

AFM

Audit firms' approach to fraud and fraud risks at audited companies

Position paper

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Key points

- ❖ **Identifying and following up on fraud and fraud risks in the statutory audit of audited companies is a vital responsibility of the statutory auditor.** After all, the auditor serves the public interest by providing assurance on the true and fair view of corporate reporting, to society in general and to the end users of those reports in particular.
- ❖ **Although there is no objectified picture, the sector as a whole still seems to be insufficiently developed in detecting and following up on fraud risks.**
- ❖ **The analysis performed has revealed three potential root causes:**
 - i. Knowledge, competence and expertise are not always sufficiently available.
 - ii. The auditor's role perception, attitude and mindset may be inadequate when it comes to detection of fraud and fraud risks.
 - iii. The internal culture at audit firms may be an impediment.
- ❖ **The AFM will make the topic of fraud an important theme in its supervision of audit firms in the coming years.** The AFM is committed to promoting fair and transparent financial markets. Fraud is by definition unfair and non-transparent. Fraud is a significant social issue which is expected to get worse. It potentially has a major impact on the end user and may lead to instability of and loss of public confidence in the integrity of the financial system. This may also put pressure on society's justified confidence in the auditor. All these factors justify enhanced and intensified supervision of this issue.

This is an English translation of the original Dutch text, furnished for convenience only. In the event of any conflict between this translation and the original Dutch text, the latter shall prevail

Introduction

1. **This position paper sets out the AFM's views of the auditor's role and responsibility in respect of detecting and following up on fraud and fraud risks at audited companies, the significance of this issue for supervision, and how exactly supervision in this area should be put in place.** This position paper is the result of internal analyses, discussions with a large number of stakeholders in the corporate reporting chain and an analysis of recent academic literature. No quantitative research has been carried out.
2. **As the supervisory authority of audit firms, the AFM recognises the importance of adopting a position on this issue.** Fraud is a wide-ranging social issue which is expected to manifest itself in further areas in the future. In addition, the number of institutions under the AFM's supervision has increased since 1 January 2022.
3. **Fraud is a wide-ranging social issue. It disrupts economic activities between parties and undermines confidence in the integrity of the financial system.** The primary responsibility for preventing, detecting and tackling fraud lies with the audited companies. At the same time, the statutory auditor's failure to timely detect and follow up on fraud and fraud risks in the statutory audit may cause losses for the company's stakeholders, in particular for investors, who are the end users of financial reports. In addition, fraud may have broader market effects in the form of instability of and loss of public confidence in the integrity of the financial system. Although such (major) fraud cases are few and far between, their impact is considerable. Not surprisingly, this issue is a long-standing concern in society and politics in the Netherlands and internationally, with a specific focus on the statutory auditor's role. The interpretation of the auditor's role and responsibility in respect of fraud and fraud risks has also been on the audit sector's agenda for a while.
4. **It is also expected that trends such as increasing sustainability, technological development and the internationalisation of business will cause the fraud problem to manifest itself in further areas.** Furthermore, the non-PIE audit firms are fully subject to the AFM's direct supervision since 1 January 2022. This has increased the number of institutions under the AFM's supervision, but at the same time the AFM currently has limited insight into the extent of the non-PIE audit firms' development in terms of fraud and fraud risk detection and follow-up.

Problem analysis

5. **The auditor serves the public interest by providing assurance on the true and fair view of corporate reporting to society in general and to the end users of those reports in particular.** Serving the public interest is one of the key duties that legitimises the legal status of the audit profession. The auditor's public role particularly manifests itself when a company goes into liquidation or when investors sustain losses due to large-scale fraud.
6. **From this perspective, identifying and following up on fraud and fraud risks at audited companies in the statutory audit is an essential responsibility of the statutory auditor.** Fraud is the *raison d'être* and the rationale for the audit profession. It was because of extensive fraud by listed companies (Enron, Parmalat, Ahold) that corporate reporting supervision and audit firm supervision was introduced in the Netherlands. Therefore, the auditor fulfils a crucial gatekeeper role in the financial system. This evidently follows from the auditing standards: the auditor must provide reasonable assurance that the financial statements are free from material misstatements due to fraud or error. In this way, the auditor makes a promise to society. Audit procedures aimed at detecting fraud are therefore an integral part of the statutory audit.
7. **In this context, it is important that the audit sector applies a broad perspective.**¹ In the statutory audit, the auditor should not only identify and follow up on risks of fraudulent financial reporting and misappropriation of assets, but also focus on matters such as risks of corruption, tax evasion, sanctions violations, money laundering, cybercrime and cartel arrangements. Doing so does justice to the complexity of the issue, the enhanced public expectations, and the fact that the issue of fraud will become ever more important and will extend to a wider range of areas in the future. In doing so, auditors also give substance to their broad gatekeeper role in the financial system in identifying and following up on fraud.
8. **Obviously, all parties in the corporate reporting chain must take their responsibility to tackle the social issue of fraud.**² **In this chain, the primary responsibility for preventing, detecting and tackling fraud lies with the audited companies.** This applies to large (multinational) enterprises as well as smaller companies, such as those with a Director and Major Shareholder (DGA) structure. Adequately and visibly giving substance to this responsibility places great demands on companies. For example, it requires having a good system of internal control and fraud controls in place, as well as a culture based on integrity and debate, and a clear mandate for and strict independence of the internal audit function. Needless to say, the internal supervisory bodies (Supervisory Board and Audit Committee) must also give adequate attention to fraud. It is important that members of the supervisory bodies have the knowledge and competence in respect of fraud and fraud risks required to perform their internal monitoring role, in line with the 'tone at the top' principle, and to challenge the Management Board and the statutory auditor. From the end user's perspective, it is also important that the management report

