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Accessible Version

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Mr. Willie Botha  
Technical Director  
International Auditing and Assurance Standards Board  
529 Fifth Avenue  
New York, NY 10017

**GAO's Response to the International Auditing and Assurance Standards Board's Proposed International Standard on Auditing 240 (Revised), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, and Proposed Conforming and Consequential Amendments to Other ISAs**

Dear Mr. Botha:

This letter provides GAO's comments on the International Auditing and Assurance Standards Board's (IAASB) proposed International Standard on Auditing (ISA) 240 (revised), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and *Proposed Conforming and Consequential Amendments to Other ISAs*. GAO promulgates generally accepted government auditing standards (GAGAS), which provide professional standards for auditors of government entities in the United States.

We support the IAASB's efforts to update ISA 240 to improve and clarify the standard for auditors. We identified several areas in our responses where some improvements and clarifications would be helpful. Specifically, we believe requirements and application material should be clarified to better expand upon ISA 315 and other ISAs. We believe paragraph 41 is not appropriate for many public sector entities, as generally these entities' transactions consist primarily of expenditures rather than earned revenues. Since the second sentence of extant ISA 240 paragraph 27 was moved to exposure draft 240 (ED-240) application material paragraph A112, there is now a disconnect between the language in ED-240 paragraph 41 and paragraph 70(d). We suggest that the IAASB consider restoring the text in paragraph A112 to paragraph 41. Also, we suggest that the IAASB add an additional application material paragraph under the heading "Considerations Specific to Public Sector Entities" as follows:

*A112A. In public sector entities, there may be fewer incentives or pressures to engage in fraudulent financial reporting by intentionally overstating or understating revenue. In public sector entities, there may be more fraud risk factors related to expenditures, especially when such expenditures are subject to statutory limits.*

We do not believe the approach taken to link the standards consistently communicates a specific fraud focus. Instead, in places ED-240 repeats requirements from other ISAs with changes that are intended to be specific to ED-240 but are unclear in their design. We recommend more succinctly linking ED-240 to the other ISAs and then providing additional

application material paragraphs that specifically explain the application of the other ISA requirements for ED-240.

In addition, we have concerns about the implications of paragraph A174, which also refers to ISA 701 paragraph A37. These paragraphs note that one of the potential results of the required key audit matters (KAMs) will be that management will include new or enhanced disclosures in the financial statements or annual reports about the KAMs' subject matter. Such additional reporting may be desirable. However, if report users have communicated that they need "more robust information about identified fraud or suspected fraud or identified deficiencies in internal control that are relevant to the prevention and detection of fraud" (paragraph A174), then there should be direct efforts to require such disclosures in the applicable financial reporting frameworks. We do not believe that it is appropriate to attempt to effect changes in generally accepted accounting principles through KAMs.

Further, ED-240 paragraph A106 could be interpreted to mean that misappropriation of assets is not a common type of fraud for private sector entities. We believe that additional language would clarify the application material and make it specific for public sector entities. First, we believe that this paragraph should note that there is generally less incentive or motivation to commit fraudulent financial reporting in the public sector. Second, we believe that there should be an explanation that misappropriation of assets may be more prevalent in the public sector due to the actions of third parties that commit fraud to take advantage of various public sector grant programs and activities. We suggest revising this paragraph as follows:

*A106. In public sector entities, there are generally fewer incentives or motivations to commit fraudulent financial reporting. Misappropriation of assets (e.g., misappropriation of funds) may be a more common type of fraud risk factor. Further, there may be greater risks of material misstatement due to fraud committed by third parties in the public sector, as there may be more numerous opportunities to defraud the public sector through grant programs, contracts, and social welfare or benefit programs.*

Finally, we recommend changing the definition of fraud to remove the phrase "unjust or illegal." We believe the concept of justification is frequently used to support an individual's fraudulent actions as just. We suggest modifying the definition as follows:

*Fraud— An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain a personal or professional advantage.*

Our responses to the IAASB's 12 specific questions follow in the enclosure to this letter.

Thank you for the opportunity to comment. If you have questions about this letter or would like to discuss any of our responses, please contact me at (202) 512-3133 or [dalkinj@gao.gov](mailto:dalkinj@gao.gov).

