

**THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD
IN AN AUDIT OF FINANCIAL STATEMENTS**

CONTENTS

	Paragraphs
Introduction	1 - 3
Characteristics of Fraud	4 - 12
Responsibilities of Those Charged with Governance and Of Management.....	13 - 15
Responsibilities of the Auditor.....	16
Inherent Limitations of an Audit	17 - 20
Professional Skepticism	21 - 23
Discussion Among the Audit Team.....	24 - 26
Inquiries of Management	27 - 0
Inquiries of Those Charged with Governance.....	0 - 39
Risk Assessment Procedures	0 - 47
Assessing the Risk of Material Misstatement Due to Fraud	0 - 49
Responding to the Risk of Material Misstatement Due to Fraud.....	0 - 51
Overall responses	0 - 54
Audit Procedures Responsive to Risks of Material Misstatement Due to Fraud at the Assertion Level.....	0- 58
Audit Procedures Responsive to Risks of Management Override of Controls.....	0 - 67
Evaluating Audit Evidence	0 - 71
Management Representations	0 - 74
Communication with Management and Those Charged with Governance.....	0 - 81
Communication to Regulatory and Enforcement Authorities	0
Auditor Unable to Complete the Engagement	0 - 86
Documentation	0
Effective Date	0

International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA, not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility to consider fraud in an audit of financial statements. While this ISA focuses on the auditor's responsibilities with respect to fraud, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance and the management of an entity.
2. The following is an overview of the requirements of this standard:
 - *This section to be completed*
3. **When planning and performing the audit to reduce audit risk to an acceptably low level the auditor should consider the risk of material misstatements in the financial statements resulting from fraud.** ISA XX "*Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*" establishes standards and provides guidance on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of misstatement resulting from fraud or error in a financial statement audit. ISA XX "*The Auditor's Procedures in Response to Assessed Risks*" establishes standards and provides guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statements and assertion levels. This ISA establishes additional standards and provides additional guidance on the auditor's responsibility with respect to the risks of material misstatement due to fraud.

Characteristics of Fraud

4. Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
5. The term "error" refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:
 - A mistake in gathering or processing data from which financial statements are prepared.
 - An incorrect accounting estimate arising from oversight or misinterpretation of facts.
 - A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.
6. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity.
7. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

8. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may be accomplished by the following:
- Manipulation, falsification, or alteration of accounting records or supporting documentation from which the financial statements are prepared.
 - Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
 - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.
9. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management override of existing controls using such techniques as:
- (a) recording fictitious journal entries, particularly close to the end of an accounting period to manipulate operating results or achieve other objectives;
 - (b) intentionally biasing assumptions and judgments used to estimate account balances, and
 - (c) altering records and terms related to significant and unusual transactions.
10. Earnings management can lead to fraudulent financial reporting. Earnings management may start out with small actions or biased judgments by management, so small that management does not believe that they are inappropriate. Rather management believes that such actions or judgments are within the boundaries of acceptable business and accounting practice. What leads to fraudulent financial reporting is when management takes positions that are aggressive and develops a scheme for concealment that to avoid discovery. It is important for the auditor to be aware of circumstances that are indicative of a greater likelihood of earnings management and particularly of positions or judgments that are so aggressive that they are unacceptable under the accounting framework and mislead stakeholders as to the entity's performance and profitability.
11. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical assets or intellectual property, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.
12. Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Individuals might have an incentive to misappropriate assets for example, because the individuals are living beyond their means. Fraudulent financial reporting might be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target – particularly since the consequences to management failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control. Individuals might be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise

honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Responsibilities of Those Charged with Governance and of Management

13. The primary responsibility for the prevention and detection of fraud rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary by entity and from country to country. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and ethical behavior, and establish appropriate controls to prevent and detect fraud and error within the entity.
14. It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, that the entity has established and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.
15. It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes establishing and maintaining controls pertaining to the entity's objective of preparing financial statements for external purposes that give a true and fair view (or are presented fairly in all material respects) in accordance with the applicable financial reporting framework and the management of risk that may give rise to a risk of material misstatement in those financial statements. Such controls reduce but do not eliminate the risk of misstatement. In determining which controls should be established management considers the costs associated with establishing and maintaining a control in relation to the reduction in the risk of material misstatement to be achieved. As a result, management may conclude that it is not cost effective to establish and maintain a particular control. Accordingly, management assumes responsibility for any remaining risk of misstatement in the financial statements.

