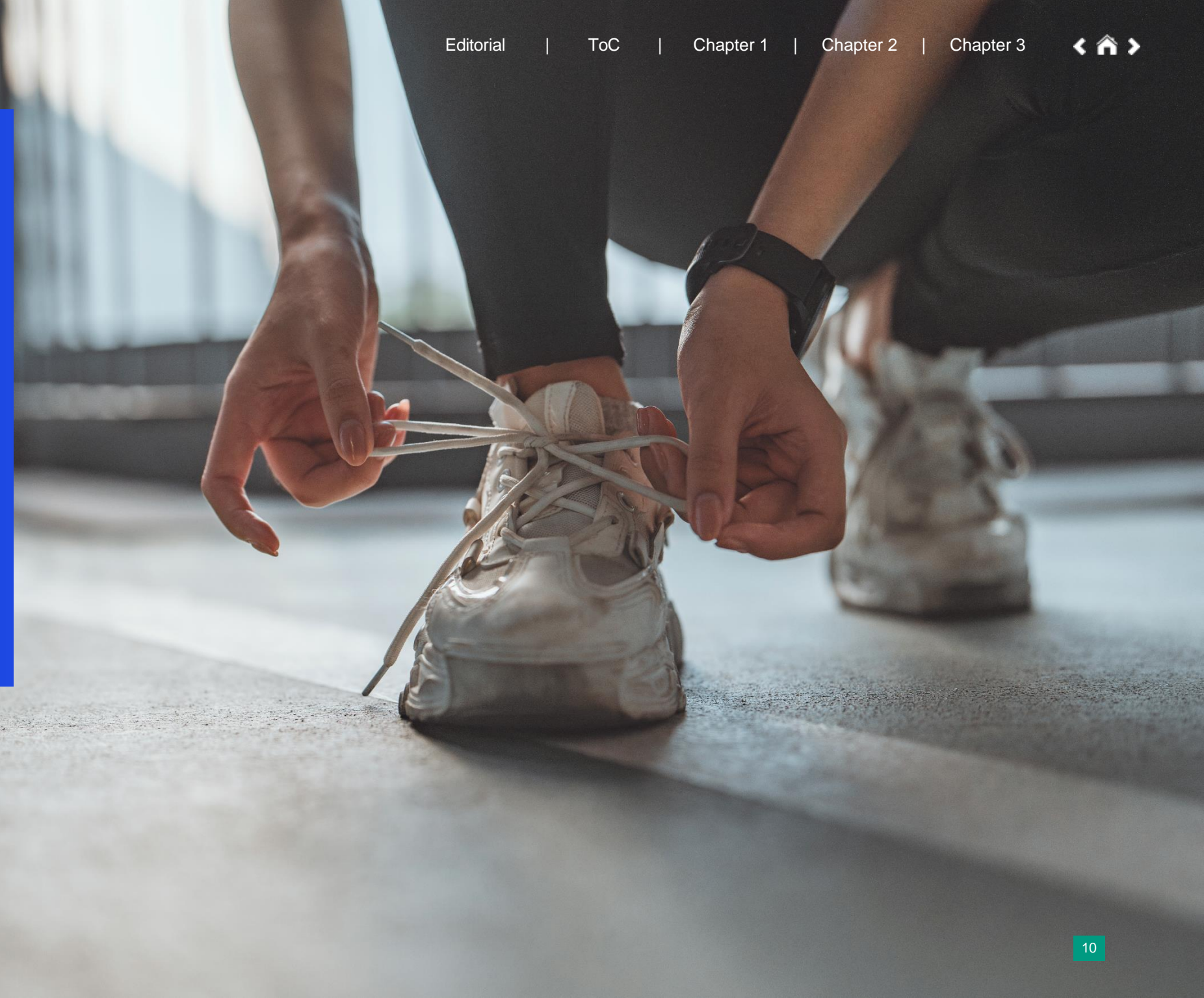


CHAPTER 2

Safeguarding financial statements from fraud: new proposals

This article aims to:

- Highlight changes proposed to ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statement*.
- Key Impact on responsibilities of management and Those Charged with Governance (TCWG).



The recent surge in global corporate scandals has thrust the issue of fraud into the spotlight, raising stakeholder concerns about the auditor's role in detecting fraud during financial statement audits. Recognising the need for clarity, the International Auditing and Assurance Standards Board (IAASB) has initiated revisions to the existing ISA 240 through an Exposure Draft (ED). This decision, informed by extensive outreach, aims to provide clarity regarding the auditor's response to fraud or suspected fraud uncovered during audits, thereby strengthening or elucidating the auditor's responsibilities in relation to fraud in financial statement audits.

