relates to the evolution gap. During our outreach a large majority of the stakeholders expressed the view that, for auditors, there is more room for evolution in the area of fraud than for going concern.

Some stakeholders also suggest that the focus should only be on the evolution gap and how the profession can evolve to satisfy users' expectations rather than keep focusing on the knowledge gap as one that will always exist. Businesses continue to increase in complexity and, in response, users' expectations of what they require from assurance changes over time.

## Performance gap

Although according to the feedback received, fewer stakeholders identified the performance gap as one of the main causes of the expectation gap, some stakeholders, other than audit practitioners, consider that the expectation gap is caused either by auditors not following the requirements of ISA 240 or because the requirements of ISA 240 are not robust enough.

We note that in respect of the performance gap, in the UK as per the Brydon report it was noted that ISA (UK) 240, the equivalent UK standard on fraud, 'appears to be a balancing act between managing, or possibly lowering, expectations whilst seeking to avoid going so far as to affect significantly users' perceptions as to the value of audit. The messaging in this standard is therefore somewhat ambiguous, in Brydon's view'. Similar points were raised by regulators during our outreach, more specifically, regarding para 5 of IAASB's ISA 240 which states that 'while the audit may be properly planned and performed, some material misstatements may not be detected' who are of the view that such statements undermine the auditor's responsibility in detecting and reporting fraud. As a result, the UK Financial Reporting Council (FRC) is currently consulting on certain revisions to ISA (UK) 240, to address some of the concerns raised in the Brydon report. In our view, the feedback received by the FRC on these revisions will be very relevant for the IAASB's consideration.

From our outreach, we believe that the main causes of the expectation gap in relation to fraud and going concern are the knowledge gap and the evolution gap. There were limited areas where performance gap issues were considered as a main cause compared to the other gaps.

## Confederation of Indian Industry (CII)

The discussion paper has a robust analysis of the expectation gap and the ACCA has appropriately classified causes into - knowledge, performance and evolution. There is clearly an increasing expectation amongst stakeholders for a higher level of assurance on the absence of material misstatement due to fraud than has been historically provided and accepted. Rapid developments in technology and availability of significant data and external evidence enable auditors to better meet those expectations.

In many corporate failures, fraud has led to concealment of factors that may lead to challenge of the 'going concern' assumption. In our view, this does not reflect on adequacy of the auditing standard on going concern but more on the audit procedures addressing the risk of fraud.

## CPA Australia (CPAA)

We consider that the main causes of the expectation gap in relation to fraud and going concern are explored and articulated well in the DP. The DP describes the expectation gap as comprising knowledge, performance and evolution gaps. However the components are categorized, in essence they arise when:

Occurrence and detection of fraud immaterial to the financial statements, but which was not identified by the external auditor and is unlikely to be, due to the scope of an audit and application of materiality (knowledge and evolution gaps).

Occurrence and detection of fraud material to the financial statements, but which was not identified by the external auditor, due to either inadequacies in the conduct of the audit (performance gap) or the nature of the fraud which often involves collusion, concealment and/or deception which impedes detection (knowledge and evolution gaps).

The entity collapses or enters into some form of administration without warning signs which, had warnings been available, may have enabled a more timely response or could have put stakeholders on notice of the risks and uncertainty faced by the entity (knowledge, performance and evolution gaps).

### **Institute of Certified Public Accountants of Uganda (ICPAU)**

According to Liggio (1974) the term “audit expectation gap” is the difference between the levels of expected performance as perceived by both users of financial statement and the auditor. The audit expectation gap has also been defined as the difference in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the message conveyed by the audit (auditor’s) reports and the difference between what the public expects from the auditing profession and what the profession actually provides (Monroe and Woodliff, 1993).

ICPAU believes that the key components of the expectation gap including the knowledge, performance and evolution gaps, require equal effort in demystifying the difference between what users expect from the auditor and the actual obligations of the auditor in an audit of financial statements. The expectation gap is generally due to the difference resulting from misconstruing and or misapplication or neglect of changes taking place world over to suit the current provisions of the auditing standards. For example, many users always expect auditors to identify and report about all incidences of fraud during audits of financial statements yet according to the requirements of ISA 240: The Auditor’s responsibility to consider fraud in an audit of financial statements- the primary responsibility for the prevention and detection of fraud rests with those charged with governance of the entity and with management. Some users don’t appreciate that the primary role of the auditor is to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Relatedly, as technological competencies take centre stage in the main business world, the aspects of fraud and going concern become vital and very sensitive. This tends to refocus the public expectation in terms of what the auditors should do if the expectation gap is to be narrowed.

### **Institute of Directors in South Africa's Audit Committee Forum (IoDSA ACF)**

The ACF Forum believes that the expectation gap arises directly from the combination of two specific gaps – the knowledge gap and the delivery gap.

The knowledge gap arises when the level of assurance with regards to the work performed by the auditor is assumed to be at a level higher than actually expected of the auditor under the current auditing standards.

The delivery gap arises when the work delivered by the audit team does not adequately meet even the current auditing standards relating to fraud and going concern. The delivery gap is a matter that both audit committees and audit regulators can pay increased attention to, in measuring whether auditors are compliant with current (and future) auditing standards on fraud and going concern.

### **Kriton (KNL)**

Fraud

From within the audited entity, management, those charged with governance and the audit committee do not communicate sufficiently to users of the financial statements about how they identify fraud risks, which fraud risks they recognise and how they manage these risks (fraud risk management).

On the part of the auditor, a lack of knowledge, skills and the right attitude plays an important role. Scientific research shows that auditors:

have too little knowledge of concepts of fraud and non-compliance;  
have difficulty applying theoretical knowledge about this in practice;  
are not really able to identify fraud risks specifically and concretely;  
cannot always determine an appropriate response to identified risks;  
do not (or cannot) perform the designed procedures adequately at all times  
and, therefore, they are unable to detect fraud properly.

What is worrying, is that auditors themselves think they have the necessary knowledge and skills. There is limited intrinsic motivation to improve the quality of the work in this area.

In addition, auditors do not sufficiently communicate to the users of the financial statements and the auditor's opinion what they must do, can do and have done when it comes to misstatements resulting from fraud. Users are unable to form a clear idea of what to actually expect from the auditor. They tend to interpret the scope of the audit too broadly. This is (possibly) also related to the definition of the term 'fraud' as used by the professional group and in professional regulations. That definition does not correspond to what is commonly understood by fraud in parlance. In 'society', the term fraud seems to be used for many aspects of financial and economic crime, which auditors do not always classify as fraud.

Lastly, the audit profession lacks an unambiguous (international) vision of necessary adjustments. Examples of good practices remain out of the picture for too long to be able to make a meaningful contribution to the 'learning audit profession'.

In our opinion, the cause is a complex of factors, as was also mentioned in the discussion paper. None of these factors can be considered the main cause of the expectation gap.

### **Malaysian Institute of Certified Public Accountants (MICPA)**

Comment:

We acknowledge that there is indeed an expectation gap relating to fraud and going concern in an audit of financial statements. The components described in the Discussion Paper (Knowledge Gap, Performance Gap and Evolution Gap) are a reasonable way to articulate the expectation gap. However, it is not always clear which of these components are the main driver of the expectation gap as it is often a combination thereof.

For fraud, the expectation gap arises due to the different expectations of the different stakeholders involved in the financial reporting ecosystem. There is a knowledge gap, giving rise to the misconception with regard to the auditor's role in an audit of financial statements as the various stakeholders may not have a clear understanding about the fundamental principle of "reasonable assurance" and "materiality" and therefore expects auditors to audit and provide assurance in all areas of the financial statements.

With regard to going concern, unlike the auditing standard ISA 570 (Revised) Going Concern, which is quite comprehensive, there are minimal requirements in the accounting standard IAS 1 Presentation of Financial Statements to govern the management's assessment and disclosures related to going concern. Based on our observation, there is a lack of robustness in the management processes and controls for identifying and responding to the risks relating to fraud and going concern exacerbated by the lack of clarity on the responsibilities of those charged with governance in this process.

While it is therefore appropriate to consider whether there are ways in which the current auditing standards can be improved, it should be acknowledged that the root causes of the expectation gap and solutions to it are unlikely to be a function of the financial statement audit alone.

Our response to part (b) below and to the other questions explores further the interaction of the roles of others in the ecosystem and the IAASB and the types of broader responses that may be needed to “move the dial” to address the expectation gap relating to fraud and going concern in an audit of financial statements in an impactful and sustained manner.

### **New York State Society of CPAs (NYSSCPA)**

The material extracted from an Association of Chartered Certified Accountants (ACCA) publication and included in the Discussion Paper on page 11 succinctly identifies the components of the expectation gap, currently identified as relating to fraud and going concern, as the knowledge gap, performance gap, and evolution gap. Each component significantly contributes to the expectation gap, with each component being interdependent of the other. With that said, the core of the issue lies in the public’s perception of the audit, the auditors, and the auditing standards. This perception is skewed by the idea that all audits are performed in the same prescribed manner, following the same “rule book.” The public may not fully understand the goal of the audit and the meaning of “reasonable assurance,” and the gap widens as advances in technology enable more transactions to be looked at and more procedures to be performed. This technological expansion is (perhaps mistakenly) perceived to increase the auditor’s ability to identify fraud and going concern issues.

### **9. Individuals and Others**

#### **Christian Minarriz (CM)**

Following the ACCA’s component classification of “expectation gap”, I think that the 2 major components are knowledge gap and performance gap, while evolution gap has some impact in fraud but a relatively smaller impact in going concern.

Regarding knowledge gap for fraud, I think there is a general misunderstanding of the general public (and also in many accountants) about the difference between an audit of financial statements and a fraud examination. Although there are some points in common between both services, their nature and objectives are substantially different. Many differences can be found in this article: <https://www.cpajournal.com/2018/03/05/audit-vs-fraud-examination/> Many users (and also many accountants) think that just because a fraud was eventually discovered and the audit did not find it, then the auditor was necessarily negligent or incompetent. A common criticism is that most of the frauds are discovered through whistleblowing and only 4% is discovered by auditors, but it does not necessarily mean that the audit was incorrectly done or the audit service itself is useless, because it is logical to expect that fraud is reported earlier by people with direct knowledge of it (also auditors are only focused in material fraud affecting the financial statements but not all kind of fraud) and the fraud deterrence impact of an audit is ignored (i.e. without audits, it would be easier for management to fraudulently misstate the financial statements). Most people also ignore the fact that many frauds cannot be detected even after a long investigation by authorities, so it is not reasonable to conclude that the auditor was incompetent because it did not find that fraud.

Regarding knowledge gap for going concern, I think many people have the idea that auditors are able to guarantee the ability of an entity to continue as a going concern but fail to understand that auditors cannot

predict the future. This is further enhanced by the increasingly volatile economic environment (especially in some jurisdictions).

Regarding performance gap for fraud, I think there is limited knowledge and/or ability to apply the knowledge about fraud schemes and the relation between the fraud schemes and risks and relevant internal controls and audit procedures that address them, and there are also difficulties in identifying which fraud schemes may be related to specific red flags. This is further enhanced by the lack of guidance in auditing standards about those issues. The different "culture" in different jurisdictions may also create some challenges (i.e. countries where some practices are considered to be illegal or fraudulent, whereas in others is legal or "accepted"), especially regarding corruption (although corruption is not currently included in ISA 240 but in ISA 250).

