ACCOUNTANCY EUROPE.

FRAUD: RECOMMENDATIONS TO STRENGTHEN THE FINANCIAL REPORTING ECOSYSTEM

VIEWS.
& IDEAS.

AUDIT & ASSURANCE
FEBRUARY 2021

HIGHLIGHTS

Corporate fraud is a serious issue that affects us all. Its consequences can weaken the public's confidence in markets and have long lasting damaging effects on society. The COVID-19 crisis has also increased the pressure on companies. This has created new opportunities to commit fraud making companies more vulnerable to corporate failure.

This publication, with its counterpart on going concern, presents recommendations to strengthen the financial reporting ecosystem. It takes another look into all key players' role (including auditors, companies' boards and management, legislators, standard setters and regulators) who must take a coordinated approach to achieve tangible results in tackling fraud. With this aim we propose the following recommendations:

- require companies to have and publicly report on a fraud risk management system
- pay specific attention to senior management fraud
- mandate an audit committee in all public interest entities
- make early warning mechanisms for auditors effective
- clarify auditing standards for a common understanding of the auditor's role
- improve auditors' access to knowledge and awareness about fraud
- auditors to clearly communicate their work and conclusions about fraud

We also invite relevant parties to explore how to use technology and forensic experts in the most effective way within financial statements audits.

We call for a joint effort of key parties to strengthen the ecosystem. To this end, we ask you to send your thoughts and opinions on our recommendations to harun@accountancyeurope.eu by 30 April 2021.

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INTRODUCTION

Fraud is a serious, and sometimes underestimated, issue that can cause irreversible harm to people, companies and to the economy. Auditors can play a crucial role in tackling fraud and stakeholders expect that auditors should be doing more or better in this area. For this to happen, all parties' role in the financial reporting ecosystem and the interactions amongst them need to evolve. The auditor is a part of this ecosystem.

The audit profession is open to changes, looking forward to a fruitful dialogue with stakeholders to develop its role. Changes to the current functioning of the ecosystem, including audit's purpose and scope, should be based on the outcome of a cost/benefit analysis or impact assessment.

The ongoing pandemic's unprecedented implications also require taking a closer look at the financial reporting ecosystem. These new circumstances may put procedures and measures (e.g., internal controls and risk management systems) under pressure, and provide new opportunities to commit fraud. They also increase fraud risks related to government support and the pressure on companies to report embellished financial performance to meet the requirements of financing agreements.

OBJECTIVE

This paper explores how to clarify and improve each party's role, including auditors, in the financial reporting ecosystem. It defines the basic concepts and sets out the respective roles of corporate governance and auditors according to currently applicable models and auditing standards. The publication also highlights principles to guide these roles' and responsibilities' evolution. Finally, we propose recommendations (see page 7) to improve the collective efforts against fraud and share forward-looking ideas to be further considered.

The recommendations are based on discussions with audit experts and stakeholders, including accountants, audit committee members, investor representatives, forensic experts, standard setters and regulators.

We aim to contribute to international debates and the European Union (EU) level policy-making process on fighting fraud. Currently, national initiatives are ongoing in some European countries to improve the financial reporting ecosystem, including the auditor's role. When developing our recommendations, we also benefited from proposals made and relevant discussions ongoing in these countries.

SCOPE

This publication refers to the requirements in the:

- EU legislation on accounting and financial reporting[1]
- EU legislation on auditing[2]
- International Standards on Auditing (ISA)[3]

Member States may have implemented the requirements above differently at national level. The starting point is therefore not the same across countries. This should be considered in the context of this publication and when deciding on any changes to the ecosystem.

[1] The Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings; available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0034

[2] Directive 2014/56/EU (the Audit Directive) contains requirements governing statutory audits in the EU. See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG
Regulation (EU) No 537/2014 (the Audit Regulation) contains additional requirements that relate specifically to statutory audits of PIEs in addition to the ones stated in the Directive. See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02014R0537-20140616

[3] The ISAs are issued by the International Auditing and Assurance Standards Board and available at https://www.iaasb.org/publications/2018-handbook-international-quality-control-auditing-review-other-assurance-and-related-services-26

The perspectives presented focus on the European public interest entities (PIEs)[4], however some of them may also be relevant for non-PIEs and their auditors. The applicability depends also on a country's and/or particular company's corporate governance model.

