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3 October 2025

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**Proposed Statement on Auditing Standards, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements***

Dear Ms. Hazel,

Ernst & Young LLP (EY US) appreciates the opportunity to provide comments to the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) on the proposed Statement on Auditing Standards (SAS), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

We support the ASB's efforts to enhance and clarify the auditor's responsibilities related to fraud in an audit of financial statements. We broadly agree the proposal would align appropriately with other standards and requirements. Given the heightened attention to this topic by stakeholders and its importance to audit quality, we suggest revisions to help clarify the auditor's ability to apply the proposal.

Specifically, we propose clarifying the auditor's responsibilities related to third-party fraud risks and removing cybercrime as an example of third-party fraud arising from unknown parties. We also encourage the ASB to consider a principles-based approach to the proposed requirement to obtain audit evidence of the completeness of the population of journal entries. Such an approach would permit the use of auditor judgment, based on assessed risks, to determine the appropriate journal entry population to test for completeness. In addition, we believe other aspects of the proposal should be clarified to improve consistency in implementation.

The Attachment contains our responses to the ASB's requests for comments and additional recommendations for your consideration. We would be pleased to discuss our comments with members of the ASB or its staff.

Sincerely,



**Attachment – Responses to request for comments**

1. **Effective Date:** Do respondents believe that if the final standard is issued no later than October 1, 2026, the proposed effective date for audits of financial statements for periods ending on or after December 15, 2028, is appropriate and provides adequate time for implementation? If not, respondents are asked to state their reasons and suggest an alternate effective date.

Yes, we believe that the effective date would provide sufficient time for auditors to implement the proposed standard.

2. **Auditor's Responsibilities:** Do respondents agree that the proposed SAS clearly sets out the auditor's responsibilities relating to fraud in an audit of financial statements, including fraud that may not result in a material misstatement to the financial statements? Respondents are asked to state their reasons.

We generally agree that the proposal would be clear, except for the description of third parties unknown to the entity (e.g., cybercriminals) as parties that may commit fraud in the scope of the proposed guidance in the third bullet point in paragraph A25.<sup>1</sup>

The first two bullet points in proposed paragraph A25 include helpful examples of third parties known by the entity that may commit third-party fraud and focus on fraud that may be concealed through collusion with the third party. This concept is consistent with Public Company Accounting Oversight Board (PCAOB) standards.<sup>2</sup>

The auditor is appropriately positioned to assess fraud risk factors if they relate to the entity's personnel, but their assessment is significantly curtailed by the limited information the auditor has about a third party. It is unclear how the auditor could reasonably assess fraud risks arising from the incentives, opportunities or rationalizations of a third party. The auditor has even less information about fraud risk factors that may be influencing a third party who is unknown to the entity. We believe the proposed standard should avoid including application material that suggests the auditor's responsibility extends to speculation about the intent or fraud risk factors affecting external parties.

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<sup>1</sup> Paragraph A25: Parties external to the entity that may commit third-party fraud may include the following:

- ▶ Related parties, in which potential opportunities for collusion with management, overly complex transactions, or bias in the structure of transactions may exist, as explained in AU-C section 550, *Related Parties*.
- ▶ Third parties with which the entity has a relationship to support their business model, such as customers, suppliers, service providers, or other external parties known to the entity. These relationships may introduce the risk of collusion with employees or others in the entity to, for example, create fictitious transactions to manipulate financial results.
- ▶ Third parties unknown to the entity that may, for example, attempt to gain unauthorized access to an entity's IT environment that affects financial reporting or assets or disrupts the entity's business operations or financial reporting processes.

<sup>2</sup> See PCAOB AS 2401.10.

