

Comments on the Discussion Paper “Fraud and going concern in an Audit of financial statements”
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To whom it may concern,

I appreciate the opportunity to comment on the Discussion Paper “Fraud and going concern in an Audit of financial statements”. My comments are included in the following pages.

All opinions and points of view outlined in this document are my own and they do not necessarily represent the views of any company, employer, organization or committee.

If you have any questions, please contact me at cristian_munarriz@yahoo.com.ar.

Yours faithfully,

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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?

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.

- (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?

Regarding fraud, I think the following actions can be done to address the expectation gap:

- 1) For IAASB: Inform the public about the difference between the scope, nature and objectives of an audit of financial statements and a fraud examination, and about the limitations of an audit (probably in the audit report). Inform of the limitations of technology to find fraud and the new fraud risks arising from new technology
- 2) For auditors and IAASB: Provide guidance, application material and training about common fraud schemes (especially for revenue recognition); internal controls and audit procedures which may be relevant for specific fraud risks and schemes; red flags commonly associated with specific fraud schemes.
- 3) For auditors and IAASB: create guidance and application material about the use of technology to find fraud and the new risks arising from new technology and how to address them
- 4) For regulators: agree to an international convention of basic policies and requirements expected for fraud prevention and detection worldwide (jurisdictions may have more strict but not less strict requirements)
- 5) Education standard setters: require minimum training about fraud prevention and detection for public accountants (including basic knowledge of fraud schemes)

Regarding going concern, I think the following actions can be done to address the expectation gap:

- 1) For IAASB: inform the public about the limitations of an audit to predict the future and guarantee the viability of the company (probably in audit report)
- 2) For IAASB: provide more guidance about the requirements in ISA 570, 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”.
- 3) Regulators- accounting standard setters (including IASB): provide more explicit requirements and guidance about the disclosures for “material uncertainty” and “close call”, including the definition of “Material uncertainty”

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?

I think that the current requirements are robust, so little changes are needed (other than application guidance and education requirements about fraud). Regarding the specific proposals:

- 1) Expanding Auditor’s responsibilities: they should not be expanded as it would be out of the objective of an audit
- 2) Evaluate internal control for fraud prevention and detection: possible implementation should be considered at a jurisdiction level if demanded by the public (it would not be appropriate to require it for all PIE as, for example audit report over ICFR is not required for non-accelerated filers in the US, so the scope should be determined in each jurisdiction), and preferably implemented as a separate engagement with a separate report (even when auditors may perform both engagements at the same time). Otherwise, it would be extending the scope of the audit (especially if it includes fraud which is not related or immaterial to financial statements). In practice, requiring evaluation of IC for fraud prevention and detection relevant to the financial statements would not be very different to evaluation of IC relevant to financial reporting (i.e. SOX 404) as many controls address both fraud and error.
- 3) Use of forensic specialists: I think that a general requirement to use forensic specialist is not appropriate as availability of specialists is limited. Therefore, using them in all engagements (and even all PIE audits) would reduce the availability for riskier engagements where they may be really needed. I think the most appropriate approach would be to incorporate a specific requirement of considering if a forensic specialist is needed considering our knowledge of the entity, its internal control and its environment, and explaining why it is considered to be not necessary if some specific factors are met (for example, identification of specific fraud risk factors or red flags). It should be noted that the requirement should not be related to a “forensic specialist” but to a “fraud specialist” (as forensic is broader than fraud) and the concept of “fraud specialist” should be defined. Also the fraud specialist should have relevant knowledge to the fraud risks (for example, if there is a fraud risk related to IT, it would be appropriate that the fraud specialist have knowledge of IT fraud risks). Simply requiring “fraud specialist” without considering specific expertise would be as using an expert in the valuation of financial instruments for the audit of the valuation of property. The involvement of the fraud specialists should be determined by the engagement team (for example, if some specific red flags are found, the involvement may be limited to evaluate which fraud schemes may be present and designing specific audit procedures to address them).