Responsibilities of the Auditor

16. As described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. An audit conducted in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud.

INHERENT LIMITATIONS OF AN AUDIT

17. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. An audit does not guarantee that all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit evidence available to the auditor is persuasive rather than

conclusive in nature. For these reasons, the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements will be detected.

18. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate selection or application of accounting principles. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.
19. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist management in carrying out a fraud, with or without the employees' knowledge.
20. The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

PROFESSIONAL SKEPTICISM

21. As required by ISA 200 "Objectives and General Principles Governing an Audit of Financial Statements," the auditor plans and performs an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. Due to the characteristics of fraud the auditor's attitude of professional skepticism is particularly important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.

22. **When conducting the audit, the auditor should recognize the possibility that a material misstatement due to fraud could exist, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity.** Professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may have occurred. When exercising professional skepticism in obtaining audit evidence, the auditor is not satisfied with less-than-persuasive audit evidence because of a belief that management is honest.
23. An audit performed in accordance with ISAs rarely involves the authentication of documentation, nor is the auditor trained as or expected to be an expert in such authentication. However, the auditor considers the reliability of the information to be used as audit evidence including consideration of controls over the preparation and maintenance where relevant. Unless the audit reveals audit evidence to the contrary, the auditor ordinarily accepts records and documents as genuine.

DISCUSSION AMONG THE AUDIT TEAM

24. **The members of the audit team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.**
25. ISA XX "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" paragraph 18, requires the members of the audit team to discuss the susceptibility of the entity to material misstatements of the financial statements, this discussion places particular emphasis on the susceptibility of the entity's financial statements to fraud. The discussion involves the engagement partner and professional judgment is used to determine which other members of the audit team are included in the discussion. Ordinarily the discussion involves the key members of the audit team. The discussion occurs with questioning mind setting aside any prior beliefs that the audit team members may have that management is honest and has integrity. The discussion ordinarily includes:
- An exchange of ideas among audit team members about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated;
 - A consideration of the known external and internal factors affecting the entity that might (a) create an incentive or pressure for management or others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management or others to rationalize committing fraud.
 - An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud;
 - A consideration of the risk of management override of controls;
 - A consideration of how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud; and
 - A consideration of which members of the audit team will conduct certain audit procedures and how the results of those audit procedures will be shared.
26. Discussing the susceptibility of the entity's financial statements to material misstatements due to fraud is an important part of planning the audit. It is also important that audit team members continue to communicate and share information obtained throughout the audit that

may affect the assessment of risks of material misstatement due to fraud or the audit procedures performed to address these risks.

INQUIRIES OF MANAGEMENT

27. The auditor should make inquiries of management to obtain an understanding of:

- (a) management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;**
- (b) management's process for identifying and responding to the risks of fraud in the entity, including any specific fraud risks that management has identified or account balances or classes of transactions for which a risk of fraud may be likely to exist; and**
- (c) the internal control management has designed and implemented to mitigate specific fraud risks that management has identified, or that otherwise help to prevent, deter, and detect fraud, and to obtain an understanding of how management monitors internal control.**

28. Management is responsible for the entity's internal control and for the preparation of the financial statements, therefore, it is appropriate for the auditor make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such controls and risk vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal and less frequent. In smaller entities the focus of the assessment may be on the risk of employee fraud or misappropriation of assets. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may be indicative of the lack of importance that management places on internal control.