We also believe the example in proposed paragraph A25 of cybercrime as a third-party fraud committed by an unknown party may create confusion about the auditor's responsibilities to assess cybersecurity risks under a fraud lens. Cybercrime encompasses a wide range of illegal or unethical activities and does not align with the definition of fraud in proposed paragraph 18.<sup>3</sup> We are concerned that the example in proposed paragraph A25 may inadvertently suggest that the auditor's responsibilities extend to providing assurance about the adequacy of the entity's cybersecurity program. We believe the auditor's responsibilities with respect to cybersecurity risks are more appropriately described in AU-C section 315, which includes investigating cyber breaches for the potential effect on financial reporting and possible noncompliance with laws and regulations under AU-C section 250.<sup>4</sup>

We suggest the ASB consider removing the last bullet of proposed paragraph A25 about third-parties unknown to the entity.

Additionally, we suggest clarifying the last bullet point in proposed paragraph A62 by aligning it with other examples in proposed paragraphs A25 and A62, which focus on assessing fraud risk factors related to the entity's personnel, as follows:

Based on the auditor's understanding of revenue contracts, the auditor became aware that the entity is using consignment agreements, where third parties sell the entity's inventory on its behalf, and the entity earns revenue from these sales. The auditor identified a risk factor (that is, incentive to commit fraud) resulting from ~~the third party's management's~~ incentive to collude with the third party to overreport underreport to the entity consigned sales in order for management the third party to meet its ~~own~~ sales targets.

We believe this clarification would reinforce the auditor's responsibility to implement AU-C section 240 consistently.

**3. Key concepts and relationships with other AU-C Sections:** Do respondents agree that the proposed SAS clearly sets out the key concepts and relationship with other AU-C sections in paragraphs 4-15? Respondents are asked to state their reasons.

We agree and have no comments.

<sup>3</sup> A similar example of a cyber breach was removed from proposed paragraph A17 (ISA 240.A15 (Revised)) by the ASB because it was unclear whether the breach met the proposed definition of fraud.

<sup>4</sup> For example, see AU-C section 315 Appendix E paragraph 19 or PCAOB AS 2110 Appendix B.

4. **Key concepts and relationships with other AU-C Sections:** Do respondents agree that the terms “fraud,” “suspected fraud,” or “fraud or suspected fraud” are used appropriately throughout the proposed SAS? Respondents are asked to state their reasons.

In addition to matters raised in our response to Question 2, we suggest the ASB include “or suspected fraud” in the following paragraphs to support consistent application and align with the definition of fraud in proposed paragraphs 6 through 8, 18, and other paragraphs in the proposal:<sup>5</sup>

57. If the auditor identifies a misstatement due to fraud or suspected fraud, the auditor should do the following:
- a. Determine whether the identified misstatement is material by considering the nature of the qualitative or quantitative circumstances giving rise to the misstatement.
  - b. Determine whether control deficiencies exist, including significant deficiencies or material weaknesses in internal control related to the prevention or detection of fraud, relating to the identified fraud or suspected fraud.
  - c. Determine the implications of the misstatement in relation to other aspects of the audit, including when the auditor has reason to believe that management is involved.
  - d. Reconsider the reliability of management’s representations and audit evidence previously obtained, including when the circumstances or conditions giving rise to the misstatement indicate possible collusion involving employees, management, or third parties.
58. If the auditor determines that the financial statements are materially misstated due to fraud or suspected fraud or the auditor is unable to obtain sufficient appropriate audit evidence to enable the auditor to conclude whether the financial statements are materially misstated due to fraud or suspected fraud the auditor should
- a. determine the implications for the audit and the auditor’s opinion on the financial statements in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report*, and
  - b. if appropriate, obtain advice from legal counsel.

5. **Key concepts and relationships with other AU-C Sections:** Do respondents agree that the proposed SAS adequately explains the relationship between the proposed SAS and AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*? Respondents are asked to state their reasons.

We agree and have no comments.

<sup>5</sup> For example, paragraphs 55, 56, 57b, 61, 62, 66c, A9, A12, A181-A183.

6. **Scalability:** Do respondents agree that the requirements and application material in the proposed SAS are sufficiently scalable; that is, is the proposed SAS capable of being applied to the audits of entities with a wide range of sizes, complexities, and circumstances? Respondents are asked to state their reasons.