The International Auditing and Assurance Standards Board (IAASB) has also identified fraud as one of the important areas in its Work Plan. It issued a Discussion Paper[5] on going concern and fraud noting that the expectation gap (the difference between what the public expects from the auditor and the financial statement audit, and the reality of what an audit currently is) is one aspect that these have in common.

LINK BETWEEN FRAUD AND GOING CONCERN

There is often a link between fraud and going concern[6] issues. Fraud can threaten a company's ability to continue as a going concern since discovery or suspicion of fraud deteriorates investors' trust in the company and can lead to corporate failure. The opposite is also true – some fraudulent behaviour may be sought to hide potential going concern issues within a company. Fraud can therefore sometimes delay the discovery of these issues.

Having considered the link between fraud and going concern, we have also worked on and issued our publication *Going Concern: Recommendations to strengthen the financial reporting ecosystem* (February 2021).

DEFINITIONS AND BASIC CONCEPTS

In this section, we first define the types of fraud relevant for a financial statements audit. Then we further describe each party's role in the financial reporting ecosystem regarding fraud.

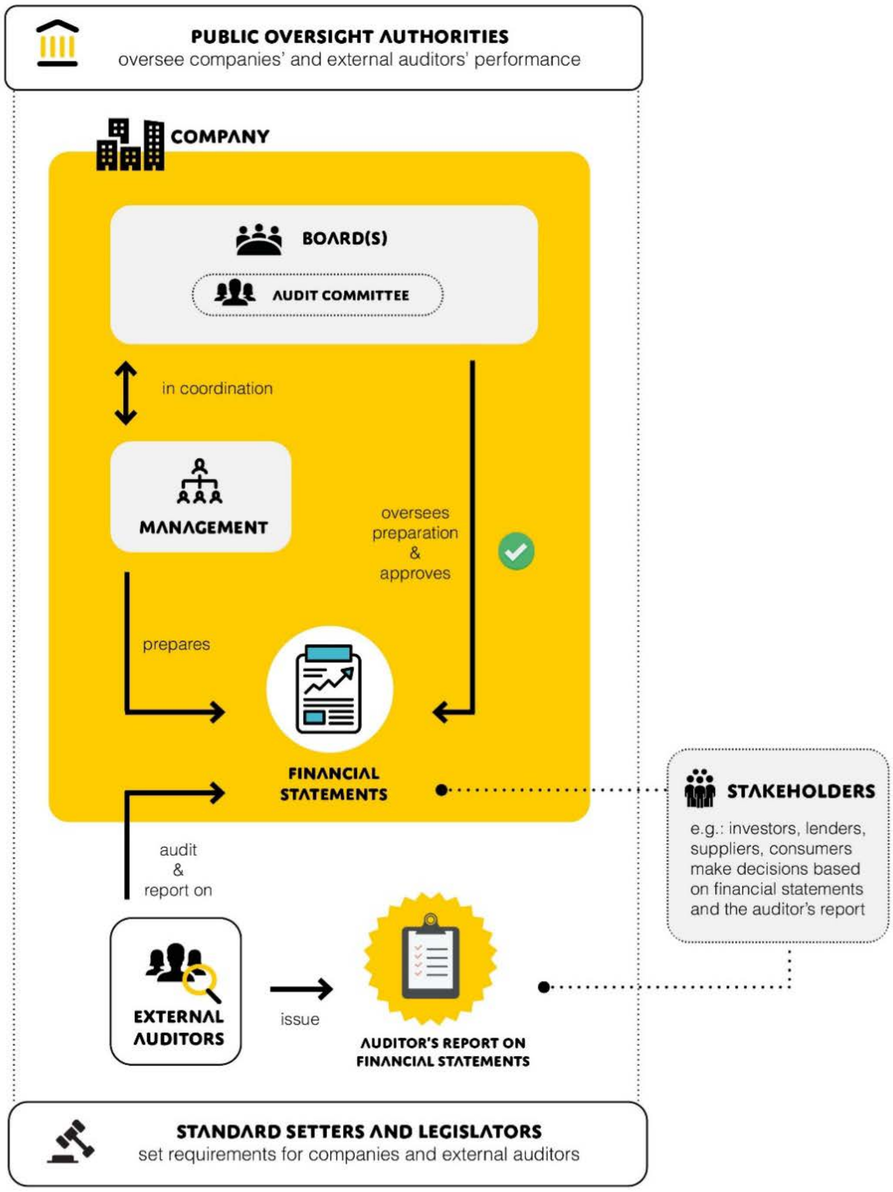
The visual below illustrates the financial reporting process and the roles of each main party. There might be differences depending on the national jurisdiction and applicable corporate governance system. For example, in some jurisdictions, companies have more than one board – in this publication, we use 'board' as a general term.

