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Dear Sir,

RESPONSE TO THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD'S (IAASB) DISCUSSION PAPER (DP) ON FRAUD AND GOING CONCERN IN AN AUDIT OF FINANCIAL STATEMENTS: EXPLORING THE DIFFERENCES BETWEEN THE PUBLIC PERCEPTIONS ABOUT THE ROLE OF THE AUDITOR AND THE AUDITOR'S RESPONSIBILITIES IN A FINANCIAL STATEMENT AUDIT

The Institute of Singapore Chartered Accountants (ISCA) appreciates the opportunity to comment on the above DP issued by the IAASB in September 2020.

To solicit meaningful feedback for the topic, ISCA undertook the following initiatives to seek views from key stakeholders:

(i) Conducted a one-month public consultation to seek feedback from its members;

(ii) Organised a roundtable discussion to engage key stakeholders to obtain their views on the DP. The participants of the roundtable included representatives from various stakeholder groups including auditors, regulators, investors, directors/audit committee members, management/preparers and academia; and

(iii) Solicited feedback on the DP from members of the ISCA Auditing and Assurance Standards Committee.

We would like to commend the IAASB for embarking on this initiative which is essential given the attention surrounding audit quality in recent years.

In 2015, the IAASB released an Invitation to Comment, *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits (ITC), which* highlighted the potential standard-setting activities which the IAASB could take to enhance audit quality. In the ITC, one of the areas being explored was whether a professional skepticism framework should be developed.

It was noted that, pursuant to the ITC, there were mixed views on developing such a framework, and consequently, the approach undertaken by the IAASB was to reinforce professional skepticism through different sections of the ISAs and embedding the expectation of professional skepticism into the design of the requirements of the ISAs.

We acknowledge that this deserves a rethink with high-profile corporate collapses becoming increasingly common globally in recent years. These are often followed by investigations revealing lapses in financial reporting which may indicate deficiencies in the audit. For example, where material fictitious revenue was recorded over a prolonged period of time, or where assets on the balance sheet were materially inflated or did not exist. We concur that an expectation gap may exist in the context of such findings which is consistent with the feedback from stakeholders from our outreach activities whom have unanimously agreed that while auditors are not expected to purposefully sniff out all types of fraud, detecting material fraud in financial reporting is the responsibility of auditors.

Accordingly, these recent developments warrant a need to relook at the approach towards audit quality, and in particular, the application of professional skepticism. This is also an important element in the context of the current Discussion Paper on Fraud and Going Concern.

In light of this trend, it might be worthwhile for the IAASB to delve into:

- Whether the underlying factors behind audit failures are isolated occurrences or if they are indicative of a more prevalent concern; and

- The root cause of audit failures – due to deficiency in audit quality or are there other contributing factors?

The following are several suggestions we have which the IAASB could consider exploring in relation to improving audit quality:

1) Develop a framework for the application of professional skepticism in audits;

2) Develop more robust procedures in relation to fraud;

3) Align the determination of the auditor's audit strategy with a specific emphasis on audit quality; and

4) Develop more robust requirements under ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment.*

Further details are elaborated in our comments to the questions in the DP below.

Our comments to the questions in the DP are as follows:

> Question 1
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> In regard to the expectation gap:
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> (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?
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> (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?

In our view, the expectation gap mainly originates from when audited financial statements are subsequently found to be unreliable. The expectation gap would be most apparent in situations where lapses are found or suspected, such as where material cash balances recorded did not exist. Such errors could have been picked up by straightforward audit procedures, leading to obvious questions over the rigor and quality of the audit of the financial statements.

Based on our observation and feedback from our stakeholders, the factors affecting the rigor and quality of the audit of financial statements can be largely attributed to three key areas:

1) Lack of professional skepticism/professional judgment

Professional skepticism, which is critical to audit quality, is defined in the ISAs as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Professional judgment, on the other hand, is defined as the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

We are concerned with audits that are performed using a "checklist" approach, which potentially reduces professional skepticism and professional judgment. This is consistent with the findings reported in the UK Financial Reporting Council's Annual Enforcement Review (2020), that an overwhelming majority of cases of audit failures have involved a failure by the auditors to exercise professional skepticism when assessing the decisions and judgments made by management.