29. When making inquiries to obtain an understanding of management's processes for identifying and responding to the risks of fraud in an entity with multiple locations, the auditor obtains an understanding of the nature and extent of monitoring of operating locations or business segments and whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist.

30. It is also important that the auditor obtain an understanding of the design and implementation of the internal control within the entity. In designing and implementing such controls, management makes informed judgments on the nature and extent of the controls it chooses to implement and the nature and extent of the risks it chooses to assume. As a result of making these inquiries of management, the auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties; this might be often be the case in small entities where the owner provides day-to-day supervision of operations. Information from these inquiries may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risk that the financial statements may contain material misstatements caused by fraud.

31. When obtaining an understanding of the design and implementation of the internal control within the entity, the auditor inquires whether management has reported to those charged with

governance how the entity's internal control serves to prevent, deter, or detect material misstatements due to fraud. The auditor also makes inquiries to obtain an understanding of whether and how management communicates to employees its views on business practices and ethical behavior.

32. **The auditor should make inquiries of management, and others within the entity, to determine whether they have knowledge of any fraud or suspected fraud affecting the entity or whether they are aware of any allegations of fraud or suspected fraud affecting the entity.**
33. Although the auditor's inquiries of management may provide useful information concerning the risk of material misstatements in the financial statements resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risk of material misstatements in the financial statements resulting from management fraud. Making inquiries of others within the entity, in addition to management, may be useful in providing the auditor with a perspective that is different from management and those responsible for the financial reporting process. Such inquiries may provide individuals with an opportunity to convey information to the auditor that might not otherwise be communicated. The auditor uses professional judgment in determining those others within the entity to whom inquiries are directed and the extent of such inquiries. In making this determination the auditor considers whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud.
34. The auditor ordinarily makes inquiries of internal audit personnel, for those entities that have an internal audit function. The inquiries address the views of the internal audit personnel regarding the risks of fraud, whether the internal auditors have performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any fraud or suspected fraud.
35. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:
- (a) In-house legal counsel;
 - (b) Operating personnel not directly involved in the financial reporting process;
 - (c) Employees with different levels of authority;
 - (d) Employees involved in initiating, processing or recording complex or unusual transactions.
36. The auditor uses professional judgment in deciding when it is necessary to corroborate responses to inquiries with other information. For example, when responses are inconsistent among inquiries the auditor obtains additional audit evidence to resolve the inconsistencies.

INQUIRIES OF THOSE CHARGED WITH GOVERNANCE

37. **The auditor should make inquiries of those charged with governance to obtain an understanding of how they exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.**

38. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and the internal control the entity has established to mitigate specific fraud risks that the entity has identified. Obtaining an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity, and the internal control that management has established to mitigate these risks, may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of such internal control and the competence and integrity of management.
39. Since the responsibilities of those charged with governance and management may vary by entity and from country to country, it is important that the auditor understands the nature of these responsibilities within an entity to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.¹
40. In addition, the auditor considers whether there are any matters of governance interest to be discussed with those charged with governance of the entity.² Such matters may include for example:
- Concerns about the nature, extent and frequency of management's assessments of the accounting and control systems in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
 - A failure by management to address appropriately material weaknesses in internal control identified during the prior period's audit.
 - The auditor's evaluation of the entity's control environment, including questions regarding competence and integrity of management.
 - The effect of any matters, such as those above, on the general approach and overall scope of the audit, including additional audit procedures that the auditor may need to perform.

RISK ASSESSMENT PROCEDURES

41. **When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risks factors are present.**
42. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, when obtaining an understanding of the entity and its environment, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud, or indicate that fraud may already have occurred. Such events or conditions are referred to as "fraud risk factors". For example, because of the need to

¹ ISA 260, "Communication of Audit Matters with Those Charged with Governance," paragraph 8 discusses with whom the auditor communicates when the entity's governance structure is not well defined.

