



Think Ahead



Closing the expectation gap in audit – the way forward on fraud and going concern: A multi-stakeholder approach

Summary of Key Findings

ACCA, in collaboration with CA ANZ, CPA Canada and the Canadian AASB, has examined the auditor's role in the areas of fraud and going concern, and the related expectation gap by publishing the report *Closing the expectation gap in audit – The way forward on fraud and going concern: A multi-stakeholder approach*. The underlying research for this report was supported by series of virtual roundtables and interviews with stakeholders of the wider financial reporting ecosystem across the globe.

This paper summarises the key points raised by our stakeholders during the roundtable discussions held across different countries and/or regions. We discuss the outcome of the roundtable discussions and interviews in more detail within *Chapter 3* of our main report.



In our report, the audit expectation gap has been divided into three components:

Knowledge gap

The 'knowledge gap' is defined as the difference between what the public thinks auditors do and what auditors actually do. This recognises that the public can sometimes misunderstand audit: for example, a belief that auditors are responsible for preventing corporate failure.

Performance gap

The 'performance gap' is defined as the difference between what auditors actually do and what auditors are supposed to do, given the requirements of auditing standards or regulations. Audit firms have systems and processes that seek to ensure quality in their engagements; in other words, that they comply with the standards and regulations. Audit regulators inspect files of completed engagements to evaluate whether quality is being achieved.

Evolution gap

The 'evolution gap' is defined as the difference between what auditors are supposed to do if they actually follow the requirements of auditing standards and regulation and what the public wants auditors to do. In other words, the evolution gap indicates the areas of the audit where there may be a need for evolution, taking into consideration the general public demand, technological advances and how the overall audit process could be enhanced to add more value in the public interest.

THE 'PERFORMANCE GAP' IS DEFINED AS THE DIFFERENCE BETWEEN WHAT AUDITORS ACTUALLY DO AND WHAT AUDITORS ARE SUPPOSED TO DO.

Summary of key findings:

Expectation Gap

- A majority of participants indicated the knowledge gap as the main cause of the expectation gap for both fraud and going concern, with some arguing it is a combination of two gaps or of all three gaps.
- Participants' views on the expectation gap focused more on fraud than on going concern in all countries and/or regions in scope.

Knowledge Gap

- A majority of participants across all stakeholder groups thought that the expectation gap was driven primarily by financial statement users' lack of understanding of the role of each party in the financial reporting ecosystem. Some views expressed included:
 - Communicating the auditor's role and responsibilities can be challenging as the financial statements and auditor's report are getting longer and more complex.
 - The inherent limitations and constraints that auditors face in detecting and reporting actual or suspected material fraud tend to be overlooked by users.
 - The concept of materiality and other audit terminology are often misunderstood by users.
- Participants across all stakeholder groups suggested that all those with an involvement in the financial reporting ecosystem should collaborate to raise awareness of the role and responsibilities of all parties within the ecosystem. Some suggestions put forward included:
 - Looking at jurisdictions that have adopted Sarbanes–Oxley (SOX-style) reporting, such as in the US and Japan, and consider how successful that has been in enhancing communication about the role of the entity and its management.
 - Introducing better and more meaningful communication channels between auditors and shareholders.
 - Reviewing IAS1, *Presentation of Financial Statements*, as the guidance currently provided is limited.

Performance Gap

- The performance gap was least commonly identified as the main cause of the expectation gap. Some views expressed included:
 - Mixed views on the current auditor requirements around professional scepticism, with some of the view that the standards are robust enough if applied with proper professional scepticism and in the presence of quality reviews, and others suggesting the profession may need to go beyond what is currently required.
 - A view that auditors should respond to risks of fraud differently from the way they respond to risks of error, owing to the need for an elevated level of professional scepticism when considering whether something was deliberate.
 - The significant role Professional Accountancy Organisations and audit regulators have to play in monitoring the performance gap via audit quality reviews and by supplying training materials to support smaller firms with resource challenges.