¹ In line with Article 7 of EU-Regulation 537/2014: '(...) when 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.'

² Audited company (Management Board, Supervisory Board/Audit Committee, Internal Audit Function), statutory auditor, investigative authorities and the AFM. See also: [nba-publiceert-aanbevelingen-voor-bestuurders-en-toezichthouders-van-organisaties-voor-de-preventie-en-detectie-van-fraude](#)

describes the fraud and fraud risk control process in clear and transparent terms. An internal control statement, in which the company management takes accountability for the quality of the system of internal controls, would be instrumental in this context. All this obviously does not release audit firms from their statutory and social responsibility to detect and follow up on fraud risks in the statutory audit.

9. **It is difficult to obtain an objectified (or quantitative) picture of the degree to which the audit sector as a whole currently implements this responsibility to detect and follow up on fraud in the statutory audit.** Put differently: it is difficult to pinpoint the extent of the problem or the progress made by the sector in reducing it. Neither the audit sector nor the AFM has systematically investigated this over a longer period of time. Based on the discussions with a large number of stakeholders in the corporate reporting chain and an analysis of recent academic literature, the AFM has nevertheless been able to form an – initial – general picture. Obviously, this general picture does not do justice to the progress which individual audit firms are already making and experiencing in giving substance to their responsibilities in terms of detecting and following up on fraud risks at audited companies. Furthermore, the AFM currently has limited insight into the degree of development with regard to fraud risk detection among the non-PIE audit firms that are fully subject to the AFM’s supervision since 1 January 2022. However, a recent AFM thematic review concerning corruption risk control has revealed that there is room for improvement.³
10. **On the one hand, the initiatives being taken suggest that the sector itself is well aware of its responsibilities with regard to fraud, and audit firms are actively working on implementing this responsibility.** In addition, the auditor can never provide 100% assurance. Despite the auditor’s efforts, there always remains an unavoidable risk of fraud. After all, fraud is caused by deliberate behaviour and collusion, which are inherently difficult to detect. In addition, confidentiality rules to a certain extent prevent the auditor from actively reporting and disclosing fraud and fraud risks of audited companies. As the Special Envoys on the Future of the Audit Sector rightly pointed out in their most recent progress report, this field of tension between confidentiality on the one hand and transparency and relevance on the other requires an open discussion, which will need to be held in the coming period.⁴
11. **On the other hand, a number of arguments have emerged which suggest that auditors are not yet sufficiently fulfilling their responsibility in terms of detecting and following up on fraud and fraud risks.** Fraud detection must be an integral part of the statutory audit, in accordance with the statutory requirements. This applies when accepting the client, assessing the risks and planning and performing the audit procedures, as well as with respect to the corporate reporting and the auditor’s report. Nevertheless, nearly every interviewee – including a number of sector representatives, – indicated that there is still a performance gap and that the laws and regulations in force are often insufficiently applied. For many audit firms, fraud risk detection and follow-up is not yet a top priority. Recent academic literature basically points in this direction as well. There seems to be consensus among the interviewees that the problem primarily manifests itself as the statutory auditor’s failure to identify fraud and not so much in

³ <https://www.afm.nl/nl-nl/nieuws/2021/mei/verkenning-beheersing-corruptierisicos-accountantsorganisaties>