The IAASB's outreach has highlighted seven key proposed amendments to ISA 240 that are poised to enhance consistency in practice and influence auditor behaviour.

This article aims to provide a comprehensive overview of these proposals, shedding light on their potential impact on the auditing landscape.

These proposed changes include:

Clarity and emphasise on the auditor's responsibilities

Reinforcing the exercise of professional skepticism through the audit

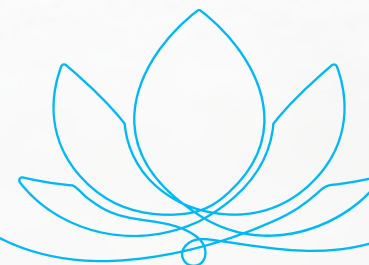
Ongoing communications throughout the audit with management and TCWG about matters related to fraud

Applying a fraud lens on risk identification and assessment

Robust work effort requirements if fraud is identified

Transparency on key audit matters related to fraud in the auditor's report

Enhancing audit documentation requirements





Clarify and emphasise on the auditor's responsibilities

The ED sets out a clear and affirmative description of the auditor's responsibilities relating to fraud in an audit. Previously, ISA 240 merged the discussion of the audit's inherent limitations relating to fraud of an audit of financial statements with the auditor's responsibilities, leading to confusion about the auditor's exact duties. Therefore, the two concepts i.e. inherent limitations of an audit and auditor's responsibilities related to a fraud in an audit have been decoupled.

The ED introduces a new statement that the inherent limitations do not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud.

The IAASB's revisions do not intend to broaden the auditor's fraud-related roles within a financial statement audit. The descriptions of the audit's inherent limitations and the auditor's fraud-related duties remain aligned with the current ISA 240.

A novel aspect introduced in the exposure draft is the auditor's responsibilities concerning non-material fraud and suspected non-material fraud. The guidance addresses the context and consequences of the fraud, clarifying that a misstatement from fraud, while not 'quantitatively material,' might still be 'qualitatively material,' especially if initiated by entity management or for specific reasons (e.g. to manage key performance metrics).



Professional skepticism

The ED underscores the criticality of professional skepticism throughout the audit, particularly in relation to fraud detection. To this end, it introduces new and strengthened requirements and application material within the standard.

The ED mandates auditors to maintain vigilance for any indications of fraud or suspected fraud during all audit stages. It emphasises the importance of this alertness, especially during the concluding phases of the audit, where time constraints could potentially hinder the proper exercise of professional skepticism. This new requirement aims to ensure that auditors consistently apply a high level of scrutiny, even under the pressure of impending deadlines.





Ongoing nature of communications with management and TCWG

The IAASB has recognised the need for more robust communication with Those Charged With Governance (TCWG) regarding fraud considerations in the current landscape. The existing protocols for such communications during the audit may not be explicitly mandated. Consequently, the ED is designed to fortify interactions with TCWG and management on fraud-related matters throughout the audit process. It introduces a new comprehensive requirement in the standard to engage with management and TCWG on fraud-related issues at suitable intervals during the audit engagement. This enhancement aims to ensure that discussions on fraud are integral and ongoing throughout the audit engagement.



Risk identification and assessment

IAASB has added additional guidance regarding applying a fraud lens on risk identification and assessment.

The IAASB has introduced additional guidance to apply a more focused approach towards fraud within the risk identification and assessment process. This enhancement calls for a more rigorous and thorough application of the auditor's risk assessment procedures specifically related to fraud, ensuring that the process is not just compliant, but robust in its execution. This guidance aims to sharpen the auditor's ability to pinpoint and evaluate the risks of material misstatement due to fraud, thereby reinforcing the overall audit quality.





Fraud or suspected fraud

The IAASB has proposed a new requirement to enhance clarity regarding the auditor's actions when encountering fraud or suspected fraud during an audit. This proposal emphasises the necessity for auditors to gain a comprehensive understanding of the fraud or suspected fraud they uncover. Depending on the specific facts and circumstances of the audit engagement, as well as the nature of the fraud, auditors may consider several actions, including:

- Involve an auditor's expert, such as a professional with forensic skills, to provide specialised insight. An individual with forensic skills may assist in planning and performing audit procedures as it relates to the specific audit area where the fraud or suspected fraud was identified
- Inspect whistleblower reports to gather additional information that may shed light on the fraud.
- Conducting further inquiries with:
 - The entity's in-house legal team or external legal advisors to understand the legal implications.
 - Members of the internal audit function, if such a function exists, to leverage their insights on internal controls and processes.