² For a discussion of these matters, see ISA 260, "Communication of Audit Matters with Those Charged with Governance," paragraphs 11–12.

obtain additional equity financing management may be facing excessive pressure to meet expectations of third parties, an important contract may be missing, a subsidiary ledger may not be satisfactorily reconciled to its control account or an analytical procedure may not be consistent with expectations. However, these events or conditions may be the result of circumstances other than fraud. Therefore, fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of the risk of material misstatement.

43. Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgment in determining whether a fraud risk factor is present and whether it should be considered in assessing the risk of material misstatement of the financial statements due to fraud.
44. The examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1 to this ISA. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists: an incentive or pressure to commit fraud; a perceived opportunity to commit fraud; and an ability to rationalize the fraudulent action. Although the fraud risk factors described in Appendix 1 cover a broad range of situations typically faced by auditors, they are only examples. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor uses professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.
45. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance, the internal audit function and the existence and enforcement of a formal code of conduct. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.
46. In obtaining an understanding of the entity and its environment the auditor performs analytical procedures. In performing analytical procedures the auditor develops expectations about plausible relationships that are reasonably expected to exist based on the auditor's understanding of the entity and its environment. When a comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or

unexpected relationships, the auditor considers those results in identifying risks material misstatement due to fraud.

47. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Consequently, the auditor, when performing analytical procedures to assist in understanding the entity and its environment, performs analytical procedures relating to revenue recognition with the objective of identifying unusual or unexpected relationships involving revenue accounts that may identify a risk of material misstatement due to fraud.
48. In addition to information obtained from applying analytical procedures, the auditor considers other information obtained about the entity and its environment that may be helpful in identifying risks of material misstatement due to fraud. The discussion among team members as described in paragraphs 24 to 26 may provide information helpful in identifying such risks. In addition information obtained from the auditor's client acceptance and continuation processes and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of risks of material misstatement due to fraud.

ASSESSING THE RISK OF MATERIAL MISSTATEMENT DUE TO FRAUD

49. **The auditor should assess the risk of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.**
50. The assessment of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including:
- The *type* of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets;
 - The *significance* of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements
 - The *likelihood* of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements
 - The *pervasiveness* of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions.

RESPONDING TO THE RISK OF MATERIAL MISSTATEMENT DUE TO FRAUD

51. **The auditor should determine overall responses to address the risk of material misstatement due to fraud at the financial statement level and should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risk of material misstatement at the assertion level.**
52. The auditor responds to the risk of material misstatement due to fraud in the following ways:

- (a) A response that has an overall effect on how the audit is conducted – that is, a response involving more general considerations apart from the specific procedures otherwise planned.
- (b) A response to identified risks involving the nature, timing and extent of audit procedures to be performed. And
- (c) A response to identified risks involving the performance of certain audit procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

Overall responses

- 53. In determining overall responses to address the risks of material misstatement at the financial statement level the auditor considers the assignment and supervision of personnel; the accounting principles used by the entity and the predictability of audit procedures.
- 54. The knowledge, skill and ability of the personnel assigned significant engagement responsibilities is commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement. For example, the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional personnel with specialized skill and knowledge, such as forensic and IT specialists, or by assigning more experienced personnel to the engagement. In addition, the extent of supervision reflects the auditor's assessment of risk of material misstatement due to fraud.
- 55. The auditor considers management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions. The auditor considers whether the selection and application of accounting principles may be indicative of aggressive earnings management.

Audit procedures responsive to risks of material misstatement due to fraud at the assertion level

- 56. The auditor's responses to address the assessed risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures in the following ways:
 - The nature of audit procedures to be performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more evidence may be needed from independent sources outside the entity, such as public-record information, about the existence and nature of key customers, vendors, or counterparties in a major transaction. Also, physical observation or inspection of certain assets may become more important. Furthermore, the auditor may choose to employ computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
 - The timing of substantive tests may need to be modified. The auditor might conclude performing substantive testing at or near the period end to best addresses an assessed risk of material misstatement due to fraud. The auditor might conclude that, given the risks of intentional misstatement or manipulation, tests to extend audit conclusions from an interim date to the period end would not be effective.