Sincerely,



James R. Dalkin  
Director  
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Enclosure

**Enclosure**

**Responses to Questions to the International Auditing and Assurance Standards Board's  
Proposed International Standard on Auditing 240 (Revised) and Proposed Conforming  
and Consequential Amendments to Other ISAs**

**1. Does exposure draft 240 (ED-240) clearly set out the auditor's responsibilities relating to fraud in an audit of financial statements, including those relating to non-material fraud and third-party fraud?**

We support the International Auditing and Assurance Standards Board's (IAASB) effort to clarify auditor's responsibilities relating to fraud in an audit of financial statements. We note that the inclusion of third-party fraud is not a new concept in ED-240 as it was part of the definition in extant International Standards on Auditing (ISA) 240, but it is not clear from the added application material what additional responsibilities the auditor may have. The example cited in paragraph A16 can be clarified to indicate that when an auditor is informed of a cybersecurity breach, the auditor will initially need to review the auditee's actions before determining what additional responsibilities the auditor has with regard to appropriate laws, regulations, and relevant ethical requirements.

**2. Does ED-240 reinforce the exercise of professional skepticism about matters relating to fraud in an audit of financial statements?**

We support the IAASB's effort to reinforce the exercise of professional skepticism in ED-240, but we believe that for the requirements and application materials the board should more clearly identify what practitioners should be doing to meet the requirements. We believe that it is unnecessary to repeat "the auditor shall maintain professional skepticism throughout the audit" in the requirements (paragraph 19) and key concepts section of ISA (paragraph 12). We suggest this statement should just be included in the requirements (paragraph 19) to be clearer to practitioners. Paragraphs 20 and 21 are listed as requirements, but it is not clear how they fundamentally differ from paragraph 19. We recommend moving paragraphs 20 and 21 to application material.

Further, we do not believe that ED-240 paragraph 43 adds substantial value to the proposed standard. Paragraph 19 already requires the auditor to maintain professional skepticism throughout the audit, which would include designing and performing audit procedures in response to the assessed risks of material misstatement due to fraud in an unbiased manner. We do not believe that auditors will be able to clearly identify what is expected by paragraph 43. We recommend that this text be moved to application material for paragraph 19 as additional examples of how an auditor maintains professional skepticism in the audit.

The inclusion of examples in the boxes in the application material for professional skepticism do not clearly tie to the related application materials. We suggest better establishing a link to the examples by including a lead-in in the prior paragraph or a specific lead-in for the examples. Further, some of the examples in paragraph A26 imply that the auditor has an affirmative

responsibility to validate the authenticity of audit evidence. We believe that these examples would only be applicable if certain conditions come to the auditor's attention.

**3. Does ED-240 appropriately build on the foundational requirements in ISA 315 (Revised 2019) and other ISAs to support a more robust risk identification and assessment as it relates to fraud in an audit of financial statements?**

We support a robust risk identification and assessment related to fraud in an audit of financial statements. We believe that some clarification of the requirements and application material is necessary to better build on ISA 315 and other ISAs. Specifically, we believe that the description of fraud risk factors in paragraph 29(a)(ii) should be part of the application material for the definition of fraud risk factors in paragraph A22. This presentation would provide more detail when fraud risk factors are defined and provide for consistent examples throughout ED-240. In addition, we believe paragraph 30 does not provide sufficient fraud focus to differentiate it from the requirements from ISA 500 paragraph 11. Further, paragraph 42 is phrased in a manner that contradicts the concept of performing an assessment of the risk of material misstatement due to fraud by designating as "significant risks" the risks of management override of controls. We believe that the paragraph should be rephrased and moved to be part of paragraph 40 as follows:

*(c) Treat the risks of management override of controls as significant risks of material misstatement due to fraud, due to the unpredictable way in which management is able to override controls.*

We believe paragraph 41 is not appropriate for many public sector entities, as generally these entities' transactions consist primarily of expenditures rather than earned revenues. Since the second sentence of extant ISA 240 paragraph 27 was moved to application material paragraph A112 of ED-240, there is now a disconnect between the language in ED-240 paragraph 41 and ED-240 paragraph 70(d). We suggest that the IAASB consider restoring the text of paragraph A112 to paragraph 41. Also, we suggest that the IAASB add an additional application material paragraph under the heading "Considerations Specific to Public Sector Entities" as follows:

*A112A. In public sector entities, there may be fewer incentives or pressures to engage in fraudulent financial reporting by intentionally overstating or understating revenue. In public sector entities, there may be more fraud risk factors related to expenditures, especially when such expenditures are subject to statutory limits.*

ED-240 paragraphs 33 through 40 are intended to build on ISA 315, but after we compared the paragraphs with the referenced paragraphs in ISA 315, we do not believe that the paragraphs do this. We believe that ED-240 creates inconsistencies between the standards. For example, in ED-240 paragraph 33, we do not believe that the understanding of the entity and its environment builds upon ISA 315 but instead creates confusion with what should be applied. ISA 315 paragraph 19 has additional considerations that are not included in ED-240. Given the potential for third-party fraud and the potential to obtain an unfair or inappropriate advantage in a regulatory environment, we believe that the auditor should also consider external and regulatory factors, as required by ISA 315 paragraph 19(a)(ii). We further suggest more clearly identifying what is specifically additive for fraud rather than restating ISA 315.

