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EY's response to the Accountancy Europe's recommendations on going concern and fraud

Dear Mr Boutellis-Taft,

EY welcomes the opportunity to offer its views on Accountancy Europe's (ACE) recommendations on going concern and fraud (the Papers). EY was also pleased to contribute to the development of the proposals through active participation in the relevant ACE Task Forces.

We support ACE proactively engaging in the growing debate about auditor responsibilities with respect to fraud and going concern and therefore we are broadly supportive of the recommendations set out in the Papers. We would like to stress that auditors cannot succeed in delivering for the stakeholders on these topics on their own: the corporate governance and reporting ecosystem, including management, boards, audit committees, standard-setters and regulators, need to work positively and constructively with auditors on fraud and going concern.

General considerations

Before making points that are specific to each Paper, we set out some general principles that are relevant to both Papers.

Internal controls

EY believes that Public Interest Entities (PIEs) should have a system of strong internal controls over financial reporting that includes going concern and fraud risk specifically. This system would set out clear roles for management, board, audit committee and internal audit.

For public interest entities, management and director certifications on the content of financial statements as well as the internal controls over financial reporting should be explored. There should be meaningful consequences for inappropriate certifications. In countries where certifications are already required, this has led to greater understanding by management and boards of the control environment and detailed work to ensure that appropriate internal controls are in place and operating effectively.

Communications with those charged with governance

In our view, the required communication about significant risks is not specific or robust enough for effective communication about fraud risks. We recommend a specific communication requirement for fraud risks to promote a two-way discussion about the fraud risks identified, the audit strategy to respond to such risks and the controls that have been implemented by the entity to address them. Views related to the effects of the entity's corporate culture on fraud risks and whether those charged with governance have considered the elements of the fraud triangle in their understanding of fraud risks would be particularly useful for the auditor to obtain.

We also believe that the communication requirement in ISA 570 (Revised)[1] should be enhanced, and application material developed, to promote a more robust dialogue with those charged with governance that would include sharing views about management's assessment of going concern, as well as a discussion of significant assumptions made in light of the identified events or conditions. The auditor could also communicate about the procedures performed to evaluate the assessment.

Fraud

We welcome ACE's recommendations and ideas for a stronger corporate governance and reporting ecosystem which require actions from all stakeholders involved. Collaboration is key to improving the prevention and detection of fraud, and ultimately protecting the victims of fraudsters.

EY issued a publication in November 2020 entitled *Preventing and detecting fraud: how to strengthen the roles of companies, auditors and regulators*. The report examines the following key areas:

Who is responsible for preventing and detecting fraud?

The prevention and detection of fraud within a company is primarily the responsibility of management under the oversight of those charged with the governance. Along with other members of the corporate governance and reporting ecosystem, auditors also play an important role in detecting material fraud.

Currently, auditors are responsible for providing reasonable assurance to shareholders that the financial statements are free from material misstatement, whether caused by fraud or error. Public opinion in many places, however, indicates that auditors are expected to play a role that extends beyond providing this reasonable assurance.

National legislation should specify the competent authority and the related procedures for PIE auditors to report irregularities suspected during the audit, including fraudulent acts[2]. There should be a designated competent authority for every type of PIE and clear guidance for auditors on how to comply with their legal obligations.

How EY is evolving the audit to detect fraud?

Drawing on both a skilled talent pool and state-of-the art technologies, EY is developing the auditing process to go beyond standard practice. Some specific developments are identified below:

- Mandating the use of data analytics for fraud testing in audits for all listed entities globally
- Using additional internal and external data and information to enable more nimble responses to external risk indicators, such as short sellers and whistleblowers
- Using electronic confirmations for audit evidence wherever possible
- Developing a proprietary fraud risk assessment framework for use with audit committees and those charged with governance

[1] International Standard on Auditing (ISA) 570 (Revised) *Going concern*
[2] Reference is made to Articles 7 and 12 of the Audit Regulation

- Mandating annual fraud training for all audit professionals that incorporates the experiences of EY forensics professionals
- Requiring the use of forensic specialists in the audit on a targeted-risk basis
- Using data, forensics, behavioural analysis and training in the audit to detect fraud

Data analytics

Companies have never been as data-rich as they are today, providing new opportunities to detect material frauds through data mining, analysis and interpretation. Auditors are ideally placed to carry out this role and are increasingly using data analytics to identify unusual transactions and patterns of transactions that might indicate a material fraud.

