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Board
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Subject: Discussion paper – Fraud and Going Concern in an audit of financial statements

Dear Sir,

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) are pleased to provide you with their comments on the discussion paper – *Fraud and Going concern in an audit of financial statements*.

The number of recent corporate collapses, which is likely to intensify in the context of the impact of the ongoing Covid 19 pandemic, as well as the cases of fraud that have recently made the headlines, lead us to wonder about the current ecosystem of financial statements reporting and the possible need to change it.

We consider that the debate is timely and vital to enhancing confidence in external reporting. The outbreak of the Covid -19 pandemic has heightened the focus on fraud and going concern. Many companies' control environments have been impacted and may not be what they were before. Furthermore, the way the evidence are obtained during the audits has significantly changed, all of which may increase the risk in many audits, particularly in relation to fraud. The uncertainty created by the pandemic will also challenge the auditor's ability to evaluate the going concern assessments of management.

In this context, we fully support the IAASB's initiative to prepare and publish a discussion paper on fraud and going concern in an audit of financial statements and to tackle the challenges, issues and possible responses related to going concern and fraud. We are particularly supportive of the state of play as set out in the document and in particular the one concerning the aspects that could possibly be addressed by standard-settings, including support materials and aspects that require further consideration.

It emerges from the document that one aspect common to both fraud and going concern is the expectation gap.

The expectation gap is probably the most burning issue for the entire corporate reporting ecosystem and if we do not manage to collectively reduce it, it will seriously impair trust for the years to come, at a time when the economy requires trust more than ever to recover from Covid 19. We are also convinced that the auditors cannot narrow the expectation gap alone. The best way to reduce fraud loss, is to prevent it from happening. Part of the solution certainly lies in enhancing entities' internal control and (because disclosure drives behaviour) in requiring Management and/or Those Charged With Governance to publicly report on the effectiveness of the entity's internal control. It is a prerequisite to the auditor providing assurance on such public reporting by Management and/or Those Charged With Governance. If Governments do not require such assessment and public reporting by the entities on their internal controls, the auditor cannot do anything alone. Because whatever the work effort and the communication around fraud and going concern by the auditor, each time a fraud will be discovered or a company will go

bankrupt the question will remain why the auditor did not discover it or why did he/she not warn the public of the entity's fragility.

Another element of the solution to rebuild trust on those difficult issues of fraud and going concern may also lie outside of the financial statements audit, in mandating the auditors to conduct specific engagements directed at identifying fraud and going concern weaknesses. At a time when huge institutional investors need to reinforce their assurance on the viability and trust of the entities where they invest their clients' money, we believe that the auditor can play a role. We believe that such an objective involves more broadly all the stakeholders of today's financial reporting ecosystem. Entities, those charged with their governance, investors, public oversight bodies, standards setters and auditors have an important role in improving external reporting in relation to fraud and going concern.

We also believe that the respective responsibilities of the various stakeholders support and reinforce one another. Generally speaking, even if we are in favour of enhancing the role of the auditor in such circumstances, we consider that such enhanced responsibilities will require the IAASB to work with other stakeholders in the financial reporting ecosystem, since we believe that the effectiveness of any potential changes will depend partly on the actions of other stakeholders.

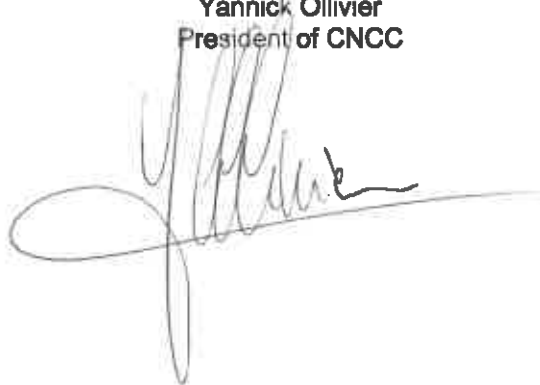
We believe in particular that IFAC, because it is the global voice of the profession and because of its thought leadership role at international level, could help in moving forward those ideas in the Public arena and towards global leaders, such as it does when it works with the G20, for example.

Our detailed responses to the specific questions raised in the exposure draft are set out below.

If you need any clarification or if you have any further questions about our views on these matters, please do not hesitate to contact us.

Yours faithfully,

Yannick Ollivier
President of CNCC



Lionel Canesi
President of CSOEC



Questions

Question 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?

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, extend 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.

