

Original ISA 240	New ISA Standards Ref.	New ISA AM Ref.	Comment
<p>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 and expand on how the standards and guidance in ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" are to be applied in relation to the risks of material misstatement due to fraud. The standards and guidance in this ISA are intended to be integrated into the overall audit process.</p>	1.		
<p>2. This standard:</p> <ul style="list-style-type: none"> • Distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor – misstatements resulting from misappropriation of assets and misstatements resulting from fraudulent financial reporting; describes the respective responsibilities of those charged with governance and the management of the entity for the prevention and detection of fraud, describes the inherent limitations of an audit in the context of fraud and sets out the responsibilities of the auditor for detecting material misstatements due to fraud. • Requires the auditor to maintain an attitude of professional skepticism recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance. • Requires members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud and requires the engagement partner to consider which matters are to be communicated to members of the engagement team not involved in the discussion. • Requires the auditor to: <ul style="list-style-type: none"> - perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud; - identify and assess the risks of material misstatement due to fraud at the financial statement level and the assertion level and for those assessed risks that could result in a material misstatement due to fraud are to evaluate the design of the entity's related controls, including relevant control activities, and to determine whether they have been implemented; - determine overall responses to address the risk of material misstatement due to fraud at the financial statement level and consider the assignment and supervision of personnel, consider the accounting policies used by the entity and incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed; 			Deleted. The construction of the <i>New ISA</i> removes the need for an overview.

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<ul style="list-style-type: none"> - design and perform audit procedures to respond to the risk of management override of controls; - determine responses to address the assessed risks of material misstatement due to fraud; - consider whether an identified misstatement may be indicative of fraud; - obtain written representations from management relating to fraud; and - communicate with management and those charged with governance. • Provides guidance on communications with regulatory and enforcement authorities. • Provides guidance 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. • Establishes documentation requirements. 			
3. In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.	2.		Reconstituted as a "shall" statement.
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.	3.		Positioned within the standards as it is essential in establishing context.
5. The term "error" refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as: <ul style="list-style-type: none"> • 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. 		A2.	Explanatory in nature.
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. <u>Although fraud is a broad legal concept, for the purposes of this ISA, the auditor is concerned with fraud that causes a material misstatement in the financial statements.</u> Auditors do not make legal	5.	A3.	Explanatory in nature. Positioned within the standards as it is essential in establishing context.

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<p>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 within the entity or with third parties outside of the entity.</p>			
<p>7. Two types of intentional misstatements are relevant to the auditor— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.</p>		A4.	Explanatory in nature.
<p>8. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may be accomplished by the following:</p> <ul style="list-style-type: none"> • Manipulation, falsification (including forgery), 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. 		A5.	Explanatory in nature.
<p>9. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:</p> <ul style="list-style-type: none"> • Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives; • Inappropriately adjusting assumptions and changing judgments used to estimate account balances; • Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period; • Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements; • Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity; and • Altering records and terms related to significant and unusual transactions. 		A6.	Explanatory in nature.

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<p>10. Fraudulent financial reporting can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.</p>		A7.	Explanatory in nature.
<p>11. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:</p> <ul style="list-style-type: none"> • Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts; • Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment); • Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees); and • Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party). <p>Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.</p>		A8.	Explanatory in nature.
<p>12. Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Individuals may have an incentive to misappropriate assets for example, because the individuals are living beyond their means. Fraudulent financial reporting may 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 for failing to meet financial goals can be significant.</p> <p>A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an</p>	4.	A9.	Positioned within the standards as it is essential to their set-up, and to introduce the concept behind earnings management.

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<p>individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control. Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.</p>			Explanatory in nature.
<p>Responsibilities of Those Charged with Governance and of Management</p>			
<p>13. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. The respective responsibilities of those charged with governance and of management may vary by entity and from country to country. In some entities, the governance structure may be more informal as those charged with governance may be the same individuals as management of the entity.</p>		A10.	Explanatory in nature.
<p>14. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a culture of honesty and ethical behavior. Such a culture, based on a strong set of core values, is communicated and demonstrated by management and by those charged with governance and provides the foundation for employees as to how the entity conducts its business. Creating a culture of honesty and ethical behavior includes setting the proper tone; creating a positive workplace environment; hiring, training and promoting appropriate employees; requiring periodic confirmation by employees of their responsibilities and taking appropriate action in response to actual, suspected or alleged fraud.</p>		A11.	Explanatory in nature.
<p>15. It is the responsibility of those charged with governance of the entity to ensure, through oversight of management, that the entity establishes 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. Active oversight by those charged with governance can help reinforce management's commitment to create a culture of honesty and ethical behavior. In exercising oversight responsibility, those charged with governance consider the potential for management override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.</p>		A12.	Explanatory in nature.
<p>16. It is the responsibility of management, with oversight from those charged with governance, 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</p>		A13.	Explanatory in nature.