Evolution Gap

- Participants emphasized the need to continue to monitor auditors' performance and to consider areas of evolution. Some views expressed included:
 - That the use of technology can help enable auditors to satisfy, to a greater extent, the users' expectations of auditors in respect of fraud.
 - That the audit should evolve using technology in areas of investor concern, such as forecasts and other future-oriented information.
- As it relates to fraud, a number of possible revisions to ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, were suggested by some participants, including:
 - Concerns about the introduction of ISA 240 and particularly paragraph 5, which notes the inherent limitations of an audit.
 - Inconsistencies, in practice, on how journal entry testing is tailored, in relation to the fraud risks identified in the audit, and the extent of testing required.

- Whether the presumption of risks of fraud in revenue recognition continues to be appropriate.
- The need for more sharing within the auditor's community, ie with other audit practitioners/firms of recently identified frauds.
- The importance of continuous training of auditors on matters relating to fraud.

Fraud: Increased use of forensic specialists or other relevant specialists

- A majority of participants supported retaining the flexibility provided in the extant standard for the auditor to apply their professional judgment when determining how to respond to identified fraud risks. They suggested that the involvement of forensic specialists could be encouraged, especially in the risk assessment process, but continue to be based on the auditor's professional judgement.
- Audit practitioners, of both large and small and medium-sized practices (SMPs) noted that mandating the involvement of forensic specialists may widen the expectation gap. Other concerns raised by practitioners included:
 - the involvement of forensic specialists would create a risk that their work would become a 'box-ticking' exercise.
 - the increase in audit costs may be difficult to justify for small or less complex audits where the need for forensic specialist involvement may be less apparent.
 - SMPs would need to outsource forensic specialists since this skillset would not be available within their firm.
- Some representatives of Those Charged with Governance (TCWG) supported the use of forensic specialists, but suggested that this should be when, in the auditor's judgement, there is a high risk of fraud.
- Regulators were the only stakeholder group that appeared to be more supportive of mandating the involvement of forensic specialists.

Fraud: Professional Scepticism or suspicious mindset?

- A majority of participants did not support the concept of a 'suspicious mindset'. They recommended that the focus should be on narrowing any performance gap that currently exists in applying professional scepticism, rather than on introducing a new concept. Some suggested the involvement of more senior level staff or placing more emphasis on effective supervision and review.
- Some concerns raised with requiring a 'suspicious mindset' included:
 - A risk of impairing the relationship between management and the auditor, impacting audit efficiency and effectiveness.
 - It would mean a greater burden of proof when collecting audit evidence, and therefore lead to onerous information demands on entities.
- Some participants noted that psychology research shows that it is difficult to have a sceptical mindset and that it is more natural to seek confirming rather than contradictory evidence.

Fraud: Enhanced quality control review requirements

- Introducing additional engagement quality control review procedures was ranked as one of the more favourable options to explore further by participants.
- Some participants cautioned against adding another 'checklist-type' procedure.
- Audit practitioners and regulators recognised that this option could be easier to implement than other options since the framework for incorporating additional quality control review procedures already exists.
- Some participants did not support this option as they argued that ISQM 2, *Engagement Quality Reviews*¹ already has sufficient requirements for the engagement quality control review role relating to fraud.

Fraud: Additional focus on non-material fraud

- A mixed group of stakeholders supported requiring additional audit procedures when a non-material fraud is identified, as it could lead to the discovery of a material fraud
- Audit practitioners noted that the extant standard requires the auditors to perform certain procedures when fraud is identified, irrespective of whether it is material or not and therefore they believe the extant requirements continue to be appropriate and sufficient.
- Audit practitioners raised the concern that requiring additional focus on non-material fraud would go beyond the objective of an audit.

Fraud: Third-party fraud

- Generally, participants did not have strong views regarding fraud related to third parties.
- Some participants suggested considering additional procedures to address the increased risk of third-party fraud, in light of Covid-19.

Going Concern: Time period for going concern assessments

- A majority of participants thought that expanding the period beyond 12 months would add little, if any, value.
- Some audit practitioners believe that users already overestimate the level of assurance obtained by auditors. Extending the time period for the going concern assessment may inadvertently increase the expectation gap.
- Some participants suggested that it would be more meaningful for the International Accounting Standards Board (IASB) to consider revising IAS1, *Presentation of Financial Statements*, to require management to take into account all available information about the future, which would be at least, but not limited to, 12 months from the date when the financial statements are authorised for issue, rather than the reporting period.