- In contrast, because an intentional misstatement—for example, a misstatement involving inappropriate revenue recognition—may have been initiated in an interim period, the auditor might elect to apply substantive tests to transactions occurring earlier in or throughout the reporting period.
 - The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.
57. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period)³. Therefore, the auditor ordinarily designs and performs further audit procedures to address the risk of material misstatement due to inappropriate revenue recognition.
58. Examples of possible further audit procedures to address the assessed risk of material misstatement due to fraud are presented in Appendix 2 to this ISA. The appendix includes examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.
59. To add a couple of paragraphs picking up the concepts in Appendix 2.

Audit procedures responsive to the risk of management override of controls

60. As noted in paragraph 19, management is in a unique position to perpetrate fraud because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. While the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Accordingly in addition to overall responses to address the risk of material misstatement due to fraud and responses to address the assessed risk of material misstatement due to fraud the auditor performs further procedures to respond to the risk of management override of controls.
61. **To further respond to the risk of management override of controls, the auditor should design and perform audit procedures to:**
- (a) **Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;**
 - (b) **Review accounting estimates for biases that could result in material misstatement due to fraud;**
 - (c) **Obtain an understanding of the business rationale of any transactions that the auditor becomes aware of that are outside of the normal course of business for the**

³ Research indicates that the majority of fraudulent financial reporting schemes involved improper revenue recognition.

entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment

Journal Entries

62. Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (a) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments and reclassifications. In designing and performing audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statement the auditor:
- (a) obtains an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments;
 - (b) evaluates the design of the controls over journal entries and other adjustments and determines whether they have been implemented;
 - (c) identifies and selects journal entries and other adjustments for testing;
 - (d) determines the timing of the testing; and
 - (e) makes inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
63. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. Because fraudulent journal entries are often made at the end of a reporting period, the auditor's testing ordinarily focuses on the journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished, the auditor considers whether there is also a need to test journal entries throughout the period. Appendix 3 to this ISA contains additional items that the auditor considers when identifying and selecting specific journal entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected.
64. To a couple of paragraphs picking up the concepts in Appendix 3.

Accounting Estimates

65. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. In reviewing accounting estimates for biases that could result in material misstatement due to fraud the auditor:
- (a) considers whether differences between estimates best supported by audit evidence and the estimates included in the financial statements, even if they are individually, reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor reconsiders the estimates taken as a whole; and

- (b) performs a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.
66. If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor evaluates whether the circumstances producing such a bias represent a risk of material misstatement due to fraud. The auditor considers whether, in making accounting estimates, management's action appear to understate or overstate all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level.

Business Rationale for Transactions

67. The auditor obtains an understanding of the business rationale for transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment. In gaining such an understanding the auditor considers:
- Whether the form of such transactions appear overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties),
 - Whether management has discussed the nature of and accounting for such transactions with those charged with governance of the entity,
 - Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
 - Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance of the entity. and
 - Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.
68. The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed. Individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. Therefore the auditor incorporates an element of unpredictability in the selection of auditing procedures by, for example, performing substantive tests of selected account balances and assertions not otherwise tested due to their materiality or risk, adjusting the timing of testing from that otherwise expected, using different sampling methods, and performing procedures at different locations or at locations on an unannounced basis.

Evaluating Audit Evidence

69. **When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.**

70. As required by ISA XX “The Auditor’s Procedures in Response to Assessed Risks” the auditor, based on the audit procedures performed and the audit evidence obtained evaluates whether the assessments of the risks of material misstatement at the assertion level remain appropriate. As part of this evaluation the engagement partner considers whether there has been appropriate communication with other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.
71. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures information may come to the auditor’s attention that differs significantly from the information on which the assessment of material misstatement due to fraud was based. For example, the auditor might become aware of discrepancies in accounting records or conflicting or missing evidence. Also relationships between the auditor and management may become problematic or usual. Appendix 4 to this ISA contains examples of the type information that may come to the auditor’s attention and problematic or unusual relationships with management.
72. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor evaluates the implications, especially those dealing with the organizational position of the individual(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a non-management employee. Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on the nature, timing, and extent of the tests of further audit procedures to respond to the assessed risk.

