

Deficiencies in reporting on irregularities in the auditor's report (Lecture A769 – 14.02 minutes)

The requirement to report how the audit was capable of detecting irregularities, including fraud, in the auditor's report has been a mandatory requirement for all audits from December 2020 year ends.

File reviews over the last year have indicated that while there is some narrative contained in auditors' reports about irregularities and fraud, the narrative is not necessarily in compliance with ISA (UK) 700 *Forming an Opinion and Reporting on Financial Statements*. Some auditors' reports simply explain what irregularities and fraud are, or merely report that no irregularities or fraud have been found during the course of the audit. This often results in deficiencies being noted during a file review and can also lead to a file being failed for compliance with ISAs (UK).

Here we will examine exactly what ISA (UK) 700 requires when it comes to reporting on irregularities including fraud in the auditor's report.

1.1 Capability of the audit to detect irregularities including fraud

ISA (UK) 700 states:

The auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including fraud.

ISA (UK)
700,
para
29-1

The application and explanatory material at paragraphs A39-1 to A39-6 then go into more detail as to how the auditor should deal with this in the auditor's report. Indeed, ISA (UK) 700, para A39-3 provides the following examples of how the auditor's work addressed the detection of irregularities as follows:

- How the auditor obtained an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- Which laws and regulations the auditor identified as being of significance in the context of the entity.
- The auditor's assessment of the susceptibility of the entity's financial statements to material misstatement, including how fraud might occur.
- The engagement partner's assessment of whether the engagement team collectively had the appropriate competence and capabilities to identify or recognise non-compliance with laws and regulations.
- Matters about non-compliance with laws and regulations and fraud that were communicated with the engagement team.
- The auditor's understanding of the entity's current activities, the scope of its authorisation and the effectiveness of its control environment where the entity is a regulated entity.
- In the case of a group, how the auditor addressed these matters at both the group and component levels.

- Communications with component auditors to request identification of any instances of non-compliance with laws and regulations that could give rise to a material misstatement of the group financial statements.

Hence, the auditor must describe **how** the audit was designed to detect irregularities including fraud as opposed to describing what irregularities are (indeed there is no specific definition of 'irregularities' in the ISAs (UK)) or the fact that fraud, including fraud risk factors, have not been detected during the course of the audit.

When the auditor is preparing their explanation for inclusion in the auditor's report, they must have regard to the various risks that have been identified. There is no 'one-size-fits-all' approach and each auditor's report will have different levels of explanations. Factors which the auditor may need to consider in preparing this part of their report include the following (note the list below is not comprehensive):

- Results of inquiries of management and other staff/third parties or those charged with governance concerning actual and potential litigation and claims.
- Reviews of minutes of meetings of those charged with governance.
- Results of inquiries of tax staff/lawyers concerning any instances of NOCLAR.
- Results of audit procedures over the testing of journal entries (particularly around the year end) and other adjustments for appropriateness. This should also include consideration of the rationale of significant transactions outside the normal course of business.
- The results of audit procedures, including tests of controls and how the auditor's procedures dealt with the risk of management override of those controls.
- Reviews of the financial statement disclosures and testing to supporting documentation for compliance with laws and regulations.

Example – How the audit was capable of detecting irregularities, including fraud

The illustration below is not prescribed text for an auditor's report. It merely shows how reporting irregularities may look in the auditor's report. Entity specific considerations will have to be taken into account, including the entity's legal and regulatory framework which may differ from client to client.

Auditor's Responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Irregularities, including fraud, are instances of non-compliance with laws and

regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatement misstatements in respect of irregularities, including fraud.

The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below:

We gained an understanding of the legal and regulatory framework applicable to the company and the industry in which it operates, and considered the risk of acts by the company that were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

We focussed on laws and regulations which could give rise to a material misstatement in the financial statements, including, but not limited to, the Companies Act 2006 and UK tax legislation. Our tests included agreeing the financial statement disclosures to underlying supporting documentation, enquiries with management and enquiries of legal counsel. There are inherent limitations in the audit procedures described above and, the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. We did not identify any key audit matters relating to irregularities, including fraud. As in all our audits, we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.
