OICV-IOSCO

Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valore

January 29, 2004

Mr. James Sylph
Technical Director
IFAC
545 Fifth Avenue 14th Floor
New York, NY 10017

Dear Mr Sylph,

Re: Proposed Revised Code of Ethics for Professional Accountants

As you know, IOSCO's Standing Committee No. 1 on Multinational Disclosure and Accounting recently commented on the International Auditing and Assurance Standards Board's (IAASB) exposure draft, The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements. In the course of reviewing this exposure draft, we noted a concern about the position taken with respect to communications by the auditor to regulatory and enforcement authorities.

We believe this concern relates in part to the adequacy and appropriateness of the guidance on confidentiality contained in Section 5 of Part A of the proposed revised Code of Ethics for Professional Accountants issued for comment in July 2003. We are therefore writing to bring our concern to the attention of the Ethics Committee so that it can be considered in the course of revising the Code of Ethics.

The essence of our concern is that the provisions of the IAASB's exposure draft do not strike an appropriate balance between the need for the auditor to preserve the confidentiality of client information and the public interest in ensuring timely disclosure of relevant information to regulatory and enforcement authorities. In part, the position taken in the IASSB exposure draft seems to be founded on restrictions on communication of information established through professional guidance, particularly Section 5 of Part A of the proposed revised Code of Ethics for Professional Accountants.

In our view, this professional guidance needs to be re-evaluated with a view to providing greater emphasis on the need to serve the public interest, subject, of course, to any constraints that may exist in law. The emphasis on serving the public interest is particularly relevant in the case of professional accountants serving as auditors of public companies.

Calle Oquendo 12
28006 Madrid
ESPAÑA
Tel.: (34.91) 417.55.49 • Fax: (34.91) 555.93.68
mail@oicv.iosco.org • www.iosco.org

To provide a more complete discussion of our concern, we have included with this letter a copy of our letter of January 13, 2003, addressed to the IAASB. We would draw to your attention the section on pages 6 and 7 under the heading "Communications to Regulatory and Enforcement Authorities".

If you have any questions or need additional information about our comments, please do not hesitate to contact me at (202) 942-4400.

Yours sincerely,

Scott A. Taub

Scott A. Taub
Chairman
IOSCO Standing Committee No. 1

CC: Chair, Ethics Committee
Chair, IAASB
Ms. Jan Munro

Organización Internacional
de Comisiones de Valores

International Organization
of Securities Commissions

Organisation internationale
des commissions de valeurs

Organização Internacional
das Comissões de Valores

OICU-IOSCO

January 13, 2004

Mr. James Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Re: Proposed Revised International Standard on Auditing 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements"

Dear Mr. Sylph:

IOSCO's Standing Committee No. 1 on Multinational Disclosure and Accounting is writing to comment on the Exposure Draft ("ED"), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements". We appreciate the opportunity to comment on this proposed standard, as it addresses an area of high interest to both regulators and investors.

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting, auditing, and professional standards. The comments we have provided herein reflect those matters on which we have achieved a consensus among members of Standing Committee No. 1 and are not intended to include all the comments that might be provided by individual members on behalf of their respective jurisdictions in the future.

Auditor responsibility to consider fraud in an audit of financial statements is a subject of long-standing concern that has become even more prominent in recent years. This topic has been the focus of numerous debates regarding an "expectation gap" between the level of assurance that auditors believe they are able to provide in financial statement audits, and public perceptions of what is, or ought to be, achieved by the auditor's work.

The existing body of International Standards on Auditing (" ISAs") provides that "reasonable assurance" in the context of an audit is "a high level of assurance, but not absolute assurance". While detecting fraud may be more difficult than detecting simple error because of efforts at

Plaza de Carlos Trías Bertrán, 7 Planta 3ª, 28020 Madrid, España · Tel.: + 34 (91) 417 55 49 · Fax: + 34 (91) 555 93 68
mail@iosco.org · www.iosco.org

concealment, investors rightfully expect that a properly conducted financial statement audit should provide a high level of assurance that the financial statements are free from material misstatements, regardless of cause.

We are pleased to see an ED that adds to coverage of this important subject area and we have a number of comments regarding areas where we believe further improvement is needed.

Our first general comment relates to the clarity and understandability of the International Standards on Auditing, a matter that has become of increasing concern. This proposed standard is affected, as are all other current standards and exposure drafts, by the need to improve clarity in distinguishing between procedures that are unconditional and always required, procedures that are presumptively required, and other guidance that the auditor should consider. This is a critical matter on which the IAASB needs to continue to focus, with a view to bringing the issue to a satisfactory conclusion as a matter of priority. Ensuring that the language and format of current ISAs is clear and understandable is an essential element in providing high quality standards for audits.

Our second general comment is of a procedural and transitional nature. With many ISAs in various stages of review, revision, and completion, we recognize that it is a challenge to maintain consistency in both principles and language among all works in progress. Nevertheless, it is very important to ensure that this standard is consistent with – and fully integrated with -- the recently issued audit risk standards, and that these and other related standards are responsive to the interests of investors and the concerns of regulators.