For ED-240 paragraph 34(b), we suggest splitting the requirement into sub-sections, thus more clearly identifying the requirements for the auditor and how they expand upon the more limited requirements in ISA 315. As currently written, it is possible to interpret the compound clauses in multiple ways.

**4. Does ED-240 establish robust work effort requirements and application material to address circumstances when instances of fraud or suspected fraud are identified in the audit?**

We believe that the IAASB should consider if the work effort requirements and application material exceed what may be appropriate when instances of fraud or suspected fraud are identified at the auditee during the audit. In ED-240 paragraph 55, the requirements in (a) through (d) for fraud or suspected fraud apply without consideration for materiality. In addition, we believe (a) through (d) in paragraph 55 go beyond “obtain an understanding of” by evaluating and making determinations. We recommend revising the requirements to align the work efforts in paragraph 55(a) through (d) with those appropriate for “obtaining an understanding” and consider whether these procedures are appropriate for every instance of fraud or suspected fraud, even those that are clearly insignificant to the risk of material misstatement of the financial statements. Further, paragraph A10 provides guidance for responding to suspected fraud by an outside party. We suggest the paragraph more clearly refer to third-party fraud or suspected fraud consistent with other sections of ED-240.

**5. Does ED-240 appropriately enhance transparency about matters related to fraud in the auditor’s report?**

While we support the concept of including reporting on matters related to fraud in the auditor’s report, we do not use key audit matters (KAM) as part of the reporting structure in our jurisdiction for fraud. Generally accepted government auditing standards (GAGAS) has specific requirements to report on fraud that is material, whether quantitative or qualitative. However, these reporting requirements differ from those proposed in ED-240 paragraphs 61 through 64. We believe requiring auditors to include a section of KAMs specifically devoted to fraud is problematic. First, a discussion of certain fraud risk factors and identified and assessed risks of material misstatement due to fraud may not be understood by all report users, particularly less sophisticated users. Further, fraud could still exist even if there are no KAMs related to fraud to communicate from a properly planned and executed audit. In such instances, users may misinterpret the implications of a statement such as that required by paragraph 64.

We also have concerns about the implications of paragraph A174, which refers to ISA 701 paragraph A37. These paragraphs note that one of the potential results of the required KAMs will be that management will include new or enhanced disclosures in the financial statements or annual reports about the KAMs’ subject matter. Such additional reporting may be desirable. However, if report users have communicated that they need “more robust information about identified fraud or suspected fraud or identified deficiencies in internal control that are relevant to the prevention and detection of fraud” (paragraph A174), then there should be direct efforts to require such disclosures in the applicable financial reporting frameworks. We do not believe that it is appropriate to attempt to effect changes in generally accepted accounting principles through KAMs.

**6. In your view, should transparency in the auditor’s report about matters related to fraud introduced in ED-240 be applicable to audits of financial statements of entities other than listed entities, such as PIEs?**

As noted in our response to question 5, the reporting on fraud that is material, whether quantitative or qualitative, is a requirement for an audit performed in accordance with GAGAS. These include but are not limited to audits of federal, state, and local government entities within the United States.

- 7. Do you agree with the IAASB’s decision not to include a separate stand-back requirement in ED-240 (i.e., to evaluate all relevant audit evidence obtained, whether corroborative or contradictory, and whether sufficient appropriate audit evidence has been obtained in responding to the assessed risks of material misstatement due to fraud)?**

We agree with the IAASB’s decision to not include a separate stand-back requirement in ED-240. While we believe that the concept of a stand-back requirement for an engagement is useful and beneficial to the overall quality of the engagement, specifically including a stand-back requirement in ED-240 may duplicate other stand-back provisions without a noticeable benefit.