⁴ [Third progress report of the Coordinators on the Future of the Accountancy Sector | Parliamentary Paper | Rijksoverheid.nl](#)

terms of failing to follow up on identified fraud signals. Furthermore, a trend can be perceived where (especially the larger) audit firms apply an increasingly strict initial risk selection process. This increases the chance that fraud risks are not detected at system level if high-risk audits are carried out by audit firms with less fraud expertise and capacity. Lastly, these concerns point in the same direction as the numerous public inquiries in the Netherlands and abroad which have reviewed the role of the audit sector in relation to fraud in recent years.⁵

Underlying causes

12. **Failure to adequately detect and follow up on material fraud and fraud risks in the statutory audit may have a significant impact on the audit firm and/or individual statutory auditor involved. Examples include financial repercussions (fines, compensation), as well as administrative consequences (enforcement action by supervising authorities), and sometimes even criminal prosecution.** Against the background of the concerns outlined above, the question arises why these consequences apparently do not always have the desired effect. What are the underlying causes, what problems do statutory auditors face in practice?
13. **The analysis performed has revealed three potential root causes:**
- i) Knowledge, competence and expertise are not always sufficiently available, ii) The auditor's role perception, attitude and mindset may be inadequate when it comes to the detection of fraud and fraud risks, and iii) the internal culture at audit firms may be impediment.**

(i) Knowledge, competence and expertise are not always sufficiently available. Specific bottlenecks in this context relate to: inadequate fraud risk analyses, where fraud risks are insufficiently recognised and fraud signals are insufficiently picked up; sometimes insufficiently detailed knowledge of the client, the business model, the sector and the environment in which the client operates; insufficient knowledge of laws and regulations and auditing standards; insufficient awareness of behavioural and cultural signals within audited companies; a lack of experience with fraud cases; sometimes insufficiently diverse expertise in audit teams; and, finally, the inherent complexity of adequately detecting and following up on fraud risks through group audits of internationally operating companies.

(ii) Behaviour: role perception, attitude and mindset may be inadequate when it comes to the detection of fraud and fraud risks. In general, the auditor's default position is often to trust the company instead of having healthy distrust. The auditor is naturally disposed towards confirmation (assuming good behaviour by the client) and may be insufficiently equipped to be attentive to signs of bad behaviour (fraud). An underlying factor may be the conviction that the client does not commit fraud and acts with integrity. This entails the risk of confirmation bias manifesting itself: the auditor unconsciously looks for confirmation of what he or she expects. However, targeted fraud risk detection and follow-up requires an attitude and mindset on the auditor's part that is fundamentally different from what is required for continuous improvement of the average quality of the statutory audits (i.e. regular detection and correction of corporate

⁵ Such as the US Senate (1977) and the Treadway Commission (1987) in the US, the Brydon report (2019) in the UK and the MCA (2020) and CTA (2020) reports in the Netherlands. The IAASB also addressed the issue in a recent discussion paper (2020).

reporting deficiencies). A tendency to overestimate one's own abilities may sometimes also play a part ('I know my client, I am bound to notice fraud'). Another factor is that a long-standing relationship with the same client entails the risks that the auditor will operate too much on autopilot and that the personal relationship makes it inherently more difficult to discuss fraud signals.

(iii) The internal culture at audit firms may be an impediment. Specific bottlenecks in this context relate to: internal disincentives (time pressure and limited capacity, being criticised for not identifying fraud earlier); possibly an inherent tendency within audit firms to 'minimise' overlooked cases of fraud, for example on account of the reputational impact and financial consequences – here the company's behaviour (reluctance to air their 'dirty laundry' in public) may reinforce the audit firm's behaviour; lack of scope or a safe space for members of an audit team to expose fraud risks within the audit firms; compliance pressure, leading to a focus on proper documentation and a fear of making mistakes that may stand in the way of professional scepticism and an independent view of fraud, meaning that genuine fraud risks may be overlooked.

What can auditors and audit firms do?