Regarding performance gap for going concern, I think there is some lack of understanding and/or difficulty to apply the ISA 570 requirements in practice, especially regarding the required work to evaluate the feasibility of management plans, the work to be done regarding assumptions for cash flow projections (and if ISA 540 also applies) and how to evaluate if there is "material uncertainty" or just a "close call". The lack of guidance in accounting standards (including IFRS) about the required disclosures also generates some issues.

Regarding evolution gap for fraud, I think there is a general expectation (probably overly optimistic) that new technologies will help to find fraud (which fails to note the limitations of those technologies and ignores the new fraud risks associated with some technologies).

Regarding evolution gap for going concern, I do not see other issue than the expectation of more explicit auditor statements about the future viability of the audited company.

## The Unlimited (TU)

The expectation gap generally explains the difference between what the public expects of auditors and what the responsibilities of auditors are in terms of the International Standards on Auditing (ISAs).

However, it must first be determined whether auditors are performing audits in terms of the ISAs or not.

### 1. Professional skepticism

The ISAs require the application of professional skepticism. Professional skepticism is defined in the IRBA professional skepticism guide as "An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence."

The extent to which audit firms currently do not have robust processes to document the questions asked, the conditions that they were alerted of as well as a critical assessment of evidence needs to be assessed. Audit firms have been known to

generally complacent and accepting of information provided by the client, often with pressing deadlines that leaves little time for questioning. Audits are also notorious for "ticking up" being the act of mindlessly quickly checking supporting documents in order to complete audit procedures and mark working papers as complete. Again, due to time constraints.

This creates a huge gap between the auditor and their responsibilities.

### 2. Nature of audit evidence

In terms of ISA 500, audit evidence should be obtained by third parties wherever possible.

An example of where this is not applied is in the audit of Revenue. A financial statement caption that has an inherent significant risk of fraud, is audited primarily by agreeing line items in the general ledger to invoices. A source of evidence that is generated by the auditee and due technology it is the invoice that generates when the general ledger item is captured and therefore provides no evidence of the existence of that revenue.

Herein lies another gap between the audit and the auditor's responsibilities.

### 3. The decline of audit quality

The media is bombarded with articles of fines being imposed on audit firms in the UK and South Africa for failing to comply with the audit standards. While these fines on its own indicates that audits are not being performed to the relevant standards, it also highlights that there is a gap between the standards and the auditors responsibilities. If the auditor is not fulfilling their responsibility, there will definitely be an expectation of the public to the profession.

### 4. Audit opinion

The unqualified audit opinion provides the users of the financial statements with "reasonable assurance that the financial statements are free from material error whether due to fraud or error".

When fraud does occur, auditors quickly turn around and say that it is not their responsibility to detect fraud.

However it is the responsibility of the auditor to ensure that the audit is planned and performed to obtain reasonable assurance that the financial

statements are free from material misstatement whether caused by fraud or error.

These instances highlight the need to consider whether, if the auditing standards were adhered to, would there be as big of an expectation gap as there is?

## **Q1a-1.2 - Evolution gap**

## **Q1a-1.3 - Knowledge gap**

## **2. Regulators and Audit Oversight Authorities**

### **Botswana Accountancy Oversight Authority (BAOA)**

What do you think is the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements?

Users of financial statements, not knowing exactly what the Auditors responsibilities are in relation to fraud and going concern. General expectation is that the responsibility for detection of fraud and assessment of going concern lies with the Auditor. This, however, is not the case as per the International Standards on Auditing (ISAs).

The Auditors responsibilities as defined by the ISAs viewed to be not as robust to detect or identify fraud and going concern matters.

ISA 200 requires the Auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to FRAUD or error. When an audit opinion has been given to that effect, and later on there is a corporate collapse, stakeholder start asking questions such

as, 'Where were the Auditors'. Ideally a reasonable assurance is expected to be supported by sufficient appropriate audit evidence, in this case such evidence is assumed to cover fraud.

### 3. National Audit Standard Setters

#### Institut der Wirtschaftsprüfer in Deutschland e.V. (IDW)

As we point out in the body of our letter, the IAASB should take an evidence-based approach to considering the basis for its future actions. To this effect, the question posed in 1 (a) to stakeholders is an important source of information, but is not sufficient on its own. As we explain in the body of the letter, the IAASB should investigate the underlying causes of supposed audit failures involving fraud or going concern issues. The identification and evaluation of these causes would provide more robust information about what the main cause of the expectations gap relating to fraud and going concern is likely to be. Based on our understanding of the issues as described below, we surmise that the knowledge and reasonableness gaps together form the largest portion of the expectations gap.

We are convinced that there will only be at most marginal reductions in the performance gap for fraud and going concern issues if the IAASB improves the clarity of its standards and adds more guidance to support implementation. Other causes of the performance gap (see (b) below), which may be more significant, can only be addressed by other participants in the audit environment.

In relation to the evolution gap, we note that, if asked, users of financial statements and auditors' reports will always want more and better information and therefore seek to have audits evolve further. However, simply seeking to be responsive to these desires without considering that audits and any other additional engagements must be completed within a reasonable time to be relevant to users and at reasonable cost (which is a public policy issue on the proportion of GDP that a society wishes to expend on audits and additional engagements) does not adequately deal with consideration of the societal costs and benefits involved. In line with our comments in the body of the letter, unless the scope of financial reporting frameworks is generally extended worldwide, to the extent that the evolution gap involves seeking to satisfy stakeholder desires (e.g., future viability) beyond an audit opinion on the financial statements and communication of the auditor's findings thereon, such required scope extensions of the audit are beyond the remit of the ISAs and hence the IAASB for financial statement audits.

Adding very robust or enhanced procedures, to improve audits of financial statements, that ultimately cause the costs of audits to increase by orders of magnitude, or incrementally augmenting standards that costs substantially less but only marginally improves audit performance, is not likely to satisfy stakeholders either way: it is unlikely that, given the history of changes made to ISAs 240 and 570 over the last twenty-two years, the IAASB will miraculously discover previously undiscovered "significant quick wins" that substantially increase audit performance for fraud and going concern issues at reasonable cost. Furthermore, as the discussion on KAM when drafting ISA 701 showed, the need, due to independence requirements, to retain audit as an attestation, rather than direct engagement, which implies that original information about the entity ought to be provided by management rather than the auditor, and the related legal confidentiality requirements that the ISAs cannot overcome, mean that improving the transparency of auditor communication to users of the financial statements beyond ISA 701 may be difficult.

The knowledge gap and the reasonableness gap both reflect severe information asymmetry between parties knowledgeable about audits (e.g., auditors, auditing standard setters and knowledgeable regulators) and parties with comparatively little knowledge about audits (e.g., legislators, the media, users, less knowledgeable regulators, and the public). Given the available literature on auditing, including, but not

limited to, introductory auditing textbooks, and the content of the auditor's responsibility section of the auditor's report (which was expanded for both going concern and fraud in 2015), lack of interest or diligence appears to be the only explanation for the knowledge gap for those parties supposedly interested in audits but that lack the knowledge to understand what auditors do and are required to do.

While the knowledge gap is severe on its own, the reasonableness gap is a more serious and intractable problem because it relates to public expectations that can never be fulfilled due to the inherent limitations of audits. With the exception of a FEE Paper from 2007 that deals systematically with the inherent limitations of audits, both auditing standards and literature only address this issue in cursory fashion which means that even if parties sought to improve their knowledge about audits in this respect, they would have great difficulty doing so.

Contributing to the reasonableness gap is the problem that for the uninitiated, auditing, like accounting, also suffers from what is often called "numeracy bias" or "precision bias" – that is, the belief that since financial accounting involves numbers and auditing involves examining the veracity of those numbers, properly audited numbers must be "right". The undersigned have encountered numerous instances in which otherwise highly educated representatives of the media, legislators and regulators (often with prestigious law degrees), and members of the public react with disbelief (they appear to believe that the auditing profession is "just being defensive") when the judgmental nature of accounting (recognition, measurement, classification, presentation and disclosures) and auditing and other assurance engagements (e.g., the persuasiveness of evidence) is explained to them.

This is all the more surprising for those with a legal education, since even they recognize that with the power of the courts to gather evidence from entities other than the entity whose financial statements are being audited, search for and seize documents, force the disgorgement of evidence, and subject individuals to interrogation or cross-examination under oath,

the prosecution may not be able to obtain the conclusive evidence needed to prove in a court the guilt of a supposed perpetrator of a financial crime beyond any reasonable doubt even when there is virtually no doubt that a crime has been committed. These inherent limitations apply even more so to auditors of financial statements, who do not have these powers and where much of the evidence obtainable is persuasive rather than conclusive. As noted above and in relative contrast to court proceedings, to be relevant audits must be completed within a reasonable time and society expects audits to be performed at a reasonable cost, which represent real inherent limitations to audits beyond the inability to force the disgorgement of evidence, etc.

We believe that auditing standard setters and the auditing profession have exacerbated the information asymmetry versus other stakeholders about the reasonableness gap by not engaging in a frank dialogue with other stakeholders about this gap for fear of appearing "defensive".

### **Malaysian Institute of Accountants (MIA)**

In addition to knowledge gap, we also believe that performance gap and evolution gap are also causes of the expectation gap, as stated below:

#### **Performance gap**

Auditors may have omitted certain audit procedures as required under the auditing standards due to the complexity and unclear requirements of certain standards.

#### **Evolution gap**

Audits may not have evolved to meet changing expectations due to changing business landscape and developments in the environment such as the use of technology by both reporting entities and auditors. Standard setters should recognise that the use of technology by reporting entities creates different opportunities and fraud risks within an organisation, particularly when those entities are implementing new technology applications at an increasing pace. On the flipside, the auditor's use of technology is equally important to address fraud risks and to identify potential misstatements due to fraud.

The public is looking for enhanced procedures in relation to fraud and going concern that is not currently provided by the requirements of the auditing standards and is getting more demanding that the financial reports should be more predictive rather than merely reporting on historical numbers.

Due to increasing disclosure requirements in the financial statements, sometimes the public may tend to ignore certain general information such as auditors' responsibilities for the audit of financial statements. This may widen the expectation gap.

We are of the view that knowledge gap is the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements whereby the public misunderstands the role and responsibilities of auditors relating to fraud and going concern, as stated below:

#### Fraud

In accordance with International Standard on Auditing (ISA) 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, one of the objectives of the auditor is to obtain reasonable assurance about whether the financial statements, taken as a whole, are free from material misstatement, whether due to fraud or error. This statement may be misconstrued by the public that the financial statements are indeed free of material misstatements due to fraud even though there is a clear caveat in the auditor's report that the level of assurance is only reasonable assurance and there is no guarantee that there is no material fraud. There may be a general perception by the public that auditors are expected to conduct an audit in a manner that extends beyond the requirements of ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements and to provide more than reasonable assurance.

## 4. Accounting Firms

### BDO International Limited (BDO)

Discussions within our network indicated that the largest factor which had resulted in an expectation gap was the knowledge gap - particularly amongst those stakeholders who are not as closely involved in the audit process – such as investors, shareholders, the public.

Taken as a whole, we also recognize that the expectation gap is not just 'someone else's problem' and that, as a profession, auditors should not be complacent. We may have a key role to play through (1) steps to evolve what and how we perform our procedures, (2) better communication of what we have done, and (3) improved or clearer performance of our procedures.

It is important to note that in our discussions, we perceived there to be:

A difference in the expectation gap relating to fraud and going concern – while they may be linked, the expectations of users for each may differ (and the causal factors may be different too).

