Canadian Public Accountability Board
Conseil canadien sur la reddition de comptes

June 4, 2024

Submitted electronically

International Auditing and Assurance Standards Board (IAASB)
Mr. Thomas Seidenstein, Chair

Dear Mr. Seidenstein,

Response to 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 (the exposure draft)

The Canadian Public Accountability Board (CPAB) is Canada's independent public company audit regulator charged with overseeing audits performed by registered public accounting firms. CPAB is committed to protecting the investing public by contributing to public confidence in the integrity of financial reporting.

CPAB is a member of the International Forum of Independent Audit Regulators (IFIAR) and was a contributor to IFIAR's written response to the exposure draft. The purpose of our individual comment letter is to emphasize specific points we feel are most important in the Canadian context.

Overall comments

CPAB is supportive of the positive steps that the IAASB has taken to improve the audit procedures related to fraud in an audit of financial statements. We performed fraud thematic reviews in 2019 and 2021, the results of which, included in communications issued in 2020 and 2022, support our comments in this letter. We agree more robust requirements are needed to promote consistent behaviour and facilitate effective identification and assessment of risks of material misstatement due to fraud and to reinforce the importance of auditors exercising professional skepticism in fraud-related audit procedures throughout the audit. In addition, we support the proposed changes to the communication of key audit matters related to fraud.

The exposure draft would be strengthened with the addition of more requirements, clarity and examples to promote consistent application by auditors. Specifically:

- Add a stand-back requirement to the fraud standard.
- Emphasize the importance of conducting fraud inquiries and use of stronger language around purpose and objective of those inquiries.
- Include more robust examples of when it is not appropriate to rebut the presumption of the risks of material misstatement due to fraud in revenue recognition.
- Emphasize unnecessarily complex entity structure and related party transactions.
- Add a requirement to evaluate an entity's whistleblower programs.
- Demonstrate strong links between unpredictability in the selection of audit procedures to fraud risk factors identified.

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Stand-back requirement

A stand-back requires the auditor to evaluate all relevant audit evidence obtained. The auditor considers the outcome of the various risk assessment and further audit procedures, as well as any other observations in the aggregate, whether corroborative or contradictory, and determines whether sufficient appropriate audit evidence has been obtained in responding to the assessed risks of material misstatement due to fraud. While we understand the concerns expressed by the IAASB related to a proliferation of stand-back requirements, there are key standards that require the auditor to consider audit evidence obtained and evaluate such evidence holistically, using professional judgment throughout the engagement, including a stand-back requirement.

Our inspections have noted instances where auditors dismissed fraud risk factors or audit evidence that should have been further investigated. It is critical that auditors are open to the possibility that a material error due to fraud can occur, that they exercise professional skepticism and judgement and they perform a stand-back assessment when evaluating the results of audit procedures. The examples related to audit evidence published in our March 2022 communication to firms, *Audit evidence: Strengthening audit quality,* continue to be relevant. They highlight that fraud risk identification and assessment is an iterative and dynamic process occurring throughout the audit and that a stand-back assessment may alert the auditor when audit procedures have not adequately addressed fraud risks.

Below are some additional examples identified in recent inspections where the auditor did not identify and assess fraud risk factors that could result in a material misstatement, resulting in the auditor not obtaining sufficient appropriate audit evidence:

a. Revenue transactions occurred between two entities, where inventory from a particular location of entity A was sold to entity B, while entity B sold the same inventory to a different location of entity A. The economic substance and business rationale of the transactions and the appropriateness of the recorded revenue was not challenged by the auditor.

b. Entity A used the services and shared employees with entity B. The auditor did not have a sufficient understanding of why the services were performed by entity B given the shared employees. In addition, the auditor of entity A did not consider evidence that indicated entities A and B were related parties.

c. Entity A purchased equipment from entity B, a related party. Consideration for the equipment was paid for by entity A by transferring crypto assets through a crypto trading platform managed by entity B. The auditor performed substantive procedures to test the existence, ownership and valuation of the equipment by agreeing to invoices prepared by entity B and tracing the consideration paid to an internally generated report from the crypto trading platform. The auditor did not evaluate if there was a reasonable business rationale for the transaction or if there was any indication it may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

d. An entity used the services of a service organization, which was identified as a related party due to common key management of both entities. The agreement between both entities was amended by the same key management personnel, which resulted in additional charges paid to the service organization that were applied retroactively. The auditor did not evaluate if there was a risk of fraud related to the contract amendment or obtain evidence this amendment was reviewed and approved by those charged with governance who were independent of the service organization.