One of the reasons for the lack of professional skepticism is an insufficient focus on the importance of understanding the audited entity and its environment. When such understanding is lacking, auditors would not have the right frame of mind to exercise professional skepticism or professional judgment.

Understanding the entity and its environment is a critical process, especially in this day and age where transactions and business models of companies are becoming increasingly complex. If this process is not performed in a robust manner, auditors would not have an appreciation of the business rationale behind transactions made that would help them pick up irregularities.

We considered the factors behind engagement teams spending insufficient time/resources on understanding the entity and its environment, and below are some suggestions we have for the IAASB's consideration:

(i) <u>More robust risk assessment requirements and emphasis on understanding the entity and its environment</u>

The IAASB's efforts in issuing ISA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* is timely to address some of the gaps in the existing standard.

We note that ISA 315 (Revised 2019) stresses the importance of exercising professional skepticism. However, this in itself may not be sufficiently robust to direct auditors towards obtaining a robust understanding of the entity and its environment. This could still result in a "light touch" approach where auditors would obtain a basic understanding of the entity for the purpose of complying with the standard, with the intention of focusing mainly on substantive procedures.

In such "light touch" approach, junior members of the audit engagement team are usually tasked to obtain an understanding of the entity via a checklist of considerations with only the entity's finance personnel, which limits the efficacy of the risk assessment process. In our view, in order to obtain a meaningful understanding of the entity, in addition to engaging with the entity's finance team, the auditors need to engage with senior personnel from other relevant business units of the client's organisation.

Some companies have enterprise risk management frameworks that describe key risk indicators, which could potentially be helpful towards such understanding. The seniority and areas of responsibility of the personnel whom the auditors engage with would enhance the quality of insights gained towards understanding the entity. Correspondingly, senior audit engagement team members, including the engagement partner, will need to be sufficiently involved in the process. In this regard, ISA 315 should include explicit requirements with the clear objective of achieving a robust understanding of the entity and its environment. One example would be to stipulate the manner in which this process should be performed and how it should be documented.

While we understand that the auditing standards are meant to be principles-based and scalable for audits of entities of varying sizes, the application of professional skepticism will improve from more robust and specific requirements in the areas of understanding the entity and its environment, together with a critical identification of risk indicators. This in turn will contribute towards higher audit quality.

(ii) <u>Linkage between risk assessment procedures, professional skepticism and sufficient appropriate audit evidence</u>

While paragraph A10 of ISA 500 *Audit Evidence* recognizes that audit evidence can be obtained through performing risk assessment procedures, paragraph 5 of ISA 315 states that risk assessment procedures by themselves do not provide sufficient appropriate audit evidence.

As a result, the insights obtained from understanding the entity may not be seen as a persuasive form of audit evidence but rather, only viewed as the basis for designing further procedures.

This could have an unintended consequence of engagement teams spending insufficient time on understanding the entity and instead only focusing on substantive procedures and obtaining evidence over financial statement line items.

Without a robust risk assessment, the auditor might not be able to appropriately identify risks and design and perform procedures to respond to those risks. In addition, insights obtained from understanding the entity and its environment would enable the auditor to exercise professional skepticism, especially in identifying unusual transactions or irregularities in audit evidence obtained.

The IAASB could relook into how the ISAs can promote an increased focus on risk assessment procedures.

(iii) Developing a framework on professional skepticism

We do appreciate that the concept of professional skepticism is one which is abstract and principle-based, and as a consequence, there are differing levels of interpretations and applications.

In this regard, we wish to propose for the IAASB to embark on a project to develop a framework which solidifies the concept of professional skepticism. This may be done by extending upon the work of the IAASB Professional Skepticism Working Group to date.

Although we recognise that this may be a challenging task, we think that it may be worthwhile for the IAASB to look into a project in defining professional skepticism in more pragmatic and measurable terms, given that it is the cornerstone of the audit profession.