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<p>establishing and maintaining controls pertaining to the entity's objective of preparing financial statements that give a true and fair view (or are presented fairly in all material respects) in accordance with the applicable financial reporting framework and managing risks that may give rise to material misstatements in those financial statements. Such controls reduce but do not eliminate the risks of misstatement. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.</p>			
<p>Inherent Limitations of an Audit in the Context of Fraud</p>			
<p>17. 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 applicable financial reporting framework. 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.</p>	5.		Positioned within the standards as it is considered essential in establishing context.
<p>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 individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.</p>	7.	A14.	The standards contain a summary description of factors resulting in a higher risk of not detecting material misstatements due to fraud, as it is considered essential in establishing the context in which the standard is set.
<p>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 in carrying out a fraud, with or without the employees' knowledge.</p>	7.		Positioned within the standards as it is considered essential in establishing context.

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<p>20. The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs. This is particularly the case for certain kinds of intentional misstatements, since audit 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 that involves falsified documentation. Whether the auditor has performed an audit in accordance with ISAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence.</p>	9.		Positioned within the standards as it is considered essential in establishing context.
Responsibilities of the Auditor for Detecting Material Misstatement due to Fraud			
<p>21. An auditor conducting an audit in accordance with ISAs obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements 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.</p>	5.		Positioned within the standards as it is considered essential in establishing context.
<p>22. When obtaining reasonable assurance, an auditor maintains an attitude of professional skepticism throughout the audit, considers the potential for management override of controls and recognizes the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of material misstatement due to fraud. The remainder of this ISA provides additional guidance on considering the risks of fraud in an audit and designing procedures to detect material misstatements due to fraud.</p>	8.		Positioned within the standards as it is considered essential in establishing context.
Professional Skepticism			
<p>23. 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 risks of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.</p>		A15.	Explanatory in nature.

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<p>28. ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" requires members of the engagement team to discuss the susceptibility of the entity to material misstatements of the financial statements.</p> <p>This discussion places particular emphasis on the susceptibility of the entity's financial statements to material misstatement due to fraud.</p> <p>The discussion includes the engagement partner who uses professional judgment, prior experience with the entity and knowledge of current developments to determine which other members of the engagement team are included in the discussion. Ordinarily, the discussion involves the key members of the engagement team. The discussion provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.</p>	<p>13.</p> <p>13.</p>	<p>A32.</p>	<p>Positioned within the standards as essential explanatory material.</p> <p>Reconstituted as a "should" statement in place of old para 27 (see above)</p> <p>Explanatory in nature.</p>
<p>29. The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion. All of the members of the engagement team do not necessarily need to be informed of all of the decisions reached in the discussion. For example, a member of the engagement team involved in audit of a component of the entity may not need to know the decisions reached regarding another component of the entity.</p>		<p>A33.</p>	<p>A new "should" statement is proposed to be introduced in <i>New ISA 315</i> as this requirement is not fraud-specific and applicable to all engagements. Consequently, this paragraph has been reconstituted as application material with a reference to the requirements of ISA 315.</p>
<p>30. The discussion occurs with a questioning mind setting aside any beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. The discussion ordinarily includes:</p> <ul style="list-style-type: none"> • An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may 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 circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting; • A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to 	<p>13.</p>	<p>A34.</p>	<p>A new "should" statement has been added in paragraph 13 of <i>New ISA</i> to include consideration by the engagement team of what matters, broadly, should be addressed in discussion. This new "should" statement provides a "hook" for the original detailed illustrative list (which has been positioned with the application material of the <i>New ISA</i>).</p> <p>*However, the IAASB is asked to consider whether this list of matters should be established in the standards in its entirety.</p>