Use of forensic specialist on audits

Forensic specialists can provide increased insight into the fraud risks of an entity and can also assist with the development of procedures to respond to fraud risks. However, we believe that the effectiveness of using forensic specialists must be considered in the context of the objectives of each financial statement audit and the nature and circumstances of the specific engagement. As the facts and circumstances can vary significantly from one audit to another, the use of forensic specialists would not in all instances result in an increase in audit quality. Further, there are capacity constraints, as well as cost implications, to consider related to the availability and use of forensic specialists.

We do not believe that forensic specialists should be required for all audits. We suggest including guidance in ISA 240[3] that forensic specialists may be involved in the auditor's identification, assessment and/or response to fraud risks. Consideration could be given to establishing a requirement similar to that included in ISA 540 (Revised)[4], where the auditor is required to determine whether the engagement team requires specialized skills and knowledge to identify and respond to fraud risks; however, the scalability of such a requirement for less complex audits would need to be determined.

We also believe it is important to recognize in the guidance that a financial statement audit is broader in scope and not forensic in nature, and as a result not as effective as a separate forensic audit engagement given that forensic specialists are typically accustomed to a scope of procedures that is often narrowly focused on specific alerts or allegations.

Because forensic specialists have expertise to respond to specific instances of identified or suspected fraud, we support the consideration of a requirement for the auditor to determine whether a forensic specialist should be involved to assist in determining the implications of any such instance for the audit. This could include non-material frauds unless they are clearly inconsequential.

In the UK, the Brydon Review suggested that forensic skills and fraud awareness should be part of the formal qualifications and continuing professional development for all auditors. EY supports that recommendation.

Behavioural analysis and training

[3] International Standard on Auditing (ISA) 240 *The Auditor's Responsibility to Consider Fraud in an Audit of Financial statements*
[4] International Standard on Auditing (ISA) 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*

Technology is not a panacea, however, and the human element also comes into play. There is an opportunity for all involved – including management and boards, auditors and regulators – to focus more on corporate culture and behaviors to support fraud prevention and detection.

We are not supportive of requiring that the auditor apply a "suspicious mindset" when executing procedures to identify and respond to fraud in all cases for all audits. We believe that the concept of professional scepticism remains the appropriate concept to apply. Throughout the audit, the auditor should scale professional scepticism based on its understanding of the entity, the risk assessments performed, and the circumstances encountered through the audit.

For the auditor's procedures related to fraud, we agree that a heightened level of professional scepticism is warranted, and in certain circumstances (e.g., when concerns about management integrity have been identified) the auditor may need to scale up their scepticism to a level that one may equate with a "suspicious mindset". This approach is consistent with the continuum of professional scepticism described in the Global Public Policy Committee publication, *Enhancing Auditor Professional Scepticism*. Therefore, we suggest an approach whereby ISA 240 be enhanced to include guidance on the scaling of professional scepticism, including how facts and circumstances affect the level of professional scepticism applied.

Auditors' professional scepticism and moral courage can be boosted through education and training in topics such as behavioral science, including the concepts of conscious and unconscious bias. These opportunities could have profound implications for auditor education and qualifications, as well as standards and audit regulation in the future.

Promoting wider collaboration to effect change

We believe adopting a "three lines of defense" approach against fraud is useful to maximize the number of opportunities to prevent or detect fraud, comprising: corporate governance and reporting; the auditor; and capital markets supervision. The suggestions below draw on best practices or requirements from different countries across the globe. The public interest would be better served if they were applied more generally:

Corporate governance

We refer to the General considerations' section above regarding the need for a strong internal controls' system with specific roles assigned to each stakeholder, including, where relevant, certification requirements.

Companies could also do more to measure and oversee corporate ethical culture, pressure and rationalization. All actors in the corporate governance chain and reporting ecosystem, including auditors, should have strong whistle-blower programs in place that both encourage and protect those who report issues.

