

5 June 2024

International Auditing and Assurance Standards Board

To: Mr. Thomas R. Seidenstein (Chair)

529 Fifth Avenue

New York, NY 10017

USA

Submitted electronically

**Subject: Comments on the IAASB's Exposure Draft on Proposed International Standard on Auditing (ISA) 240 (Revised): The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**

Dear Mr Seidenstein,

1. The International Forum of Independent Audit Regulators (IFIAR) appreciates the opportunity to comment on the International Auditing and Assurance Standards Board (IAASB) request for input on its Exposure Draft for Proposed ISA 240 (Revised): *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (ED-ISA 240) issued in February 2024. As an international organisation of independent audit oversight regulators that share the goal of serving the public interest and enhancing investor protection, IFIAR is committed to improving audit quality globally through the promotion of high-quality auditing and professional standards, as well as other pronouncements and statements.
2. IFIAR's objectives are as follows:
  - Sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity, with a focus on inspections of auditors and audit firms.
  - Promoting collaboration and consistency in regulatory activity.
  - Initiating and leading dialogue with other policy-makers and organisations that have an interest in audit quality.
  - Forming common and consistent views or positions on matters of importance to its members, while taking into account the legal mandates and missions of individual members.
3. The comments we provide in this letter reflect the views expressed by many, but not necessarily all, of the members of the IFIAR. However, the comments are not intended to include, or reflect, all of the views that might be provided by individual members on behalf of their respective organisation.
4. Where we did not comment on certain specific matters, this should not be interpreted as either approval or disapproval by the IFIAR,

## Overall comments

5. In our response letter to the IAASB's Discussion Paper on Fraud and Going Concern in an Audit of Financial Statements dated February 1, 2021 ("2021 Response Letter") we encouraged the IAASB to examine the benefits of strengthening ISA 240 (Revised) and we welcome the positive steps that the IAASB has taken to improve the audit procedures related to fraud in an audit of financial statements.
6. We support the changes to the auditor's risk identification and assessment process as it relates to fraud to make it more robust, including the evaluation of fraud risk factors, understanding the entity and its environment, understanding the components of internal control and control deficiencies within the entity's system of internal control to determine if there is an impact on the prevention or detection of fraud and more closely aligning the requirements to identify and assess the risks of material misstatement with the revised ISA 315, *Identifying and Assessing the Risks of Material Misstatement* (ISA 315R).
7. We also support the enhanced transparency on fraud-related responsibilities and procedures in the auditor's report, including key audit matters (KAMs) relating to fraud.
8. In addition, IFIAR has recommendations in the following areas:
  - Stand-back requirement.
  - Presumption of the risks of material misstatement due to fraud in revenue recognition.
  - The entity's organizational structure and ownership, governance, objectives and strategy, and geographic dispersion.
  - Unpredictability in the selection of audit procedures.
  - Consideration of effective control environment when evaluating fraud risk factors.
  - Whistleblower program.
  - Management override of controls.
  - Quantitative and qualitative materiality considerations.
  - Fraud inquiries.
  - Conforming amendments.

## Stand-back requirement

9. We understand the concerns raised by the IAASB in the explanatory memorandum to ED-ISA 240 relating to proliferation of stand-back requirements, however, there are key standards that require the auditor to consider audit evidence obtained and evaluate such evidence holistically, using professional judgment. The stand-back requirement in 315R is critical as it requires the auditor to take into account all evidence obtained and refine the initial identification and assessment of the risks of material misstatement as the audit progresses. The objective of the initial and on-going risk identification and assessment applies to risks of material misstatement whether due to fraud or error. Audit evidence that is inconsistent with the auditor's initial identification and assessment of risk is identified, in practice, in inspections where the auditor has not revised their risk assessment, and accordingly, has not performed further audit procedures. Audit evidence not considered by the engagement team is often information that was included in the audit file and/or public filings.

10. The auditor's evaluation of whether audit evidence (whether corroborative or contradictory) is indicative of an error or suspected fraud requires significant professional skepticism. This evaluation cannot be made in isolation but needs to consider the cumulative effect of audit evidence obtained and be re-considered throughout the audit. A separate stand-back requirement within ED-ISA 240 is necessary to emphasize the importance of the auditor remaining open to the possibility that audit evidence obtained (whether corroborative or contradictory) may be indicative of either an error, a fraud risk factor not previously identified including, for example, possible management bias, or fraud. The distinction is important as the further audit procedures necessary will be different in the different circumstances. The separate stand-back in ED-ISA 240 would be strengthened with the use of stronger language (such as "challenge, question and re-consider") to describe the expectations of auditors.
11. Given the importance of auditors not concluding on individual items in isolation and performing a stand back assessment to determine if sufficient appropriate audit evidence has been obtained, we recommend the IAASB revisit the word 'intentional' that has been added throughout the application guidance. For example, ED-ISA 240, A22 should refer to possible management bias as a fraud risk factor as whether the possible management bias is intentional or unintentional may not be known until further audit procedures are performed. Similarly, A29 and A37 refer to related parties and/or transactions that were intentionally not disclosed; these examples as well as many of the other examples listed in the application guidance could be the result of fraud (i.e., the result of an intentional act), suspected fraud, or an error because management lacked the appropriate expertise. The determination of whether individual acts are indicative of an error, fraud, or suspected fraud cannot be made in isolation and must be considered cumulatively. The determination requires the application of professional skepticism in evaluating all evidence obtained to conclude on whether the audit evidence is indicative of potential fraudulent behavior on the part of one or more individuals among management, those charged with governance, employees, or third parties.
12. The requirements of paragraph 29 regarding key engagement team discussions should specify that the discussion of fraud risk factors and fraud risks should consider which component auditor engagement team members to include in the discussion based on initial expectations about the risks of material misstatement. The engagement partner should also consider the need for discussions relating to fraud risk factors and fraud risks at later stages during the audit to ensure conclusions remain consistent with those determined at the audit planning stage.