Management Representations

73. **The auditor should obtain written representations from management that:**
 - (a) **It acknowledges its responsibility for design and implementation of internal control to prevent and detect fraud;**
 - (b) **It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and**
 - (c) **It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.**
74. ISA 580, “Management representations,” provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that management acknowledges its responsibility for internal control designed to prevent and detect fraud.
75. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to

the auditor all facts relating to any frauds or suspected frauds that it is aware of that may have affected the entity, and that management has 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.

Communication With Management or Those Charged With Governance

76. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters to an appropriate level of management.

77. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of an appropriate level of management. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, likelihood of collusions, magnitude and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement or suspected fraud.

78. If the auditor has identified fraud involving senior management and fraud (whether caused by senior management or other employees) that results in a material misstatement in the financial statements the auditor should communicate these matters to those charged with governance.

79. The auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about fraud involving misappropriation of assets by a lower-level employee.

80. The auditor should make those charged with governance or management aware, as soon as practicable, and at the appropriate level of responsibility, of material weaknesses in the design and implementation of internal control to prevent fraud which may have come to the auditor's attention.

81. If the auditor identifies risks of material misstatement of the financial statements due to fraud, which the entity has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgment there is a material weakness in the entity's risk assessment process as it related to risk of fraud, then the auditor includes such internal control deficiencies in the communication of audit matters of governance interest. See ISA 260 "Communications of Audit Matters with Those Charged with Governance."

82. If the integrity or honesty of management or those charged with governance are doubted, the auditor considers seeking legal advice to assist in the determination of the appropriate course of action.

Communications to Regulatory and Enforcement Authorities

83. The auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by country and in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. For example, in some countries, the auditor

of a financial institution has a statutory duty to report the occurrence of fraud and to supervisory authorities. The auditor considers seeking legal advice in such circumstances.

Auditor Unable to Continue the Engagement

84. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit the auditor should:

- (a) consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;**
- (b) consider the possibility of withdrawing from the engagement; and**
- (c) if the auditor withdraws:**
 - (i) discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and**
 - (ii) consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.**

85. Such exceptional circumstances can arise, for example, when:

- (a) the entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;
- (b) the auditor's consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- (c) the auditor has significant concern about the competence or integrity of management or those charged with governance

86. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of continuing association with the entity.

87. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action.

Documentation

88. The auditor should document:

- (a) The discussion among the audit team regarding the susceptibility of the entity's financial statements due to fraud, including how and when the discussion occurred, the audit team members who participated and the subject matter discussed;
- (b) The results of the risk assessment of material misstatement due to fraud at the financial statement level and at the assertion level;
- (c) The specific risk of material misstatement due to fraud and the overall responses to these risk at the financial statement level and the nature, timing and extent or the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level and the results of the audit procedures;
- (d) The results of the audit procedures designed and performed to further respond to the risk of management override of controls; and
- (e) The nature of the communications about fraud made to management, those charged with governance and others.

Effective Date

89. This ISA is effective for audits of financial statements for periods beginning on or after XXXX.

Appendix 1

The fraud risk factors identified in this Appendix are examples of such factors typically faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration—that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk factors relating to misstatements arising from fraudulent financial reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

INCENTIVES/PRESSURES

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - High degree of competition or market saturation, accompanied by declining margins
 - High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
 - Significant declines in customer demand and increasing business failures in either the industry or overall economy
 - Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
 - Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
 - Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
 - New accounting, statutory, or regulatory requirements
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
 - Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
 - Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements

- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards
3. Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:
- Significant financial interests in the entity
 - Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow⁴
 - Personal guarantees of debts of the entity
4. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