- 4) Additional focus on non-material fraud: currently auditors are required to report to management about identified fraud, even if immaterial, and reporting to TCWG if considered to be relevant to their responsibilities (even if immaterial). The auditor is also explicitly required to consider in current ISAs that fraud may not be isolated occurrence. I think current requirements are appropriate and should not be expanded. Otherwise, the audit effort will be inefficiently wasted in misstatements that may not materially impact in the financial statements.
- 5) Third party fraud: current definition of “fraud” in the ISAs includes fraud perpetrated by third parties. Placing particular emphasis on third party fraud may create an unnecessary focus on fraud perpetrated by third parties, while diverting attention from internal fraud (which is more common, especially for fraudulent financial statements schemes). Requiring auditors to design procedures to detect third party fraud which is not material to financial statements may inappropriately expand the scope of an audit. Some third party fraud that may severely impact the entity (like cyber-attacks) may generally be included in the scope of ISA 250 as fraud is generally a illegal act, so the ISA 250 requirements may be applicable.
- 6) Enhanced quality control requirements: I think that the proposed requirements are reasonable and may be explicitly included in the ISAs.

(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.

Refer to answers above.

(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?

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I think a “suspicious mindset” would not be appropriate.

Audits are different to fraud examinations because fraud examinations typically require the existence of “predication” as a precondition to start the engagement (according to ACFE Fraud Examiners Manual, predication “is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe that a fraud has occurred, is occurring or will occur”). In an audit, it would be inefficient and impractical to have a “suspicious mindset” because it would give the idea of suspecting fraud where there are no indications of it. It would also create unnecessary friction with management. I think a correct application of professional skepticism would require to be further alert and inquisitive when red flags are found, while a more neutral attitude is applied when no red flags are found.

- (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.)?

I think that some additional information in the audit report (as mentioned in question 1.a) may be useful to address the expectation gap. I do not think that further communication with TCWG is necessary.

I strongly believe it would not be convenient to make detailed communications about the audit approach related to fraud risks as it may make it more predictable and therefore less effective.

3. This paper sets out the auditor’s 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?

I think that the requirements should not be expanded but clarified through additional application guidance, 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”.

I think that audit requirements should be based on accounting requirements for going concern, so coordination with IASB is necessary. Incorporating additional concepts of “resilience” would not be appropriate unless those concepts are incorporated in financial statements (otherwise it would be expanding the scope of the audit)

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

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- (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.

Refer to answers above. I think the requirements should be applied to all entities as part of the audit, within the ISAs.

(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, and what action is required to put this into effect?

I think that some additional information in the audit report (as mentioned in question 1.a) may be useful to address the expectation gap. I do not think that further communication with TCWG is necessary.

When there is “material uncertainty” about going concern, currently ISA 570, paragraph A30, permits but not requires providing additional information about how the matter was addressed in the audit. Therefore, I think there is some inconsistency because:

- If there is a “close call” it would usually be considered a KAM, and therefore the auditor would have to explain how the matter was addressed in the audit
- If there is “material uncertainty”, it cannot be reported as a KAM (even when conceptually it is), and it is optional to explain how the matter was addressed in the audit

I think it would be appropriate to require to explain how the material uncertainty was addressed in the audit in the “material uncertainty related to going concern” section of the report, unless it does not fall under the definition of KAM. It may be useful to include a rebuttable presumption that it is a KAM because in most, if not all, cases a material uncertainty related to going concern would fall under the definition of KAM.

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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?

I think that the interaction between ISA 240 (fraud) and ISA 250 (non compliance with laws and regulations) should be considered (as all fraud is typically illegal, everything that falls within ISA 240 typically also falls under ISA 250, but some frauds that are not included in ISA 240, like bribery and corruption, fall within ISA 250). Some issues that are typically considered to be fraud or fraud-related (like corruption or money laundering) currently fall within the scope of ISA 250, which has a very different approach to ISA 240. In practice, most of the red flags of corruption and money laundering may be hard to distinguish from fraud red flags. For example, it would be hard to determine if a significant unusual transaction which is not appropriately explained and supported by management, it is indication of fraud, corruption or money laundering. Probably corruption and money laundering may be scoped into ISA 240.

Currently, the UK FRC has an exposure draft of a revised ISA (UK & Ireland) 240. Coordination of work with UK FRC may be useful.