8 February 2021

IAASB
529 Fifth Avenue, 6th Floor
New York
NY 10017
United States

Via IAASB website "Submit a Comment" link

Dear Sir/Madam,

Re: FRAUD AND GOING CONCERN IN AN AUDIT OF FINANCIAL STATEMENTS

The Corporate Reporting Users' Forum (hereinafter referred to as CRUF) welcomes the opportunity to provide the IAASB with our comments. The CRUF was established in December 2005 and we have been holding regular meetings since. CRUF Japan have prepared this comment letter based on discussions in CRUF meetings and have reflected input from other CRUFs globally. We have highlighted any contrasting views in our response. Our comments are based on our professional experience.

Question 1 (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?

We think that the expectation gap is primarily derived from the knowledge gap which is the difference between what users think is expected of the auditor and the actual role and authority of auditors.

For example, it was challenging for users to grasp the concept and impact on audit practice of the recent fundamental revisions to the conceptual ISAs such as ISA540, ISA315, IAS 220 and ISA 600 and ISQMs. We hope that users of financial statements will be provided with a comprehensive and easy-to-understand explanation of these new standards in tandem with local auditing standard setters to help narrow the knowledge gap.

Also, as is the case with IFRSs, translation into languages other than English will facilitate non-English-speaking users' participation in the discussion during the development of standards. While there may be resource constraints, we would like the IAASB to cooperate with local auditing standard setters to achieve this.

The knowledge gap could also be derived from differences in the perspectives of users, such as investors and analysts, and auditors. Investors and analysts place importance on information that affects stock prices and ratings, but auditors place the highest priority on whether financial statements are free from material misstatements. It is possible therefore that auditors are not familiar with the information that investors and analysts place importance on, such as the future prospects of the company's products and services, industry trends, and the economic and market environment, or auditors might have a different view on the company and industry than users. We would expect auditors to proactively gather information on the audited company and its industry, including points and perspectives that investors and analysts place importance on.

Key Audit Matters (KAMs), plus the addition of Critical Audit Matters (CAMs) in the USA, may include the auditor's explanation with respect to the company's system for preventing frauds which may lead to material misstatements. We expect the IAASB to analyze such descriptions to a wider extent in cooperation with local accounting bodies.

We believe also that the expectation gap arises from the performance gap, where the performance of an audit is not up to a high enough quality. Regarding the performance gap, the CRUF would like the IAASB to continue its efforts to clarify the ambiguity of the standards as the discussion paper mentioned. We also expect the IAASB to encourage countries to take appropriate actions including enactment of laws and regulations in alliance with IOSCO and/or ICGN for tight deadline issues. We expect auditing firms to improve their governance through ISQM1 implementation to reduce concerns that auditing firms might not develop clear guidelines and procedures regarding audit quality. We are concerned about whether accountants effectively execute professional skepticism in the current audit environment. Any fraud could affect a company's financial statements through negative impacts from fines, damage claims and impairment of reputation. Auditors are expected to confront the risk of fraud with this in mind. Some CRUF UK Members indicate that an example of removing ambiguity from standards may be seen in the proposed revisions to ISA (UK) 240 and their consultation on this by the Financial Reporting Council in the UK.

We agree with the discussion paper that there is insufficient provision of information from auditors to shareholders on their procedures performed and outcomes. We recognize that the IAASB has expanded initiatives for auditors' disclosure, such as transparency reports of audit firms, however we would like such efforts to be accelerated. As discussions during the development of ISQM1 did not always go positively in this area, we expect the IAASB to be more proactive in addressing this. One way to do this is to ensure that audit standards' changes and developments are consumer rather than producer led with the IAASB listening more to what the users of audits and audited financial statements are looking for.

During an audit, auditors should understand the actual state of the company's governance, including whether those charged with governance are independent from management (in mind, as well as in appearance, possess necessary knowledge, skill and authority, and align with internal audit functions), and are committed to their duty. Auditors should know who is the right contact of those charged with governance, its subordinates and others within the company who are responsible for dealing with allegations of fraud raised by employees or other parties, in case management is reluctant to identify and respond to fraud. In addition, we expect auditors to assist management and those charged with governance to regularly reinforce their knowledge of GAAP and GAAS. Furthermore, auditors should understand the company's culture well. If similar, even insignificant frauds occur repeatedly or with the involvement of management, it indicates a company culture that creates or overlooks frauds leading to material misstatements. Auditors should request companies to identify the root cause of the frauds and remedy internal control weaknesses and assist companies in cultivating a culture that does not permit any frauds.

Auditing standards should focus more on reliance of audits on internal financial controls and how these may indicate the possibility of material misstatements in financial statements arising from fraud.

Question 1 (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?

Advances in IT can enable the analysis of all transactions, rather than sampled transactions. The use of AI to detect fraud has also been researched. In addition, if there is a high possibility that fraud has been committed, use of a certified fraud examiner or conducting a forensic audit could be a choice. An audit procedure without prior notice by the auditor could also be an effective method, provided the those charged with governance acknowledges its importance. However, in such a case, it is necessary to consider whether the auditor can have such authority and resources, as well as the impact it may have on the regular audit work. We would like the IAASB to conduct research and analysis about the usage of new technology, the use of a certified fraud examiner, conducting forensic audits, and audit procedure without prior notice to management then issue audit practice notes or reflect the findings in the standards.

Whistleblowing is a major trigger for revealing corporate fraud. We would like the IAASB to include the utilization of the whistleblowing system in the standard, show the desirable form of the system and examples of effective utilization methods by the auditor in the audit practice notes.

In addition, it is strongly encouraged that auditors and those charged with governance discuss risk of material misstatements due to fraud.

