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Mr T Seidenstein
Chair
International Auditing and Assurance Standards Board
New York
UNITED STATES OF AMERICA

Dear Mr Seidenstein

COMMENTS ON DISCUSSION PAPER – FRAUD AND GOING CONCERN IN AN AUDIT OF FINANCIAL STATEMENTS

Thank you for providing the opportunity to comment on the IAASB Discussion Paper - *Fraud and Going Concern in an Audit of Financial Statements* (the IAASB Discussion Paper).

The New Zealand Auditor-General is responsible for auditing all New Zealand's public sector entities. Public sector entities in New Zealand include public benefit entities and for-profit entities. We provide the New Zealand Parliament and the public with independent assurance that public sector entities are operating and accounting for their performance as intended.

We support the efforts of the IAASB to seek comments on fraud and going concern; two aspects of financial statement audits where a considerable expectation gap exists. Bridging or narrowing this expectation gap is obviously very difficult; particularly in an increasingly evolving and dynamic environment. In our view, part of the solution lies in:

1. Clarifying the respective roles and responsibilities of preparers and auditors for financial statements, and clearly communicating these respective roles and responsibilities to users (including, for example, through the auditor's report). This may help address the expectation and knowledge gaps that users have about the work of an auditor.

2. Ensuring preparers and auditors have continuing education on their roles, responsibilities and knowledge. This may help address the knowledge, performance and evolution gaps of the auditors.

An important measure that the New Zealand Auditor-General has put in place is to establish a high standard of audit independence that prohibits auditors from carrying out non-assurance work for public sector entities that they audit. The purpose of this is to give those parties who rely on the work of the Auditor-General confidence that the auditor's attention is solely devoted to auditing, and that other interests that might influence, or be seen to influence, objectivity have either been eliminated or appropriately mitigated.

Although this measure may not directly address the expectation gap, it does mitigate the criticism that auditors often attract when material fraud or going concern issues arise when affected parties and commentators express concerns that the auditor's attention was "distracted" because of the provision of non-assurance services to the entity for which their primary role is the auditor.

We have made some observations in the attachment to this letter, responding to the IAASB's questions to contribute to the discussion.

If you have any questions about our comments please contact Roy Glass at roy.glass@oag.parliament.nz or me at todd.beardsworth@oag.parliament.nz.

Yours sincerely

Todd Beardsworth
Assistant Auditor-General
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OUR RESPONSE TO THE QUESTIONS IN THE IAASB DISCUSSION PAPER – FRAUD AND GOING CONCERN IN AN AUDIT OF FINANCIAL STATEMENTS

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?*

   (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?*

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.

What can be done to narrow the expectation gap relating to fraud?

Above, we identified what we consider to be the main causes of the expectation gap relating to fraud. Here, we:

- comment on some steps we have taken towards narrowing the expectation gap; and
- make some suggestions about narrowing the expectation gap.

The knowledge gap

We consider the ***knowledge gap*** in relation to fraud will continue to exist. However, we encourage the IAASB to educate all parties (preparers, auditors and users) about their roles and responsibilities in respect of fraud. We also encourage the IAASB to keep improving communication, including within the audit report, about the respective roles and responsibilities of preparers and auditors to users.

The performance gap

We comment on the ***performance gap*** under three sub-headings, below.

Improving understanding of the entity's controls in relation to fraud

- The New Zealand Auditor-General has adopted the practice of requiring the entities we audit to inform us of all instances of suspected fraud, irrespective of materiality, as part of the terms of the engagement. Possession and analysis of this information is intended to serve several purposes, including:

  - providing us with insights into the entity's attitude towards fraud including the extent of investigation carried out by the entity, the action taken by the entity, and whether the suspected fraud was referred to a law enforcement agency;

  - providing us with information about how the suspected fraud was detected, and about the entity's system of internal control;

  - allowing us to consider if the suspected fraud could be more extensive than what was actually found, or whether the opportunity exists for similar frauds to be carried out within, or on, the entity; and

  - assessing if the suspected fraud has implications for our audits of other entities.

  Overall, possession of this information gives us information about the effectiveness of the control environment within the entity; in particular, how management is carrying out its responsibilities in creating and maintaining the entity's culture and in demonstrating management's commitment to integrity and ethical values.

- Developments in technology have created complexities that management and those charged with governance need to understand, and respond to, if they are to effectively meet their responsibility to prevent and detect fraud within an entity. Identity theft, the creation of false documentation, the ability to infiltrate IT systems, and so on is the *modus operandi* of the modern fraudster. Unless the entity has addressed the threat of fraud posed by technology (usually by enhancing its system of internal control), the auditor will have difficulty in completing their audit.

  For example, paragraph 14 of ISA 240 states that "unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine…". Advances in technology and associated invoice fraud has increased the importance of a robust system of internal control to support the legitimacy of records and documents that auditors place reliance on.

  We believe the threat of fraud posed by technology is a responsibility that management and those charged with governance within an entity should address. However, the awareness of threats of this nature amongst management and those charged with governance is often low, with the consequence that the auditor is not able to fully rely on the entity's system of internal control to mitigate the threat. The auditor may rely on paragraph 14 of ISA 240 and not carry out any extended procedures to mitigate this threat (a threat that is clearly present) with the consequence of risking audit effectiveness.