When a material fraud has occurred at some point in the past and the nature of an auditor's work is to review to what has already happened (i.e., to look back retrospectively), there is an expectation that auditors should be able to identify that material fraud.

For going concern, stakeholders have a more realistic understanding that auditors are not able to predict the future especially as the 'future' is being set out by management's assessment of going concern. So, in general, there appears to be less of an expectation gap in this particular area.

Differences in the relative importance of the knowledge, performance and evolution gaps for fraud and going concern respectively; also, the extent to which these 'gaps' were dependent on each national jurisdiction (for example, a number of colleagues cited innovations in financial reporting ecosystems that had been implemented to improve reporting on fraud or going concern matters, through additional procedures or controls testing).

Potential causes of the knowledge gap included:

Communication challenges – whereby components of the financial reporting ecosystem and those outside the system, such as the media and public, may not have a sufficient understanding of what the scope of an audit entails and specifically the standards' requirements for auditors in relation to fraud and going concern. Conversely, we received feedback that:

Auditors may need to do a better job of communicating what has been done (through improved transparency, greater focus on certain areas, etc.).

There may also be a role for regulatory and professional bodies to aid consumption of financial statements information (and an understanding of what it is to be audited), and to better explain how different parts of the financial reporting ecosystem operate.

Expectations about the extent of an audit – there may be a perception that being audited means that everything has been checked which contrasts with ISA concepts of:

Materiality

Adopting a risk-based set of procedures to address assessed risks

Obtaining reasonable (but not absolute) assurance that the financial statements are not materially misstated.

Nature of fraud and going concern – another factor contributing to the knowledge gap is that despite the procedures performed by auditors, there remains an element of risk that is unaddressed, essentially because:

Fraud is, by its very nature, designed to be concealed, making it difficult to detect, particularly when accompanied by collusion and/or extending over a longer period of time;

Going concern includes an element of unpredictability as it is based on future events and, as we have seen in recent recessions and the COVID-19 pandemic, facts and circumstances can and often change quickly and without warning.

Other suggestions we received during our discussions, included:

Variations in laws and regulations at the national level which may mean there are different requirements when reporting on fraud in the auditor's report (which has already started to emerge in certain jurisdictions)

or regarding the reporting timeframes being considered in respect of going concern (whether from reporting date, financial statement date, auditor's report date, etc.).

A failure to communicate to TCWG (or, in the case of small owner-managed businesses, directly to management) what procedures we have performed around fraud and, to a more limited extent, going concern.

A perceived failure by auditors to use forensics or fraud experts as part of their audit strategy and planned approach, particularly where facts and circumstances, with hindsight, may seem to suggest that it would have been prudent to do so.

### **Crowe (CG)**

The main cause of the expectation gap relating to fraud and going concern in an audit of financial statements are perceptions by some groups of stakeholders that the audit is an exercise in "fraud discovery" and that auditors have a greater responsibility for forming an opinion on going concern than is actually the case.

(b) In your view, what could be done, by the IAASB and/or others (please specify), to narrow the expectation gap related to fraud and

### **Deloitte (DTTL).pdf**

DTTL believes that elements of the knowledge gap, performance gap, and evolution gap (as described in the discussion paper) all contribute to what has been described as the "expectation gap" (our recommendations on specific steps to address the knowledge gap, performance gap, and evolution gap are included in our response to Question 1b). However, we have specific concerns about the knowledge gap, as outlined below.

Knowledge gap - Lack of public understanding of the responsibilities of all constituents in the financial ecosystem.

The "expectation gap" that has been described and discussed for many years is not limited to the difference between the perceived role of the auditor vs. their actual responsibilities. There is a lack of common public understanding:

that the primary responsibility for the prevention, detection, and communication of matters related to fraud and going concern lies with both management and those charged with governance (TCWG), which includes company directors and others who oversee the strategic direction and obligations related to the accountability of the entity;

of the importance of internal controls over performing an evaluation of the entity's ability to continue as a going concern; and

of the importance of internal control over financial reporting and the part it plays in supporting strong capital markets, fraud prevention, and management accountability.

Entity management, TCWG, and auditors all have a distinct part to play in providing the public with robust financial reporting worthy of trust—and DTTL believes the public's misunderstanding of these shared roles has perpetuated the expectation gap.

Responsibilities related to fraud

Specifically related to fraud, the varied responsibilities include: (1) management – implementing and executing a fraud risk identification, prevention, and detection program, (2) TCWG – understanding and actively monitoring/overseeing the program established by management, and (3) auditors – executing audits in accordance with auditing standards, which require that they plan and perform the audit to detect material misstatement due to fraud. While the audit report states the auditor’s responsibility related to fraud in an audit of the financial statements, some readers may mistakenly interpret that “obtaining reasonable assurance” creates an obligation for the auditor to detect and prevent fraud that is indistinguishable from, or even greater than, the obligation of management and TCWG. DTTL believes it is both this public misunderstanding of “reasonable assurance,” as well as a lack of common understanding about the responsibilities of all parties, that contributes significantly to the expectation gap described in the discussion paper.

Knowledge gap - Lack of understanding of the inherent limitations of an audit.

In addition to the lack of understanding of the responsibilities of management and TCWG, the repeated question, “Where were the auditors?” in each instance of a company’s financial demise demonstrates that the public doesn’t fully appreciate the inherent limitations of an audit.

By definition, an audit of the financial statements provides reasonable, not absolute, assurance, and there will always be a risk that some material misstatements may not be detected by the auditor, even if the audit was properly planned and performed in accordance with professional auditing standards. The risk of not detecting a material misstatement due to fraud is even higher than not detecting one caused by an error because of the potential for sophisticated fraud schemes designed to hide fraud from detection during the audit, intentional misrepresentation to the auditor, and collusion between employees, or even management and TCWG.

Related to going concern, there is an obvious limitation to predicting future events and conditions. The auditor evaluates management’s assessment of the entity’s ability to continue as a going concern based on information known at the time and reasonable assumptions made on such information. The occurrence of unexpected or unlikely circumstances could have a significant detrimental effect on the information and assumptions used, resulting in unforeseen challenges to the financial viability of an entity in the short term.

## **Ernst and Young (EY)**

### **Fraud**

We believe that the “Knowledge Gap” as outlined in the Discussion Paper is the primary cause of the expectation gap relating to fraud in an audit of financial statements. Public opinion in many places indicates that auditors are expected to conduct the audit in a manner that extends beyond the requirement in ISA 240 to provide reasonable – not absolute – assurance to shareholders that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. It is also important that the public understand what can be reasonably be achieved by an audit.

Although the auditor plays an important role in detecting material fraud, it is important for the public to understand that the prevention and detection of fraud within an entity is primarily the responsibility of management under the oversight of those charged with the governance. Acknowledgement of this responsibility, and how it has been fulfilled, should be more evident from the entity’s corporate reporting.

Although advancements in technology are out of scope for the purposes of the Discussion Paper, we do believe there is an evolution gap growing due to the use of technology by both entities and auditors that is

important to be addressed through the IAASB's project on fraud. Refer to our response to Q4 for further details.

We find the Association of Chartered Certified Accountants' articulation of the expectation gap included in the Discussion Paper to be useful, particularly in determining the underlying causes of the stakeholder perspectives calling for the audit to evolve. We also see a relationship between the audit expectation gap and potential gaps in corporate reporting (i.e., gaps in the information provided to users by preparers, which may have similar underlying causes as, and in some cases contribute to, the gaps that comprise the audit expectation gap).

## GTI

In our view, the main cause of the expectations gap relating to fraud and going concern in an audit of financial statements is the knowledge gap – described in the Discussion Paper as the difference between what the public thinks auditors do and what auditors actually do. This can also be somewhat exacerbated by the media focus on the auditor when frauds or going concern issues are uncovered subsequent to the completion of the audit and the issuance of the auditor's report, especially when this results in the failure of the business. Media focus, in general, is naturally biased towards coverage of such issues and the perceived failures of the auditor, rather than providing more balanced reporting that also reports instances where the auditor has been instrumental in identifying issues or have even prevented a fraud from being perpetrated just through the performance of an effective audit.

This misperception, in part, could be addressed by regulators through the provision of 'thematic reviews' that anonymously analyse the work of auditors in the areas of fraud and going concern, including situations where the auditor has been effective in identifying and responding to risks of material misstatement arising from fraud or going concern. The development of 'fraud indices' may also be an effective means of highlighting the value of audits as this would provide the ability to contrast the prevalence and magnitude of frauds in jurisdictions where audits are more pervasive with jurisdictions where audit is less pervasive. This could be something similar to the 'Corruption Perceptions Index' that has been developed by Transparency International that ranks countries on a scale from 'very clean' to 'highly corrupt'.

## HLB International (HLB)

We believe that the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements is a knowledge gap, a difference between what the public thinks is provided by an audit engagement and what an audit engagement is actually intended to do. In particular, there is a knowledge gap regarding the concept of reasonable assurance (as required by the ISAs) versus absolute assurance, as is sometimes expected by the public. In our view, to narrow this knowledge gap, the IAASB and others could undertake public education campaigns regarding the concept of reasonable assurance, and the importance of other participants in the financial reporting ecosystem. The responsibility for fraud and going concern is a shared responsibility with those in the financial reporting ecosystem, in particular management and those charged with governance.

We acknowledge that the performance gap is also a contributing cause to the expectation gap. In particular, consideration of fraud and going concern in an audit of financial statements should be an area lead and completed by partners and managers, with junior staff observing for training and education purposes. To reduce the performance gap, the IAASB could provide more support for practical examples, audit programs or checklists and other tools to assist practitioners in appropriate implementation and documentation of the ISA requirements. We note size and complexity matter in the performance of an audit engagement, and

that these practical examples and tools would need to be responsive to the differences encountered across publicly traded entities and small and medium sized entities. In addition, we expect these issues would also be dealt with through implementation of the ISQM1 and ISA 220 revisions.

#### Question 2 (a)

We do not believe the auditor should have enhanced or more requirements with regard to fraud in an audit of financial statements. We believe the existing standards are sufficient and appropriate and enhanced or more requirements with regard to fraud in an audit of financial statements will ultimately not serve the public interest. We agree that sometimes auditors do not fully understand or appreciate the requirements and more application guidance is needed, not enhanced or additional requirements. Failures occur because the auditor did not do what should have been done. This does not mean the existing standard is insufficient and will therefore not be fixed by a new standard.

#### Question 2 (b)

We do not believe there is a need to prescribe enhanced procedures only for certain entities or in specific circumstances. We believe there are other engagements and methods to address fraud, such as forensic audits or use of forensic specialists, that are already available in instances where additional effort is necessary in the professional judgement of the auditor or in the evaluation of management or those charged with governance.

#### Question 2 (c)

We do not

### KPMG

We agree with the IAASB that there has long been an 'expectation gap' in terms of a difference between what users of financial statements and the auditor's report thereon expect from auditors and the financial statement audit and what an audit actually is, in particular, in relation to the critical areas of fraud and going concern. We believe the analysis in the DP, which breaks the expectation gap down into the constituent parts of 'knowledge gap', 'performance gap' and 'evolution gap' is helpful in supporting further exploration of the underlying issues. We consider that all three of these aspects contribute to the expectation gap in respect of fraud and going concern.

#### Fraud

In respect of fraud, we suggest that the knowledge gap component is likely the main contributor to the expectation gap as the inherent limitations of an audit in this area are not well understood by the public in general.

ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, states that "the auditor's responsibilities are to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error" [ISA 240.5]. The standard further states that "owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs." [ISA 240.5]. This unavoidable risk is due, in part, to the fact that most audit evidence is persuasive rather than conclusive, in order to support reasonable assurance. Additionally, as stated in ISA 200.A53, "the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud." ISA 200.A53 highlights particular challenges when a fraud involves senior management, or collusion. ISA 240.6 highlights that fraud "may

involve sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.” We note that when serious frauds occur, they are often perpetrated by (senior) management, who have the ability to override control procedures designed to prevent similar frauds by other employees; directly or indirectly manipulate records/documents and make false representations.

ISA 240.6 also highlights that “the auditor’s ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved.” Further, ISA 240 notes that “it is difficult for the auditor to determine whether misstatements in judgement areas such as accounting estimates may be caused by fraud or error”.

Accordingly, ISA 240 focuses on procedures to assist the auditor to identify and assess risks of material misstatement due to fraud, with specific identification procedures targeted at certain aspects. These are:

the auditor understanding the entity and its environment;

risk assessment procedures, including discussion amongst the engagement team, and considering specific fraud risk factors including whether there may be incentives/ pressures to commit fraud;

making enquiries of management and others;

understanding how those charged with governance exercise their oversight responsibilities; and

identifying unusual relationships, and whether other information obtained by the auditor indicates risks of material misstatement due to fraud.

There are also targeted procedures required to respond to risks related to management override, including with respect to journal entries, accounting estimates and significant transactions that are outside the normal course of business or that otherwise appear to be unusual. The ISA emphasises the importance of exercising professional scepticism in this area throughout the audit, including in considering the implications for the audit when potential misstatements may be indicative of fraud.

We believe there is a fundamental lack of understanding by users of financial statements about the inherent limitations of an audit as described above, and the way in which ISA 240 and other ISAs are designed to address fraud, in particular, the fact that an audit is a risk-based, and not an absolute, assurance engagement, rooted in the concept of materiality.

We also highlight that there is a lack of clarity as to what ‘fraud’ in an audit of financial statements actually means. There is an interaction between the concept of fraud and that of breaches of laws and regulations, which have some degree of overlap, especially in the case of intentional violations, but with breaches of laws and regulations encompassing a significantly broader scope, including operational and reputational matters such as in respect of environmental or health and safety legislation. We believe users of financial statements may believe ‘fraud’ encompasses such breaches beyond those that are directly connected to the financial statements themselves. ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements describes the inherent limitations of an audit in addressing breaches of laws and regulations, principally when these do not have a direct effect on the financial statements. Although ISA 250 sets out required procedures, based primarily on inquiry of management and inspection of regulatory correspondence, to assist auditors in identifying actual or suspected breaches of laws and regulations in this area, there again remains a risk that not all such breaches will be identified by an audit and this risk increases significantly if the breach also involves an aspect of fraud.

We also acknowledge that there are aspects of the performance gap, and we suggest that the IAASB further consider certain enhancements to ISA 240 and other ISAs, that may address this. For example, we recommend consideration of:

the introduction of a 'stand-back' requirement to ISA 240, to consider and evaluate all audit evidence in this area, and how this affects our fraud risk assessment and the nature, timing and extent of our procedures to address fraud risks, before forming an audit conclusion. This could be similar to other stand-back requirements such as that introduced in ISA 315 (Revised), together with additional material regarding specific areas which would benefit from the exercise of heightened professional scepticism, and include guidance on how to do this, such as material introduced in ISA 450 (Revised) and in proposed ISA 600 (Revised), Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors);

potential enhancements to considerations as to when to involve forensic specialists. Please refer to our response to Question 1b) for further information;

increased emphasis on evaluating the culture and tone at the top, clearly linked to the enhanced material in this area set out in ISA 315 (Revised), with related guidance as to how to do this and the implications for the audit if there are concerns in this area;

expanding guidance with respect to responding to financial statement level fraud risks, such as:

obtaining more audit evidence from external sources, which may be appropriate if we are concerned about management override/ collusion within the entity, and which may assist the auditor with identifying assertion level fraud risks;

increased use of tests of details in the audit to respond to a risk of fraud that is more pervasive in nature, when the engagement team considers this to be appropriate;

involvement of specialists/ auditor's experts, when considered appropriate by the engagement team, focused on evaluation of subjective judgments across the financial statements to help identify/ address indicators of possible management bias that may be intentional and fraudulent (e.g. in relation to estimates).

We also note that there is an evolution gap, which we describe in more detail below under Evolution Gap – Fraud and Going Concern.

#### Evolution Gap – Fraud and Going Concern

We recognise that there is a significant evolution gap in respect of both fraud and going concern. The UK Brydon Report identified these as being the two areas that stakeholders want more information and clarity about – which we summarise as being whether the company is 'honestly' run and whether the company is 'resilient', i.e. whether it is likely to survive for a reasonable length of time. We believe it likely that stakeholders would call for certain key aspects of this information to be independently assured. Please refer to our responses to questions 2a) and 3a) for further information and our recommendations to address this aspect of the expectation gap.

There are inherent limitations to the ability of an audit, that is nevertheless carefully planned and properly executed, to detect material fraud. This unavoidable risk is due, in part, to the fact that most audit evidence is persuasive rather than conclusive, in order to support reasonable assurance. Additionally, some frauds are highly sophisticated, carefully organised, may be perpetrated by senior management, and may involve collusion, making them particularly challenging to detect.

We believe there may be a fundamental lack of understanding by users of financial statements about the inherent limitations of an audit as described above, in particular, because these limitations interact with the fact that an audit is a risk-based, and not an absolute, assurance engagement, and is rooted in the concepts of materiality and reasonable assurance.

We believe there is also a lack of understanding as to what 'fraud' in an audit of financial statements actually means. There is also an interaction between the concept of fraud and that of breaches of laws and regulations, which have some degree of overlap (especially in the case of intentional violations) but with breaches of laws and regulations encompassing a significantly broader scope, including operational and reputational matters such as in respect of environmental or health and safety legislation. We believe users of financial statements may believe 'fraud' encompasses such matters beyond those that are directly connected to the financial statements themselves, however, as auditors, our focus is on risks of material misstatement of the financial statements due to fraud. Furthermore, ISA 250, Consideration of Laws and Regulations, which addresses such areas, also highlights inherent limitations of an audit in this area, particularly where the effects of such laws and regulations on the financial statements are indirect. Therefore, there again remains a risk that not all such breaches that are material to the financial statements will be identified by an audit, and this risk increases significantly if the breach also involves an aspect of fraud in the form of intentional action or collusion by management.

We believe that, overall, the standards are clear regarding the role and responsibilities of the auditor with respect to the detection of material fraud and we do not consider that these should be changed more broadly, or the concept of an 'audit' changed fundamentally in this area. Management and those charged with governance are responsible for the control environment and policies and processes to prevent and detect fraud at an entity, including setting the right 'tone' regarding business conduct. However, we recommend considering certain enhancements to the current requirements set out in the ISAs, which we describe below under Changes to the ISAs.

## **Mazars (MAZ)**

### **Fraud**

The discussion paper mentions "The public thinks the role of the auditor is to detect fraud, including non-material fraud." However, we believe that the main expectation is that material frauds will be discovered.

To start, the expectation gap is impacted by the fact that the fraud term is not always clearly defined and there can be confusion with the concepts of Non-compliance with Laws and regulation (NoClar), corruption, and money-laundering. Even if you then get to a common understanding of the meaning of fraud and understand the role of the auditor to detect material fraud, the fact is, the public has no insight into the materiality thresholds applied in the audit. As a result, what is appropriately deemed non-material by the auditors may, if known, be considered material by the financial statement users. Beyond simply being knowledgeable of the role of the auditors, this literal lack of knowledge regarding materiality creates a knowledge gap. The fact that a fraud is noted which does not give rise to the financial statements being materially misstated, and thus is reported internally to management - depending on law and regulation possibly externally - but not necessarily publicly in the auditor's report (except possibly as KAM) is of little interest or value to certain financial statement users.

The expectation gap is split in the paper between knowledge, performance, and evolution gaps and we believe all are valid.

We do not believe that the evolution gap is a significant contributor to the expectation gap at this time.

The knowledge gap has historically, and continues to be, a significant cause of the expectation gap. This is in part due to the expectations of stakeholders, many of whom are not necessarily concerned with understanding the role and responsibilities of the auditor. Clearly there is a need to engage all financial statement users in having a common understanding of the relevant roles and responsibilities for addressing fraud and going concern among the auditors and the Management and TCWG.

Even though we believe it is not the main reason, the expectation gap may be also linked to the performance gap as described in the discussion paper.

### **Mazars USA (MAZUSA)**

Response: We believe the knowledge gap is the main cause of the expectation gap. We recognize there are performance and evolution gap factors as well, but to a much lesser degree, therefore our focus is on closing the knowledge gap.

Fraud:

There are many financial statement users who think the auditor's main focus during an audit is to search for and uncover any possible fraud. Many users fail to understand that ISA 240, The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements (ISA 240) clearly indicates that management and those charged with governance (TCWG) have the primary responsibility for the prevention and detection of fraud. Additionally, it is management who has the primary responsibility to determine that its financial statement disclosures are compliant, complete and fairly stated. Many users overestimate the assurance an audit truly provides, namely that the audit is designed to provide only reasonable, not absolute, assurance that the financial statements are free of material misstatement, whether due to fraud or error. Said another way, a standards compliant audit may not identify all fraud or error, or even material fraud or error, due to inherent limitations in an audit and the actions of those perpetrating the fraud. This lack of common understanding between the auditors and users of financial statements causes the difference in "knowledge" between what the auditors are actually responsible for, and what the public perceives as the auditor's responsibility, hence the expectation gap. If the users of financial statements had more education leading to a better understanding the auditors' responsibilities, there would be less of an expectation gap.

### **Nexia International (NI)**

The "expectation gap" in general terms is the difference between what the financial statement users expect from the auditor and the audit, and the reality of what an audit actually is. The ITC discusses three components of the expectation gap: the knowledge gap, the performance gap and the evolution gap. We believe that the knowledge gap is the most significant of these to be addressed.

Under the current auditing standards, an audit provides reasonable assurance about whether the financial statements as a whole are presented fairly, in all material respects, in accordance with an applicable financial reporting framework. Today's audit standards include materiality considerations, sample size determination (not 100% audit) and the concept of professional scepticism. Based on these concepts, it is simply not possible to design an audit to detect all forms of fraud. An audit does not provide absolute assurance.

We also think part of the problem is the users' belief that frauds can always be detected in a timely manner. This is simply not true. Sophisticated fraud (often involving collusion with external parties) is very difficult to detect with the limited power, access to data and time constraints that auditors have. Using a forensic expert as referred to in the ITC will be unlikely to change this outcome without change to the other constraints.

There is also an expectation gap regarding going concern. Here the gap lies in user's reliance on the auditors to tell the story of a company's strategic and operational plans to continue as a going concern. In the past, too much emphasis is placed on the auditor as it relates to this topic. Much of what is provided by management to support going concern assumptions are related to future or projected events and transactions. Management is in a better position to tell users this story than the auditor. The expectation can simply not be that the auditor is responsible for the viability of a company's operations.

The directors do not guarantee an entity is a going concern, and there is no basis for the auditor, who is not responsible for the management or operation of the entity, to be held to a higher threshold.

However, although this gap has narrowed in recent years as accounting standards rather than only audit standards, address this topic, we do believe that IAS 1 could be much more detailed on when and how management report issues around going concern. The auditing standards provide more guidance, but this does not apply to management.