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Fraud inquiries

We believe that fraud inquiries of management, the audit committee and others at the entity including internal auditors, legal counsel, etc. should not be carried out by email or audio call. As highlighted in our May 2022 *Fraud Thematic Review*, in the audits we inspected in 2021, 25 per cent had fraud inquires carried out by email or audio call (nine and 16 per cent respectively). The reliability of information obtained through fraud inquiries is enhanced significantly when those inquiries are made in person and include senior members of the engagement team. This allows auditors to observe the body language of interviewees, which is important because interviewees with knowledge of fraudulent schemes may exhibit signs of discomfort during interviews. In-person interviews also allow auditors to have a less scripted, and therefore less predictable, two-way dialogue with interviewees as auditors obtain answers to follow-up questions in real time. We recommend strengthening the requirements related to fraud inquiries within paragraphs 34 and 35 by providing examples of how this can be achieved by the auditor, such as by holding interviews with the appropriate individuals and asking probing and clarifying questions.

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

In many audits, we observed that 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. The application guidance should be expanded to clarify that limiting the fraud risk to manual journal entries or the cut-off assertion is ordinarily not appropriate.

Unnecessarily complex entity structure and related party transactions

As noted in examples provided, we observed various situations where unnecessarily complex entity structures were not identified as potential fraud risk factors and situations where the business rationale of unusual transactions was not 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. Assessment of related party transactions should be specifically highlighted in the standard and additional examples should be added to paragraphs A59, A109 and Appendix 3 to highlight such potential fraud risk factors.

Whistleblower program

A study by the Association of Certified Fraud Examiners (ACFE)[1] found that 42 per cent of frauds reported by entities from around the world were detected through tips, with more than half of those tips coming from employees. Considering this, 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. If a listed entity does not have a whistleblower program the auditor should be satisfied that it is appropriate for the nature of circumstances of the entity, and if not, consider whether the lack of a whistleblower program is a deficiency in the entity's control environment that should be communicated to those charged with governance.

[1] Refer to page 21 of ACFE's: A Report to the Nations (2022).

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Unpredictability in the selection of audit procedures

Paragraph A114 discusses incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed. In our inspections, we often observed auditors incorporating an element of unpredictability by sampling a seldom-used account, changing the sampling method, or altering the testing approach for certain financial statement account balances from previous audits, consistent with the examples included in paragraph A114. The effectiveness of these methods for identifying and addressing the risk of fraud will vary depending on fraud risk factors identified by the auditors. In many instances, these procedures do not have a clear or direct link to the risk of fraud. Selecting audit procedures that incorporate an element of unpredictability should consider the specific circumstances of the audit and risks of material misstatement due to fraud. Some additional examples of how to incorporate an element of unpredictability in the selection of audit procedures have been included in IFIAR's written response to the Exposure Draft.

Closing remarks

We are supportive of the IAASB's work to improve the audit procedures related to fraud in an audit of financial statements. We encourage the IAASB to consider the specific matters highlighted in this letter to support more consistent application of the standard.

We would be happy to discuss our views further or answer any questions you may have about this letter. If you wish to discuss, please contact me (carol.paradine@cpab-ccrc.ca) or Stacy Hammett, CPAB Audit Standards Leader (stacy.hammett@cpab-ccrc.ca).

Yours truly,

Carol A. Paradine, FCPA, FCA
Chief Executive Officer

cc: Bob Bosshard, Canadian Auditing and Assurance Standards Board Chair
Brian Banderk, Canadian Securities Administrators Chief Accountants Committee Chair

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