



FRC CONSULTATION ON REVISIONS TO ISA (UK) 240 (UPDATED JANUARY 2020) *THE AUDITORS' RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS*

Issued 29 January 2021

ICAEW welcomes the opportunity to comment on the FRC's proposals to revise ISA (UK) 240 (Updated January 2020) *The auditors' responsibilities relating to fraud in an audit of financial statements* published on 20 October 2020, a copy of which is available from this [link](#).

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KEY POINTS

Fraud needs to be addressed on a realistic and holistic basis

1. The press release accompanying this consultation notes that:
...concerns have been raised that auditors are not doing enough work to detect material fraud, including by Sir Donald Brydon in his review of the quality and effectiveness of audit.

As described in the Consultation Paper, the FRC is proposing revisions to address these concerns...
2. Fraud is a complex issue and expectations are high, perhaps excessively so. While we welcome a discussion of these proposals as a potential starting point for action needed by a wide range of stakeholders to more effectively prevent and detect fraud, **we do not think the limited proposals suggested by the FRC are sufficient to warrant a revision to ISA 240 at this time.** The journey will start in earnest with the publication of the anticipated BEIS consultation, and as IAASB progresses its project on fraud and going concern.
3. The auditors we consulted believe that there is more they can do in this area. But they also said that on many audits, much of what is proposed is already being done. The FRC's proposals are limited. Auditors did not see that the proposals alone would turn the dial in terms of auditor performance significantly. In particular, the proposed change to the overall objective which adds in a specific reference to material misstatements caused by fraud, changed little, if anything, in the minds of auditors who said that this is what they already believe.
4. Even so, our discussions on this subject were rich: it became clear early on that a significant issue for many auditors is the belief that the distinction between fraud, error and non-compliance with laws and regulations (NOCLAR) is always clear, and the presentation of fraud and error as binary alternatives.
5. As paragraph 3 of ISA 240 has long acknowledged, fraud is only ever determined definitively by the courts - often long after the event. The real issue for many auditors related to timing at what point should auditors have 'spotted' a fraud? At what point should they raise the alarm? In practice, they emerge from the shadows over time.
6. A fraud might start with directors changing an accounting policy or method, or pushing the boundaries within existing policies or methods, at which point there is no error, still less a fraud. Over time - often several years - changes and boundary pushing degenerate into error, and finally fraud.
7. An example of this was provided by the Auditing Practices Committee in its 2001 publication **Aggressive Earnings Management**, described as, *A simple example to demonstrate how legitimate business practices can develop into unacceptable financial reporting.*
8. Broadly, it describes a situation in which in year 1, an entity makes an effort to meet targets during a year of slow-down after many years of growth. In year two, it changes its method of calculating provisions to meet targets that have been again revised upwards after the previous year and takes a more optimistic view in all cases. In year three, after targets have again been revised upwards, it starts making sales on a sale or return basis without making a provision for returns, and falsifying invoices.
9. What might reasonably be expected of the auditors in year 2? And in year three when the bigger picture becomes clear? The example demonstrates the need for auditors to exercise judgement carefully because answers to this and similar questions are not straightforward. The anticipated BEIS consultation - and the pandemic - provide an opportunity for a nuanced discussion of this difficult subject. The coming reporting season will also focus attention on

the blurred boundary between fraud, error and NOCLAR relating to government support schemes for business during the pandemic.