[4] Based on the Audit Regulation, PIEs are all listed entities, banks and insurance companies. For more details, please refer to our publication Definition of Public Interest Entities in Europe (March 2019), available at https://www.accountancyeurope.eu/publications/definition-public-interest-entities-europe/

[5] The Discussion paper is available at https://www.iaasb.org/publications/fraud-and-going-concern-audit-financial-statements and it was open for comment until 1 February 2021. Accountancy Europe has submitted its response which is available on our website.

[6] 'Going concern' is an economic and accounting term used to describe a company which is assumed to be financially stable enough to continue to operate for the foreseeable future.

THE FINANCIAL REPORTING ECOSYSTEM



TYPES OF FRAUD

There are two primary fraud categories relevant for a financial statements audit:

- asset misappropriation, which includes embezzling, stealing or misusing the company's resources by its management, employees, and/or third parties
- fraudulent financial reporting, in which the perpetrator intentionally causes a material misstatement or omission in the company's financial statements, such as reporting fictitious revenue or understating liabilities

The distinction between these two categories is not always clear, and one may lead to the other. For example, stealing company's resources will most likely result in fraudulent financial reporting. We note that stakeholders are mainly concerned with the risk of fraudulent financial reporting that involves company's management.

Organisations' non-compliance with laws and regulations is also a matter of importance for stakeholders. When committed intentionally, such non-compliance or irregularity may be considered as fraud by stakeholders. This is particularly relevant in case of breaches such as money laundering, corruption, tax evasion, cybersecurity violations and non-compliance with data protection rules. Auditors have certain responsibilities regarding non-compliance and irregularities, established by both professional standards and legislation. This is a broad issue and not the primary focus of this paper. However, some of the recommendations set out could also help to address stakeholder's expectations in this area.

THE ROLE OF BOARD AND MANAGEMENT

Company's management and board[7] hold the primary responsibility for preventing and detecting fraud. Consequently, they establish systems and structures to manage fraud risks.

Mitigating fraud risks is vital to achieve a company's operational, reporting and compliance objectives. It is also a key aspect for shareholder protection and management's role as their agent.

Fraud risk management programs are usually constructed as a component of wider risk management systems that focus on business risks and can take various forms. The COSO Fraud Risk Management Guide[8], for instance, suggests five key elements for an overall fraud risk management program:

- establish fraud risk governance policies
- perform a fraud risk assessment
- design and deploy fraud preventive and detective control activities
- conduct investigations
- monitor and evaluate the total fraud risk management program

FINANCIAL STATEMENTS AUDIT AND FRAUD

Auditing standards and the EU legislation define the audit's purpose as to enhance the intended users' confidence in financial statements. The auditor's objective is to obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement. A misstatement can arise from fraud or error. The distinguishing factor between these two is that the action which results in the misstatement is intentional in the case of fraud.

Many frauds start small and are less likely to be detected. Not all fraud instances will cause the financial statements to be materially misstated. Frauds may grow in size and/or frequency over time, and when they do, the misstatement may or may not be material.

Auditors apply a risk-based approach and their main responsibility with regards to fraud is to identify, assess and respond to risks of material misstatements. In doing so, they consider fraud risk factors which are the events or conditions that indicate an incentive or pressure; or provide an opportunity to commit fraud.

There is an unavoidable risk that some material misstatements in the financial statements may not be detected. This risk is higher for misstatements resulting from fraud. Fraud usually involves sophisticated schemes designed to conceal it, such as collusion with third parties or forgery of third-party evidence. Detecting fraud can be particularly difficult when committed by management. This is because management is in a position to manipulate accounting records, present fraudulent financial information or override internal control procedures.

Business models change at a rapid pace in today's world and so do the audit procedures to address emerging risks. The Appendix to this paper provides further details on how the fraud risk is addressed in a financial statements audit.