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<p>rationalize committing fraud;</p> <ul style="list-style-type: none"> • A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation; • A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team; • 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 types of circumstances that, if encountered, might indicate the possibility of fraud; • A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed; • A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatements due to fraud and whether certain types of audit procedures are more effective than others; • A consideration of any allegations of fraud that have come to the auditor's attention; and • A consideration of the risk of management override of controls. 			
<p>31. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud is an important part of the audit. It enables the auditor to consider an appropriate response to the susceptibility of the entity's financial statements to material misstatement due to fraud and to determine which members of the engagement team will conduct certain audit procedures. It also permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, the engagement partner, having personally conducted the planning of the audit, considers the susceptibility of the entity's financial statements to material misstatement due to fraud.</p>		A35.	Explanatory in nature.
<p>32. It is important that after the initial discussion while planning the audit, and also at intervals throughout the audit, engagement team members continue to communicate and share information obtained that may affect the assessment of risks of material misstatement due to fraud or the audit procedures performed to address these risks. For example, for some entities it may be appropriate to update the discussion when reviewing the entity's interim financial information.</p>	13.	A36.	Reconstituted as a "should" statement. Repeated in the application material for purposes of setting up the additional explanatory guidance.

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Risk Assessment Procedures			
<p>33. As required by ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement”, to obtain an understanding of the entity and its environment, including its internal control, the auditor performs risk assessment procedures. As part of this work the auditor performs the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud:</p> <ul style="list-style-type: none"> (a) makes inquiries of management, of those charged with governance, and of others within the entity as appropriate and obtains an understanding of how those charged with governance exercise oversight of management’s processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks; (b) considers whether one or more fraud risk factors are present; (c) considers any unusual or unexpected relationships that have been identified in performing analytical procedures; and (d) considers other information that may be helpful in identifying the risks of material misstatement due to fraud. 		A17.	Explanatory in nature, setting up the flow of the text of the application material.
Inquiries and Obtaining an Understanding of Oversight Exercised by Those Charged With Governance			
<p>34. When obtaining an understanding of the entity and its environment, including its internal control, the auditor should make inquiries of management regarding:</p> <ul style="list-style-type: none"> (a) Management’s assessment of the risk that the financial statements may be materially misstated due to fraud; (b) Management’s process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist; (c) Management’s communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and (d) Management’s communication, if any, to employees regarding its views on business practices and ethical behavior. 	12(a)		
<p>35. As management is responsible for the entity’s internal control and for the preparation of the financial statements, it is appropriate for the auditor to make inquiries of management regarding management’s own</p>		A18.	Explanatory in nature.

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<p>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 risk and controls 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 some entities, particularly smaller entities, the focus of the assessment may be on the risks 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 in some circumstances be indicative of the lack of importance that management places on internal control.</p>	12(a)(i)		Inquiring of the nature, extent and frequency of management's assessment included as part of the standards.
<p>36. In a small owner managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity, thereby compensating for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because of the informal system of internal control. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.</p>		A19.	Explanatory in nature.
<p>37. When making inquiries as part of obtaining an understanding of management's process for identifying and responding to the risks of fraud in the entity, the auditor inquires about the process to respond to internal or external allegations of fraud affecting the entity.</p> <p>For entities with multiple locations, the auditor inquires about 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.</p>	12(a)(iii)	A20.	<p>Reconstituted as a "should" statement.</p> <p>Explanatory in nature.</p>
<p>38. The auditor should make inquiries of management, internal audit, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.</p>	12(b)		Repositioned within the standards for drafting purposes only.
<p>39. Although the auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risks of material misstatement 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 may 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 the risks of</p>	12(b)	A21.	<p>Explanatory in nature.</p> <p>Positioned within the standards as essential explanatory guidance.</p>

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material misstatement due to fraud.			
40. The auditor makes inquiries of internal audit personnel, for those entities that have an internal audit function. The inquiries address the views of the internal auditors regarding the risks of fraud, whether during the year the internal auditors have performed any procedures to detect fraud, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any actual, suspected or alleged fraud.	12(b)		Reconstituted as a “should” statement.
41. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include: (a) Operating personnel not directly involved in the financial reporting process; (b) Employees with different levels of authority; (c) Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees; (d) In-house legal counsel; (e) Chief ethics officer or equivalent person; and (f) The person or persons charged with dealing with allegations of fraud.		A22.	Explanatory in nature.
42. When evaluating management’s responses to inquiries, the auditor maintains an attitude of professional skepticism recognizing that management is often in the best position to perpetrate fraud. Therefore, the auditor uses professional judgment in deciding when it is necessary to corroborate responses to inquiries with other information. When responses to inquiries are inconsistent, the auditor seeks to resolve the inconsistencies.	12(b)	A23.	Explanatory in nature. Reconstituted as a “should” statement.
43. The auditor should obtain 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.	12(c)		Repositioned within the standards for drafting purposes only.
44. 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 of the internal control the entity has established to mitigate specific risks of fraud that the entity has identified. Since the responsibilities of those charged with governance and management may		A24.	Explanatory in nature.