10. For these reasons, fraud demands an intelligent joined up response from companies, investors and auditors. Auditors can and should do more but without a corresponding effort by audit committees, internal audit, audit regulators and investors, the benefits of auditor actions will be limited. For example, consideration might be given to requiring companies to include 'fraud triangle' within their entity's risk management system. Investors might be asked to re-engage on what they want. Our discussions in the past suggest that they might welcome audits scoped more widely with respect to fraud for greater cost, and in particular more nuanced communication in the audit report of where on the spectrum an entity's fraud risks lie. Those we consulted noted in particular the Brydon recommendation that ARGA maintain an open access case study register detailing corporate frauds and the importance of education.
11. In the minds of some we consulted, a critical feature of the way forward in this area will be the development of reporting by management and auditors on internal controls over financial reporting, without which little will change.¹
12. We note above that the auditors we consulted suggested that there is more they can do. For example, some firms say that they are:
 - mandating data analytics for fraud testing using additional internal and external data and information relating to short selling, for example;
 - using electronic confirmations wherever possible;
 - developing fraud risk assessment frameworks;
 - mandating annual fraud training, incorporating techniques borrowed from the behavioral sciences relating to bias;
 - requiring the use of forensic experts on a targeted-risk basis;
13. Most of these innovations are already used by many firms on an *ad hoc* basis but mandating their use helps embed the techniques and goes beyond what is required by ISA 240. Some of these innovations are discussed in IAASB's consultation on fraud and going concern.
14. We heard mixed opinions about whether the historical focus on asset fraud rather than financial reporting fraud is still appropriate, and there may be something to be learned from the US focus on financial reporting, tax, options, and off-balance sheet financing, despite the different economic and business environment.
15. The FRC's *8 December letter to heads of audit* states that:

For more than 80% of those audits which required more than limited improvement, the effectiveness of challenge was a key audit quality consideration. Firms have developed action plans and strategies to embed a challenge culture more consistently across their audit teams.

We agree with the FRC that 'challenge' is an important area worthy of pursuit. We believe that it has the potential to have more of a long-lasting and substantial effect on auditor behaviour than the changes to auditing standards alone.

How far do the FRC's proposals turn the dial?

16. In asking ourselves how the proposals might enhance the scope, relevance or quality of audit, we asked 'what might auditors do differently?' Might the proposals, applied

¹ EY in a recent *report* notes that according to findings by the Association of Certified Fraud Examiners, a lack of internal controls could contribute to nearly one third of all frauds.

retrospectively, have contributed to the prevention or earlier detection of any recent corporate collapses involving fraud?

17. Few of those we consulted believe that the proposals will result in significant change, nor did they believe that the proposed changes would have made a significant difference in any of the recent corporate collapses. This is not to say that we believe that the proposals have no value - they may add clarity in relation to when auditors should consider specialist expertise, for example, and may change behaviour to a limited extent in some cases - but we urge the FRC not to widen the expectation gap in this area by suggesting that the proposals are likely to deliver more than they actually can.
18. No-one we consulted believe that the change to the wording of the objective alters their understanding of the auditor's duties, which were and are to design and perform audit procedures to reduce the risk of undetected material misstatement to an acceptable level. Auditors are already clear that frauds resulting in a material misstatement are relevant to the audit. Similarly, auditors in larger firms already engage forensic experts, generally when suspected or actual material frauds are uncovered because forensic experts' expertise lies in fraud investigations. The time and cost constraints of an audit have to date prevented greater involvement of forensic experts. While some firms are beginning to use forensic experts at the planning stage of the audit, because they are able to provide input to the risk assessment in terms of the nature of potential frauds, most of those we consulted believe that the proposals overall would be unlikely to alter the risk of undetected management fraud that is more than trivial, but less than material.
19. The only proposed change that generated significant interest was the paragraph 3 reference to qualitatively but not quantitatively material fraud, and we set out our detailed observations on this in our answer to question 1, below.

ANSWERS TO SPECIFIC QUESTIONS

Question 1. Has ISA (UK) 240 been appropriately revised to give increased clarity as to the auditor's obligations relating to fraud in the audit of financial statements. If you do not consider this to be the case, please set out why and how you believe those obligations should be clarified.