We consider that this is a matter to be considered by the IAASB.

Using fraud specialists in the audit

The suggestion in the IAASB Discussion Paper to consider using fraud specialists when auditing entities with certain characteristics has considerable merit. The reasoning for bringing specialist skills to the audits of certain entities at least at the planning stage links to the sophisticated and innovative means of perpetrating frauds in a world where technology is advancing rapidly, and in recognition that traditional auditors "don't know what they don't know".

Enhanced external reporting by auditors

We agree with the comments made by the IAASB in the discussion paper that the synergies between auditors, standard-setters and regulators and audit oversight bodies is critical to the effective functioning of the financial reporting ecosystem.

We believe that some matters related to the expectation and performance gap can be addressed through stronger direction from regulators and audit oversight bodies, combined with a strong focus of independence on auditors, as discussed earlier.

The IAASB may be aware of legislation in South Africa that requires "reportable irregularities" observed by an auditor for certain categories of audit to be communicated to a regulator – a form of mandatory whistle-blowing.

We raise this because whistle-blowing can play an important role in enhancing the effectiveness of corporate governance. In particular, legislation mandating that auditors' blow the whistle can assist in overcoming agency-related costs and improve confidence in external audit.

The IAASB could consider setting requirements for auditors to report externally on particular irregularities.

The evolution gap

The definition of fraud in paragraph 12 of ISA 240 could be expanded to include bribery and corruption.

New Zealand, together with 43 other countries, is a signatory to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The OECD has commented that they see auditors as playing an important role in identifying and reporting bribery. Furthermore, the OECD has noted that the auditing standards do not explicitly refer to bribery as falling within the definition of fraud.

In audits carried out by the New Zealand Auditor-General, we have explicitly included bribery and corruption in the definition of fraud because bribery and corruption is an intentional act … involving the use of deception to obtain an unjust or illegal advantage.

We encourage the IAASB to engage with the OECD about the appropriate role of the auditor in respect of bribery and corruption in the context of the audits of financial statements.

Causes of the expectation gap relating to going concern

We consider that a ***knowledge gap*** and a ***performance gap*** exists in respect of going concern. In our view, this gap arises because of a misunderstanding amongst preparers, auditors and users about what "going concern" actually means in the context of an entity's financial statements. Preparers are required to assess if the entity is entitled to use the "going concern basis of accounting".

For practical purposes the use of the "going concern basis of accounting" is often interpreted as the ability of the entity to survive 1 year from its balance date, or 1 year from the date of the auditor's report on the financial statements for a particular balance date. This is a very narrow concept of going concern and the users of the financial statements often look at various other indicators to consider an entity's performance. The general understanding of going concern often does not take into account other factors or external developments that could provide an indication that the entity's business model may be unsustainable.

The requirement to consider other external factors will increasingly become important in audits of sustainability and climate-related information where the timeframes for the information involved are likely to span more than 12 months.

In our view, the requirements placed on preparers to justify their use of the "going concern basis of accounting" as the basis for preparing their financial statements needs to be very clear. For example, the "resiliency statement" prepared by certain entities in the United Kingdom places greater demands on entity management and governors when asserting an entity is a going concern in the context of preparing the financial statements of the entity.

If a clear understanding is reached on what going concern means, in the context of an entity's financial statements, the entity will need to provide evidence (supported by suitable disclosures in the financial statements) that it is justified in asserting it is a going concern. This in turn provides the auditor with an appropriate platform from which to assess management's use of the going concern assumption.

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?*

   We have made some comments on the expectation gap in relation to fraud under question 1.

   (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.

We do not have specific responses to these questions.

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

Making a formal distinction between professional scepticism and a suspicious mind-set is challenging – particularly when applying these somewhat theoretical notions in practice. We already have an understanding that the auditor will be "on alert" if they encounter situations that cause them concern. To be put "on alert" appears to be similar to the suspicious mind-set idea.

The "on alert" expectation of auditors applies to every audit. Our view is that this expectation should not be confined to certain 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.)?*

We consider that greater transparency is generally a good thing, including transparency about fraud in an audit of financial statements. In principle improved transparency should narrow the audit expectation gap but, on its own, may not make a significant impact. Adding more into the auditor's report may reduce clarity and make the report less understandable to a lay reader.

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?

Please refer to our comments on the expectation gap in relation to going concern under question 1.

(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.

We do not have specific responses to these questions.

(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?

There may also be merit in re-examining the audit report to improve the wording, and to make this more understandable for lay readers.

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?

The IAASB has sought views on whether additional quality control review procedures specifically focused on the engagement team's responsibilities relating to fraud should be considered for audits of financial statements.

Our initial reaction is that such additional quality control review procedures may not be a particularly effective measure to narrow the expectation gap in relation to fraud. These procedures may confirm that the audit team has complied with the ISAs, but that is a compliance related measure. A stronger measure is to instil an awareness of the possibility of fraud at the outset of an audit through careful planning and by ensuring all members of the audit team remain aware of the possibility of fraud throughout the conduct of the audit.