

Mr Seidenstein
Chair
International Auditing and
Assurance Standards Board
(IAASB)
529 Fifth Avenue, 6th Floor
New York, NY 10017
United States of America

Ref: 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

Dear Mr. Seidenstein,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to provide comments on IAASB's Exposure Draft (ED) on the 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. The views expressed in this letter are made considering ESMA's mission to enhance the protection of investors and to promote stable and well-functioning financial markets in the European Union (EU) by, among others, ensuring high-quality financial reporting.

ESMA's mandate on corporate reporting includes consistent and correct application of relevant requirements and the convergence of supervisory practices and outcomes. These objectives are best pursued not only when high-quality reporting standards are in place, but also when the assurance process can rely on sound and standardised requirements that are internationally recognised. Therefore, we are pleased to provide the following feedback on selected areas of this ED addressing the role and responsibilities of the auditor on matters relating to fraud, professional scepticism, as well as on enhancing the transparency and communications with Management and Those Charged with Governance (TCWG).

ESMA agrees that the recent fraud cases demonstrate that the extant ISA 240 necessitated revisiting to accommodate developments in technology and the sophistication that some fraud schemes currently entail. In this respect, ESMA invites the IAASB to further investigate if the current proposals and examples are sufficient to tackle the challenges and opportunities that Artificial Intelligence (AI) may introduce to audit work related to fraud in financial statements. Given the fast development of AI, underestimating its effects on audit procedures and audit evidence relating to fraud at this moment may prompt another revision of the standard(s) in the near future.

ESMA also considers that, given the increased importance of narrative information (for instance, in the context of sustainability reporting¹), the revised ISA on fraud may need to reinforce the audit procedures, the guidance on professional scepticism and on auditors' responsibilities when analysing disclosures or narrative information. Corporate information is only relevant for users' decision-making if it can be understood. It is not sufficient that assets, liabilities, profit or loss or cash flows are recognised, measured and presented correctly in the financial statements if these transactions and the underlined accounting principles are not disclosed in a clear, comprehensive and informative manner. Intentionally failing to comply with disclosure requirements or intentionally providing unclear or ambiguous disclosures may indicate the existence or an intention to commit fraud in the financial statements. ESMA's experience is that fraud (whether resulting in material misstatement or not) often goes hand and hand with a lack of transparency of information and/or with misleading disclosures.

Role and Responsibilities of the Auditor on matters relating to fraud

ESMA welcomes the IAASB's proposal to clarify the role and responsibilities of auditors relating to fraud in an audit of financial statements. ESMA considers that the proposals from the IAASB to decouple the concepts addressing the auditor's responsibilities from the inherent limitations of an audit significantly improve the clarity of the role, responsibilities and limitations of auditors' work in the context of fraud. ESMA considers that it is key that the auditor's responsibilities are clearly stated and understood by all parties to reduce expectation gaps between what the market may expect from auditors and auditors' actual role.

In this vein, ESMA is of the view that the description of auditors' responsibilities should not include any language that could be perceived by users of financial statements as disclaimers that discharge auditors from their duties. Therefore, ESMA agrees with the IAASB's proposal to include language clarifying that the limitations inherent to the audit work should not be understood as an exoneration of auditors' responsibilities (i.e., the auditor remains responsible for planning and performing the audit to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatements due to fraud).

Furthermore, ESMA supports the Board's approach on the assessment of materiality in the context of fraud. Notably, ESMA strongly believes that materiality of a misstatement due to fraud should be assessed both from a quantitative and qualitative perspective based on who instated or perpetrated the fraud and why the fraud was perpetrated. While ESMA agrees with the considerations included in paragraph A11 of ED-240, it also considers that other circumstances could be explicitly referred to in the application material. The IAASB could consider including the following examples to illustrate as to when qualitative factors may be relevant when assessing materiality: intentionally omitting qualitative (or narrative) information or intentionally providing unclear qualitative (or narrative) information in the financial statements to achieve a particular presentation of an entity's financial position, financial

¹ Please also consider ESMA's response to [Proposed International Standard on Sustainability Assurance \(ISSA\) 5000, General Requirements for Sustainability Assurance Engagements](#)

performance or cash flows (e.g., by obscuring material information with non-material information or by intentionally using vague, boilerplate or ambiguous language).