The following are further specific comments on provisions in this ED:

Introduction

In the seventh bullet in paragraph 2 (and also later in paragraph 51), the ED says that the auditor should evaluate the design of the entity's controls and determine whether they have been implemented. We believe that evaluating design and implementation should include consideration of whether the controls are "operating effectively", that is, the controls are capable of effectively preventing, or detecting and correcting, material misstatements, that they exist, and that they are being used. We suggest that this terminology, which is consistent with paragraph 54 in the Audit Risk ISA 315, be added to the text in the ED.

Characteristics of Fraud

In paragraph 9, it might be helpful to add the following additional examples to the bulleted items listed:

- Omitting or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

- Concealing conditions that would affect the amounts reported in the financial statements

In paragraph 12, last sentence, it may be helpful to add "experience has shown that" after the word "however".

Responsibilities of Those Charged with Governance and of Management

In paragraph 13, the second-to-last sentence would be enhanced if revised to say "Such a culture is rooted in a strong set of core values that *is communicated and demonstrated by management and those charged with governance* and that provides the foundation for employees as to how the entity conducts its business.

In paragraph 14, the proposed standard states that in exercising oversight responsibility, "those charged with governance consider the potential for management override of controls..." We recommend that a reference be added to guide the auditor to consider whether those charged with governance have also established *controls that would serve to prevent or detect management override*, for example, providing a hot line number through which employees or others might report suspected fraud, or an ombudsman whom employees, suppliers, or customers might contact if improper actions are suspected, and whether such controls have been implemented and are operating effectively.

Responsibilities of the Auditor, and Professional Skepticism

Paragraphs 16-23 contain just one positive statement regarding the responsibilities of the auditor. In contrast, there are numerous statements made regarding what an auditor cannot do and conditions that may interfere with the audit, as well as what the auditor should not be held responsible for. Much of this discussion would be appropriate in a section providing background information on fraud and audits, but is not, in our view, appropriate in a section that purports to describe the auditor's responsibilities.

Rather than being written with the recurring negative theme about what the auditor is "only" able to achieve, the section on the auditor's responsibilities could be written with a more positive, yet still realistic tone along the lines of "fraud is more difficult to detect than simple error, and in view of this the audit needs to have an enhanced level of vigilance for both risk of fraud and potential signs of fraud." More coverage should be provided about the need for the auditor to be vigilant and exert professional skepticism, particularly in connection with evaluating and accepting explanations from all levels of management. Experience has shown that override may occur at any level.

The standard also needs to mention that those charged with governance may be involved in fraud. Professional skepticism should be exercised in the auditor's consideration of the nature and effectiveness of the entity's system of governance. Instances have been found of collusion as well as neglect at the board of directors level, and all information about the governance of the entity is relevant to detection of potential fraud. The last sentence of paragraph 20 provides a summary of the auditor's responsibility and accountability. We would suggest that this sentence be amended to read as follows: "Whether the auditor has performed an audit in accordance with ISAs is determined by the sufficiency and appropriateness of the audit procedures performed in the circumstances, the suitability of the auditor's judgments in applying the ISAs, and the suitability of the auditor's report based on the results of the audit." The context for our suggested revision arises from points that have been made by IAASB members and others that "auditing standards should be principles-based" and "all audits require considerable exercise of professional judgment on the part of the auditor". These are statements with which we agree; however, we believe it is also important to emphasize that auditors will be held accountable for their professional judgments.

Attachment A includes an illustration of some of the kinds of statements that we believe might be more appropriate to a section describing responsibilities of the auditor. This material is provided only as illustrative text for the Board's consideration in its deliberations, and is not definitive of all content that we believe might be included in any redraft of paragraphs 16-20.

In regard to authentication of documentation as discussed in paragraph 23, we would recommend revision as follows (change shown in italics):

"*While* an audit performed in accordance with ISAs *ordinarily does not involve specific measures to authenticate documents*, nor is the auditor trained as or expected to be an expert in such authentication, *an auditor should consider the reliability of all information to be used as audit evidence, including controls over its preparation and maintenance where relevant.* Unless the audit reveals audit evidence to the contrary, the auditor ordinarily accepts records and documents as genuine. However, the auditor should also consider performing additional procedures to address the risk of fraudulent documents in other circumstances, for example, when a document is the sole supporting evidence for a material financial statement amount and is of a nature that is susceptible to fraud."

Discussion Among the Engagement Team

Paragraph 25 states that "ordinarily the discussion involves the key members of the engagement team." This very general statement which appears to leave it entirely up to the judgment of the engagement partner as to who will be involved in the discussions or receive information about them. We believe that all members of the engagement team should either be included in the discussions or receive some communications regarding the results of the discussions, so that no one, including those at the junior level who may be in a position to discover evidence of fraud, is excluded from receiving significant information about the entity.