20. We note in our main points above that we welcome these proposals in anticipation of the BEIS consultation and the IAASB project, both of which represent the start of an important journey involving a series of actions by a wide range of stakeholders to more effectively prevent and detect fraud.
21. There is more that auditors can do but expectations are very high, fraud is a complex issue and those we consulted believe that on many audits, much of what is proposed is already being done. The proposed change to the overall objective in particular, changed little if anything in the minds of most auditors who said that this was what they already believe, which is that the purpose of the audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud or error.
22. We had detailed discussions in three areas:
 - the unrealistic belief that the distinction between fraud, error and NOCLAR is always clear, the presentation of fraud and error as binary alternatives, and a timing issue - at what point should auditors have 'spotted' a fraud? We do not discuss this issue further in this response but we will continue to develop our thinking in this area;
 - the proposed use of forensic experts which we discuss in our answer to questions 2 and 3 below;
 - qualitatively but not quantitatively material fraud.

Qualitatively but not quantitatively material fraud: proposed paragraph 3

23. This paragraph states that:

... judgements about whether a misstatement is material involves both qualitative and quantitative considerations. For example, a fraud or suspected fraud by a key member of management may be considered material even if the potential misstatement is less than materiality determined in quantitative terms.

24. Our discussions relating to qualitatively but not quantitatively material fraud suggested that further clarity is needed on how auditors should deal with potential frauds that are neither material nor clearly trivial. These include egregious abuses of management expenses by highly paid executives where the nature and extent of the claims are enough to hit the headlines, and enough to warrant reconsideration of the tone at the top and the control environment.
25. Clarity is needed to ensure that auditors are not required to treat every small error in every management expense claim in every company as a potential fraud. The proposed wording implies that any fraud or suspected fraud by key management is material. Another example would be where a CFO reviews and signs a bank reconciliation but fails to call out a small apparently erroneous transaction that subsequently turns out to be fraudulent. It is unrealistic and impractical to expect auditors to plan the audit to detect all such frauds, regardless of size.
26. The issue turns on the need for a clear recognition that very small and clearly trivial frauds quantitatively may not be detected, even if they have a qualitatively material impact such as the breach of a loan covenant.
27. Paragraph 3 also acknowledges that frauds are determined by the courts. Requiring auditors to determine the *mens rea* necessary for fraud prospectively is a high hurdle and the boundaries between fraud, recklessness, negligence and error are not clear. It might be helpful to acknowledge that evidence of any of these should put auditors on their guard in *all* areas.

Question 2. Have appropriate enhancements been made to the requirements for the identification and assessment of risk of material misstatement due to fraud, and the procedures to respond to those risks, to promote a more consistent and robust approach to the auditor's responsibilities in relation to fraud? If you do not consider this to be the case, please set out why and how you believe the requirements should be enhanced.

Question 3. Have appropriate enhancements been made to the application material? If you do not consider this to be the case, please set out why and how you believe the application material should be enhanced.

28. **New paragraphs 15-1 to 15-3:** specifying matters to cover in the team discussion, including how management could perpetrate and conceal fraudulent financial reporting, how assets could be misappropriated, the susceptibility of significant components to material misstatement due to fraud, and how to investigate allegations of fraud.
29. Auditors suggested that the required engagement team discussion as described by these paragraphs was being done already but they did not object to the clarification. Auditors acknowledged variations in how far firms think they should go in this discussion and how it should be followed up.
30. Concerns were expressed about how the proposed requirement of paragraph 15-2 will be recast in the light of the proposals to revise the definition of the engagement team and to drop the concept of 'significant components'.

31. **New paragraph 15-4:** requiring the engagement partner to determine whether further engagement team discussion(s) be held at later stages in the audit to consider fraud risk factors that have been identified and the implications for the audit.
32. Clarification is needed regarding whether this decision should be made at the time of the initial discussion, later or, potentially, both. It seems reasonably clear from the application material that no additional discussion should be required unless new fraud-relevant factors or information warranting a recast of the fraud risk assessment come to light. This could be clearer in the wording of the requirement.
33. **New paragraph 18-1:** requiring that those persons the auditor makes inquiries of within the entity include those responsible for dealing with allegations of fraud raised by employees or others.
34. Auditors acknowledged that more work might be done in this area but suggested that it would be unlikely to have an impact on the fraud risk assessment because of timing issues.
35. **New paragraphs 24-1 and 27-1:** requiring auditors to determine whether the engagement team requires specialised skills or knowledge and if they identify a (potential) misstatement due to fraud, determine whether a forensic expert is needed.