[7] International standards on auditing use the term 'those charged with governance'. It means the person(s) with responsibility for overseeing the strategic direction of a company and obligations related to the accountability of the company. Throughout this paper we refer to board and audit committees for equivalent structures.
[8] https://www.coso.org/Documents/COSO-Fraud-Risk-Management-Guide-Executive-Summary.pdf

ROLE OF STANDARD SETTERS AND LEGISLATORS

Standard setters and legislators such as the IAASB, and EU and national legislators set requirements for:

- companies' governance and financial reporting
- auditors' work and reporting on fraud

International standards and EU legislation drive consistency which our interconnected economies need. Any changes related to the requirements on fraud should come from international standard setters on auditing and EU legislators. They are the ones that can enact structural changes to the roles and responsibilities of the companies and auditors.

ROLE OF THE PUBLIC OVERSIGHT

National securities market authorities (SMAs) are responsible for investor protection. Their main aim is to supervise markets' order and efficiency. Their role involves enforcing the transparency rules including financial reporting requirements. SMAs contribute to promoting a market environment that upholds the public's trust.

National audit oversight bodies (AOBs) have the ultimate responsibility for the oversight of the audit profession. By examining the quality of the work that auditors do, they are expected to ensure audit quality which warrants the public's confidence in audit.

GUIDING PRINCIPLES FOR DEVELOPING THE RECOMMENDATIONS

We would like to highlight the principles which guided us in developing our recommendations and ideas.

All organisations are subject to fraud risks

There is no proportionate way to eliminate the fraud risk in an organisation, hence all organisations are subject to fraud risks. The most cost-effective way to limit fraud losses is to prevent fraud from occurring.

The existence of an independent financial statements audit can serve as a deterring factor. It contributes to preventing fraud by increasing the likelihood of detection and by increasing the schemes´ sophistication needed to conceal fraud.

An effective corporate governance system is key as a first line of defence

An appropriate, effective and adequate corporate governance system is key as a first line of defence to detect and prevent fraud. Management needs to establish internal controls as part of the corporate governance structure and the board is responsible for overseeing this. When designed and implemented properly, these controls provide comfort to boards and management that the fraud risk is reduced to an acceptable level. They also help auditors adopt a more effective and efficient approach relying on the controls operating effectively (having tested them) and focusing on the areas where there are deficiencies.

Senior management fraud requires a different approach

Although rare, the consequences of fraud committed by senior management will generally be more severe when compared to employee fraud. Management is in a unique position to perpetrate and conceal fraud, such as by overriding internal controls or allowing falsification of documents in collusion with external parties. Therefore, measures addressing management fraud should consider its particular characteristics. A control environment that is effective for preventing employee fraud may not be sufficient on its own against fraud involving senior management. Tone at the top, promoting ethical behaviour and monitoring of management´s financial incentives are important elements that can reinforce the control environment.

A collective effort is needed

Successfully tackling fraud depends upon a joint effort by all relevant parties, including those responsible for corporate governance, management, auditors, regulators, standard-setters and public oversight bodies. Only a coordinated approach and commitment of all the key parties can achieve tangible results as cost effectively as possible.

Enforcing robust corporate governance should be the starting point and the driver for any enhanced role of the auditor. Regardless of the nature of the changes, board and management will still have the primary responsibility for preventing and detecting fraud.

The human aspect is crucial

New technologies provide opportunities for fighting fraud and pose risks at the same time. Nevertheless, we should keep in mind the underlying human behaviour; a fraudster will try to deceive and conceal. This is also relevant for evolving fraud types that employ advanced technology.

Auditors will exercise professional judgment when making decisions during an audit engagement. For example, automated tools are often used to analyse a dataset and identify the anomalies in a population. Determining what is an anomaly and evaluating the implications of identified anomalies on the audit approach require exercising professional judgment.

9 RECOMMENDATIONS TO STRENGTHEN THE FINANCIAL REPORTING ECOSYSTEM

In this section, we recommend ways to improve the role of all relevant parties in the ecosystem regarding fraud in PIEs. By suggesting these enhancements, we aim to contribute to the debate which is already taking place at an international level (e.g., IAASB Discussion Paper on this topic) and in several European countries. *Our main proposals* represent Accountancy Europe views and *Ideas to be explored* are areas which would require further consideration especially by standard setters and audit oversight bodies.

The main proposals complement each other and therefore it is not appropriate to consider any of them in isolation.