One factor to consider could be to introduce a criteria or measurement, to help auditors assess how professional skepticism has been applied.

2) Firm culture

We agree with the DP that firm culture is a key component of audit quality and a lack of clear firm policies and procedures with regard to audit quality is a cause for poor audit quality. While standards can endeavour to influence mindset and behaviour, firm culture plays a critical role in driving behaviour that impact audit quality.

Paragraph 32 (b) of the recently issued ISQM 1[1] requires personnel to demonstrate a commitment to quality through their actions and behaviors, develop and maintain the appropriate competence to perform their roles, and are held accountable or recognized through timely evaluations, compensation, promotion and other incentives.

In our view, there needs to be an increased emphasis within ISQM 1 on the accountability of the engagement partner vis-à-vis other firm personnel. We note some commendable firm practices where engagement partner remuneration is linked to audit

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[1] ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

quality. Any major audit quality issues will have a direct impact on an engagement partner's remuneration and prolonged audit quality issues may even result in an engagement partner's dismissal from the firm.

Appropriate actions which commensurate with the engagement partner's responsibilities are important as the tone from the top ultimately cascades down to the engagement team and drive how the audit is carried out.

3) Choice of audit strategy

The alignment of choice of audit strategy to audit quality is another important component towards achieving high audit quality.

The ISAs generally provide flexibility in the choice of audit strategy. For instance, paragraph A4 of ISA 330 *The Auditor's Responses to Assessed Risks* allows the auditor to determine that only substantive procedures are performed (fully substantive strategy) if the auditor finds testing of controls to be inefficient and therefore does not intend to rely on the operating effectiveness of controls. We note that the above allows the auditor to adopt an audit strategy based on efficiency, which may not always equate with audit quality. While we understand that the intention behind the flexibility may be to allow for scalability and application of the auditor's judgment, we notice that it may potentially lead to audit teams determining audit strategy based on factors such as resources, fees or time pressure, instead of audit quality.

Audit quality should be a key determination factor when the auditor decides on the audit strategy. A fully substantive strategy would not be able to highlight any lapses in key internal controls over financial reporting. Where there are such lapses, the risk of fraud in the financial statements would increase.

With efficiency in mind, audit teams might be inclined to adopt a fully substantive strategy. However, there may be situations where substantive procedures may not by themselves provide sufficient appropriate audit evidence, such as when checking the completeness of revenue.

In this regard, tests of controls may be more effective as the auditor might be able to identify lapses in key internal controls over financial reporting which might have led to fictitious or fraudulent transactions.

Accordingly, we recommend that IAASB relook into paragraph A4 of ISA 330 which allows for efficiency to be the determining factor in the auditor's choice of strategy. IAASB should require audit quality to be a key determinant when the auditor decides on the audit strategy to be employed.

<u>Question 2</u>

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

(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)?

Through our engagement with key stakeholders, we found unanimous agreement that, while auditors are not expected to purposefully sniff out all types of fraud, it is the responsibility of auditors to detect fraud that has a material impact on the financial statements.

This is consistent with paragraph 5 of ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements which already requires the auditor to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.*

However, we note a rather heavy reliance on inquiries of management for the purpose of risk assessment procedures in ISA 240, which could potentially lead to a situation of overreliance on management representation. In addition to the comments and suggestions in our response to Question 1 above, some proposals are as follows:

1) Senior management fraud

While paragraph 31 of ISA 240 recognises management override of controls as a significant risk, there appears to be few specific requirements or guidance in this regard. We are of the view that the current mandatory procedures under paragraph 32 of ISA 240 such as review of journal entries, while needed, might not be sufficient in the current environment.

In this regard, the IAASB could look into introducing procedures akin to a 'culture audit'. For instance, one key aspect which we believe warrants increased emphasis in audits of financial statements is an understanding over management compensation schemes and Key Performance Indicator-setting. Remuneration is a key driver behind management's actions and decisions, and this deserves an increased focus by the auditor for an effective risk assessment process over fraud.

2) Contradictory audit evidence

Paragraph A1 of ISA 500 *Audit Evidence* highlights that audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. We believe that there could be further guidance on how auditors should deal with contradictory audit evidence and whether they may be expected to actively seek such contradictory audit evidence.