The auditor

Auditing standards should be reviewed to provide auditors with a stronger framework to detect fraud. Such a review should examine materiality, level of scepticism, use of forensic specialists, internal controls, access to and use of corporate culture and assessments of the pressure and rationalization elements, discussions with audit committees and public reporting. External auditors could be required to assess and report on a PIE's internal controls and risk management processes (including how the company monitors and tests compliance) to boards, regulators and the public.

Capital markets supervision

Minimum corporate governance and reporting standards (including the proposals above) should be a precondition for a listing on a major stock market index. In many places, auditors already have red-flag obligations to escalate, or determine whether to escalate, any concerns they have over potential breaches of laws and regulations that may impact the financial statements, to an appropriate authority. Where these obligations exist, they must be clearly enshrined in law or regulation.

Going concern[5]

We welcome the fact that ACE's recommendations recognise the role of the entire corporate eco-system i.e. management, boards, auditors and regulators on 'going concern' matters.

If ACE's eight main proposals were adopted on a harmonised basis across the EU we can foresee that there would be a step change in how the market identifies issues with a company's ability to continue as a going concern leading to the improved trust and confidence in the information reported by companies and ultimately improved functioning of the capital markets and economy at large.

Accounting requirements

We believe there is an underlying knowledge gap about the accounting requirements for going concern (partly due to lack of specificity in IAS1[6] regarding the underlying process management must go through to complete a going concern assessment) and the role of management versus the auditor. To address these gaps and because there is an interrelationship with accounting frameworks as it relates to the auditor's responsibilities for going concern, we recommend that the International Auditing and Assurance Standards Board (IAASB) engage with the IASB on clarifying going concern requirements in IFRS. Although we believe there are opportunities for the IAASB to enhance auditor responsibilities related to going concern independently of how these are dealt with in the financial statements, enhancements to accounting and related disclosure frameworks would facilitate a more robust basis for the auditor's responsibilities related to going concern.

Audit committees

We support ACE's recommendation five on audit committees for PIEs, however would go further to require such audit committees to disclose in the annual report and accounts what they have specifically done to exercise oversight and challenge over the work of management in relation to going concern.

Longer-term viability and resilience

We think that the going concern related ideas expressed in the paper, around longer-term viability/resilience and interconnected financial and non-financial information, should be further developed to avoid widening the expectation gap and to clarify the responsibilities of the different

[5] 'Going concern' is an economic and accounting term used to describe a company which is assumed to be financially stable enough to continue to operate for the foreseeable future. 'Foreseeable future' is usually regarded as being at least 12 months **from the date that the financial statements were approved**.
[6] International Accounting Standard (IAS) 1 *Presentation of Financial Statements*

parties involved. It would be helpful if ACE could also monitor developments with respect to resilience statements on which the UK Government is consulting currently.

We see a significant risk of unintended consequences, including widening the expectation gap, should auditor reporting requirements be expanded in a manner that would put the auditor in the position of disclosing information about the entity's viability that is not included in the financial statements, or is not included in the context of going concern. We also believe that the auditor's responsibilities need to be determined in context of the entity's reporting responsibilities. Because reporting responsibilities vary by jurisdiction (e.g., viability statements, solvency declarations), we do not view broader auditor responsibilities for auditing resilience (beyond the requirements of the applicable financial reporting framework) as within the purview of the IAASB.

Conclusion

EY is committed to work with boards, audit committees, standard setters, regulators and other parties in the corporate governance and reporting ecosystem to strengthen fraud detection and to enhance the assessment of/ communication on an entity's ability to continue as a going concern.

Finally, we also would like to refer to EY's response to the *Discussion Paper on Fraud and Going Concern in an Audit of Financial Statements* issued by the IAASB.

We hope these views are helpful inputs for ACE's current work and further consideration. We look forward to actively engaging in the further dialogue together with other stakeholders on going concern and fraud in the context of an audit of financial statements.

If you have any questions or comments on this letter, please contact Andrew Hobbs, EMEIA Public Policy Leader on +44 202 7951 5485 or by email: ahobbs@uk.ey.com.

Yours sincerely,

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