We generally agree in consideration of our responses to Questions 2, 10, and 12.

7. **Linkages with other AU-C Sections Including the Use of Technology:** Do respondents agree that the proposed SAS has appropriate linkages to other AU-C sections (for example, AU-C section 200, AU-C section 220, AU-C section 315, AU-C section 330, AU-C section 500, AU-C section 520, and AU-C section 540)? Respondents are asked to state their reasons.

We agree and have no comments.

8. **Maintaining Professional Skepticism:** Do respondents agree that the proposed SAS appropriately reinforces maintaining professional skepticism about matters relating to fraud in an audit of financial statements? Respondents are asked to state their reasons.

We agree and have no comments.

9. **The Auditor's Risk Identification and Assessment:** Do respondents agree that the proposed SAS appropriately builds on the foundational requirements in AU-C section 315 and other AU-C sections to enhance the auditor's risk identification and assessment as it relates to fraud? Respondents are asked to state their reasons.

We agree, except for third-party fraud perpetrated by parties unknown to the entity as described in our response to Question 2.

10. **Management override of Controls:** Do respondents agree that the risks of material misstatement due to fraud related to management override of controls should be treated as a risk of material misstatement due to fraud at the financial statement level? Respondents are asked to state their reasons.

We agree but suggest the ASB consider explicitly stating that the requirement in proposed paragraph 50b to obtain audit evidence about the completeness of the population of journal entries would only apply to the populations from components for which further audit procedures are performed.<sup>6</sup>

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<sup>6</sup> See IAASB ISA-240 (Revised) Basis for Conclusions, paragraph 87 "... the IAASB did remove the word 'all' in paragraph 49(b) of ISA 240 (Revised) to address any confusion that in a group audit the requirement relates to all components (i.e., it only relates to components for which further audit procedures are performed)."

Also, we encourage the ASB to consider scaling the proposed requirement in paragraph 50b to obtain audit evidence about the completeness of the population of journal entries throughout the period to the population of journal entries that the auditor determines necessary to test based on their judgment and risk assessment. We believe that scaling this requirement would better align it with a principles-based approach and PCAOB auditing standards.<sup>7</sup>

In addition, we suggest that the language in proposed paragraphs 49 and 50 use terms that are consistent with the application material, such as A155 and Appendix D, A207.

We suggest the ASB consider the following revisions:

49. The auditor should design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including ~~entries posted~~ **adjustments made** directly to the financial statements. In doing so, the auditor should identify controls over such journal entries and other adjustments, and in accordance with AU-C section 315, evaluate the design and determine whether the controls have been implemented, to provide a basis for the design of the audit procedures.
50. In designing and performing audit procedures in accordance with paragraph 49, the auditor should do the following:
  - a. Make inquiries of individuals involved in the financial reporting process about their knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
  - b. Obtain audit evidence about the completeness of the population **based on the auditor's risk assessment** of journal entries recorded in the general ledger and other adjustments made **in the preparation of the financial statements** throughout the period.
  - c. Consider fraud risk factors, the nature and complexity of accounts, and unusual entries processed.
  - d. Select journal entries recorded in the general ledger and other adjustments made at the end of a reporting period, including those ~~posted~~ **adjustments made** directly to the financial statements.
  - e. Determine the need to test journal entries recorded in the general ledger and other adjustments made throughout the period, including those ~~posted~~ **adjustments made** directly to the financial statements.

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<sup>7</sup> See PCAOB AS 2401.61 and .62

**11. Presumption of the Risks of Material Misstatement Due to Fraud in Revenue Recognition:**

Do respondents agree that the proposed SAS appropriately addresses the risks of material misstatement due to fraud in revenue recognition? Respondents are asked to state their reasons.