Expectation gap relation to going concern

Assessing an entity's ability to continue as a going concern has its inherent limitations which cannot be eliminated. This is due to the fact that no one can predict future events with certainty. A number of recent corporate failures where their financial statements had an audit report with a clean opinion may increase the expectation gap relating to going concern in an audit of financial statements. We consider that the main causes of such expectation gap could be explained as follows:

- There is no requirement for Management to disclose in the Financial statements its assessment of the going concern of the entity (i.e. what are the assumptions that have enabled management to assess the entity as a going concern). Unless there is a material uncertainty on the going concern, Management simply states in the notes to the financial statements that they have been prepared on a going concern basis.
- There is no clear definition of the going concern concept and no explicit statement from management regarding going concern in the financial statements. It thus seems important to improve external reporting in relation to going concern and the role of all relevant parties (entities and auditors) to narrow the expectation gap relating to going concern.
- There are different interpretations on the reference period (time horizon) of the going concern
Going concern is an economic and accounting term used to describe a company which is assumed to be financially stable enough to continue to operate for the foreseeable future, even if there is a material uncertainty about its ability to continue to do so. In accounting terms, financial statement information is considered material if its misstatement, including an omission, would influence users' economic decisions. The notion of "Foreseeable future" is apprehended differently according to the financial reporting framework. It is usually regarded as being at least 12 months from the company's year-end date or the date of auditor's report (depending on the financial reporting framework that the company follows or the country is located in).
- Concomitance between bankruptcies and certified accounts with a clean opinion
Stakeholders note a significant number of bankruptcies even though the accounts had an audit report with a "clean" opinion. Users of financial statements expect the auditors to have issued a qualified opinion, as a kind of warning, before a company goes bankrupt, when in fact it can be perfectly appropriate to issue a clean opinion on a set of financial statements that points out to a material uncertainty on the going concern.

In addition, users of financial statements are not aware of the work performed by the auditors in terms of prevention and alert with regard to going concern. As a matter of fact, French law provides for specific reporting responsibilities on the part of the statutory auditors with respect to prevention and alert in terms of going concern, i.e. a specific legal procedure in case of going concern uncertainties (procedure d'alerte, "early warning procedure"), review of specific documents required by French law for certain entities above certain thresholds relating to the prevention of difficulties and going concern.

(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?

All parties in the financial reporting ecosystem have a role to play in addressing the expectation gap related to fraud and going concern in an audit of financial statements. We should focus possible actions to respond to valid expectations and proposed changes on the outcome of a cost/benefit analysis.

We believe that in order to narrow the expectation gap, it would be important to clarify:

- the expectations of stakeholders;
- the role of each party (including audit committees, management, internal audit, regulators and supervisory authorities) in the financial reporting ecosystem to address these expectations;
- the responsibilities of each party in terms of preventing and detecting fraud and assessing the entity's ability to continue as a going concern.

As at today, we note a real transfer of responsibilities to the auditor.

An audit conducted under the ISA follows a risk-based approach and does not provide an absolute assurance. Accordingly, auditors identify and assess risks of material misstatement and response to these risks by designing and performing audit procedures.

Such clarification should involve more "education" from the IAASB and more communication in the auditor's report on the work of the auditor performed on going concern and fraud.

Furthermore, period for assessing the foreseeable future should be clarified and harmonized.

Finally, another option to narrow the expectation gap related to fraud could be national legislators to tighten the rules of entities in terms of the internal control system on fraud and the role of auditors in such procedures. However, even if such provisions are not within the purview of the IAASB, we think it is important to point out this line of action.

Question 2: This paper sets out the auditor's current requirements in relation to fraud in an audit of financial statements, and some of the issues and challenges that have been raised with respect to this (see Sections II and IV). In your view:

(a) Should the auditor have enhanced or more requirements with regard to fraud in an audit of financial statements? If yes, in what areas?

(b) Is there a need for enhanced procedures only for certain entities or in specific circumstances? If yes:

(i) For what types of entities or in what circumstances?

(ii) What enhancements are needed?

(iii) Should these changes be made within the ISAs or outside the scope of an audit (e.g., a different engagement)? Please explain your answer.

(c) Would requiring a "suspicious mindset" contribute to enhanced fraud identification when planning and performing the audit? Why or why not?

(i) Should the IAASB enhance the auditor's considerations around fraud to include a "suspicious mindset"? If yes, for all audits or only in some circumstances?