In practice, many entities have poor and/or unstructured fraud risk assessment processes and monitoring of controls (even some of the larger entities). Making public statements around fraud risk management and adopted controls will assist in entities placing more focus on the risk of fraud.

The IAASB should work with regulators to encourage better communication to manage stakeholder expectations, rather than increasing the scope of audit.

This entails more consistent and more transparent communication of the work performed by auditors to address significant matters (e.g., fraud and going concern). While ISA 260 Communication with Those Charged with Governance may have set down the framework on how significant matters are communicated by the auditors to TCWG, there may not be similar requirements to ensure that there is a similar information flow from the TCWG to other stakeholders.

Closing this gap requires the joint efforts of various parties including:

Standards setters who should ensure that standards are clear and understandable and should provide adequate and appropriate guidance on their implementation. In particular, more examples could be provided on how complex fraud risks, such as external collusion, can be addressed.

More stringent requirements for training auditors through education and examination and on the job training.

Robust supervision/monitoring by the firms, national professional bodies and regulators.

The improvements in quality arising from the new Quality Management Standards may help narrow the performance gap.

### **PKF International Limited (PKF)**

The expectation gap relating to fraud and going concern in an audit of financial statements is caused by a combination of two factors:

users of financial statements not having an accurate understanding of how the audit is conducted; and

ineffective communication from auditors to the users of financial statements on how the audit is conducted.

The expectation gap is further widened where users of financial statements desire, and believe they receive, a greater level of assurance from the audit than the reasonable assurance that the audit opinion provides.

The expectation gap comes under increased public scrutiny for each high-profile corporate failure. In light of current global conditions and the economic outlook for the medium-term, it is probable that more situations will arise which will provoke further debate on this topic.

### **RSM International Limited (RSM)**

Given the responsibilities of auditors, management and those charged with governance under the current auditing standards, in our view the main cause of the expectation gap which exists at the present time is the “knowledge gap”.

However, we also acknowledge the findings of the recent report in the UK by Sir Donald Brydon “Report of the Independent Review into the Quality and Effectiveness of Audit”, which was clear that auditors cannot solely blame this expectation gap on a lack of user knowledge. The profession has been attempting for decades to help users to better understand the nature and limitations of the audit, yet the expectation gap persists, so we suggest that a change of approach should be considered.

High-profile instances of audit failures in several, though not all, jurisdictions make it difficult to avoid the conclusion that there is also a “delivery gap” in the performance of audits that needs to be addressed. While this may be partly attributable to failures to follow the current ISAs, a “performance gap”, we believe there is also a need to assess whether the ISAs in these areas are fit for the purpose of meeting users’ reasonable expectations; an “evolution gap.” Therefore, we welcome the IAASB’s discussion paper on these critical audit areas and support a review into whether these current responsibilities remain appropriate.

In conducting this review, we believe the IAASB should continue to focus on principles based standards that permit the responsibilities of the auditor to evolve in line with the evolving needs of users. It is critical that consideration is given to whether the audit product is delivering what the users of the financial statements want and need, given the evolution of the expectations of an audit, such that it provides the confidence that capital markets require. This is further discussed below.

## **5. Public Sector Organizations**

### **Auditor General of South Africa (AGSA)**

a) The main cause in our view is the lack of understanding by users of the financial statements as to what the objective of an audit and the responsibilities of an auditor are. Users and the public at large do not understand what reasonable assurance means or that there are inherent limitations within an audit. The general public may also not understand that there is a difference between a regularity and forensic audit and what the key differences are.

Unfortunately there is also an element of incorrect application of the audit standards on fraud and going concern, partly due to the complexity of the standards and partly due to the limited application of professional scepticism by the auditors. Furthermore the general public may not be regarded as a primary user of the financial statements resulting in the information needs of the public not really being considered when planning the audit approach for fraud and going concern.

### **Australasian Council of Auditors General (ACAG)**

We acknowledge the three components of the expectation gap published by the Association of Chartered Certified Accountants.

We noted the following as the main causes of the expectation gap:

The ongoing misunderstanding by users of the financial report of:

- the scope of a reasonable assurance engagement (with linkages to fee pressure)
- the period that the audit report covers; historical not forecasts
- concept of materiality for the detection of fraud
- extent of audit work done in relation to fraud
- accountability for fraud

Detection risk: in particular when fraud is as a result of collusion.

Increased public expectations attributable to many factors including the use of enhanced auditing tools and industry responsiveness to significant frauds.

We note that the expectation gap for going concern is less of a focus in the public sector.

What do you think is the main cause of the expectation gap relating to fraud and going concern in an audit of financial statements?

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We noted the following as the main causes of the expectation gap:

The ongoing misunderstanding by users of the financial report of:

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Detection risk: in particular when fraud is as a result of collusion.

Increased public expectations attributable to many factors including the use of enhanced auditing tools and industry responsiveness to significant frauds.

We note that the expectation gap for going concern is less of a focus in the public sector.

### **US Government Accountability Office (GAO)**

We generally believe that the expectation gap exists because financial statement users may not understand financial statement auditing standard requirements and related scope of financial audits. As noted in the discussion paper, auditing standards require auditors to obtain reasonable assurance rather than absolute assurance. Also, audits focus on material misstatements rather than all misstatements. In our view, financial statement users' misunderstanding of auditing standards is the main cause of the expectation gap relating to fraud and going concern.

## 6. Member Bodies and Other Professional Organizations

### Accountancy Europe (AE)

We agree with the IAASB that the audit expectation gap should be broken into the three components: the knowledge gap, the performance gap, and the evolution gap.

Fraud

Causes of the expectation gap

An audit conducted in accordance with the ISA framework follows a risk-based approach, focuses on material misstatements as opposed to all misstatements and does not provide absolute assurance. Accordingly, auditors identify and assess risks of material misstatement and respond to these risks by designing and performing audit procedures. The combination of reasonable but not absolute assurance and a risk-based approach results in an unavoidable risk that some material misstatements in the financial statements may not be detected.

The auditor's current responsibility is to plan an audit to obtain reasonable assurance that the financial statements are not materially misstated due to fraud or error. There is not a clear distinction between these two categories, i.e., fraud or error: one may lead to the other and, the auditor's responsibility in respect of error or fraud is equal, but the work effort is different. It raises the question if we should be referring to fraud and error in this way.

### Botswana Institute of Chartered Accountants (BICA)

The main contributor to the expectation gap is the knowledge gap. More often the public, including those charged with governance, lack the basic principle of what financial statements audit entails. In most cases the expectation is that the auditor has the responsibility of detecting fraud and assessing an entity's going concern. For this reason, investors often attempt to take action against the auditors when things go wrong for any period for which the auditor issued an unmodified report.

### Center for Audit Quality (CAQ)

Of the three components outlined in the Discussion Paper, we believe that the "Knowledge Gap", or the difference between what the public thinks auditors do and what auditors actually do with respect to fraud and going concern, is the component that is most often responsible for the expectation gap. Despite a handful of recent corporate failures across the globe, it is important for the public to understand that the IAASB's current auditing standard, ISA 240, The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements (ISA 240), requires the auditor to provide reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. As outlined in ISA 240, the primary responsibility for the prevention and detection of fraud rests with management and those charged with governance. Properly designing and executing an audit in accordance with auditing standards to obtain reasonable, not absolute, assurance does not mitigate all risks of material misstatement. Risk remains, in part, because attempts by management to conceal a potential fraud can be difficult to detect, particularly in situations where fraud is accompanied by collusion, as outlined in ISA 240. However, as described in our response to Question 2(a), we believe a better understanding of actual or perceived performance gaps also is important.

With respect to going concern, we believe that in addition to the "Knowledge Gap", the "Evolution Gap" also contributes to the expectation gap. Considering the related accounting and auditing standards together with

the modernization of business and user needs could address the “Evolution Gap”. We discuss this in more detail in our response to question 3(a).

### **Federacion Argentina de Consejos Profesionales de Ciencias (FACP)**

Knowledge gap: We understand that this is the main cause of the expectation gap.

Evolution gap: respect going concern the auditor frequently uses professional judgment, it is also possible that the latest technological tools available for detecting the risk of fraud in financial statement audits are not used, for these reasons it is convenient that some procedures used by the auditors are reviewed.

(b) In your view, what could be done, by the IAASB and / or others (please specify), to narrow the expectation gap related to fraud and going concern in an audit of financial statements?

### **Institute of Chartered Accountants of Scotland (ICAS)**

We note the audit expectations gap model adopted by the IAASB for the purposes of this paper. From the model used by the IAASB, the main cause in our view is the “knowledge gap”, i.e. the difference between what the public thinks auditors do and what auditors actually do. This recognises that the public may misunderstand the role of auditors and the requirements of the auditing standards. We do need to be careful here, however, as to regards what constitutes “the public”. Given the inherent complexities associated with business, and indeed financial reporting, it is questionable whether it would be possible for an average member of the public to properly understand the purpose and objectives of an audit. Therefore, we believe that closing the perceptions gap has to be targeted at a particular group, e.g. an informed investor or equivalent in relation to the audits of public interest entities to have any real hope of closing this gap.

We would also note that as the IAASB highlights there is an information gap which may be consumed within the knowledge gap. Auditors with their privileged access to company records and personnel are in possession of far more information about an entity than is reported in their audit report. One of the key aspects of that is information relating to any weaknesses in internal controls that are reported to those charged with governance. Whilst they have always been important, internal controls are taking on even more importance nowadays given the rapid development of new technology. Efforts targeted at improving an entity’s system of internal controls should help to reduce the risk of fraud occurring in the first place and, where it does occur, of detecting the particular fraud in question. Therefore, at a jurisdictional level we believe that there is merit in jurisdictions considering whether they should impose requirements on directors of public interest entities to attest as to whether the entity concerned has an effective system of internal control over financial reporting. The more effective such systems are, and we fully appreciate that they cannot be absolute, the less is the risk that these controls can be bypassed, or circumvented by management. We need to build on strong foundations, audit is at a disadvantage if an entity does not have in place an effective system of internal control. Such jurisdictions could also decide on the extent to which the auditor should provide assurance, if any, over such attestations. Such developments would help to improve the financial reporting ecosystem. In those UK companies which are subject to the US SOX regime there is general acceptance that this has led to a better control environment within those organisations.

### **International Federation of Accountants (IFAC).pdf**

We believe that a key issue with the expectation gap is around education of external users/stakeholders to have an appropriate understanding of audit and assurance engagements (the “knowledge gap”). We agree that the IAASB cannot solve the issue of the expectation gap alone. Addressing this issue effectively calls for looking across the participants in the corporate reporting ecosystem, including preparers of reports, audit

committees, directors, and management. It is important other stakeholders consider whether addressing gaps in the expectations placed on audit might require broader changes, including a more rigorous approach to the accountability of company management for high quality financial reporting processes and internal controls. An organization's policies and procedures for whistleblowing will also be an important component of detecting and dealing with fraud.

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We strongly agree that each participant in the financial reporting ecosystem has an essential role that contributes to high-quality financial reporting. Unfortunately, very often with corporate collapses or significant accounting restatements, it is the auditor's role which is challenged first by the media, politicians, and other commentators, before also considering the responsibilities of management, boards, and audit committees. This significantly contributes to the general perception that the auditor must be responsible which impacts the expectation gap.