OUR MAIN PROPOSALS

1. REQUIRE COMPANIES TO HAVE AND PUBLICLY REPORT ON A FRAUD RISK MANAGEMENT SYSTEM

EU (and national) legislation should ensure that companies' risk management and compliance management systems include anti-fraud mechanisms. These mechanisms should set out specific procedures, and clear responsibilities for boards, audit committees, and management.

As part of these systems and based on a well-defined framework, companies' management should be required to operate a fraud risk management program, covering fraud risk assessment, internal controls and responses to allegations and incidents of fraud. Legislation should require board and management to publicly disclose a statement about the effectiveness of this program and relevant controls.

This disclosure could be made as part of a broader statement included in company's management report, along with statements on the internal controls over financial reporting.

2. PAY SPECIFIC ATTENTION TO SENIOR MANAGEMENT FRAUD

If senior management members are involved in fraud, this means they are breaching the company's code of conduct and overriding internal controls. Consequently, the board's and the audit committee's role becomes more critical in adequately addressing such fraud risk.

The board should therefore strengthen the functioning of audit committees and ensure their independence from management.

Board and audit committees should include fraud risks relevant to the company as a recurring item on their agenda. Discussions around (potential) fraud by senior management can often be misinterpreted as mistrust.

Having a trustful relationship, however, should not stop board and audit committee members from asking controversial questions to management or making appropriate enquiries in the organisation.

Audit committees should review and approve the company's annual internal audit plan to ascertain that it is aligned with audit committee's expectations and addresses management fraud risk appropriately.

Audit committee's collaboration with external auditors is also vital for addressing management fraud risk. Auditors would benefit from audit committees' commitment and cooperation, based on openness and honesty. Audit committees should also ensure that external auditors have sufficient resources to perform their engagements in a highly qualitative way.

3. MANDATE AN AUDIT COMMITTEE IN ALL PUBLIC INTEREST ENTITIES

According to the EU audit legislation[9], member states may allow a PIE not to have an audit committee in case it has a body that performs equivalent functions.

Given the critical role of audit committees in mitigating fraud risk, it should be mandatory for all PIEs to have:

- a separate audit committee independent from management
- a sufficient number of members in the audit committee with competence in accounting and/or auditing as well as risk management
- an independent internal audit function supervised by the audit committee

Legislators should abolish provisions that allow member states to derogate from the requirements above.

In addition, audit committee's effectiveness should be supported by well-established whistleblowing structures[10].

4. MAKE EARLY WARNING MECHANISMS FOR AUDITORS EFFECTIVE

In accordance with the EU Audit Regulation[11], auditors should inform the audited company and invite its management to investigate and take appropriate measures when they suspect that irregularities, including fraud regarding the financial statements may have occurred. If management does not investigate the matter, the auditor has to inform the authorities responsible for investigating such irregularities.

National legislation should specify the competent authority and the related procedures for PIE auditors to report instances of irregularities, including fraudulent acts, suspected during the audit. In many EU countries, it is unclear how the auditors should report and to which authority for some types of PIEs. This leads to an ineffective and inconsistent implementation of the Regulation. There should be a designated competent authority for every type of PIE and clear guidance for auditors about how to comply with their legal obligations.

5. CLARIFY AUDITING STANDARDS FOR A COMMON UNDERSTANDING OF THE AUDITOR'S ROLE

International (and national) standard-setters should clarify the auditing standards to better explain commonly misunderstood requirements and concepts about the auditor's role on fraud. These include:

- auditor's responsibility and the inherent limitations, especially related to fraud
- application of professional scepticism
- the relationship between fraud and intentionally committed non-compliance with laws and regulations

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[9] Reference is made to Article 39 of the 2014 EU Audit Directive, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056

[10] As per Article 26 of Directive (EU) 2019/1937 (the EU Whistle-blowers Protection Directive), EU Member States shall bring into force the laws, regulations, and administrative provisions necessary to comply with this Directive by 17 December 2021 for legal entities with more than 250 workers and by 17 December 2023 for others. See https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32019L1937

[11] Reference is made to Articles 7 and 12 of the Audit Regulation. see https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02014R0537-20140616

- qualitative materiality with regards to misstatements due to fraud
- two-way communication with audit committees on fraud risk

Auditing standards should also require specific procedures addressing the risk of senior management fraud. These could include:

- having a purposeful and timely discussion with board and audit committee on this specific risk
- communicating specific procedures performed to address the risk of senior management fraud (see recommendation 7 below)

6. IMPROVE AUDITORS' ACCESS TO KNOWLEDGE AND AWARENESS ABOUT FRAUD

Establishing and maintaining a platform to share (anonymised) case studies and experiences on discovered fraud could help auditors understand the main indicators of fraud schemes. Such a platform should provide a secured and controlled access to audit firms and other relevant parties. An alliance among firms, with support from professional organisations as well as relevant subject matter experts and audit oversight bodies, could be the best mechanism for operationalising this initiative.