OPPORTUNITIES

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
 - A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
 - Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
 - Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
 - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
 - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
2. There is ineffective monitoring of management as a result of the following:
- Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
 - Ineffective board of directors or audit committee oversight over the financial reporting process and internal control
3. There is a complex or unstable organizational structure, as evidenced by the following:
- Difficulty in determining the organization or individuals that have controlling interest in the entity

⁴ Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- High turnover of senior management, counsel, or board members

4. Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems, including situations involving reportable condition

ATTITUDES

1. Risk factors reflective of attitudes by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to correct known reportable conditions on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
 - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report

- Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Risk factors arising from misstatements arising from misappropriation of assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

INCENTIVES/PRESSURES

1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
2. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following
 - Known or anticipated future employee layoffs
 - Recent or anticipated changes to employee compensation or benefit plans
 - Promotions, compensation, or other rewards inconsistent with expectations

OPPORTUNITIES/PRESSURES

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - Large amounts of cash on hand or processed
 - Inventory items that are small in size, of high value, or in high demand
 - Easily convertible assets, such as bearer bonds, diamonds, or computer chips
 - Fixed assets that are small in size, marketable, or lacking observable identification of ownership
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - Inadequate segregation of duties or independent checks
 - Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations
 - Inadequate job applicant screening of employees with access to assets

- Inadequate recordkeeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

ATTITUDES

Risk factors reflective of employee attitudes that allow them to justify misappropriations of assets, are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from misappropriation of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

Appendix 2**Examples of possible further audit procedures to address the assessed risk of material misstatement due to fraud**

The following are example of possible further audit procedures to address the assessed risk of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. The auditor exercises judgment to select the most appropriate audit procedures in the circumstances. The audit procedures identified may not be the most appropriate not necessary in each circumstance.

Overall considerations

Assessment of the risk of material misstatement due to fraud may affect the audit in the following ways:

- Professional skepticism. The application of professional skepticism may include: (i) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (ii) increased recognition of the need to corroborate management explanations or representations concerning material matters.
- Assignment of members of the audit team. The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor's assessment of the level of risk for the engagement. In addition, the extent of supervision needs to recognize the risk of material misstatement resulting from fraud and the qualifications of members of the audit team performing the work.
- Accounting principles and policies. The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalizing versus expensing.

The nature, timing and extent of procedures may need to be modified in the following ways:

- The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more audit evidence may be needed from independent sources outside the entity.
- The timing of substantive procedures may need to be altered to be closer to, or at, year-end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive procedures should be performed near or at year-end because it would not be possible to control the incremental audit risk associated with that fraud risk factor.
- The extent of the procedures applied will need to reflect the assessment of the risk of material misstatement resulting from fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate.

The auditor considers whether changing the nature of the audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risk of material misstatement resulting from fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas will need to be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the fraud risk factors or conditions identified.

The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis. For example, observe inventory at locations where auditor attendance has not been previously announced or count cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Alter the audit approach in the current year. For example, contact major customers and suppliers orally in addition to sending written confirmation, send confirmation requests to a specific party within an organization, or seek more and different information.
- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigate the possibility of related parties and the sources of financial resources supporting the transactions.
- Perform substantive analytical procedures using disaggregated data. For example, compare sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conduct interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, consider discussing with them the extent of work necessary to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect a financial statement item for which the risk of misstatement due to fraud is high, perform additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engage another expert for that purpose.
- Perform audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Perform procedures on account or other reconciliations prepared by the entity, including consideration of reconciliations performed at interim periods.

- Perform computer-assisted techniques, such as data mining to test for anomalies in a population.
- Test the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific responses – Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risk of material misstatements resulting from fraudulent financial reporting are as follows:

- Revenue recognition: Because revenue recognition is dependent on the particular facts and circumstances, as well as accounting principles and practices that can vary by industry, the auditor ordinarily will develop auditing procedures based on the auditor's understanding of the entity and its environment, including the composition of revenues, specific attributes of the revenue transactions, and unique industry considerations. If there is an identified risk of material misstatement due to fraud that involves improper revenue recognition, the auditor also may want to consider:
 - Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
 - Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
 - Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
 - Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.
 - For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.
- *Inventory quantities.* If there is an identified risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date. In addition, it may be appropriate for inventory counts to be conducted at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.