Globally, many thousands of audits are performed annually—in the public interest and in accordance with high-quality international standards for audit and ethics. From this perspective the number of significant audit failures is extremely low. It is also likely that the expectation gap around fraud and going concern is more acute when it leads to large companies going bankrupt than for SMEs. The level of attention given to the auditor's potential role in a small number of recent corporate failures leads to misperception of problems with audit and potentially invites overreaction.

IFAC's Achieving High-Quality Audits Point of View (the IFAC Audit PoV) notes that achieving high-quality audits (which includes in relation to fraud and going concern) requires a well-functioning ecosystem involving a number of factors and participants including the right people, the right governance, and the right regulation. The five elements in the IFAC Audit PoV discussed must all work together to produce the right audit that meets the expectations of stakeholders. The quality of audit must be assessed by the right measurements. In the absence of any of these components, the audit may not meet the expectations of stakeholders.

The IAASB's reference to the ACCA's description of three components of the expectation gap: the "knowledge gap," "performance gap" and "evolution gap" is helpful. The significance of the gap is likely to vary internationally, and measuring its extent objectively is inherently challenging as there are many different expectation gaps, even between those in the same stakeholder groups. We agree that some users of financial statements and other stakeholders may misunderstand the role of auditors and requirements of the ISAs in relation to others in the financial reporting ecosystem. In addition, there can be a lack of understanding that management and those charged with governance have the primary responsibility for the prevention and detection of fraud and assessing the entity's ability to continue as a going concern. One of the factors contributing to the expectation gap is a failure to understand the situation auditors face in reporting on matters such as going concern in the absence of adequate reporting to investors and

employees by directors, which may also lead to calls for auditors to address issues that are unreasonable (i.e., an unreasonableness gap).

The role of the audit is to test the veracity of management's assertions as presented in the financial statements, which means that the auditor cannot be the original source of information about a company. Client confidentiality regulations also generally prohibit this. If the auditor finds that a company has presented information incorrectly, including its omission, such that the financial statements are materially misstated the auditor cannot form a so-called clean opinion, whereas if the auditor considers the impact of a misstatement to be immaterial a clean opinion can be expressed. Understanding the difference between material and immaterial in this context is likely to be a challenging part of the expectations gap. Therefore, the IAASB could explore how it might best foster a better understanding of materiality in the context of the audit.

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### **Mexican Institute of Public Accountants (IMCP)**

Users expect a high degree of protection for the results of decisions they make based on audited financial statements. The auditor cannot assume the role of provider of that protection.

Despite the existing literature on auditing matters, many users of audited financial statements still do not have a whole understanding of the nature, scope and limitations of an audit of financial statements, nor the responsibilities of external auditors. Consequently, users' expectations exceed the corresponding professional standards and regulatory requirements.

#### **Fraud**

Frequently, users of audited financial statements expect auditors to discover all types of frauds, ignoring that auditor's responsibility is limited on that matter, and do not recognize that ultimate responsibility for the identification and assessment of fraud risks, as well as the design and implementation of policies and procedures to prevent, and to detect and correct those risks, lies with management and those charged with governance of the entity.

### **Pan African Federation of Accountants (PAFA)**

The three components (knowledge, performance and evolution gaps) detailed in the Discussion Paper aptly describe contributors to the audit expectation gap with a greater emphasis towards the knowledge gap.

### **REA Auditores - Consejo General de Economistas (REA)**

We understand that the main cause of the expectations gap is due to the difference between what the general public thinks that the auditors do and what the auditors actually do, which implies that the users of the audit report can misinterpreting the role of auditors or confusing their professional activity. And we believe that this is due, fundamentally, to the lack of knowledge of a good part of the users of the audit reports of what is the objective of the audit of accounts of financial statements and the requirements of the technical auditing standards (NIA).

Although the DP mentions three components of the "Audit expectation gap", according to an ACCA publication of May 2019, we consider that the expectation gap, in general terms, is the difference between what users expect from the auditor of audit accounts of financial statements, and the reality of what an audit is defined in its regulations.

### **South African Institute of Chartered Accountants (SAICA)**

One of the reasons for the expectation gap is that there appears to be a lack of understanding of what the needs of the public are in relation to an audit of financial statements. This could be due to the fact that there

are no mechanisms for dialogue between the public and the auditors resulting in a lack of understanding in terms of what auditors are expected to deliver. The term 'public' is undefined and often used loosely without clarity as to which stakeholder groups represent the public's views with regard to the audit process. These stakeholder groups may vary from one jurisdiction to the other but it is critical that they are identified and for formal mechanisms to be implemented in order to identify how best to solicit their views on the expectations of an audit of financial statements. The stakeholder groups may also vary as a result of differences in complexities, size, laws and regulations and the regulators who oversee the entities being audited. Some of the traditional stakeholder groups include regulatory authorities such as audit regulators, stock exchanges and large institutional investors that may have a direct interest in the audit process. However, there is a need to move beyond the traditional stakeholder groups to allow for a more inclusive process.

Users of financial statements have evolved from being predominantly individuals with financial backgrounds to individuals from various other careers. This has led to a lack of understanding over audit concepts such as materiality, the responsibilities of management with respect to fraud and going concern, and the concept of reasonable rather than absolute assurance.

It can be argued that a significant contributor to the expectation gap is the information contained in media reports and other information reported on informal platforms such as social media, which may contain misleading information that adds to widening the knowledge gap. There is a need for appropriate structures to be created to address the expectation gap in appropriately responding to media reports and ultimately educating the public on the roles and responsibilities of the auditor.

The distinction between the knowledge, performance and evolution gap as defined in the Discussion Paper is useful. Any changes to the International Standards of Auditing (ISAs) that the IAASB may propose will only address the performance gap in clarifying the requirements and the evolution gap in responding to the changing needs of the general public demands, but other action is required to address the knowledge gap. This is probably the reason why, although the ISAs have been updated and revised over the years, the issue of the expectation gap remains unabated. The importance of educating and having a continuous dialogue with the appropriate stakeholder groups in an effort to close the knowledge gap cannot be emphasised enough. This should not be the responsibility of the IAASB alone but of everyone involved in the wider financial reporting ecosystem. It is SAICA's view that the knowledge gap is the main contributor to the expectation gap as this is beyond the profession's control. The mere fact that auditors are also called "watch dogs" might be an indication on what the public expects from auditors, compared to what they really do.

The complexities of business and the very stringent reporting deadlines imposed by regulators and management, together with the ever-reducing number of auditors have increased the workload and pressure and due to this, the appropriate composition of the audit teams may be lacking. This contributes to widening the evolution and performance gaps.

With regards to fraud, there seems to be an expectation by the public that the auditor should be performing procedures to detect fraud while the ISAs only require the auditor to:

Identify and assess the risks of material misstatement of the financial statements due to fraud;

Obtain sufficient appropriate evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

Respond appropriately to fraud or suspected fraud identified during the audit.

This has the potential effect that where the auditor's risk assessment procedures do not indicate that fraud may exist at the audited entity then it may go undetected by the auditor. The risk of this scenario occurring is heightened when the auditor's ability to exercise professional scepticism is compromised, where as an example the auditor has a long association with the client or financial dependency on the audit fee from the client. Tight audit deadlines and the resultant pressure to complete the audits on time, either from management and regulators are other examples that could result in the diminishing of professional scepticism by the auditor.

### **The Institute for the Accountancy Profession in Sweden (FAR)**

We think that the description of the expectation gap in three components: the knowledge gap, the performance gap and the evolution gap is relevant to explain the expectation gap. Concerning fraud and going concern we believe that there primarily is a knowledge gap. There is a lack of common understanding that the responsibility for identifying and providing users with information and disclosures related to fraud and going concern begins first and foremost with the management and those charged with governance. However, we also believe that there is a difference between what auditors do and what the public thinks auditors do.

### **Union of Chambers of Certified Public Accountants of Turkey (TURMOB)**

Lack of sufficient understanding of the scope and purpose of an audit of financial statements, and the extent of responsibilities of the auditor regarding fraud and going concern while conducting an audit and issuing an auditors' opinion.

### **Wirtschaftsprüferkammer (WPK)**

We see the main cause of the expectation gap in the general public's misunderstanding of the role and the legal task of the auditor, including the inherent limitations of the audit ("knowledge gap"). The informational value of the auditor's opinion is accordingly overestimated and falsely rather considered as a guarantee for flawlessness of the financial statements and future viability of the audited company by a trustworthy, external party.

The number of professionals conducting statutory audits is small, at least in Germany, and regarding the audit of financial statements they operate rather unobserved by the public due to the trusting relationship with its clients and discretion obligations. The audit itself is conducted on the basis of a comprehensive set of rules (laws and statutes, standards, codes) containing complex requirements and concepts that are hard to understand for people outside the profession. These include amongst others concepts like reasonable assurance, materiality with all its different forms, or the elaborated allocation of responsibilities between auditor and management with regard to the going concern ability of the audited company. Knowledge of and interest in the conduct of a financial statement audit of the general public is accordingly limited.

Whereas the public image of the professionals seems to be one of well-paid, well-trained specialists with comprehensive expertise in various economic and business-related disciplines (e.g. tax, financial reporting, controlling, valuation services, forensic). This image may be reinforced by financial news in the media and self-presentation of the firms (image brochures, recruiting conventions, social media). In case of large corporate failures, like Wirecard, the media coverage swiftly reports about alleged duties and failures of the auditor and others even though legal investigations are still ongoing, thereby creating a potentially distorted picture of the role, responsibilities and capabilities of the parties involved.

Considering the evolution gap expectations in the digital expectations might be that technologies enable the auditor to perform 100% audits, resulting in absolute assurance auditor's reports.

## 7. Investors and Analysts

### Corporate Reporting Users Forum (CRUF)

We think that the expectation gap is primarily derived from the knowledge gap which is the difference between what users think is expected of the auditor and the actual role and authority of auditors.

For example, it was challenging for users to grasp the concept and impact on audit practice of the recent fundamental revisions to the conceptual ISAs such as ISA540, ISA315, IAS 220 and ISA 600 and ISQMs. We hope that users of financial statements will be provided with a comprehensive and easy-to-understand explanation of these new standards in tandem with local auditing standard setters to help narrow the knowledge gap.

Also, as is the case with IFRSs, translation into languages other than English will facilitate non-English-speaking users' participation in the discussion during the development of standards. While there may be resource constraints, we would like the IAASB to cooperate with local auditing standard setters to achieve this.

The knowledge gap could also be derived from differences in the perspectives of users, such as investors and analysts, and auditors. Investors and analysts place importance on information that affects stock prices and ratings, but auditors place the highest priority on whether financial statements are free from material misstatements. It is possible therefore that auditors are not familiar with the information that investors and analysts place importance on, such as the future prospects of the company's products and services, industry trends, and the economic and market environment, or auditors might have a different view on the company and industry than users. We would expect auditors to proactively gather information on the audited company and its industry, including points and perspectives that investors and analysts place importance on.

Key Audit Matters (KAMs), plus the addition of Critical Audit Matters (CAMs) in the USA, may include the auditor's explanation with respect to the company's system for preventing frauds which may lead to material misstatements. We expect the IAASB to analyze such descriptions to a wider extent in cooperation with local accounting bodies.