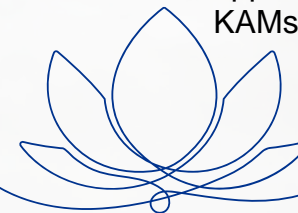
Transparency on fraud-related responsibilities and procedures in the auditor's report

The IAASB has recognised that the auditor's report may not sufficiently convey the auditor's responsibilities and procedures related to fraud. As a result, it proposes consequential amendments to ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, which focusses on forming an opinion and reporting on financial statements, to better articulate the auditor's fraud-related duties in the auditor's report. The proposed enhancements to ISA 700 include detailing the auditor's obligation to inform TCWG about identified fraud, suspected fraud, or other relevant fraud-related matters, as per the auditor's judgement.

Furthermore, the ED underscores the significance of communicating Key Audit Matters (KAMs) associated with fraud. It introduces a new paragraph that applies a 'fraud lens' to filter specific considerations such as:

- Identified and assessed risks of material misstatement due to fraud
- The identification of fraud or suspected fraud
- The identification of significant deficiencies in internal control pertinent to fraud prevention and detection.

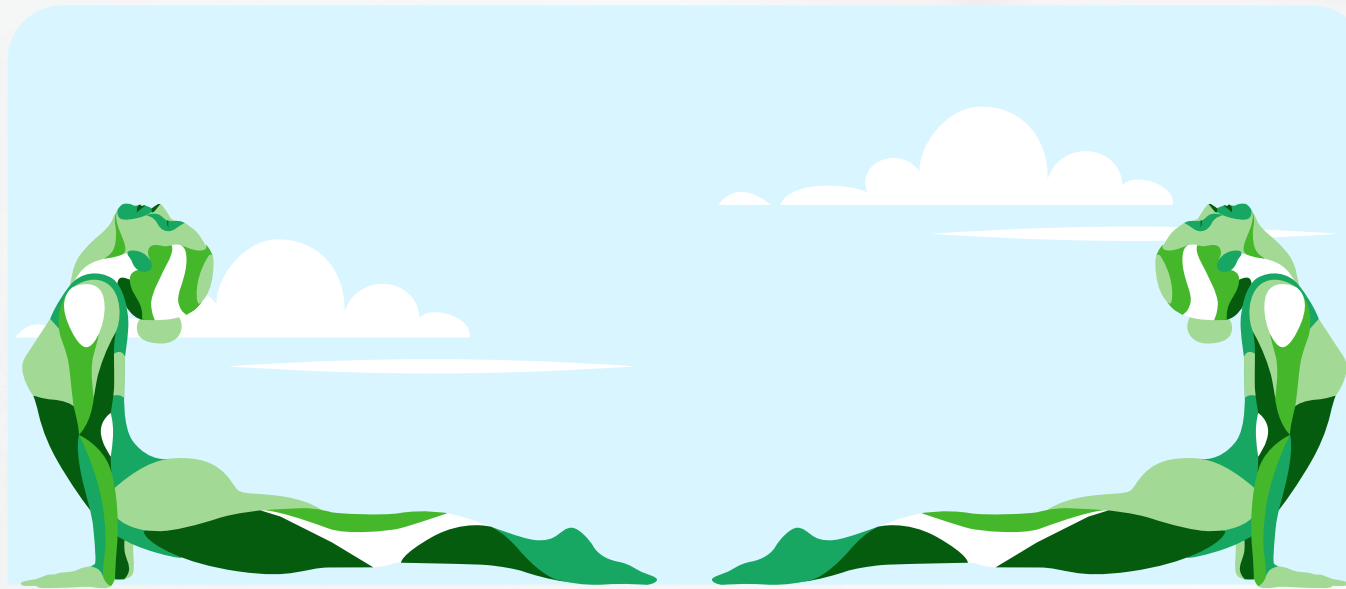
To encourage more reporting of KAMs related to fraud, the IAASB has included additional application guidance and is advocating against the use of generic, boilerplate language in KAMs concerning fraud in the auditor's report.





Documentation

The IAASB is committed to enhancing the clarity of the auditor's documentation requirements, ensuring that the auditor's efforts and work are thoroughly recorded. A new requirement has been introduced, mandating auditors to document the outcomes of procedures carried out to mitigate the risk of management's override of controls, the significant professional judgements made, and the conclusions drawn. Similar documentation mandates have been established for identified frauds and suspected fraud, aiming to provide a clear and comprehensive record of the auditor's findings and rationale.



Key impact on responsibilities of management and TCWG

The proposed amendments to ISA 240 introduce more stringent requirements for auditors, which will also have implications on an entity's management, as they have the primary responsibility for fraud prevention and detection with those charged with governance. It is crucial that management, under the oversight of governance, emphasises robust fraud prevention measures to minimise the potential for fraudulent activities and implements strong deterrence strategies to discourage fraud by highlighting the likelihood of detection and subsequent consequences. This collaborative effort between auditors, management, and TCWG is essential to create a fortified front against fraud.



