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Dear Keith,

Re: Comments - Proposal to revise ISA (UK) 240 (Updated January 2020) The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements

We appreciate the opportunity to comment on the consultation paper and impact assessment from the Financial Reporting Council (FRC) regarding proposed revisions to ISA 240 in the UK. This is a pivotal time for the audit market in the UK and overseas against a backdrop of increased scrutiny of the accounting profession and several high-profile instances of fraud.

ISA (UK 240) is a critical audit standard and the FRC's proposal is timely to address the concerns raised in reviews such as Sir Donald Brydon's independent review of the quality and effectiveness of audit.

Inflo was founded by former Big 4 auditors with the objective of making advanced technologies available to audit firms of all sizes, to improve the quality and relevance of the audit process through leveraging automated tools and techniques.

Many of the accounting firms falling under the scope of the FRC's regulation utilise Inflo as a third-party solution to enhance their audit services. Our work with these firms, as well as PAOs and international networks, provides us with a unique perspective on the UK and global audit market. This response letter articulates our views based on this work and our team's deep experience and specialisms.

If you would like to discuss any of our comments, please do not hesitate to contact us.

Yours sincerely,

Mark Edmondson

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Request for Input - Inflo

Proposal to revise ISA (UK) 240 (Updated January 2020) The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements

Question 1:

Has ISA (UK) 240 been appropriately revised to give increased clarity as to the auditor's obligations relating to fraud in the audit of financial statements. If you do not consider this to be the case, please set out why and how you believe those obligations should be clarified.

Yes. We believe the revisions proposed to paragraph 3, and specifically the references regarding frauds or suspected frauds potentially being material due to qualitative factors, are beneficial.

We do however, highlight an item of potential interest relating to auditor obligations over management override of controls. Paragraph 31 articulates this risk is present in all entities, and that it is a fraud risk, thus a significant risk. Yet nowhere in the extant standards is it made explicit that management override of controls is a significant risk on all audit engagements. The language used is also somewhat different to the language referencing the risk of fraud in revenue recognition within paragraph 26.

Given regulatory reviews have in the past reported on auditors inappropriately rebutting the risk of management override of controls alongside other misinterpretations of auditor's obligations we believe the current revision process could address this matter to cement understanding and ensure the avoidance of misunderstanding.

Question 2:

Have appropriate enhancements been made to the requirements for the identification and assessment of risk of material misstatement due to fraud, and the procedures to respond to those risks, to promote a more consistent and robust approach to the auditor's responsibilities in relation to fraud? If you do not consider this to be the case, please set out why and how you believe the requirements should be enhanced.

Yes – though we suggest some additional items for consideration.

While subtle, we believe the changes within paragraph 32 (a) will be helpful in clarifying some common misconceptions regarding procedures in response to fraud. The clearer articulation that journal entries include both manual and automated entries should ensure auditors no longer inappropriately exclude from journal entry testing transactions which they are assuming to be automated.

We believe though that given the significant advancements in the world of modern business since this standard was first drafted in 2004, the FRC should consider the continued appropriateness of paragraph 32 (a) (iii) and the related A44.

These paragraphs may risk being interpreted that such procedures are always required over journal entries at the end of the reporting and only sometimes required over entries during the period. Yet we believe a conclusion that fraud risk does not exist during the year would only be appropriate in the most exceptional of circumstances. We therefore recommend the wording of these paragraphs is inverted so the testing of journal entries and other adjustments during the period is expected rather than considered.

In practical application, the clarified definition of journal entries in 32 (a) combined with the increased engagement team discussion introduced in revision paragraphs 15-1 to 15-4 should reduce or eliminate auditors inappropriately excluding journal entries throughout the period from testing. Therefore, the inversion of paragraph 32 (a) (iii) would serve to clarify rather than expand expectations.

Based on the changes discussed here regarding journal entries, combined with the additional guidance added to paragraph A44, we believe any manual audit techniques which may currently be deployed by auditors to test journal entries will be ineffective across an expanded population, inclusive of automated journals throughout the period. We believe this is likely to require a greater adoption of automated tools and techniques to perform these procedures, which would benefit the quality of audit work in relation to fraud as well as the broader risk assessment and evidence gathering process.

While UK firms are generally well advanced in their adoption of ATTs in this area, many SMPs will need to give this additional thought when considering the impact on their implementation of these revisions. It may be worthwhile to reference this topic within the implementation assessment.

Question 3:

Have appropriate enhancements been made to the application material? If you do not consider this to be the case, please set out why and how you believe the application material should be enhanced.

Yes.

Question 4:

Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk assessment procedures, the procedures to respond to those risks and the evaluation of audit evidence obtained? If you do not consider this to be the case, please give reasons and describe how you consider the exercise of professional scepticism could be better supported.

Yes. The increased prominence to avoid bias and identify information which is contradictory as well as corroborative is beneficial.

Question 5:

ISA (UK) 240 establishes a rebuttable presumption that there are risks of fraud in revenue recognition (paragraph 26). Are there other account balances, transactions or disclosures for which such a rebuttable presumption should be established? If you consider there are, please identify them and set out why.

Yes. While revenue recognition is a long-established area of focus in relation to fraud, we believe consideration should also be given to a rebuttable presumption being introduced regarding cash and cash equivalents.