We believe also that the expectation gap arises from the performance gap, where the performance of an audit is not up to a high enough quality. Regarding the performance gap, the CRUF would like the IAASB to continue its efforts to clarify the ambiguity of the standards as the discussion paper mentioned. We also expect the IAASB to encourage countries to take appropriate actions including enactment of laws and regulations in alliance with IOSCO and/or ICGN for tight deadline issues. We expect auditing firms to improve their governance through ISQM1 implementation to reduce concerns that auditing firms might not develop clear guidelines and procedures regarding audit quality. We are concerned about whether accountants effectively execute professional skepticism in the current audit environment. Any fraud could affect a company's financial statements through negative impacts from fines, damage claims and impairment of reputation. Auditors are expected to confront the risk of fraud with this in mind. Some CRUF UK Members indicate that an example of removing ambiguity from standards may be seen in the proposed revisions to ISA (UK) 240 and their consultation on this by the Financial Reporting Council in the UK.

We agree with the discussion paper that there is insufficient provision of information from auditors to shareholders on their procedures performed and outcomes. We recognize that the IAASB has expanded

initiatives for auditors' disclosure, such as transparency reports of audit firms, however we would like such efforts to be accelerated. As discussions during the development of ISQM1 did not always go positively in this area, we expect the IAASB to be more proactive in addressing this. One way to do this is to ensure that audit standards' changes and developments are consumer rather than producer led with the IAASB listening more to what the users of audits and audited financial statements are looking for.

During an audit, auditors should understand the actual state of the company's governance, including whether those charged with governance are independent from management (in mind, as well as in appearance, possess necessary knowledge, skill and authority, and align with internal audit functions), and are committed to their duty. Auditors should know who is the right contact of those charged with governance, its subordinates and others within the company who are responsible for dealing with allegations of fraud raised by employees or other parties, in case management is reluctant to identify and respond to fraud. In addition, we expect auditors to assist management and those charged with governance to regularly reinforce their knowledge of GAAP and GAAS. Furthermore, auditors should understand the company's culture well. If similar, even insignificant frauds occur repeatedly or with the involvement of management, it indicates a company culture that creates or overlooks frauds leading to material misstatements. Auditors should request companies to identify the root cause of the frauds and remedy internal control weaknesses and assist companies in cultivating a culture that

does not permit any frauds.

Auditing standards should focus more on reliance of audits on internal financial controls and how these may indicate the possibility of material misstatements in financial statements arising from fraud.

We think that the expectation gap is primarily derived from the knowledge gap which is the difference between what users think is expected of the auditor and the actual role and authority of auditors.

For example, it was challenging for users to grasp the concept and impact on audit practice of the recent fundamental revisions to the conceptual ISAs such as ISA540, ISA315, IAS 220 and ISA 600 and ISQMs. We hope that users of financial statements will be provided with a comprehensive and easy-to-understand explanation of these new standards in tandem with local auditing standard setters to help narrow the knowledge gap.

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We believe also that the expectation gap arises from the performance gap, where the performance of an audit is not up to a high enough quality. Regarding the performance gap, the CRUF would like the IAASB to continue its efforts to clarify the ambiguity of the standards as the discussion paper mentioned. We also expect the IAASB to encourage countries to take appropriate actions including enactment of laws and regulations in alliance with IOSCO and/or ICGN for tight deadline issues. We expect auditing firms to improve their governance through ISQM1 implementation to reduce concerns that auditing firms might not develop clear guidelines and procedures regarding audit quality. We are concerned about whether accountants effectively execute professional skepticism in the current audit environment. Any fraud could affect a company's financial statements through negative impacts from fines, damage claims and impairment of reputation. Auditors are expected to confront the risk of fraud with this in mind. Some CRUF UK Members indicate that an example of removing ambiguity from standards may be seen in the proposed revisions to ISA (UK) 240 and their consultation on this by the Financial Reporting Council in the UK.

We agree with the discussion paper that there is insufficient provision of information from auditors to shareholders on their procedures performed and outcomes. We recognize that the IAASB has expanded initiatives for auditors' disclosure, such as transparency reports of audit firms, however we would like such efforts to be accelerated. As discussions during the development of ISQM1 did not always go positively in this area, we expect the IAASB to be more proactive in addressing this. One way to do this is to ensure that audit standards' changes and developments are consumer rather than producer led with the IAASB listening more to what the users of audits and audited financial statements are looking for.

During an audit, auditors should understand the actual state of the company's governance, including whether those charged with governance are independent from management (in mind, as well as in appearance, possess necessary knowledge, skill and authority, and align with internal audit functions), and are committed to their duty. Auditors should know who is the right contact of those charged with governance, its subordinates and others within the company who are responsible for dealing with allegations of fraud raised by employees or other parties, in case management is reluctant to identify and respond to fraud. In addition, we expect auditors to assist management and those charged with governance to regularly reinforce their knowledge of GAAP and GAAS. Furthermore, auditors should understand the company's culture well. If similar, even insignificant frauds occur repeatedly or with the involvement of management, it indicates a company culture that creates or overlooks frauds leading to material misstatements. Auditors should request companies to identify the root cause of the frauds and remedy internal control weaknesses and assist companies in cultivating a culture that does not permit any frauds.

Auditing standards should focus more on reliance of audits on internal financial controls and how these may indicate the possibility of material misstatements in financial statements arising from fraud.

## **8. Academics**

### **Auditing Standards Committee of the Auditing Section of the American Accounting Association (ASC)**

For over 50 years, researchers have been investigating the potential causes of the expectation gap across a broad range of countries. A recent review of the expectation gap literature by Quick (2020) suggests that a primary cause of the expectation gap likely results from differences in understanding auditors' responsibilities. In their review of the academic literature related to the auditor's report, Church, Davis, and

McCracken (2008, 81) reached a similar conclusion, that although communications to financial statement users have been enhanced over time, “users do not appear to fully understand the auditor’s responsibility, the extent of work performed in an audit, and the level of assurance provided by the auditor’s report.”

Several studies examine perceptions of different stakeholder groups and highlight persistent differences in what the various stakeholders think auditors do and what auditors actually do (i.e., the knowledge gap). These studies focus on fraud-related responsibilities, perhaps because the expectation gap is widest on that aspect of the auditor’s work. For example, Baron, Johnson, Searfoss, and Smith (1977) find that non-auditors perceive higher auditor responsibility for detecting and disclosing corporate irregularities and illegal acts than auditors perceive. Similarly, Lowe (1994) and Frank, Lowe, and Smith (2001) find significant perceptual differences between auditors and judges/jurors, particularly in relation to the auditor’s role in fraud detection. Epstein and Geiger (1994) noted 71 percent of investors wanted absolute assurance that financial statements are free of material misstatements due to fraud, which is also similar to findings of McEnroe and Martens (2001) who compare expectations of audit partners to investors.

As noted in Quick’s (2020) recent review of the expectation gap literature, recent studies suggest that these differences in perceptions still persist between different stakeholder groups across many countries. For example, studies have been conducted in China (Lin and Chen 2004), Barbados (Alleyne and Howard 2005), Egypt (Dixon, Woodhead, and Sohlman 2006), Australia (Schelluch and Gay 2006), Lebanon (Sidani 2007), Saudi Arabia (Haniffa and Hudaib 2007), Netherlands (Hassink, Bollen, Meuwissen, and De Vries 2009; Litjens, van Buuren, and Vergoossen 2015), Bangladesh (Siddiqui, Nasreen, and Choudhury-Lema 2009), Iran (Noghondari and Foong 2013), UK/New Zealand (Porter, Ó hÓgartaigh, and Baskerville 2012), Germany (Ruhnke and Schmidt 2014), and the USA (DiGabriele 2016), with the majority of these studies noting specific differences in how various stakeholders view the auditor’s role in detecting fraud.

While much of the research examines the auditor’s role in detecting fraud, there are also differences in perceptions as to going concern. Campbell and Mutchler (1988) find that lending officers believe auditors issue a going concern opinion because it is their duty to provide a signal of financial distress to financial statement users, while auditors issue a going concern opinion because they believe there is risk that assets will not be recoverable. A similarly disparate understanding of financial statement audits was reported by Frank et al. (2001), who find that jurors perceive auditors’ role as a public watchdog (in addition to expecting auditors to search for the smallest of frauds as noted above).

Other research compares perceptions of auditors and investors related to terminology in the audit report and on auditors’ responsibilities involving various dimensions of the attest function including going concern and fraud. McEnroe and Martens (2001, 356) conclude that investors do “not want auditors to issue an unqualified opinion unless: every item of importance to investors and creditors has been reported or disclosed, auditors have been ‘public watchdogs,’ the internal controls are effective, the financial statements are free of misstatements resulting from management fraud, the financial statements are free of misstatements intended to hide employee fraud, and the firm has not engaged in illegal operations.”

Gray, Turner, Coram and Mock (2011, 661) conduct focus groups research with “financial statement preparers (CFOs), users (bankers, analysts, and non-professional investors), and external auditors.” They find that those in the “users” group frequently misinterpret common terms that are included in the audit report, such as reasonable assurance, materiality, and sampling. In addition, they report that non-professional investors indicated that they use secondary sources for financial data and do not search for the auditor’s report, suggesting that attempts to address the knowledge gap via enhanced communications in the auditor’s report may not be effective. However, a more recent study by Kachelmeier, Rimkus, Schmidt, and Valentine (2020) examines critical audit matter disclosures and finds that such disclosures prompted

participants (MBA students, financial analysts, and lawyers) to recognize measurement uncertainty and lower their assessments of auditor responsibility for subsequent misstatements related to the critical audit matter. These findings suggest that key audit matters in the updated auditor's report might be able to reduce the expectation gap by lowering users' perceptions of audit assurance and auditors' responsibilities.

It is interesting to note that findings reported in the above studies echo observations by the Commission on Auditors' Responsibilities from the 1970s (see the Cohen Commission 1978). That Commission found that "many users appeared to misunderstand the nature of the attest function, especially in the context of an unqualified opinion. For example, some users believed that an unqualified opinion means that the entity is financially sound. Others felt that the auditor should not

only provide an audit opinion, but also interpret the financial statements in such a manner that the user could evaluate whether to invest in the entity" (McEnroe and Martens 2001, 347).

Some of the more notable conclusions reached by Quick (2020) were that the expectation gap differed between countries; stakeholders had widely varying expectations about what the audit should achieve; and that two of the most promising avenues for reducing the expectations gap are education of stakeholders and revised reporting standards like the expanded reporting via key audit matters (KAMs).

## 9. Individuals and Others

### Constantine Cotsilinis (CC)

#### Fraud

There is an expectation gap relating to the perception that the auditors should uncover any fraud in the presentation of the financial results. This is a matter relating primarily to "materiality" and not to "going concern". A misstatement in the financial statements is not necessarily the result of a fraudulent act. e.g. it can result from an inadequate system of internal control in the processes relating to the preparation of the financial statements or an inadequate appreciation of risks leading to poor provisioning.

Obviously, a fraudulent act, which deliberately aims to cover up a going concern problem, should be discovered by the audit if it is above the materiality levels set by the audit.

I believe the expectation gap relating to fraud is more general. People believe that all fraud should be found by the audit. Should a million dollar misappropriation in a billion dollar enterprise be discovered by the audit – unlikely. This is the job of management.

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## **Q1a-1.4 - Performance gap**

## **Q1a-1.5 - Other cause**

### **4. Accounting Firms**

#### **CohnReznick (CR)**

We believe a number of factors contribute to the expectation gap relating to fraud and going concern. Some of this expectation gap is perpetuated by litigators and regulators looking to assign blame for a perceived shortcoming, such as a high-profile restatement. We encourage the IAASB to work to narrow expectation gaps in existing standards but to not sacrifice audit quality.