- 8. Do you believe that the IAASB has appropriately integrated scalability considerations in ED-240 (i.e., scalable to entities of different sizes and complexities, given that matters related to fraud in an audit of financial statements are relevant to audits of all entities, regardless of size or complexity)?**

The IAASB may need to consider how an audit of a less complex entity (LCE) works and consider whether specific requirements or guidance may be necessary to apply a revised ISA 240 to LCE audits. Further, additional application material related to immaterial and third-party fraud and the guidance around qualitative fraud would be helpful, particularly for audits of larger and more complex entities.

- 9. Does ED-240 have appropriate linkages to other ISAs (e.g., ISA 200 (Revised), ISA 315 (Revised 2019), ISA 330, ISA 500, ISA 520, ISA 540 (Revised), and ISA 701) to promote the application of the ISAs in an integrated manner?**

While we support sufficiently linking ED-240 to other ISAs, we do not believe the approach taken to link the standards consistently communicates a specific fraud focus. Instead, in places ED-240 repeats requirements from other ISAs with changes that are intended to be specific to ED-240 but are unclear in their design. We recommend more succinctly linking ED-240 to the other ISAs and then providing additional application material paragraphs that specifically explain the application of the other ISA requirements for ED-240.

- 10. Are there any other matters you would like to raise in relation to ED-240? If so, please clearly indicate the requirements(s) or application material, or the theme or topic, to which your comment(s) relate.**

As part of our review of the ED-240, we identified a few areas for which we suggest changes. We recommend changing the definition of fraud to remove the phrase “unjust or illegal.” We believe the concept of justification is frequently used to support an individual’s fraudulent actions as just. We suggest modifying the definition as follows:

*Fraud— An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain a personal or professional advantage.*

In addition, we believe that there is frequently an unclear connection between the examples in boxes in the application material and the surrounding application material paragraphs. We suggest removing these boxes if they are not more clearly introduced and linked to the related application materials. If the examples are maintained in the documents as they are currently presented, then they should have specific discrete paragraph numbers so they can be clearly

identified within the guidance. Placing the examples in a box after an application material paragraph does not clearly connect the two.

In paragraph 36(b), we believe the structure of the sentence should be revised to clearly reflect the conditional nature of the requirement. We suggest the revision as follows:

*(b) If an internal audit function exists, inquire with appropriate internal audit individuals about whether they have knowledge of any fraud or suspected fraud, including allegations of fraud, affecting the entity and to obtain their views about the risk of fraud.*

We believe that paragraph 38 should be reorganized to better convey the requirement as follows:

*38. In applying ISA 315 (Revised 2019), the auditor's understanding of the entity's control activities component shall include identifying controls designed to prevent or detect fraud, including controls over journal entries, that address risks of material misstatement due to fraud at the assertion level.*

Paragraph A106 is not clearly written. As proposed, it could be interpreted to mean that misappropriation of assets is not a common type of fraud for private sector entities, which is not necessarily true. We believe that additional language would clarify the application material and make it specific for public sector entities. First, we believe that this paragraph should note that there is generally less incentive or motivation to commit fraudulent financial reporting in the public sector. Second, we believe that there should be an explanation that misappropriation of assets may be more prevalent in the public sector due to the actions of third parties that commit fraud to take advantage of various public sector grant programs, contracts, and social welfare/benefit programs. We suggest revising this paragraph as follows:

*A106. In public sector entities, there are generally fewer incentives or motivations to commit fraudulent financial reporting. Misappropriation of assets (e.g., misappropriation of funds) may be a more common type of fraud risk factor. Further, there may be greater risks of material misstatement due to fraud committed by third parties in the public sector, as there may be more numerous opportunities to defraud the public sector through grant programs, contracts, and social welfare or benefit programs.*

**11. Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing ED-240.**

We do not plan to translate the ISA, so we do not have any comments regarding translation issues.

**12. Given the need for national due process and translation, as applicable, and the need to coordinate effective dates within the Going Concern project and the Listed Entity and PIE – Track 2 project, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning approximately 18 months after approval of the final standard. Earlier application would be permitted and encouraged. Would this provide a sufficient period to support effective implementation of the ISA?**

There are numerous IAASB projects under way that will require national standard setters to update their standards, which will then require audit organizations to make corresponding

changes in their audit programs and report templates. We suggest that the IAASB consider the projected completion dates for each project and the collective implementation efforts that these projects will entail when determining the appropriate implementation period. We agree with permitting and encouraging earlier application of the final standards, as this will permit an audit organization to align implementation with its existing engagement and quality management cycles.