14. **What can the audit sector do in order to make a further contribution to effective fraud detection and follow-up in the statutory audit, in accordance with the statutory requirements and public expectations?**
15. **First and foremost, the current laws and regulations provide an adequate basis for auditors to fulfil their role as gatekeeper in respect of a wide-ranging fraud concept, and it is up to the audit sector to comply with both the letter and the spirit of the law.** In this context, it is not primarily the AFM's duty to dictate in detail how the audit sector should handle the issue of fraud. The International Auditing and Assurance Standards Board (IAASB) has also placed the topic of fraud on the agenda for 2022-2023, with the aim to adopt an updated auditing standard in 2024.
16. **The AFM largely agrees with the change initiatives – instigated in part by the Netherlands Institute of Chartered Accountants (NBA) – that have been set in motion, such as greater transparency, greater attention to fraud detection in training and continuing professional education, and the targeted use of forensic expertise.** Greater transparency in the auditor's report about the audit procedures the statutory auditor performed to detect fraud is an important step. At the same time, the AFM believes that it would offer significant benefits to the end user if the auditor also reported on the outcomes of these procedures in the auditor's report. In addition, the AFM sees opportunities in a much broader application of a systematic integrity risk analysis (such as SIRA) in the sector. The mandatory use of forensic expertise at various moments in the audit and the provision of professional support by means of consultation and the formation of fraud panels may also contribute to the timely detection and adequate follow-up of fraud risks. The same applies to thematic internal investigations, and a focus on the issue of fraud in the engagement quality control review and audit file coaching in respect of high-risk clients. Where the development of professional scepticism is concerned, potential improvements might include the creation of more debate and checks and balances in the statutory audit in case of fraud signals; increased attention for contra-indications and

contradictory audit information (which will address the confirmation bias by placing less focus on only audit information aimed at the confirmation that figures and/or assertions are correct); specification of risks (in particular with regard to management override of controls: where can the management commit fraud?); and even greater emphasis on quality control reviews within firms.

What will the AFM do?

17. **In view of all this, the AFM will make the fraud topic an important theme in the supervision of audit firms.** The AFM is committed to promoting fair and transparent financial markets. Fraud is by definition unfair and non-transparent. After all, it involves concealment and creates information asymmetry between companies and the end users of corporate reporting. Fraud is a significant social issue which is expected to manifest itself in further areas in the future. It potentially has a major impact on the end user and may lead to instability of and loss of public confidence in the integrity of the financial system. This may also put pressure on society's justified confidence in the auditor. An underlying factor is the conviction that deception and fraud is a more serious problem than unintentional misstatements in the corporate reporting. After all, fraud may be an expression of a wider integrity problem in a company's culture. Furthermore, although there is no objectified picture, the sector as a whole still seems to have made insufficient progress in adequately detecting and following up on fraud risks, even though the issue of fraud has received attention for years. All these factors justify enhanced and intensified supervision of this issue.
18. **This means that the AFM will carry out a range of supervisory activities in the coming years.** In line with the AFM's supervisory approach towards the audit sector, the supervisory activities in respect of the fraud issue will link up with the three levels of quality: the quality-oriented culture, the system of quality control within the audit firm and the quality of the statutory audit. In this way, the supervisory activities will address the related underlying causes of the fraud problem. A combination of exploratory studies and assessments will produce a clearer picture of relevant factors, such as the statutory auditor's role perception, attitude and mindset in the detection of fraud risks, or the extent of debate within the audit team. Another relevant investigation theme is the extent to which the elements in the system of quality control – such as the professional consultations within the internal fraud panels – ensure effective follow-up on fraud risks. It also appears desirable to obtain clearer insight into the quality level and effectiveness of the fraud risk analysis and of the performance of the audit procedures in respect of fraud risks in the context of the statutory audit. In addition to carrying out investigations, the AFM intends to develop a data position, and thereby a more objectified picture of the fraud issue, as part of a structured annual data request. This could involve factors such as the amount of time, number of staff members and amount of resources the audit firm devotes to fraud risks in the statutory audit. Another perspective which the AFM intends to include is that of responsibility of the corporate reporting chain. From this perspective, the AFM will pay supervisory attention to the role of the internal supervisory bodies of the audited companies.
19. **In this context, the AFM wants to support the audit sector where possible in implementing its responsibility to further improve fraud risk detection and follow-up in the statutory audit.** For

example, the AFM may – in accordance with the sector’s wish – share best practices (on an anonymised basis) which the various supervisory reviews have brought to light. This will provide the sector with insights and concrete ideas. In addition, the AFM will participate more actively in the public debate and, where required, make a contribution to educational programmes or other initiatives rolled out by the sector. This does not alter the fact that the AFM will obviously take enforcement action in the event of fraud cases involving evident negligence and violation of laws and regulations.

20. **Finally, it appears advisable for the AFM, the sector and the Special Envoys to jointly reflect on the target on the horizon: what is the long-term aim, and when will the sector and the AFM be satisfied with the auditor’s role in respect of fraud?** The important point for the AFM in this context is that a positive development should become visible in the coming years, with clear signals that fraud risk detection and follow-up receives structural attention in the statutory audit and takes root within audit firms. Such signals may take the form of indicators such as the amount of time, attention, number of staff members and amount of resources audit firms devote to fraud in the statutory audit. In addition, the AFM expects to see a positive development in the outcomes of the various supervisory reviews which the AFM will carry out.



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