Forensic experts

36. We have significant concerns about the proposed requirement in Paragraph 27-1. This requires auditors to '*...determine whether a forensic expert is needed to investigate further*' if auditors identify '*...a misstatement due to fraud or suspected fraud*'.
37. There is no generally accepted definition of a forensic expert, however, we do not believe that an audit manager within the firm who has been on a three-day online course should be classified as a forensic expert, however, the number of fully qualified forensic experts available to auditors is small. In many jurisdictions forensic experts simply do not exist. We note in our main points above that some firms are beginning to use forensic experts at the planning stage of the audit, but most of those we consulted believe that the proposals overall would be unlikely to alter the risk of undetected management fraud that is more than trivial, but less than material.
38. Extant ISA 240 already refers to IT and forensic experts in application material and it remains the case that both are rarely used routinely outside large audits, although they are often brought in where fraud is identified. We believe the existing references are adequate and that the FRC should deal with any failure to engage such experts for whatever reason through enforcement rather than standard-setting.
39. We believe that the emphasis should instead be on training auditors, the nature of fraud, challenging management and basic forensic techniques. Sir Donald Brydon recommended that... *training in both forensic accounting and fraud awareness be parts of the formal qualification and continuous learning process to practice as a financial statements auditor.*
40. If the FRC does proceed with Paragraph 27-1, it must as a bare minimum:
 - add the word 'material' before the word 'misstatement' to prevent overzealous inspectors demanding that experts should have been brought in to investigate minor asset fraud;
 - restrict the application of the requirement to public interest entities; and
 - add application material to the effect that the skills and experience of the forensic expert should be commensurate with the nature and size of the entity.
41. The main danger of proceeding with the proposal as it stands is that it will raise expectations but do little to enhance audit quality. The proposal (even as amended) may see the auditors of a few smaller listed and other public interest entities consider engaging forensic experts.

However, while many of those we consulted believe that forensic experts may help deal with fraud or suspected fraud once auditors have found them, they do not believe that they will help auditors find them, despite their increased use at the planning stage. The FRC should not inappropriately raise expectations in this area.

42. The PCAOB in the USA considered requirements to use forensic experts in 2007. A paper by its Standard Advisory Group (SAG) noted that the purpose of forensic audits is clearly different from those of financial statement audits:

....users of forensic audits (e.g., audit or special investigative committees, management, and regulators) establish their objectives on a case-by-case basis. For example, an audit committee may engage an accountant or other person with specialized expertise to determine whether an accounting error was intentional and, if so, to then determine the participants in the fraud and how it was orchestrated

43. Fraud is central to AS 9 and AS 12 on risk assessment, i.e. hardwired into the equivalents of ISA 315. There is no suggestion in either standard that auditors should specifically consider the need for the use of forensic experts.
44. Some of those we consulted referred to the need for the ISA to address complexity in IT to a greater extent than it does now, in the context of the need for expert intervention. They noted that this is an issue on a much greater number of audits than those in which there may be a need to involve forensic experts. We hope that this issue will be addressed by IAASB in its forthcoming work on audit evidence and ISA 330.

Question 4. Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk assessment procedures, the procedures to respond to those risks and the evaluation of audit evidence obtained? If you do not consider this to be the case, please give reasons and describe how you consider the exercise of professional scepticism could be better supported.