### **Presumption of the risks of material misstatement due to fraud in revenue recognition**

13. The ED-ISA 240 project proposal in December 2021 originally noted that the intention was to focus on when it is inappropriate, rather than clarify when it is appropriate to rebut the presumption of the risks of material misstatement due to fraud in revenue recognition. The application and other explanatory material still focus on when it is appropriate to rebut the presumption of the risks of material misstatement due to fraud. The ED should be expanded to include examples for both situations and should cover all assertions.
14. The ED-ISA 240 does not sufficiently enhance or clarify that the threshold for rebuttal should be high and applied in limited circumstances but instead memorializes what is already seen in practice. Unless revenue includes cash sales or there are complex revenue arrangements,

auditors often limit the fraud risk in revenue to inappropriate manual journal entries impacting revenue recognition and the cut-off assertion at year end.

15. We support the addition of examples provided such as paragraphs A108 and A109 which identify situations when the risks of material misstatement due to fraud in revenue recognition may be greater. However, additional examples should be added to these paragraphs and Appendix 3 such as existence of tolling arrangements, or unnecessarily complex entity structures where revenue transactions may be with undisclosed related parties (as discussed in A59).
16. The application guidance should be expanded to clarify that limiting the fraud risk to manual journal entries or the cut-off assertion would ordinarily not be appropriate and should tie to expanded examples.
17. The additional examples added to paragraph A111 lack sufficient detail and may lead an auditor to inappropriately conclude that fraud risks factors are not significant. For instance, the example of rendering one type of service for a fixed fee where fraud risks factors may not be significant may be too simplistic. It may not be appropriate to conclude there are no fraud risks factors if it's a service with a high volume of customers. It should also be clarified what is meant by simple or straightforward ancillary revenue sources as these could include revenue sources that have more complexity than the examples provided (interest or dividend revenue from investments with level 1 inputs) and could lead auditors to inappropriately rebut the risks of material misstatement due to fraud.
18. Further, the examples in A111 may inadvertently suggest that fraud risk factors relevant to financial reporting relate only to opportunities to commit fraud versus reminding the auditor that opportunities should be considered in combination with incentives/pressures and attitudes/rationalization. If the opportunity is low but the incentive and rationalization is high, there could be a fraud risk.
19. We recognize that paragraph A56 identifies 'an ability to rationalize the fraudulent action' as a fraud risk factor while stating that fraud risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Rationalization should also be added to the definition of a fraud risk factor included in paragraph 18(b) and require an auditor to specifically take into account an attitude that permits rationalization of a fraudulent action when the auditor is aware that such an attitude exists. The requirement in paragraph 40, does not appear to require auditors to take into account rationalization as a fraud risk factor in identifying and assessing the risks of material misstatement due to fraud.
20. We recommend the documentation requirement expand on the analysis that should be undertaken in paragraph 41 to conclude no fraud risks factors are present over revenue recognition. Paragraph 70 (d) specifies the documentation requirement when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and has not identified revenue recognition as a risk of material misstatement due to fraud but provides no further guidance on what factors should be considered to support their conclusion.

## **The entity's organizational structure and ownership, governance, objectives and strategy, and geographic dispersion**

21. Paragraph A59 indicates that “*An overly complex organizational structure involving unusual legal entities may indicate that a fraud risk factor is present.*” This should also include unnecessarily complex or unusual for the industry and organizational structures where an entity is organized in a manner that introduces layers of complexity. It is important that the business rationale is understood by the auditors as part of their fraud risk assessment. For example, entities entering into an arrangement with a third party to perform a specific service that the entity could provide on its own could be an indication of an unidentified related party relationship or potential side arrangements.

### **Unpredictability in the selection of audit procedures**

22. Paragraph A114 discusses incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed. The examples of procedures to be performed do not have a clear or direct link to the risk of fraud. The element of unpredictability should have substance for the specific circumstances of the audit. For example:

- Selection of audit evidence that may be more susceptible to fraud and assess the authenticity of such evidence.
- Use of fraud/forensic specialists as part of audit planning and the execution of certain procedures.
- Sending third-party confirmations with requests specific to potential material misstatement due to fraud, for example confirming sales transactions, including the details of the sales agreements, any rights of return and delivery terms.