Given the plethora of information available in the public domain (which might be reliable or unreliable), it is becoming increasingly challenging for the auditor to decide whether to only deal with contradictory audit evidence which the auditor happens to obtain while performing other required procedures, or if the auditor needs to perform certain specific procedures to seek such contradictory audit evidence.

3) Element of unpredictability in audits

We have heard feedback of audits being increasingly predictable and this leads to concerns over the effectiveness of audits in detecting material fraud. While paragraph 29 (c) of ISA 240 already requires the auditors to incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures, we think that the guidance materials in paragraph A36 may not accord sufficient emphasis on the importance of this concept of element of unpredictability. The current examples, while valid, are rather broad and might give an impression that only minor tweaks are required of the auditor in order to fulfil the requirement of paragraph 29 (c).

4) Forensic audit

While ISA 240 does indicate certain situations where the auditor should investigate further, such as when there are doubts over the authenticity of a document, we find that there is insufficient guidance on how deep the auditor needs to dig.

In this context, we note that forensic audits are very different in nature and in terms of cost. We believe that the ISAs could provide clarity into how and when the auditor evaluates a forensic audit to be necessary. Apart from the benefits from a technical aspect, such clarity would also aid the auditors in highlighting to those charged with governance of the need for involvement of forensic experts and ease discussions over increased costs of the audit.

> Question 2 (cont'd.)
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> (c) Would requiring a "suspicious mindset" contribute to enhanced fraud identification when planning and performing an audit? Why or why not?
> (i) Should the IAASB enhance the auditor's considerations about fraud to include a "suspicious mindset"? If yes, for all audits or only in some circumstances?

In furtherance to our comments in response to Questions 2 (a) and (b) above, while it is meaningful to introduce the concept of suspicious mindset, it is critical to first solidify the concept of professional skepticism as suggested in our response to Question 1.

There needs to be clear distinction between the two states of mind. Guidance is necessary for the auditor to assess their circumstances within the spectrum of professional skepticism and suspicion.

This distinction and guidance to navigate between professional skepticism and suspicion are critical as the implications to the nature of the audit and its costs could be very different. Once suspicion is warranted, there will be wide ranging implications to the auditor's strategy, procedures and reporting.

We think that the above considerations on professional skepticism and suspicious mindset should be applied consistently across all audits. When there is sufficient clarity as to how the auditor navigates between professional skepticism and suspicion, enhanced considerations and/or procedures will then be applied to those instances where there is merit for suspicion.

> Question 2 (cont'd.)
>
> (d) Do you believe that 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.)?

Transparency in auditor's report

On transparency about the auditor's work in relation to fraud, we are of the view that the auditor's report could increase its communicative value by including an assessment of the effectiveness of the entity's internal controls to prevent and detect fraud.

The following could be considered:

- Embed in key audit matters what the auditor has performed as part of the audit, the auditor's assessment of the control environment, controls which the auditor had relied upon and those that the auditor could not rely on due to weaknesses or other reasons. Such transparency in the auditor's reporting will also provide users of the financial statements with insights into the companies' tone at the top and company culture in respect of internal controls.

- Directors can disclose and auditors can comment on the system of internal control over financial reporting and the control environment over prevention and detection of fraud. However, this would encompass an expansion of the scope of the auditor's work, which has to be carefully considered in relation to costs and benefits. There is currently no internationally recognised framework on reporting on the system of internal controls. For such reporting to be effectively carried out, it must be accompanied by a proper framework which clearly sets out the requirements and measurement criteria, as well as the roles and responsibilities of all stakeholders.

However, we have also heard feedback that certain groups of users of financial statements may not be interested in reading extensive information in the auditor's report (such as key audit matters) and prefer to rely solely on the binary conclusion in the auditor's report.

This may result in such users missing out on "warning signals" that have been embedded in the auditor's report or financial statements, which compounds to the expectation gap. As such, we feel that any efforts for increased transparency (discussed here and later under Question 3 (c)) need to be accompanied with educational efforts to change the users' perspective towards the auditor's report.