(d) Do you believe more transparency is needed about the auditor's work in relation to fraud in an audit of financial statements? If yes, what additional information is needed and how should this information be communicated (e.g. in communications with those charged with governance, in the auditor's report, etc.)?

As mentioned in question 1, the prevention and detection of fraud within a company is primarily the responsibility of management under the oversight of those charged with the governance. Together with other members of the corporate governance and reporting ecosystem, auditors also play an important role in the detection of material frauds (but in a second step).

When a fraud extends to a broad network across management and third parties, it is very difficult to find the evidence and may take more than a normal audit to find them. We believe that detecting fraud goes far beyond the auditing profession but implies a broader collaboration among members of the financial reporting ecosystem. Large-scale fraud is mostly very well thought through and very difficult to detect. Auditing is an important step but it is not the only one. Nor should it be, if we are to maximize the number of opportunities to prevent or detect fraud as efficiently as possible. In this regard we believe that preventing and detecting fraud needs a collective effort, depending on a joint effort by all relevant parties, i.e. (1) corporate governance and management, (2) public oversight bodies, (3) standards setters and (4) auditors.

(1) Corporate governance and management

– Role of boards and management

The primary responsibility for preventing and detecting fraud lies with management as overseen by boards of company. Consequently, they establish systems and structures in order to manage fraud risks. Managing fraud risks is vital for achieving a company's operational, reporting and compliance objectives. It is also a key aspect for shareholder protection and management's role as their agent.

We consider that legislation, at any appropriate level, whether national, regional or federal should provide that companies' risk management include anti-fraud mechanism. These mechanisms should set out specific procedures and clear responsibilities for boards, i.e. audit committees and management boards respectively. Legislation could require the entities to publicly disclose a statement about the effectiveness of this program and relevant controls. This disclosure could be made as part of a broader statement included in a company's annual report for example. Moreover, auditors could be required, in a separate assurance engagement to:

- Assess the effectiveness of these systems and controls to prevent and detect material fraud in the financial statements;
- Express an opinion on the boards and management board's statement;
- Report their conclusions to the boards and to the public.

– Role of audit committees in terms of senior management fraud

A control environment that is effective for preventing employee fraud may not be sufficient on its own against fraud involving senior management.

We therefore consider it important that legislations strengthen the role of the audit committee to prevent and detect senior management fraud. Inquiries around potential fraud by senior management could be required by the EU and national legislation.

An active collaboration and interaction of audit committee with auditors is also essential for addressing senior management fraud risk. We believe that such a commitment and cooperation lead to greater efficiency in the prevention and detection of senior management fraud.

(2) Public oversight bodies

As mentioned in question 1, French law requires the auditor to inform the public prosecutor of all criminal acts he may have discovered during his audit. The expression "criminal acts" covers all categories of offences, regardless of their legal classification as a crime, misdemeanour or contravention, and regardless of the status or function of the person or entity that committed them. It refers to established, objectively observed situations, as opposed to suppositions or suspicions.

We believe that such a reporting obligation to public oversight bodies provided for by law or regulation would strengthen the fraud detection and prevention process.

(3) Standards setters

We consider that the IAASB should further communicate to clarify the auditors' role on fraud and clarify commonly misinterpreted responsibilities. This includes:

- auditor's responsibility and inherent limitations, especially related to fraud and in particular related to senior management frauds, which are the most spectacular with major financial impacts,
- materiality with regards to misstatements in the financial statements due to fraud,
- effective two-way communications with audit committees on fraud risk.

We believe that the IAASB's communication on the auditor's role which focus on fraud that has a significant impact on the accounts and fraud from internal management is essential. This excludes frauds perpetrated by third parties external to the entity.

Before including additional specific procedures in the auditing standards for example to address the risk of senior management fraud by including additional responsibilities for the engagement quality reviewer, we consider it would be advisable to first wait for the feedback from the implementation of the new ISQM1 - *Quality Management for Firms that Perform Audits or Reviews of Financial Statements and Other Assurance and Related Services Engagements*, ISQM2 – *Engagement Quality reviews* and ISA 220 – *Quality management for and Audit of Financial Statements* standards.

(4) Auditors

– Suspicious mindset

While we agree that it is important for the auditor to demonstrate professional scepticism at all stages of the risk-based audit process, it would not be possible to begin an audit by questioning the integrity of management or assuming that any information provided by management is inaccurate. We encourage the IAASB to more clearly emphasize the importance of applying professional scepticism rather than introducing new concepts and additional requirements.