All participants in the financial reporting ecosystem, that means: 1) auditors, 2) issuers who should be primarily responsible for preparing appropriate financial statements and preventing fraud, and 3) users of financial statements such as investors and analysts who should properly evaluate and analyze the issuers, are expected to strive to narrow the expectation gap, with the mindset to prevent fraud, as well as understanding the role, necessity and function of an audit. The interest of companies and users of financial statements in audit has increased with the introduction of KAMs and, in the USA, CAMS. Taking this opportunity, further efforts are expected by the participants in the financial reporting ecosystem, including business organizations, investors / analyst groups, and supervisors.

And we suggest the following

- The audit standard relating to fraud in financial statements should consider including the following audit processes to identify and assess the risk of material misstatement due to fraud:

- Discussions amongst the audit engagement team
- Discussions with management and those charged with governance
- Discussions with an audited entity's available shareholders, especially those who may have expressed previous concerns in financial statements indicative of fraud, and
- Discussions with an audited entity's operational management, especially those tasked with implementing controls mitigating against material frauds.

- Another enhancement to the fraud audit standard would be to identify transactions and balances with a rebuttable presumption that there are risks of fraud, such as revenue and cash.

- From known past reported alleged frauds, it appears that material frauds (as they have usually resulted in the collapse of the group or company) missed by auditors tend to be those where there has been senior management collusion and/or falsification of asset records, especially cash at bank. We suggest that a sharper focus is brought on an auditor's responsibility to consider whether or not a record or document is authentic. While this should reduce the risk of auditors missing material falsifications of asset records, we would also recommend any new requirement in this respect to say "For each record or document, the auditor should conclude whether they can rely upon it being authentic, and document that conclusion either for specific records and documents or for categories of records and documents as appropriate." We consider that this requirement would more effectively sharpen the focus of auditors on the issue.

Question 2 (a)
Should the auditor have enhanced or more requirements with regard to fraud in an audit of financial statements? If yes, in what areas?

Yes. It is already clear that auditors need to look for fraud as a potential cause of financial misstatements. They must do their job on this front. We request improvement on the points mentioned in Questions 1 (a) and (b). It is understandable that it is difficult for the auditor to detect the kind of fraud that does not lead to misstatement of financial statements. However, ISA720 requires the auditor to read and consider other information beyond the financial statements. Other information, including non-financial information, includes the description of a wide range of matters such as corporate risks, business models, governance systems. Auditors need to pay close attention to these as well. This means better communication is needed between the auditor, those charged with governance at the company and others. By strengthening the checking of non-financial information by auditors, it is expected that they will have more opportunities to notice fraud that does not directly lead to misstatement of financial statements.

It is not entirely clear to us whether IAS require auditors to carry out procedures to consider or identify material non-compliance with laws and regulations, as such would highlight a risk of fraud. If ISAs do not or they are ambiguous, some CRUF members suggest that it is made clear that auditors have an obligation to carry out such procedures.

Question 2 (b)
Is there a need for enhanced procedures only for certain entities or in specific circumstances?

Some CRUF participants answered no, as all entities and all circumstances should be considered in deciding whether to use enhanced procedures. Other CRUF participants answered yes, but they think that not only are large-scale companies, and companies with complicated businesses, considered to be at high risk, but that start-up or young and fast-growing companies with strong owner-manager authority are too. This is because the latter companies are less likely to be controlled by shareholders other than the owner and its affiliates.

Question 2 (c)
Would requiring a "suspicious mindset" contribute to enhanced fraud identification when planning and performing the audit? Why or why not?

Conditionally, yes. However, the definition of Suspicious Mindset needs to be clarified. It is usually sufficient for auditors to conduct audits with professional skepticism. This is because there are some executives who do not convey the inconvenient facts of the company to the auditor, and some of those charged with governance who are not active in coordinating with the auditor. Professional skepticism should identify the most inconvenient facts or ensure questions are asked and discussed with those charged with governance. Professional skepticism is not supposed to change the initially neutral view of management's integrity, but in the event of suspicion of fraud that could lead to misstatement, the auditor needs to exercise a more suspicious mindset when engaging in audit work. In such a case, it may be determined that there is a high possibility of fraud, and the auditor has to engage in an audit on the premise that the management is dishonest or those charged with governance are uncooperative. However, if such doubts have not arisen, in order to produce proper financial reporting, it is desirable for auditors to remain neutral but skeptical and to maintain a constructive relationship with those charged with governance as well as management.
Some UK CRUF members insist that the above is not strong enough. They indicated that the UK's proposed revisions to ISA 240 set out how the engagement team should consider the entity's susceptibility to fraud and it includes several important steps to promote a skeptical mindset. They explain these steps include seeking contradictory evidence, considering in what ways the entity might be susceptible to fraud and the potential role of management bias and incentives among fraud risks.

Question 3
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?
(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?**
> **(ii) About going concern, outside of the auditor's work relating to going concern?**

Regarding questions 3 (a) Yes and (c)(Conditionally) Yes. If an auditor provides a statement that there is a material uncertainty in relation to going concern, it certainly will have a significant impact on the company. As such, the auditor is expected to collect sufficient information and to have high skill to make this judgement. We would like to ask the IAASB to develop, and review in a timely manner, auditing standards with such expectation in mind, while responding to changes in the situation such as the Covid-19 pandemic. We would appreciate it if the IAASB could exemplify in the audit practice notes, a case where the period to consider the judgement of going concern needs to exceed 12 months from the end of the reporting period. If it is appropriate to prepare financial statements on the assumption of a going concern, but significant uncertainties exist, the rule mentions that the audit report should emphasize such significant uncertainties in the footnote. We would appreciate it if the IAASB coordinated with the IASB, regarding the treatment of the footnote.

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

Yes and no, as our opinion is basically the same as the content described in Question 2 (b).

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting and audit standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

Signatures

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