Professional Scepticism

ESMA agrees with the importance of exercising professional scepticism throughout an audit not only in the context of fraud but also when carrying out audit procedures or when obtaining audit evidence that do not specifically address fraud. The exercise of professional scepticism should be independent from past experiences and of whether the auditor or the audit team is already familiar with the audit engagement, the management or TCWG; for instance, because it is not its first year of an audit. In this respect, ESMA suggests that the IAASB considers making this point explicit (in a different sentence) in paragraph 19 of ED-240 or in the application material to the ED. For instance, ESMA suggests that the IAASB considers emphasising that the apparent cooperation and the auditor past experience of the honesty and integrity of entity's management, TCWG or knowledge of the issuer's processes and internal control should not impact the level of professional scepticism that should remain high and be exercised in all circumstances.

ESMA is of the view that exercising professional scepticism is especially key in areas where the use of judgment or discretion by management is significant, such as (i) when there are no specific relevant reporting requirements dealing with certain topics (e.g., groups restructurings or business combinations under common control under IFRS), (ii) revenue recognition, (iii) assumptions and accounting estimates (e.g., impairment of non-financial assets and goodwill, level 3 fair-value measurement or the recognition and measurement of deferred tax assets arising from tax losses), (iv) assessing control, joint control and/or significant influence, and (v) related party transactions. Therefore, ESMA suggests that the IAASB considers these points more prominently by reinforcing the application guidance of the ED.

Lastly, ESMA considers that auditors should keep professional scepticism when performing the audit work by, among others, assessing the reliability and the relevance of information obtained and which is intended to be used as audit evidence. In ESMA's view, exercising professional scepticism should imply, among others, evaluating and determining the authenticity of the documentation and information gathered during an audit. This could be particularly relevant when performing audit procedures in certain areas where fraud could be more commonly perpetrated such as the areas referred above, but also when carrying out confirmations or when assessing contradictory evidence. For this purpose, ESMA considers it would be relevant to provide auditors with further guidance on how to assess the reliability and authenticity of the external confirmations received in the ED (for instance, by including a link in paragraph 20 to ISA 500 *Audit Evidence*).

Transparency and communications with Management and TCWG

ESMA agrees with the extant ISA 240 when stating that (i) the primary responsibility for the prevention and detection of fraud rests with both TCWG of the entity and management and (ii) the role of the auditor is to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. While both roles should not be confused, ESMA believes that there is a valid expectation that auditors are also responsible to detect and to report on fraud and fraud risks that are material to financial statements. Therefore, we concur with the changes proposed to the audit report and, particularly, to the proposals regarding *Key Audit Matters*. ESMA is of the view that these changes will enhance the clarity of the auditor's responsibilities *vis-à-vis* fraud.

For ESMA, it is key that communication between the auditor, TCWG and management is constant and ongoing. Therefore, ESMA is of the view that when grounded signals exist of fraud being committed or suspected fraud, the engagement partner should have reinforced responsibilities to enquire the management and the TCWG to understand if those signals or suspicions materialise. Furthermore, ESMA considers that the engagement partner and/or the auditor should consider involving the relevant authorities (either criminal or regulatory) without undue delay in specific circumstances². To this end, ESMA is of the view that this aspect should be explicitly referred to in paragraph 58 of the ED-240 by including a cross reference to paragraph 69 (a). Provided that no legislative impediments exist³, a prompt communication could enable the relevant authorities (such as securities regulators) to timely act to safeguard the public interest.

Should you have questions or comments, please contact Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit.

Yours sincerely,

Verena Ross

² For example in Europe, Article 7 of EU Regulation n. 537/2014 states that a statutory auditor or an audit firm carrying out the statutory audit of a public-interest entity suspects or has reasonable grounds to suspect that irregularities, including fraud with regard to the financial statements of the audited entity, may occur or have occurred, he, she or it shall inform the audited entity and invite it to investigate the matter and take appropriate measures to deal with such irregularities and to prevent any recurrence of such irregularities in the future. Where the audited entity does not investigate the matter, the statutory auditor or the audit firm shall inform the authorities as designated by the Member States responsible for investigating such irregularities.

Furthermore, Article 12 of the said Regulation requires the statutory auditor or the audit firm carrying out the statutory audit of a public-interest to report promptly to the competent authorities supervising that public-interest entity or, to the competent authority responsible for the oversight of the statutory auditor or audit firm, any information concerning that public-interest entity of which he, she or it has become aware while carrying out that statutory audit and which may bring about any of the following: (a) a material breach of the laws, regulations or administrative provisions which lay down, where appropriate, the conditions governing authorisation or which specifically govern pursuit of the activities of such public-interest entity; (b) a material threat or doubt concerning the continuous functioning of the public-interest entity; (c) a refusal to issue an audit opinion on the financial statements or the issuing of an adverse or qualified opinion.

³ Taking into consideration ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*