Risk Assessment Procedures

In paragraph 43, the statement, "The fact that fraud is usually concealed can make it very difficult to detect" and the passage that follows are overly conclusive and seem to downplay the chances that an auditor may detect fraud. We suggest revising the sentence as follows: "The fact that fraud usually involves schemes designed to conceal it…" or "The fact that fraud usually involves attempts at concealment…can make it very difficult to detect. Nevertheless, through the exercise of professional skepticism and increased vigilance when obtaining an understanding of the entity and its environment, including its internal control, the auditor may identify ...etc" We also suggest providing coverage of how the auditor can and should use his consideration of any fraud risk factors present to increase the likelihood that material misstatements will be detected.

Assessment of the Risk of Material Misstatement Due to Fraud

ISA 580, Management Representations, recognizes that representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. Accordingly representations from management cannot be a substitute for the auditor obtaining audit evidence to be able to draw conclusions on which to base the audit opinion.

Communications with Management and Those Charged with Governance

We believe that paragraph 89 should be clarified. In the last sentence of paragraph 89, in a discussion of the auditor reporting evidence that fraud involving senior management or involving a material misstatement exists or may exist, the phrase appears "...the auditor ordinarily orally reports such matters as soon as practicable and considers whether it is necessary to also report such matters in writing." It would seem that the auditor would always make a written report on such matters in addition to any oral report made.

Communications to Regulatory and Enforcement Authorities

The opening sentence in paragraph 95 is overly negative and pessimistic about the auditor's ability to report fraud. While this statement has been taken from a similar statement in ISA 250, it is a statement that was developed some years ago and is not in line with public expectations as they exist today. The statement leads the reader to assume that the standard setter knows the conditions that exist in each country, and that such reporting is widely precluded. We believe that this is not the case and that it would be a matter of the current legal framework in each jurisdiction. It would be more helpful and more balanced to turn this sentence around to be more positive about the potential for the auditor to provide benefit in this area.

Instead, it might be said in the ED that "the auditor plays a key role in providing assurance to the capital markets and this role is often supported by regulation and legislation requiring direct or indirect reporting by auditors to government authorities when fraud is detected. For example, (the text following the previous sentence would repeat the financial institution example now in the ED.) Other examples which could be mentioned include regulatory and legal requirements to report misstatements to authorities in cases where management and those charged with governance of public companies fail to take corrective actions when advised of fraud by the auditor."

Although reporting to third parties, including government, is largely dependent on the legal framework in each jurisdiction, Standing Committee No. 1 wishes to emphasize that it is in the public interest for the auditor to seek legal counsel and search for an appropriate way to make a report whenever possible.

SC 1 notes that paragraphs 5.1 of the draft IFAC Code of Ethics and 4.2 of the current code require that confidentiality should always be observed unless there is a legal or professional duty to disclose. In the absence of a legal duty to disclose, this requirement of the Ethics Code serves to preclude reporting because no professional obligation exists. SC 1 believes the current Code and professional obligation should be revised to balance the obligation of confidentiality and the public interest. SC 1 urges the IAASB and the Ethics Committee to review the interaction of the guidance in this area, in order to provide a greater emphasis on the public interest, consistent with legal frameworks. This ISA needs to set a clear obligation to report, if the legal framework allows for or does not prohibit this, and provide other guidance that helps the auditor.

Conclusion

Thank you for the opportunity to comment on this important exposure draft. If you have any questions or need additional information regarding the comments of Standing Committee No. 1, please do not hesitate to contact me at (202) 942-4400.

Sincerely,

Scott Taub
Chairman
IOSCO Standing Committee No. 1

Illustrative Attachment

Inherent Difficulties in Detecting Fraud

16. As described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs.

17. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends in part on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is sometimes difficult to determine whether misstatements in judgmental areas, such as accounting estimates, are caused by fraud or error.

18. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist in carrying out a fraud, with or without the employees' knowledge.

19. The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs. Whether the auditor has performed an audit in accordance with ISAs is determined by the sufficiency and appropriateness of the audit procedures performed in the circumstances,

the suitability of the auditor's judgments in applying the ISAs, and the suitability of the auditor's report based on the results of the audit."

Responsibilities of the Auditor

20. As noted above, an auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. However, an auditor conducting an audit in accordance with ISAs obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Reasonable assurance as used in ISAs indicates a high level of assurance, but not absolute assurance. As such, an auditor must plan and perform the audit with a goal of providing a high level of assurance that misstatements due to fraud, in addition to those due to error, will be identified.

20A. In designing audit procedures to provide reasonable assurance of detecting misstatements due to fraud, an auditor considers the fact that audit procedures that are effective for detecting error may be ineffective for detecting fraud. As such, an auditor needs to have an enhanced level of vigilance for both risk of fraud and potential signs of fraud. In addition, the auditor considers the potential for management override of policies and procedures in designing audit procedures to detect fraud. The remainder of this ISA provides additional guidance on considering the risk of fraud in an audit and designing procedures to detect misstatements due to fraud.