The main characteristics of more frequently occurring types of fraud (per region, sector, and type of business) should be made available for audit teams' consideration. Audit teams could use this information when developing certain fraud risk scenarios during their risk assessment process and when designing specific audit procedures accordingly.

7. AUDITORS TO CLEARLY COMMUNICATE THEIR WORK AND CONCLUSIONS ABOUT FRAUD

Auditors of PIEs should report their work on fraud and present related findings to board and audit committees even when they have not identified any issue to report as a key audit matter or to modify their opinion. This could include:

- a description of the specific audit procedures performed to address common fraud schemes observed in the industry or region where the company operates
- an overview of any further audit procedures, including forensic elements, auditors decided to incorporate into the audit procedures, including the ones addressing risk of management fraud

Auditors should also describe specific procedures performed rather than having boilerplate explanations when communicating with board and audit committees. For instance, if a forensic expert is involved for the first time, the reasons behind this could be explained to the audit committee in a more detailed manner.

In addition, auditors could be required to report publicly their conclusion on the management's statement on fraud risk management (against an acceptable framework as described in the recommendation (1) above). This could be done as part of the financial statements audit or in a separate assurance engagement. In practice, such an engagement might necessitate auditors to consider the internal controls over financial reporting as a whole.

IDEAS TO BE EXPLORED

In this section, we assess different aspects of ideas proposed by some stakeholders about auditor's potential role on fraud. These are meant to stimulate debate amongst all stakeholders to ensure a proportionate way forward without further widening the expectation gap.

1. CONSIDERING MORE EXTENSIVE USE OF FORENSIC EXPERTS BY AUDITORS

Based on their judgement, auditors may decide to assign additional individuals with specialised skill and knowledge, such as forensic and Information Technology (IT) experts, to an audit engagement. Some stakeholders, however, suggest that the use of forensic experts should be mandatory for PIE audits.

Others suggest that audit firms should analyse their audit client portfolio to identify the companies with a high(er) inherent risk of fraud. In these engagements, forensic experts would support the audit teams in identifying fraud risks and designing audit procedures to respond to these risks.

Forensic audit significantly differs from a financial statement audit in terms of its scope and methodology. Forensic experts generally investigate suspected or known fraud with a targeted approach. Consequently, they need to modify their approach when they are used by auditors in the risk identification process of an audit. Based on their experience, these experts can help the audit team to think about where and how fraud might have been committed.

The experts to be involved in financial statements audit should have an understanding of the audit and its objectives. Experts with this profile are scarce and involving them may increase the cost of audit considerably.

Some forensic elements are already incorporated in detailed testing and analytical procedures performed by auditors. Their effectiveness can be enhanced by more extensive training of auditors about forensic techniques.

The auditor has the overall responsibility for planning and performing the audit and for reporting its results. Therefore, the way forward could be that auditors continue to decide whether and when to involve forensic experts, based on the outcome of their risk assessment and depending on the circumstances of the engagement.

2. CONSIDERING MORE EXTENSIVE USE OF DATA AND TECHNOLOGY BY AUDITORS

Auditors already use computer-assisted audit techniques such as data analytics to identify anomalies and patterns of unusual transactions that might indicate a fraud risk. This enables auditors to target their work effort more effectively on areas with higher risk. The main source of data for auditors is company's financial reporting systems.

Companies use other systems to manage their operations and capture various types of data internally in addition to IT systems used for financial reporting. A wide range of external data and information (e.g., in tax registers, analyst reports, news, social media posts, etc.) about companies is also publicly available.

Some stakeholders suggest that analysing selected internal data captured in other systems and publicly available external data, potentially with the support of IT experts, could provide useful insights to auditors in their fraud risk assessment.