### **Consideration of effective control environment when evaluating fraud risk factors**

23. Although paragraph A22 explains that fraud risk factors relate to incentives, pressures or opportunities that arise from events or conditions that create susceptibility to misstatement before consideration of controls, the below examples suggest that an effective control environment can mitigate the risk of fraud:

- Paragraph A57 provides examples of factors that may constrain improper conduct by management including effective oversight by those charged with governance, an effective internal audit function and the existence and enforcement of a written code of conduct. It would be better to expand on what level of evidence is expected under ISA 315R to support the auditor's conclusion that the oversight is effective and use the existence and enforcement of written code with an example of procedures that could be performed.
- Paragraph A58 refers to a smaller or less complex entity that may not have formalized controls, but has a developed culture that emphasized the importance of integrity and ethical behaviors, through oral communications and management example. It also indicates that management approval can compensate for otherwise deficient controls. It is not appropriate for the auditor to take into consideration mitigating factors that cannot be validated.

24. Further, paragraph 40 should specify that fraud risks factors should be identified before taking internal controls into consideration. There also needs to be greater clarity that while the auditor cannot take credit for an effective control environment, there may be other events or conditions that increase the risks of material misstatement due to fraud such as known control deficiencies.

### **Whistleblower program**

25. Considering the high number of frauds uncovered due to a whistleblower complaint, a requirement should be included and referenced to paragraph A70, for the auditor to evaluate the entity's whistleblower program and matters identified through the program as part of the understanding of the entity's controls environment and assessment of fraud risk factors.

### **Management override of controls**

26. Paragraph 42 should require the auditor to determine the account balances and/or classes of transactions where the risk of management override could be perpetrated. Also, the text "*irrespective of the auditor's assessment of the risks of management override of controls*" should be removed from paragraph 48 to be clear that an auditor cannot determine the risks of management override of controls as not a significant risk. Similarly, the text "*Although the level of risks of management override of controls will vary from entity to entity*" should be deleted from paragraph A113 as this could be subject to different interpretations.

### **Quantitative and qualitative considerations**

27. The qualitative considerations included in paragraph A11 are useful. Additional qualitative considerations that should be added include the amount of the illegal advantage such as a large contract obtained for a small bribe and other key elements included in paragraph A157.
28. Paragraph A155 examples should include consideration of cumulative materiality based on the duration of the fraud and the amount of a misstatement on an aggregate basis.

### **Fraud inquiries**

29. The importance of fraud inquiries with management, other appropriate individuals and those charged with governance would be elevated with the use of stronger language in the requirements within paragraphs 34 and 35. For example, the standard should highlight the importance of establishing robust two-way communication related to fraud which would be consistent with ISA 260, *Communication with Those Charged with Governance*. Examples should also be provided for ways to strengthen inquiries such as by holding interviews with the appropriate individuals and asking probing and clarifying questions.

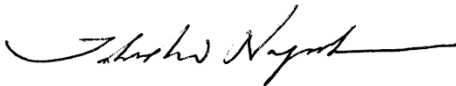
### **Conforming amendments**

30. The following conforming amendments are necessary to ensure the understandability and clarity of the ISAs is not reduced. For example:
- A conforming amendment is needed to eliminate a circular reference included within ISA 540 and ISA 240 relating to the retrospective review requirements previously in ISA 240.33(b)(ii). ISA 240.28 references that the requirement is in ISA 540 while ISA 540 paragraph A57 references the requirement is in ISA 240.

- The addition of the specific references to the International Ethics Standards Board for Accountants (IESBA) Code in A43 related to integrity, standing one's ground when confronted by dilemmas and difficult situations or challenging others should also be included as a conforming amendment to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Auditing Standards* (ISA 200). Inclusion within ISA 200 would be more impactful because the role and mindset of professional accountants is critical to all aspects of the audit and should not just be limited to the engagement leader's interaction with management and those charged with governance related to fraud. We would also encourage the IAASB to link A43 with the stand-back requirement discussed above.
- Additional responsibilities related to fraud should be made as conforming amendments to ISA 220 so that the engagement leader's responsibilities are clearly laid out in one standard.
- The changes to ISA 240 specifying that "*The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary*" should also be made in ISA 200.A24 (i.e., delete this lead-in sentence in ISA 200).

Please do not hesitate to contact me or James Ferris, Chair of the IFIAR Standards Coordination Working Group (SCWG), to discuss any of our comments.

Yours sincerely,



Takashi Nagaoka, IFIAR Chair

Cc: Kevin Prendergast, IFIAR Vice Chair  
James Ferris, SCWG Chair,  
Stacy Hammett, SCWG Vice Chair  
Carl Renner, Executive Director