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vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals. ¹ Those charged with governance include management when management performs such functions, such as may be the case in smaller entities.			
45. 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. The auditor may obtain this understanding by performing procedures such as attending meetings where such discussions take place, reading the minutes from such meetings or by making inquiries of those charged with governance.	12(b)	A25.	Explanatory in nature. Positioned within the new standards as essential explanatory guidance.
46. The auditor should make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.	12(d)		Repositioned for drafting purposes only.
47. The auditor makes inquiries of those charged with governance in part to corroborate the responses to the inquiries from management. When responses to these inquiries are inconsistent, the auditor obtains additional audit evidence to resolve the inconsistencies. Inquiries of those charged with governance may also assist the auditor in identifying risks of material misstatement due to fraud.	12(d) 12(d) 12(d)		Positioned within the new standards as essential explanatory guidance. Reconstituted as a "should" statement. Positioned within the new standards as essential explanatory guidance.
Consideration of Fraud Risk Factors			
48. 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 risk factors are present.	12(e)		Repositioned within the standards for drafting purposes.
49. 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, including its internal control, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Such events or conditions are referred to as "fraud risk factors". For example:		A26.	Explanatory in nature.

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.

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Original ISA 240	New ISA Standards Ref.	New ISA AM Ref.	Comment
<ul style="list-style-type: none"> The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud; The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and An ineffective control environment may create an opportunity to commit fraud. <p>While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of the risks of material misstatement.</p>	12(e)		Positioned within the standards as essential explanatory guidance.
<p>50. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the auditor exercises professional judgment in determining whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud.</p>		A27.	Explanatory in nature.
<p>51. 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. Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist. The auditor also has to be alert for risk factors specific to the entity that are not included in Appendix 1. Not all of the examples in Appendix 1 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.</p>		32.	Explanatory in nature.
<p>52. 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 and of the internal audit function and the existence and enforcement of a formal code of conduct. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes</p>		A29.	Explanatory in nature.

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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. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.			
Consideration of Unusual or Unexpected Relationships			
53. When performing analytical procedures to obtain an understanding of the entity and its environment, including its internal control, the auditor should consider unusual or unexpected relationships that may indicate risks of material misstatement due to fraud.	12(f)		Repositioned within the standards for drafting purposes.
54. Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. 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, including its internal control. When a comparison of those expectations with recorded amounts, or with ratios developed from recorded amounts, yields unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement due to fraud. Analytical procedures include procedures related to revenue accounts with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting, such as, for example, fictitious sales or significant returns from customers that might indicate undisclosed side agreements.		A30.	Explanatory in nature.
Consideration of Other Information			
55. When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether other information obtained indicates risks of material misstatement due to fraud.	12(g)		Repositioned within the standards for drafting purposes.
56. 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 the risks of material misstatement due to fraud. The discussion among team members described in paragraphs 26-31 may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be		A31.	Explanatory in nature supporting the preceding requirement.

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relevant in the identification of the risks of material misstatement due to fraud.			
Identification and Assessment of the Risks of Material Misstatement Due to Fraud			
<p>57. When identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor should identify and assess the risks of material misstatement due to fraud.</p> <p>Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented.</p>	<p>14.</p> <p>14.</p>		<p>Reconstituted as a "shall" statement, with reference to ISA 315 added.</p> <p>Retained as a "should" statement with references to ISA 315 added.</p>
<p>58. To assess the risks of material misstatement due to fraud the auditor uses professional judgment and:</p> <ul style="list-style-type: none"> Identifies risks of fraud by considering the information obtained through performing risk assessment procedures and by considering the classes of transactions, account balances and disclosures in the financial statements; Relates the identified risks of fraud to what can go wrong at the assertion level; and Considers the likely magnitude of the potential misstatement including the possibility that the risk might give rise to multiple misstatements and the likelihood of the risk occurring . 		A37.	A reference to ISA 315 has been added as this material is duplicative to that contained in ISA 315. No new requirements in relation to fraud are introduced and therefore considered explanatory in nature.
<p>59. It is important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud because in designing and implementing such controls, management may make 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. The auditor may learn for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties; this may often be the case in small entities where the owner provides day-to-day supervision of operations. Information from obtaining this understanding may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.</p>		A38.	Explanatory in nature.
Risks of Fraud in Revenue Recognition			
<p>60. 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). Therefore, the auditor ordinarily presumes that there are risks of fraud in revenue recognition and considers which types of revenue, revenue transactions or assertions may give rise to such risks. Those assessed risks of material misstatement due fraud related to revenue recognition are significant risks to be</p>	<p>15.</p>	<p>A39.</p>	Reconstituted as a "should" statement.

