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Tom Seidenstein
The International Auditing and Assurance
Standards Board
Online submission

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NZAuASB
Online submission

Dear Tom

I write this submission after recently attending a joint AAuASB – University of New South Wales Going Concern Roundtable. This was an excellent forum that introduced and discussed the IAASB's recent Discussion Paper: *Fraud and Going Concern in an Audit of Financial Statements*. The audit expectation gap is a fundamental problem and I support the IAASB trying to address this issue. Furthermore, I think breaking down the gap into issue such as going concern and fraud is an appropriate way forward.

In this submission I do not comment on the specific questions in the Discussion Paper, rather I address some conceptual issues that need to be resolved if the IAASB is to provide an enduring solution to the problem.

Please note that I am a member of the New Zealand's External Reporting Board (XRB) and I am currently acting chair of the New Zealand Accounting Standards Board (NZASB). However, the comments in this submission are my personal views and should not be attributed in any way to the XRB or NZASB.

Expectation GAP Model

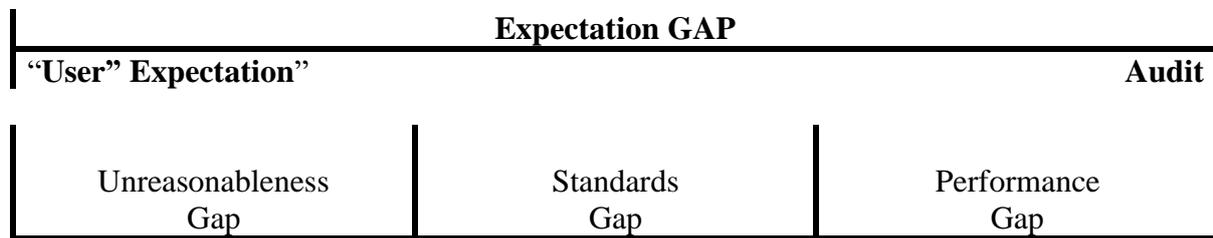
The IAASB (2020) DP *Fraud and Going Concern in an Audit of Financial Statements* uses the ACCA model of the expectation gap (EXGAP). This model has three components: (1) performance gap. (2) knowledge gap and (3) evolution gap. However, this model is, at best, incomplete. First, the model mixes levels and flows. The EXGAP is a gap, which is a level. Whereas *evolution* is a flow or change in the level (gap).

Bringing in the dynamics of the EXGAP might be a useful attribute to focus on, but it should be correctly characterised in the conceptual model. [In my view, the EXGAP has been around for a long time, which suggests that it is a fundamental problem and that any change or 'evolution' is a second order issue].

Does it matter if the conceptual model is not well-specified? If the model is not well-specified then any missing components will not receive the appropriate consideration; they

may be overlooked or ignored. For example, one bullet point the DP mentions unreasonable expectations. However, this is not a specific feature of the EXGAP model in the DP.

A more reasonable portrayal of the EXGAP is:



I am not arguing that this ought to be the conceptual model that is adopted. However, it is more sensible, as the components add up to 100% and it does not confuse levels and flows. My recommendation is that that the IAASB develops and agrees upon a conceptual model before it turns to a solution.

It is also worth trying to estimate the importance of each component in order to allocate the effort to solving the issue. Although missing from the model in the DP, unreasonable expectations may be the single major component of the model. Included in unreasonable expectations are those situations where the expectation gap is used as an argument for litigation against auditors in going concern cases. Without specific recognition of this component, auditors are considered ‘insurers’ in addition to assurers.

The notion of “public” is a fundamental part of any EXGAP model, as it ‘anchors one side of the goalpost’. Before any notion of the EXGAP can be measured, assessed or remedied, there needs to be a clear view on what “public” means. Does it include mom and pop investors, or should it be limited to financial intermediaries? Would “audit report user” be a better term?

The notion of “public” is also important when assessing evidence. For example, there have been several extensive surveys of the EXGAP. However, unless this evidence reflects the views of the appropriate population, the information is not relevant, and if relied on may potentially result in poor decisions and may even exacerbate the audit expectation gap problem.

A reasonable starting point to consider this issue is the IASB’s Conceptual Framework which refers to “potential investors, lenders and other creditors” (CF.OB2). as the users of general purpose financial reports. Furthermore, the Framework considers that financial reports “...are prepared for user who have reasonable knowledge of business and economic activities and who review and analyse the information diligently” (CF,Q32). Why would the audit report be applicable to a wider range of users that intended by the preparers?

Is audit part of an eco-system?

Another concept employed in the IAASB (2020) DP is the use of the term *ecosystem*. In this case the concept is a *symbolic* representation rather than an explicit model. My main objection to the use of this term is that in a previous IAASB document ((IAASB 2014, *A Framework for Audit Quality*) the environment in which the audit takes place is portrayed as the financial reporting supply chain.

Does it matter whether *ecosystem* or *supply chain* is used? Whether the concepts we use are formal models or symbolic representations they are likely to frame the issue and therefore the solution. The language used (e.g., *public* or *report user*) can both define the problem and restrict the possible solutions. More importantly, the IAASB would achieve internal consistency and improve external communications if it did not change its 'world view' of the audit environment each time it released a new document.

My preference would be to use the supply chain analogy because this is terminology well understood in a business context. The term ecosystem is not representative of the audit environment.

Audit and accounting are not ecosystems. Ecosystems are complex bio-systems that are difficult to model because of the underlying (typically not well understood) interactions. Unintended consequences can be significant. They are Darwinian in the sense that, parts of the ecosystem are in competition. In ecosystems, lions eat gazelles. This is not an appropriate view of the environment in which auditing sits. Audit and accounting are man-made constructs, where the process of producing financial statements is sequential and linear. Auditing is part of a supply chain.

Recommendations

The plea in this submission letter is that the IAASB pays more attention to conceptual issues before it develops further policy. Specifically:

1. The IAASB refers to the audit environment surrounding the audit as a supply chain and as an ecosystem. My recommendation is that the IAASB agree on and consistently apply a 'world view' of the process in which the audit exists. While, this is largely symbolic, it ought to lead to more consistent policy making and effective communication.
2. The IAASB should develop its own model of the expectation gap. A key feature which will be to agree upon who the "public" refers to in the expectation gap.

Sincerely

Michael Bradbury