<u>Question 3</u>

(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?

(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)?

We note the discussion in the DP on whether the assessment of going concern should go beyond 12 months. While we understand the rationale, this proposal is not feasible, given the challenges involved in determining a reasonable forecast for such an extended period of time.

As it is, we hear from stakeholders that it is challenging for an entity's management to prepare reasonable forecasts (and for auditors to evaluate appropriateness) for a period of at least 12 months. One key point to consider is the fundamental limitation behind the process of going concern assessments. The conditions existing at the point in time when the assessment was performed may subsequently change and these changes in conditions may result in going concern issues.

From our outreach activities, we find that many stakeholders are cognizant of this fundamental gap and understand that a clean audit opinion should not be seen as an absolute guarantee of going concern. However, when a company gets into financial difficulties shortly after an unmodified opinion was issued with little warning signals, there will be inevitable questions as to why the stakeholders were not warned. As such, more transparency would be helpful as further discussed in the response to Question 3 (c) below.

Question 3 (cont'd.)

(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 be put into effect?

Transparency in auditor's report

An area that we would like to highlight is the seeming imbalance of disclosure requirements between two scenarios which auditors may have to deal with in the context of going concern. One is the "close-call" scenario where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained, the auditor concludes that no material uncertainty exists. The other is the scenario where material uncertainty over going concern (MUGC) exists.

For the "close-call" scenario, to justify the conclusion that no MUGC exists, auditors typically include a description of the audit procedures performed as part of a key audit matter. In contrast, for the MUGC scenario, the disclosures are limited to the requirements of ISA 570 *Going Concern*, highlighting the disclosures of indicators of MUGC and drawing references to the disclosures in the financial statements, with little mention of the audit procedures performed. The IAASB could look into further guidance to address this imbalance, with specific focus on the narrative description required in the auditor's report.

Another area which we would like to highlight is the increasingly boilerplate MUGC disclosures in financial statements. In some instances, such disclosures may only include a statement that credit facilities or financial support are available from the holding company or controlling shareholder.

While we encourage more transparency from the auditors, this can only be achieved if there are more detailed disclosures in the financial statements. Additional information on the entity's ability to continue as a going concern that would be useful to users of financial statements include:

(i) Sufficiency of working capital to satisfy the entity's present cash flow requirements;
(ii) Assumptions used in the entity's assessment of its ability to operate as a going concern;
(iii) Sensitivity analysis on the entity's financials;
(iv) Plans put in place with regard to how the entity intends to fulfil its short-term obligations in the next twelve months; and
(v) Whether the entity has renegotiated its facilities and/or been granted extension of time to meet its debt obligations. If so, disclose on whether the entity has fulfilled or is able to meet its debt obligations.

In this regard, the IAASB could consider working with the International Accounting Standards Board (IASB) on key relevant disclosures.

The above information could be provided under the directors' report in the annual report or the financial statements and the auditors' assessment of the above information could be included under key audit matters. More transparency over the audit procedures carried out by auditors in critically evaluating the assumptions/representations made by directors would be welcomed by users.

Considering that going concern assessment is a forward-looking exercise and to a large extent, dependent on the entity's internal assessment, it could be worthwhile to explore the merits for auditors to provide commentaries on management's going concern assessment process in the auditor's report, including the accuracy of historical forecast. This would assist users to gauge the reliability of management's forecast process.

With more extensive disclosures, the audit report could potentially move towards a non-binary nature where users can judge the appropriateness of management's going concern assessment. This, we believe, will result in better communication to users of financial statements, the risks attached to an entity's ability to continue as a going concern, and the complexity of such assessments.

Should you require any further clarification, please feel free to contact myself, Mr Terence Lam, Senior Manager or Ms Wang Zhumei, Manager, TECHNICAL: Audit & Assurance, from ISCA via email at jumay.lim@isca.org.sg, terence.lam@isca.org.sg or zhumei.wang@isca.org.sg respectively.

Yours faithfully,

Ju May

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TECHNICAL: Financial & Corporate Reporting;
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