45. The capacity of auditing standards to support or enhance the exercise of professional scepticism is limited and this debate also has a history.
46. The PCAOB's SAG Paper referred to in question 3, above discussed a number of ideas for improving fraud detection at public companies including 'forensic audits' on a regular or random basis and other 'choice-based' options. None of these options have been pursued, nor has the year 2000 US Panel on Audit Effectiveness' recommendation for the introduction of a 'forensic-type fieldwork phase', despite the fact that this was intended to be a 'forensic-type phase' involving 'an attitudinal shift in the auditor's degree of skepticism' during which auditors would modify their 'neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, override of internal control, and falsification of documents.'
47. Nevertheless, those we consulted were rightly concerned about the exercise of professional scepticism and noted the following:
- the number of prior year adjustments evident on a change of audit partner or firm suggests that professional scepticism needs to be addressed;
 - more work needs to be done by IAASB on the complex issues associated with corroborative and contradictory evidence and the extent to which auditors can and should be required to seek out the latter;
 - scalability: some of the requirements in the international standard are often wasted in smaller audits (see our answer to Q8, below). There should be more focus in the ISA on fraud in revenue recognition facilitated by collusion with third parties, and practices such as the issue of false invoices just over 90 days before the year-end;

- IAASB's 'suspicious mind-set' proposals: we acknowledge the UK origins of this discussion, however those we consulted believe that:
 - it would be impossible to conduct an audit on the assumption that management assertions and representations are always 'suspect' because of time and cost constraints;
 - it would fundamentally alter the relationship between auditors and management and would turn auditors into a form of financial reporting police force, which is properly the job of those responsible for regulating management - a perceived area of weakness in the UK;
 - management is, in fact, generally honest;
 - it would be impossible to distinguish properly between auditor behavior when applying the two different mindsets.

48. The value of corporate reporting arises from a combination of its relevance and its reliability. Costs and time are mutable concepts and can be flexed if there is good reason for doing so. Assuming it is possible to undertake an audit with a 'suspicious mind-set', it would have a significant impact on the time it takes to complete an audit. The resulting delay in providing information to the market would seriously undermine the information's value. Furthermore, if a suspicious mindset was required only in certain circumstances, the translation issues would create an unacceptable level of confusion as both terms are often defined in terms of each other.

Question 5. ISA (UK) 240 establishes a rebuttable presumption that there are risks of fraud in revenue recognition (paragraph 26). Are there other account balances, transactions or disclosures for which such a rebuttable presumption should be established? If you consider there are, please identify them and set out why.

49. We do not believe that there are other account balances, transactions or disclosures for which a rebuttable presumption should be established. We note in our answer to question 8, below, issues with the manner in which auditors are required to respond to the rebuttable presumption of fraud in revenue recognition

Question 6. ISA (UK) 240 specifies particular audit procedures responsive to risks related to management override of controls (paragraphs 31 – 33). Are there other audit procedures responsive to those risks, or any other risks of material misstatement due to fraud, that you believe should be required for all audits? If you consider there are, please describe them and set out why.

50. Beyond the proposed additions relating to consolidated financial statements, we do not believe other audit procedures responsive to those or other risks are required. However, other audit procedures the FRC might consider for application material relate to disclosures, in specific situations such as where there are significant changes in financial reporting requirements or accounting principles or policies.

Question 7. In complying with the requirements of ISA (UK) 240 (Revised), the auditor may also need to consider whether there has been non-compliance with laws and regulations, and therefore that requirements in ISA (UK) 250 Sections A and B (Revised November 2019) also apply. Is it sufficiently clear in these ISAs (UK) of the interaction between them?

51. We note in our main points above our belief that the forthcoming reporting season will highlight blurred boundaries between fraud, error and NOCLAR. It may be time to merge the two standards.

Question 8. Are the requirements and application material sufficiently scalable, including the ability to apply ISA (UK) 240 (Revised) to the audits of entities with a wide range of sizes, complexities and circumstances? If you do not consider this to be the case, please set out why and how you believe that could be addressed.

52. The following examples of a lack of scalability in this ISA reflect a broader issue with scalability that IAASB must address through its LCE audits project.