Cash and cash equivalents are quite uniquely relevant to both the misappropriation of assets and fraudulent financial reporting. They are a highly desirable asset for a perpetrator of fraud, while often the exposure point for more complex and sophisticated frauds, where an entity is unable to demonstrate the expected outputs of, for example, fraudulent overstatement of revenue.

Multiple high-profile frauds either have or have not been identified by auditors based on the effectiveness of quite established audit procedures. The performance of procedures such as external confirmations with financial institutions who provide banking facilities to the entity ensures a third-party verification over a key balance within the financial statements which is vital to going concern basis and viability of the business model.

The process also addresses key fraud risks relating to off-ledger liabilities or relationships hidden from the auditor, which alternative procedures fail to address.

Related party transactions is another area of potential consideration, although we believe this might be an unnecessary extension to the extant requirements of ISA 550.

Question 6:

ISA (UK) 240 specifies particular audit procedures responsive to risks related to management override of controls (paragraphs 31 – 33). Are there other audit procedures responsive to those risks, or any other risks of material misstatement due to fraud, that you believe should be required for all audits? If you consider there are, please describe them and set out why.

Possibly. Relating to our view regarding question 5, were a rebuttable presumption of fraud to be introduced regarding cash and cash equivalents, then it would be worthwhile considering the requirement to perform robust audit procedures such as external confirmation of bank accounts. Yet even were this risk regarding cash and cash equivalents highlighted in such a way, the ability to rebut the risk would make it impractical to make related procedures required for all audits.

Question 7:

In complying with the requirements of ISA (UK) 240 (Revised), the auditor may also need to consider whether there has been non-compliance with laws and regulations, and therefore that requirements in ISA (UK) 250 Sections A and B (Revised November 2019) also apply. Is it sufficiently clear in these ISAs (UK) of the interaction between them?

Yes. We believe so.

Question 8:

Are the requirements and application material sufficiently scalable, including the ability to apply ISA (UK) 240 (Revised) to the audits of entities with a wide range of sizes, complexities and circumstances? If you do not consider this to be the case, please set out why and how you believe that could be addressed.

Yes. We believe the revisions will require reasonable additional time and focus from engagement teams performing complex engagements over PIEs and/or groups where specialists will often form part of the engagement team. But this investment of time is essential for teams to provide appropriate effort and attention to the area of fraud.

We believe the requirements should not be impractical for SMPs auditing less complex entities where the overall engagement risk, and the risk in relation to fraud, is considered low.

If this interpretation is correct, the implementation guidance could perhaps better reflect this expectation rather than the blanket 10 hours per audit estimation currently included.

Question 9:

References to 'computer assisted audit techniques' have been updated to 'automated tools and techniques' and we have identified that these may enable more extensive testing and assist in identifying unusual transactions or relationships (paragraphs A44, A48 and A50). Is there other guidance in relation to the use of automated tools and techniques that you believe could assist auditors in relation to their obligations with regard to fraud? If you consider there is, please give an explanation of it.

Yes. A key topic in relation to the use of ATTs is the input data upon which such tools are executed. While we recognise this transcends across other efforts by the FRC in relation to topics such as audit evidence and information produced by the entity, there is an opportunity to re-emphasise the concept informally referred to as "rubbish-in-rubbish-out". Additionally, when considering the topic of fraud, if management is perpetrating fraud they are likely to also control the information and data provided to auditors for their review and analysis.

Many traditional methods of extracting data from client accounting systems are susceptible to manipulation by management. As an example, a firm would traditionally request a report is run by management to extract all general ledger transactions underpinning the financial statements. This report would commonly be extracted from the system into a file, such as an Microsoft Excel or text file. Yet a fraudulent member of management could quite easily tamper with the file to remove transactions or data fields likely to be flagged through an auditor's use of ATTs before they passed this data to their auditor.

This is an area of continued confusion, with some firms feeling the need to physically observe management running the requested reports and emailing them without any manipulation, something which is often unnecessary and now impractical given the increased performance of audit services remotely.

As auditors continue to increase their use of data within the audit process, the assessment of risk and expected level of testing over the reliability and accuracy of input data, as well as management tampering, is a vital component in the adoption of ATTs. ATTs themselves can provide solutions to this problem, in particular automated data ingestion techniques which extract data using techniques that eliminate the opportunity for management tampering.

Question 10:

Do you agree with the proposed effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted, which is aligned with the effective date of ISA (UK) 315 (Revised July 2020)? If not, please give reasons and indicate the effective date that you would consider appropriate.

Yes. Alignment with the timetable for the effective date of ISA 315 (Revised July 2020) is advantageous and the impact assessment expectations are not prohibitive.

Question 11:

Should an additional requirement be placed on auditors to have a specific discussion with those charged with governance on the risks of material fraud in the business, including those which are business sector specific, in order to further the risk assessment process in respect of the risk of material error in the financial statements relating to fraud?

No. We believe the extant requirements relevant to interactions with those charged with governance on this topic are adequate, or that should clarification of this be required this could be achieved through expanding application guidance.

Background to Inflo

Inflo is a high growth fintech company serving the audit and accounting profession. Inflo's technology provides streamlined, secure digital collaboration between accounting firms and their clients. Inflo also utilises financial data from the accounting system of an organisation to enhance the value of compliance and advisory accounting services, using techniques such as process mining, data analytics, advanced visualizations, machine learning and AI.

For more information on Inflo visit www.inflosoftware.com

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