Fraud risk identification and assessment

The IAASB's proposed revisions to ISA 240 include enhanced requirements for a more robust, explicit, and specific fraud risk identification and assessment. Auditors are now expected to incorporate specific fraud considerations while gaining an understanding of the entity and its environment, the financial reporting framework, and the internal control system components. Consequently, management is anticipated to implement more precise controls around fraud, encompassing areas such as the control environment, risk assessment processes, monitoring of internal controls, information systems, communication, and control activities.





Understanding environment, framework and controls

The exposure draft also specifies focus areas for the auditor's understanding related to the entity's environment, financial reporting framework, and internal control system, as per ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*. These focus areas include:

- The entity's corporate culture
- Key performance indicators
- Employee performance measures and incentive compensation policies
- The entity's risk assessment process
- Specific control activities designed to prevent and detect fraud
- Other relevant information, such as insights gained from procedures performed in accordance with ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, or knowledge obtained throughout the audit.

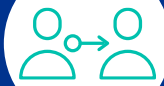
In light of these focus areas, management's risk assessment process is expected to be comprehensive, incorporating the aforementioned elements to facilitate the auditor's understanding and enhance the audit's effectiveness in fraud detection.



Qualitative misstatements

Management should take note that the ED delineates specific instances where misstatements resulting from fraud, though not quantitatively material, may still hold qualitative materiality based on the identity of the fraudster and their motivations.





Two-way communication

The ED also stresses the importance of robust two-way communication between management or TCWG and the auditor, which aids in identifying risks of material misstatements due to fraud. It further clarifies that the effectiveness of TCWG's oversight is influenced by their objectivity, including independence from management, and their familiarity with the controls management has established to prevent or detect fraud. This enhanced communication is vital for a comprehensive understanding and effective management of fraud risks.



Other Considerations



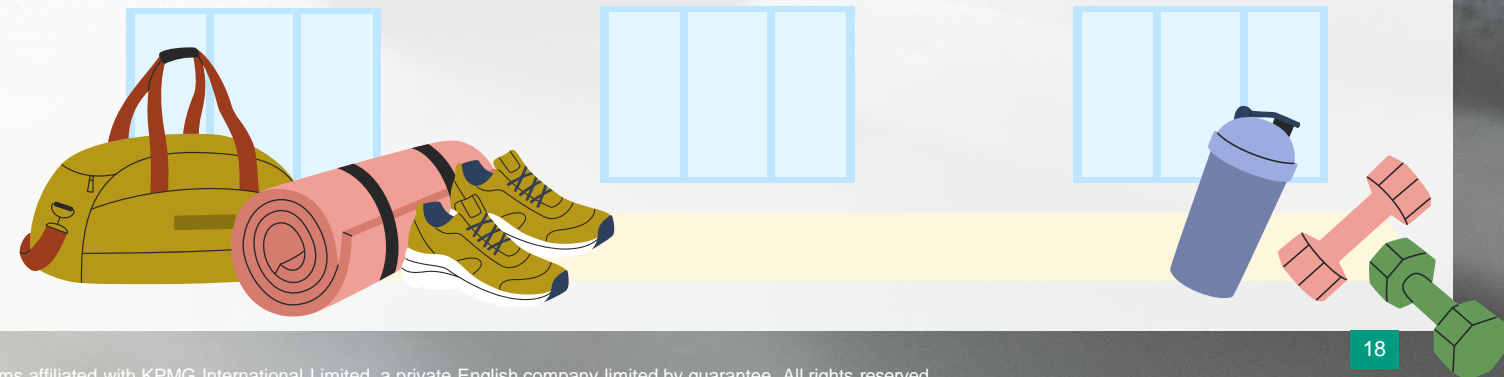
Written Representation

The ED strengthens the requirement for obtaining written confirmations from management and, where appropriate, TCWG. These confirmations should state whether they have adequately fulfilled their responsibilities regarding the design, implementation, and maintenance of internal controls aimed at preventing or detecting fraud.



Use of Automated Tools

The ED offers guidance on the auditor's use of automated tools and techniques. These tools and techniques can be employed to carry out audit procedures that are related to the identification and assessment of risks of material misstatement due to fraud.



Next steps

The ED is designed to ensure that auditors have a thorough understanding of the fraud, enabling them to respond effectively and maintain the integrity of the audit process. This initiative is part of the IAASB's broader efforts to ensure that standards are explicit and detailed, promoting transparency and accountability in the auditing process.

The comment period to this ED ended on 5 June 2024 and IAASB is expected to start the deliberation on the comments from September 2024. The standard is expected to be released in first half of 2025.