While more extensive use of data and advanced technologies presents an opportunity for identifying and better addressing fraud risks, there are some challenges that should be considered:

- selecting what is relevant for the auditor's purposes from the vast amount of internal and external data can be time consuming
- large scale disinformation, including misleading or outright false information, is a major challenge for ensuring that publicly available data, especially on social media and other online platforms, is reliable
- obtaining complete and accurate data from the company, especially from larger companies with unintegrated legacy systems, on a timely basis can be difficult
- such an analysis may result in an unmanageable number of exceptions and uncommon patterns which need to be interpreted further to draw a conclusion
- technology can support but cannot replace the human element of an audit

With increased dependence on information technology for both financial reporting and auditing, a positive development could be that auditors continue improving their skills in using technology. Technologies could particularly help auditors in performing mechanical audit procedures that require limited application of professional judgement. This would allow the auditor to invest more in testing critical areas.

APPENDIX: OVERALL CONSIDERATIONS ABOUT THE AUDITOR'S ROLE ON FRAUD

This Appendix provides overall considerations about the auditor's role on fraud. It also describes how the fraud risk is addressed in a financial statements audit based on the current ISAs and EU legislation about audit. It does not provide a complete overview of how auditors deal with fraud under the auditing standards. These standards are principles-based and provide flexibility for auditors to design and perform additional procedures where appropriate.

OVERALL CONSIDERATIONS

Fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The courts are the ultimate arbiters of whether fraud has been committed or not.

Auditors are expected to form their opinion on the financial statements as a whole within a reasonable period of time and at a reasonable cost. It is therefore impracticable for an auditor to address all information that may exist or to pursue every matter exhaustively on the assumption that it may be fraudulent.

Auditors plan and perform an audit with professional scepticism which is an attitude that includes:

- a questioning mind
- being alert to conditions which may indicate possible misstatement due to error or fraud
- a critical assessment of audit evidence

The members of an audit team should collectively have the appropriate competence to perform a high-quality audit. With regards to identifying and addressing fraud risks, this might require the involvement of experts. Accordingly, experts in various fields already contribute to planning and performing audit engagements when deemed necessary in the auditor's professional judgement.

PIE audit engagements are subject to engagement quality control reviews (EQCR) where a reviewer, who is not a part of the engagement team, objectively evaluates the judgements and conclusions of the team. This evaluation is performed in the context of professional standards and applicable legal and regulatory requirements for the auditor. EQCR constitutes an important element of audit firms' quality management systems.

AUDIT PROCEDURES

While developing the audit strategy and plan, the auditor and the key members of the engagement team discuss the susceptibility of the company's financial statements to material misstatement. In these discussions, a particular emphasis is placed on how and where the company's financial statements may be susceptible to material misstatement due to fraud.

Based on their risk assessment, auditors design and perform procedures which take into account materiality and sampling methodologies.

When identifying and assessing the risks of material misstatement due to fraud, auditors presume that there are risks of fraud related to revenue recognition as required by ISA 240[12]. Based on this presumption, they evaluate which types of revenue transactions or assertions give rise to such risks.

In addition, management can override controls in unpredictable ways. Hence, ISA 240 requires auditors to consider this as a risk of material misstatement due to fraud and thus as a significant risk. Accordingly,

[12] *ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*; available at https://www.ifac.org/system/files/publications/files/IAASB-2018-HB-Vol-1.pdf

irrespective of the auditor's assessment of the risk of management override of controls, the auditor designs and performs specific audit procedures addressing this risk.

Auditors obtain written representations from management and, where appropriate, the board and audit committee that they have disclosed to the auditor:

- the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud
- their knowledge of fraud and suspected fraud affecting the company

REPORTING AND COMMUNICATION

The auditor communicates appropriately to the board, audit committee and management, deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

If the auditor suspects fraud involving management, the auditor communicates these suspicions to the board and audit committee.

From the matters communicated to the board and audit committee, the auditor determines whether any of these should be reported as key audit matters (KAM). Each KAM is described and reported publicly in a separate section of the auditor's report.

Auditors modify the opinion in the auditor's report if they:

- conclude that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement, due to fraud or error; or
- are unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, due to fraud or error.

In accordance with the EU Audit Regulation, when an auditor suspects that irregularities, including fraud regarding the financial statements, may have occurred, and company's management does not investigate the matter, the auditor has to inform the authorities as designated by EU member states (see recommendation 4).

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