CHAPTER 3

IAASB discussion paper on expectation gap

This article aims to:
Summarise the key challenges and issues regarding the expectation gap relating to the role of an auditor, and areas where IAASB seek responses.

Recently, the International Auditing and Assurance Standards Board (IAASB) has issued a discussion paper[1] to deliberate and gather perspectives from all the stakeholders about the role of the auditor in relation to fraud and going concern in an audit of financial statements. The purpose of the discussion paper is to obtain input on matters about whether the auditing standards relating to fraud and going concern reman fit-for-purpose in the current environment.

The discussion paper pointed out that in recent years there have been certain high-profile corporate failures or significant accounting restatements around the globe. This has led to erosion of trust in the financial reporting ecosystem. Therefore, corrective steps in all parts of the financial reporting ecosystem are needed to address this crisis of confidence in financial reporting.

It highlighted that many commentators continue to challenge the auditor's role in respect to fraud and going concern. The paper mentions that the concept of an audit 'expectation gap' has existed for decades and has been described in several ways. In the discussion paper, the IAASB referred to the May 2019 publication by the Association of Chartered Certified Accountants (ACCA) titled 'Closing the Expectation Gap in Audit' which describes three components of the expectation gap: the 'knowledge gap', the 'performance gap' and the 'evolution gap'.

In order to narrow down the expectation gap, all parts of the financial reporting ecosystem would have to play their role in improving external reporting in relation to fraud and going concern.

Key areas of deliberation

Following are the key areas of challenges and issues deliberated by the IAASB:

- **Corporate culture:** The current auditing standards (ISAs) emphasise the importance of a culture of honesty and ethical behaviour, reinforced by active oversight, as well as management and those charged with governance by placing a strong emphasis on fraud prevention and fraud deterrence. The discussion paper seeks inputs on the impact of corporate culture on fraudulent financial reporting and additional audit procedures that should be considered by the IAASB in this regard.
- **Forensic specialists or other relevant specialists:** The current auditing standards (ISAs) do not specifically require the use of forensic specialists. However, the use of forensic specialists on an audit engagement more broadly may help narrow the evolution gap by strengthening the procedures of the auditor with respect to fraud. Forensic specialists or other relevant specialists may help provide increased insight into the fraud risk of a company. It is important to note that a financial statement audit is broader in scope and not forensic in nature, and the effectiveness of using forensic specialists or other relevant specialists must be considered in the context of the objectives of each financial statement audit and the nature and circumstances of the specific engagement. In addition, many audit firms do not have access to these specialists in-house, and therefore, this may present scalability issues.

  Additionally, training in both forensic accounting and fraud awareness could be enhanced as part of the formal qualification and continuous learning process for financial statement auditors.

  The discussion paper seeks views on requiring the use of forensic specialists or other relevant specialists in a financial statement audit.
- **Non-material fraud:** While the auditor is not required to design and perform specific procedures with regard to misstatements that are not material, any misstatement related to fraud that has been identified may be indicative of a bigger issue. For example, evidence that an employee is not acting with integrity may also reflect broader issues in the entity's corporate culture. Furthermore, frauds that are not material that recur over long periods of time may become material (quantitatively or qualitatively) in the future.

  As the world is changing and non-material frauds are becoming more prevalent, the discussion paper explores whether more needs to be done in relation to non-material frauds identified e.g., additional audit procedures and what types of procedures.

1. Fraud and going concern in an audit of financial statements: Expectation gap published by IAASB in January 2021

- **Third party frauds:** Current auditing standards[2] contain guidance on identification and assessment of risks of material misstatement due to fraud. However, audit procedures should be designed to detect fraud that is not directly related to risks of material misstatement (e.g., cyber-attacks resulting in theft of customer information) and are rather related to reputational or operational risk. This would expand the scope of the financial audit beyond what is currently required.

  The discussion paper seeks feedback about the auditor's role in relation to third party fraud that does not result in a material misstatement of the financial statements but may have a severely negative impact on the entity (e.g., cybercrime attacks).

- **Going concern, concept of resilience and material uncertainty:** The assumption that an entity will be able to continue as a going concern is fundamental to the preparation of the financial statements. Given the number of high-profile corporate failures, some stakeholders are also looking for enhanced procedures for the auditor with regard to the entity's ability to continue as a going concern.

  Certain jurisdictions require management to report on other concepts of the company's resilience. For example, in the UK, certain entities have a responsibility to report on the entity's longer-term viability.

  Therefore, the discussion paper seeks perspectives on whether entities should be required to assess their ability to continue as a going concern for longer than 12 months, and therefore, whether auditors should be required to consider this longer time period in their assessment, beyond the current required period. If stakeholders believe a longer timeframe should be required, alignment will need to be retained between the requirements under the applicable financial reporting framework and the auditing standards for auditors to be able to adequately perform their procedures.

Next steps

The discussion paper seeks an open communication among companies, those charged with governance, investors, regulators, and others. Additionally, the synergies between auditors, standard-setters and regulators and audit oversight bodies, is critical to the effective functioning of the financial reporting ecosystem. Some matters related to the expectation gap may also need to be addressed by regulators and audit oversight bodies as appropriate, as they are in the unique position to influence auditors, and management and those charged with governance through oversight, stakeholder engagement, inspections and enforcement actions.

2. ISA 240, *The auditor's responsibility to consider fraud in an audit of financial statements*