We agree but suggest clarifying the example in proposed paragraph A133 by removing “ancillary” as a type of revenue source for which the auditor may conclude that no risks of material misstatement due to fraud exist. We do not believe fraud risk considerations are dependent on whether the revenue stream is primary or ancillary. We suggest the following revision:

A133. There may be limited circumstances in which it may be appropriate to rebut the presumption that there are risks of material misstatement due to fraud in revenue recognition. The auditor may conclude that no risks of material misstatement due to fraud exist relating to revenue recognition when fraud risk factors are not significant. Examples of revenue and revenue transactions that may not give rise to fraud risk factors include the following:

- ▶ *Lease revenue from a single unit of rental property, or multiple rental properties, with a single tenant.* Based on the risk assessment procedures performed, the auditor determined that lease revenue is not a key performance indicator for the lessor because it is predictable and stable. Therefore, there are no significant incentives or pressures related to lease revenue.
- ▶ *Simple or straightforward ~~ancillary~~ revenue sources, which are determined by fixed rates or externally published rates (for example, interest or dividend revenue from investments with level 1 inputs).* Based on the risk assessment procedures performed, the auditor determined that there are no significant incentives or pressures related to the interest or dividend revenue from investments because the transactions are recorded in a highly automated system with no significant opportunities for management to manipulate the interest or dividend revenue from investments.

**12. Fraud or Suspected Fraud:** Do respondents agree that the proposed SAS appropriately establishes proper work effort requirements and application material to address circumstances when instances of fraud or suspected fraud are identified in the audit? Respondents are asked to state their reasons.

We agree but suggest the ASB consider revising the example in proposed paragraph A180 to align with the requirements of proposed paragraph 55, which would permit other members of the engagement team to perform those procedures. In addition, we suggest the ASB consider revising the example to clarify that the suspected fraud is clearly inconsequential because it involves employees who are not members of management and, therefore, do not cause us to doubt the integrity of management. Specifically, we recommend the following revisions:

A180. The nature and extent of the auditor’s work in accordance with paragraph 55b-c, and the documentation of such work, may also vary based on the circumstances, depending in part on the results of inquiries made in accordance with paragraph 55a. Auditors may use information obtained (1) from their understanding of the entity’s whistleblower program in accordance with paragraph 33a(ii), including the entity’s process for investigating and remediating allegations of fraud that came through the entity’s whistleblower program, and (2) through

performing other risk assessment procedures, to satisfy the requirements in paragraph 55b-c, and determine whether a fraud or suspected fraud is clearly inconsequential. For example, based on an understanding of the suspected fraud obtained through understanding the entity's whistleblower program, the **auditor with appropriate involvement of the engagement partner** determined the suspected fraud was clearly inconsequential because it was limited to the misappropriation of immaterial assets by employees who are not members of management or do not have significant roles in internal control.

**13. Overall Evaluation Based on Audit Procedures Performed:** Do respondents agree that the proposed SAS should include a stand-back provision as included in paragraph 59 and, if so, where it is placed? Respondents are asked to state their reasons.

We agree with the inclusion of a stand-back provision, because this proposed requirement would align with AU-C section 330 and the proposed location of the provision in paragraph 59.

**14. Communication With Those Charged With Governance:** Do respondents agree that the requirements for the auditor to communicate fraud or suspected fraud with those charged with governance are appropriate? Respondents are asked to state their reason.

We agree and have no comments.

**15. Communication With Those Charged With Governance:** In particular, do respondents agree that it is appropriate for the auditor to communicate with those charged with governance identified fraud or suspected fraud involving others, except for matters that are clearly inconsequential, rather than when the fraud results in a material misstatement in the financial statements? Respondents are asked to state their reasons.

We agree and have no comments.

**16. Documentation:** Do respondents agree with the revisions to the documentation requirements in the proposed SAS? Respondents are asked to state their reasons.

We agree and have no comments.

**17. Inquiries** Do respondents agree that the required inquiries about matters related to fraud are appropriate? Respondents are asked to state their reasons.

We agree and have no comments.

**18. Other matters:** Are there any other matters you would like to raise in relation to the proposed SAS? If so, clearly indicate the requirements, application material, appendix, or the theme or topic to which your comments relate.

None.