Management override

53. Paragraph 31 of ISA 240 states that:

Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

54. This does not reflect the reality of how SMEs are run. Where controls are operated on an informal basis through the day-to-day involvement of management in all aspects of the business, the idea that management overrides controls makes little sense. Management is the control. Where that is the case, erratic application represents a weak control environment and/or control ineffectiveness in terms of design and implementation - not management override. Auditors of SMEs are thus required to shoehorn the presumptive significant risk of fraud due to management override applicable in larger entities into the audit of entities in which the concept makes little sense. This is an issue for IAASB's LCE audits project, but application material should acknowledge more clearly than it does now that the risks related to management override are much greater in larger and more complex entities where controls are formalised.

Journal entries

55. In some smaller audits, particularly where the accounts are prepared by the audit firm, the required paragraph 32 review of journal entries rarely if ever produces any evidence of fraud. Journal entries are not always used by management to close off the accounts. The application material should acknowledge that where the risk of fraud through the use of journal entries is low, the review of journal entries need not be detailed.

Complex IT systems

56. We note in our answer to question 9 below the need for a wider debate on complex IT systems and its relationship with complexity more generally. Complexity can be a feature of audits of any size, but it tends to represent more of a fraud risk in larger audits. Neither are dealt with adequately in the proposed standard.

All three issues demonstrate a lack of scalability in this ISA.

Question 9. References to 'computer assisted audit techniques' have been updated to 'automated tools and techniques' and we have identified that these may enable more extensive testing and assist in identifying unusual transactions or relationships (paragraphs A44, A48 and A50). Is there other guidance in relation to the use of automated tools and techniques that you believe could assist auditors in relation to their obligations with regard to fraud? If you consider there is, please give an explanation of it.

57. The FRC notes in its March Thematic Review, *The Use Technology in an Audit of Financial Statements* that:

The use of automated tools and techniques may promote audit quality by deterring fraud and the manipulation of accounts (section 2.2). As ADA is now pervasive in the audit of journals (section 2.3), management may be less inclined to make aggressive adjustments via simple journal entries. Similarly, the analysis of entire populations of transactions using ADA should help to identify unusual activity.

58. This could be reflected in application material. However, the FRC must strenuously avoid the inference that the use of ADA is likely to detect more fraud. Used without skill, as the FRC knows better than most, they can provide a wholly false sense of security and spurious corroborative audit evidence.
59. We are more concerned about the need for better and more basic guidance for directors first, about the risks associated with cyber-security, the significance of these risks, the need to control them and the means available to directors to do so. The FRC can and should develop such guidance. As we note in our main points above, these issues need to be dealt with on a holistic basis.
60. We also note a lack of more basic references to the risks associated with complexity in IT systems. The recently revised version of ISA 315 refers to complexity as a risk factor in many areas but only scratches the surface of this issue. Past FRC audit monitoring reports also refer to this issue in the context of over-reliance on systems and the FRC has sufficient reach to consider this too, on a more holistic basis than it has done to date.

Question 10. Do you agree with the proposed effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted, which is aligned with the effective date of ISA (UK) 315 (Revised July 2020)? If not, please give reasons and indicate the effective date that you would consider appropriate.

61. We are content with the proposed effective date for audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted.

Question 11. Should an additional requirement be placed on auditors to have a specific discussion with those charged with governance on the risks of material fraud in the business, including those which are business sector specific, in order to further the risk assessment process in respect of the risk of material error in the financial statements relating to fraud?

62. We are content with an additional requirement for auditors to discuss with those charged with governance the risks of material fraud in the business, including business sector specific risks. This will help ensure a common and potentially more complete view of risks. There can be a lag between frauds emerging behaviour changing and this proposal will help reduce that lag.
63. The FRC should implement a parallel requirement in the UK Code for the audit committee to discuss the same risks with auditors, to ensure that the conversation is two-way and open.