It also may be appropriate for the auditor to perform additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard. Furthermore, additional testing of count sheets, tags, or other records, or the retention of copies of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

Following the physical inventory count, the auditor may want to employ additional procedures directed at the quantities included in the priced out inventories to further test the reasonableness of the quantities counted—for example, comparison of quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records. The auditor also may consider using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

- *Management estimates.* The auditor may identify a risk of material misstatement due to fraud involving the development of management estimates. This risk may affect a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other postretirement benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Estimates are based on subjective as well as objective factors and there is a potential for bias in the subjective factors, even when management's estimation process involves competent personnel using relevant and reliable data.

In addressing an identified risk of material misstatement due to fraud involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained. In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of a derivative), it may be appropriate to engage a specialist or develop an independent estimate for comparison to management's estimate. Information gathered about the entity and its environment may help the auditor evaluate the reasonableness of such management estimates and underlying judgments and assumptions.

A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

Specific Responses – Misstatements Resulting from Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement resulting from fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions.

Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the

misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, it may be useful for the auditor to obtain an understanding of the control procedures related to the prevention and detection of such misappropriation and to test the operating effectiveness of such controls.

Appendix 3**Matters the auditor considers in examining journal entries and other adjustments for evidence of possible material misstatements due to fraud**

The auditor uses professional judgment in determining the nature, timing and extent testing of journal entries and other adjustments. For the purposes of identifying and selecting specific journal entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor considers:

- The auditor's assessment of the risk of material misstatement due to fraud. The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing;
- The effectiveness of controls that have been implemented over journal entries and other adjustments. Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of this control. Even though controls have been operating effectively the auditor's procedures for testing journal entries and other adjustments includes the identification and testing of specific items;
- The entity's financial reporting process and the nature of the evidence that can be examined. The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the auditor's procedures include selecting from the general ledger journal entries to be tested and examining support for those items - journal entries and other adjustments might exist in either electronic or paper form;
- The characteristics of fraudulent entries or adjustments. . Inappropriate journal entries and other adjustments often have certain unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or a consistent ending number.
- The nature and complexity of the accounts. Inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to errors in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components consideration is given to the need to select journal entries from multiple locations.
- Journal entries or other adjustments processed outside the normal course of business. The auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.

Appendix 4

Examples of information that may come to the auditor's attention that differs significantly from the information on which the risk assessments were based and examples of problematic or unusual relationships with management

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy
- Unsupported or unauthorized balances or transactions
- Last-minute adjustments that significantly affect financial results
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties
- Tips or complaints to the auditor about alleged fraud

Conflicting or missing evidence, including:

- Missing documents
- Documents that appear to have been altered
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
- Significant unexplained items on reconciliations
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures
- Unusual discrepancies between the entity's records and confirmation replies
- Missing inventory or physical assets of significant magnitude
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought
- Undue time pressures imposed by management to resolve complex or contentious issues
- Complaints by management about the conduct of the audit or management intimidation of audit team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
- Unusual delays by the entity in providing requested information
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent

ISA 260 COMMUNICATION OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

The following paragraphs would be added to ISA 260 *Communication of Audit Matters to those Charged with Governance*

The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The uncorrected misstatement communicated to those charged with governance need not include the misstatement below a designated amount.

ISA 320 AUDIT MATERIALITY

The following paragraphs would be added to ISA 320 *Audit Materiality*

If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260 “Communication of Audit Matters to Those Charged with Governance.”

ISA 580 MANAGEMENT REPRESENTATIONS

The following paragraph would be added to ISA 580 *Management Representations*:

The auditor should obtain written representations from management that it believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.

[Blank page]