¹ <https://www.ifac.org/system/files/publications/files/IAASB-Quality-Management-ISQM-2-Engagement-Quality-Reviews.pdf>

Going Concern: Going concern and other concepts of resilience

- Some participants suggested exploring resilience could be beneficial for assessing the company's prospects as they regard current disclosure requirements on 'material uncertainty relating to going concern' as a binary determination that may take place too late in an entity's life cycle.
- Participants noted that introducing new resilience concepts must be coordinated with accounting standard-setting bodies and regulators. They emphasised that TCWG and management have primary responsibility for assessing going concern and resilience.
- Some public sector audit practitioners mentioned that the concept of resilience is consistent with the concepts set out in public sector accounting standards in some jurisdictions that deal with an entity's flexibility, sustainability, and vulnerability.
- One suggestion on enhancing the transparency of such assessments is to incorporate some form of stress-testing from management's perspective. Another suggestion that could be explored is disclosure of risk exposure, including risks related to fraud or error and strategic risks.

Going Concern: Material uncertainty related to going concern

- Many participants asked for more guidance on the distinction between discussions of going concern issues in the Key Audit Matters (KAM) section and the going concern section in the audit report.
- Audit practitioners suggested that the International Auditing and Assurance Standards Board (IAASB) should consider whether there is evidence that users understand the difference between a material uncertainty related to going concern and a KAM, as this may be contributing to the knowledge gap.
- Audit practitioners noted that there is a lack of clarity about what constitutes 'material uncertainty related to going concern' as well as inconsistent practices in this area.
- Participants raised concerns about the lack of understanding of the terms 'going concern' and 'material uncertainty' outside of the accountancy profession.
- Some public sector representatives noted that these concepts are mostly irrelevant, as the government is highly unlikely to cease operations even for those defaulting on debt. Other public sector representatives mentioned that going concern is important in their jurisdiction as it effectively determines whether a public sector function will continue to operate.
- Many participants recommended that the IAASB should work with the IASB to clarify what events or circumstances would give rise to a material uncertainty relating to an entity's ability to continue as a going concern.

MANY PARTICIPANTS RECOMMENDED THAT THE IAASB SHOULD WORK WITH THE IASB TO CLARIFY WHAT EVENTS OR CIRCUMSTANCES WOULD GIVE RISE TO A MATERIAL UNCERTAINTY RELATING TO AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN.

Transparency about fraud and going concern

Fraud

- Some regulatory representatives suggested enhanced management disclosures regarding how they addressed their responsibility for preventing and detecting fraud. The auditor's report could also be enhanced regarding the auditor's work in response to the disclosure by management.

Going concern

- A majority of participants were supportive of considering the disclosure of a spectrum of going concern risks to supplement the current binary approach of determining whether disclosure of material uncertainty on going concern is required.
- Some participants noted a need for more disclosures on management's assessment that the going concern assumption is appropriate.
- Some participants noted that users find the use of both KAMs and material uncertainty related to going concerns confusing and suggested that the IAASB consider revisiting how the auditor's report discusses 'close call going concern assessments' in KAMs and material uncertainties in the going concern section.

Given the findings of our research, we collectively emphasise the following key messages.

- Stakeholders recognise that a holistic approach is needed to narrow the expectation gap related to fraud and going concern and that they all play a vital role in driving meaningful change.
- Addressing the knowledge gap provides an opportunity to ensure that the auditor's role and responsibilities, relating to both fraud and going concern, evolve in a more meaningful way. This further substantiates the initial findings of ACCA's report *Closing the expectation gap in audit* on the knowledge gap.
- Professional scepticism and applying professional judgement are among the key factors in addressing any performance gap related to fraud. These skillsets could be enhanced through further training.

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Discover the full report: https://www.accaglobal.com/gb/en/professional-insights/global-profession/closing-expectation-gap-audit_way-forward.html