#### **SRA**

The note on page 11 of the Discussion Paper states, that situations where auditors fail to do what standards or regulations require are not discussed in the Paper. Also referring to the remark, made above, under point 2, regarding the lack of analysis in the Paper, we feel that these situations might be an important cause of failures and scandals also in the non-public interest segment of the audit market. We therefore do not understand the exclusion of these situations in the Paper, as these situations might require other measures, than those suggested in the Paper.

### **5. Public Sector Organizations**

#### **Office of the Auditor General of Canada (OAGC)**

While it is difficult to identify one single cause, broadly speaking the main cause of the current expectation gap relating to fraud and going concern in an audit of financial statements is likely sourced from the ease of access to markets by investors and the scope and pace of information impacting financial market valuations. While market valuations and traditional financial reporting include in their scope fraud and going concern impacts, the information used in each is not identical in terms of timing and scope, and impacts to market valuations may be inconsistent with accounting presentation and disclosure judgments. Traditional audits, performed at regular intervals, as at a point in time, have at best an indirect link to today's fast paced market valuations – yet their presence is seen as more directly linked. More investor/user awareness of audit limitations/scope may be needed.

### **6. Member Bodies and Other Professional Organizations**

#### **Institute of Chartered Accountants in England and Wales (ICAEW)**

Expectation gaps relating to fraud and going concern are long-standing and not straightforward. They are linked because it is not uncommon for the failure of large businesses shortly after an unqualified audit report has been issued to be associated with fraud. Something needs to be done. But we are not convinced that analysing these gaps, or even seeking to address them, is the right starting point. Repeated analyses of expectations gaps over many years have borne little fruit.

Expectation gaps are more a symptom of an underlying problem, which is that more needs to be done by everyone concerned. IAASB's focus should be less on managing expectations, and more on helping all stakeholders, including auditors, enhance their ability to prevent, detect and report fraud, and to challenge management and report more effectively on going concern.

## **Institute of Singapore Chartered Accountants (ISCA)**

In our view, the expectation gap mainly originates from when audited financial statements are subsequently found to be unreliable. The expectation gap would be most apparent in situations where lapses are found or suspected, such as where material cash balances recorded did not exist. Such errors could have been picked up by straightforward audit procedures, leading to obvious questions over the rigor and quality of the audit of the financial statements.

## **Inter-American Accounting Association (IAA).pdf**

a) We believe that there are three fundamental causes.

1. Greed, voracity, craving, etc. for the money by many of those responsible for the administration that do everything in their power to appropriate the entity's resources, covering fraud with accounting tricks,

2. Lack of greater intervention by personnel with sufficient experience professional in conducting the audit of financial statements, in particular in the application of the respective auditing standards in force, both for fraud and for the operating entity, and

3. We also believe that another of the main causes of the Expectation gap related to fraud and going concern in an audit of financial statements is based on the diversity of entities that are subject to audit in different environments from one country to another and in changing situations, in this way it is difficult to raise a common approach since it must be approached in a flexible way completely made and designed tailored to the needs of each entity and in the context of the country in which it is carried out.

## **9. Individuals and Others**

### **Alvaro Fonseca Vivas (AFV)**

The gap that I estimate is the main cause of this gap is the ignorance of the fraud itself and the risks that arise from them or are generated from the same ignorance, which is acquired as experience is gained and it is helped, especially to the new auditors or who dabble in it.

### **Dmitrii Timofeev (DT)**

The perceived gap between auditor's responsibilities and financial information user's expectations is a classic principal-agent problem. Auditors profit from their services and consequently incentivized to preserve client-oriented relations with an auditee. Users may disagree with the financial reporting but that knowledge usually remains private and there is no formal way to provide relevant feedback and to pressure the auditors and organizations. Here are some real-life examples.

According to a decision by the government, ownership of a state-owned enterprise (SOE-1) was transferred to another holding SOE. The following year SOE-1 restored some of the previous write-downs of inventories leading to the increase in profit. Both SOEs reported the new management's success, as SOE-1 turned "operating profitable". Company restored inventory write-downs the next year with the same magnitude. It looks very like to a deliberate shift of the profits between years. Write-downs and reversals were hidden in the cost of the sales line in the income statement of the SOE-1.

The government pursues a policy of 50% dividend payout of profit for all SOEs. One electric power generating SOE routinely impairs value of newly installed capacities referring to non-economic tariffs on heat and electricity. Impairments decrease profits and, consequently, the dividends. For the purpose of fair value estimation of cash generating units company applied an unjustifiably high pre-tax discount rate of 15 -

17% (inflation target in the country is 4%, profit tax rate is 20%). At the same time, comparable SOEs with regulated tariffs apply 10-11% pre-tax rate. Significant impairment expenses were included in one number together with costs of sales in the Income statement.

One socially significant enterprise reported “assets for sale” combined in single big lump line in the Balance sheet supposedly for concealing a significant part of its cash. The assets for sales were impaired using a very high discount rate, and the corresponding costs were aggregated in the costs of sales in the Income statement. Finally, the enterprise applied for the government support justifying the claim with its overstated net debt and understated profits.

In all cases, relevant material information was buried in footnotes, and auditors were silent on the ways of calculation and presentation. As the government employs IFRS in the dividends' policy and for distribution of subsidies, for setting key performance indicators and management remuneration, one can find incentives to game the figures. Auditors have to safeguard fair representation, respecting materiality principle, and express opinion on doubtful revaluations. All discretionary accounting decisions (tangible and intangible asset write-downs, reserve creations, etc.) have to be scrutinized by the auditor. The presentation has to be strictly according to materiality principle. I believe it is more important than going concern and outright fraud issues. Going concern is a credit analysis, and appears to be the responsibility of investors and creditors. Fraudsters sometimes will find a way to defraud, and the auditors may be deceived.

This highlights a need for establishment of a feedback mechanism to fill the gap between user's expectations and the auditors work. This has to be an institutionalized and public way for the users to complain with subsequent assessment of the audit quality, be it some “court” or peer-auditors review.

### **Q1a-1.6 - Disagree that there is an expectation gap**

## **6. Member Bodies and Other Professional Organizations**

### **PIRC**

The central premise of this consultation is incorrect because there is no ‘expectation gap’ under the law of many countries including the UK and other jurisdictions. In the UK, both the Judiciary and Parliament are clear on this.

Disappointingly, this IFAC-IAASB consultation spreads misinformation. We request that it is withdrawn by 21 February 2021, and we will also be asking accounting firms in the UK and the Financial Reporting Council to repudiate it.

The Business, Energy and Industrial Strategy Committee of the UK Parliament (‘The Parliamentary Committee’) determined that there was not an expectation gap under UK law. We are copying this to the UK Parliament and other parties.

The legal position is that fraud may cause a company (and a group of companies) not to be a going concern and the auditors can be responsible for it if they have missed it.

The Parliamentary Committee described the evidence of the largest accounting firms given to it as “blatant” and concluded that the problem was not the public's expectation of auditors being wrong, the problem was a ‘delivery gap’ by the auditors, The Committee concluded:-

“We were both surprised and disappointed to hear the view from audit firms that because fraud is difficult to detect, the public should not expect auditors to find it. The most blatant example came from Grant Thornton's CEO, David Dunckley:

“We are not looking for fraud. We are not looking at the future. We are not giving a statement that the accounts are correct. We are saying they are reasonable. We are looking in the past and we are not set up to look for fraud.”

“We do not accept the attempts of auditors—particularly the Big Four and Grant Thornton—to underplay the role or scope of audit, nor to implicitly blame the public for failing to understand the purpose of audit. Rather, the firms should focus on the poor quality of their audits, and on how they are falling short of what audits are for within the current framework.”

A High Court case settled in the middle of the hearing, *Asset Co vs Grant Thornton*, which involved a fraud. Not only was Grant Thornton held to be accountable for the illegal dividends, as a result of missing the fraud which led to the company not being a going concern (it had failed the capital maintenance requirements of the Companies Act) but Grant Thornton was also accountable for the misinvestment that this had caused the company to undertake.

We therefore had the “Alice in Wonderland” situation where:-

Grant Thornton admitted in court what the profession told Parliament, and this consultation, denies. Paragraph 2 of the Appeal Court decision states:-

“GT admitted that it had in important respects carried out the audits in breach of its duty of care and that it had failed in its duty to identify management fraud, particularly dishonest representations and evidence provided to it by senior management in the course of the audits.”

Grant Thornton told Parliament the opposite:-

“We are not looking for fraud. We are not looking at the future. We are not giving a statement that the accounts are correct. We are saying they are reasonable. We are looking in the past and we are not set up to look for fraud.

The consultation cites the position of the Certified Public Accountants of the USA. The USA itself has a framework of law and governance such that there may be different positions from US courts depending on the interaction of duties in state law and federal law. Indeed the legal responsibilities in the UK (and jurisdictions with similar law) exceed what most people would envisage given the consistent message from the auditors misleading people.

We needed to go no further than the introductory letter from the IAASB’s Chair, to see the strategy at play here.

The IFAC-IAASB is attempting to initiate a debate on the false premise that there is an expectation gap and that the

auditor’s role needs to be expanded. Under the guise of offering an ‘upgrade’ the consultation is tilted towards a downgrade.

Mr Seidenstein’s - the IFAC-IAASB Chair – introduction states [our underlines].

“Our specific focus is on the auditor’s responsibilities and whether they should be expanded with regard to these topics in the context of an audit of financial statements. We will also consider whether such enhanced responsibilities are needed in all audits, or only in some circumstances. Our efforts will necessarily require us to work with others in the financial reporting ecosystem, because the effectiveness of any potential changes may depend partly on the actions of other stakeholders.

The suggestion too that parties other than auditors have a role is a buck pass. Mr Seidenstein's introduction also states:-

“Companies, those charged with their governance, investors, regulators, and others have an important role in improving external reporting in relation to fraud and going concern. The respective responsibilities of the various stakeholders support and reinforce one another.”

Problems with false assertions about an ‘expectations gap’ also flow through to the accounting standards regime, as some accounting treatments under IFRS are also inconsistent with the going concern position.

The overstatement of assets and understatement of liabilities permitted and required by the IFRS system, may in fact achieve similar outcomes to fraud and false accounting, by masking whether a company or group of companies is a going concern or not.

The situation is so serious that PIRC is minded to recommend that shareholders vote against any accounting firm that does not publicly repudiate the assertions in this document by 28 February 2021, as audits conducted on that basis would be in breach of duties and contract.

## **Q1a-1.7 - No comment**

### **1. Monitoring Group**

#### **International Association of Insurance Supervisors (IAIS)**

International Association of Insurance Supervisors (IAIS)

#### **International Forum of Independent Audit Regulators (IFIAR)**

International Forum of Independent Audit Regulators (IFIAR)

### **2. Regulators and Audit Oversight Authorities**

#### **Canadian Public Accountability Board (CPAB)**

Canadian Public Accountability Board (CPAB)

### **6. Member Bodies and Other Professional Organizations**

#### **Belgian Institute of Registered Auditors (IBR-IRE)**

Belgian Institute of Registered Auditors (IBR-IRE)

#### **Belgian National Chapter of Transparency International (BNCTI)**

#### **European Audit Committee Leadership Network (EACLN)**

Tapestry Networks

#### **International Air Transport Association (IATA)**

International Air Transport Association (“IATA”)

### **9. Individuals and Others**

#### **Ahmed Al-Qawasmi (AAQ)**

Ahmed Al-Qawasmi

**Michael Bradbury (MB)**

Michael E. Bradbury