– Increase auditor awareness of fraud cases

We consider it important to make auditors as aware as possible of cases of fraud (both at the level of initial and ongoing education).

We recommend the implementation and maintenance of a platform recording cases of fraud and accessible to auditors. Such a platform could be a powerful tool for auditors to be all the more vigilant and informed of the main indicators of fraud schemes. Audit teams could use this information when

developing certain fraud risk scenarios during their assessment process and when designing specific audit procedures accordingly.

– **Communication of the work of the auditor and conclusion about fraud**

We consider that it would be appropriate to strengthen the communication in the auditor's report on the work performed and conclusion about fraud. We recommend adding in the auditor's report boilerplate explanations on the work performed on fraud.

– **Use of forensic experts by auditors**

We consider that, based on their judgement and individual engagement circumstances specific to each engagement, the auditors may decide to use additional individuals with specialised skill and knowledge, such as forensic and IT experts. In other cases, the audit engagement team may itself use forensic-type audit procedures. As, the integration of this approach into the risk identification process of an audit may not be proportionate (particularly in the absence of an identified risk), we do not recommend the systematic use of a forensic expert in the audit. These experts could be used when there is some trigger, e.g. an indication of fraud.

Question 3: This paper sets out the auditor's current requirements in relation to going concern in an audit of financial statements, and some of the issues and challenges that have been raised with respect to this (see Sections III and IV). In your view:

(a) Should the auditor have enhanced or more requirements with regard to going concern in an audit of financial statements? If yes, in what areas?

(b) Is there a need for enhanced procedures only for certain entities or in specific circumstances? If yes:

(i) For what types of entities or in what circumstances?

(ii) What enhancements are needed?

(iii) Should these changes be made within the ISAs or outside the scope of an audit (e.g., a different engagement)? Please explain your answer.

(c) Do you believe more transparency is needed:

(i) About the auditor's work in relation to going concern in an audit of financial statements? If yes, what additional information is needed and how should this information be communicated (e.g., in communications with those charged with governance, in the auditor's report, etc.)?

(ii) About going concern, outside of the auditor's work relating to going concern? If yes, what further information should be provided, where should this information be provided, and what action is required to put this into effect?

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.

The requirements for management's responsibilities with regard to going concern are generally set out in the applicable financial reporting framework. When management is aware of material uncertainties related to events or conditions that may cast a significant doubt upon the entity's ability to continue as a going concern, those uncertainties are required to be disclosed.

The appropriateness of the use of going concern basis of accounting is a matter for the auditor to consider after evaluating management's assessment. This is an integral part of each financial statements' audit. Assessing a company's ability to continue as a going concern has its inherent limitations which cannot be eliminated. This is due to the fact that such assessment is based on forecasts and therefore always involves a level of uncertainty.

It is important to emphasize that the primary responsibilities for the accuracy of the financial statements of a company, including the assessment of its ability to continue as a going concern, lies with the management and boards of the company. We consider that more detailed disclosures should be required from management to explain why the entity is a going concern according to their assessment. We acknowledge that such requirements are outside the scope of the IAASB's standard setting and that enhanced disclosures within the purview of accounting standards. We consider that the IAASB should thus get in touch with the IASB on this issue.

With regard to the company's future viability, the current work of companies and auditors on going concern includes looking 12 months ahead. We acknowledge that shareholders seek more insight into a company's future viability than is currently provided for in accounting and auditing standards. To meet this expectation, companies should be required to include more detail in the disclosures on going concern assumptions and also, for example in management commentary, on the main risks that impact the viability of the business over the longer term. If such information were to be required, the auditor's role could be further extended to cover these statements. However, the auditor would not be able to issue any conclusion beyond the management/governance declaration period. Nevertheless, it is important to note that the further into the future management or the auditor look, the less reliable the assumptions will be.

Question 4: Are there any other matters the IAASB should consider as it progresses its work on fraud and going concern in an audit of financial statements?

IAASB should continue to remind stakeholders that the responsibility for fraud prevention and the assessment of the entity's going concern lies with management and those charges with going concern.

We therefore consider that even if specific measures are taken at the IAASB level, these will not be sufficient. In particular, we consider that a law mandating disclosure and evaluation of internal control procedures over financial statements by management (and auditor's appreciation of such evaluation) would make it possible to respond to and limit certain internal control deficiencies and should prevent and detect cases of fraud.

We are also aware that such recommendations could be perceived as too burdensome at the entity level, but they appear to be an essential element of the financial reporting ecosystem without which it would be difficult to reduce the expectation gap.