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<p>addressed in accordance with paragraphs 57 and 61.</p> <p>Appendix 3 includes examples of responses to the auditor's assessment of the risk of material misstatement due to fraudulent financial reporting resulting from revenue recognition. If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor documents the reasons supporting the auditor's conclusion as required by paragraph 109.</p>		A39.	Explanatory in nature and appropriately cross-referenced to the related standards.
Responses to the Risks of Material Misstatement Due to Fraud			
61. The auditor should determine overall responses to address the assessed risks 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 risks at the assertion level.	16.		Reconstituted as a "shall" statement.
62. ISA 330, "The Auditor's Procedures in Response to Assessed Risks" requires the auditor to perform substantive procedures that are specifically responsive to risks that are assessed as significant risks.		A40.	Explanatory in nature.
<p>63. The auditor responds to the risks of material misstatement due to fraud in the following ways:</p> <p>(a) A response that has an overall effect on how the audit is conducted – that is, increased professional skepticism and a response involving more general considerations apart from the specific procedures otherwise planned;</p> <p>(b) A response to identified risks at the assertion level involving the nature, timing and extent of audit procedures to be performed; and</p> <p>(c) A response to identified risks involving the performance of certain audit procedures to address the risks of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.</p>		A41.	Explanatory in nature.
<p>64. The response to address the assessed risks of material misstatement due to fraud may affect the auditor's professional skepticism in the following ways:</p> <p>(g) Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions; or</p> <p>(h) Increased recognition of the need to corroborate management explanations or representations concerning material matters.</p>		A42.	Explanatory in nature.
65. The auditor may conclude that it would not be practicable to design audit procedures that sufficiently address the risks of material misstatement due to fraud. In such circumstances the auditor considers the implications for the audit (see paragraphs 89 and 103).		A43.	Explanatory in nature.

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Overall Responses			
<p>66. In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level the auditor should:</p> <p>(a) Consider the assignment and supervision of personnel;</p> <p>(b) Consider the accounting policies used by the entity; and</p> <p>(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.</p>	17.		Retained in the standards unchanged, with the exception of item b) which has been expanded to include guidance contained in original para. 68, noted below, and c) to provide additional explanatory guidance.
<p>67. The knowledge, skill and ability of the individuals assigned significant engagement responsibilities are 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 identified risks of material misstatement due to fraud by assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement. In addition, the extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.</p>		A44.	
<p>68. The auditor considers management's selection and application of significant accounting policies, particularly those related to subjective measurements and complex transactions.</p> <p>The auditor considers whether the selection and application of accounting policies may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.</p>	<p>17(b)</p> <p>17(b)</p>		<p>Included as part of the "should" statement of 17 (b).</p> <p>Reconstituted as part of the "should" statement of 17 (b).</p>
<p>69. 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 the nature, extent and timing of audit procedures to be performed. This can be achieved by, for example, performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk, adjusting the timing of audit procedures from that otherwise expected, using different sampling methods, and performing audit procedures at different locations or at locations on an unannounced basis.</p>	17(c)	A45.	<p>Incorporated in New ISA as essential explanatory guidance.</p> <p>Explanatory in nature, supporting an established bold type requirement.</p>
Audit Procedures responsive to Risks of Material Misstatement Due to Fraud at the Assertion Level			
<p>70. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:</p>		A46.	Explanatory in nature.

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<ul style="list-style-type: none"> The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files. In addition, the auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms. The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the risks of intentional misstatement or manipulation, audit procedures 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 improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures 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. 			
71. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to 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.		A47.	Explanatory in nature.
72. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions,		A48.	Explanatory in nature.

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<p>restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating 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.</p>			
<p>73. Examples of possible audit procedures to address the assessed risks 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 risks of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.</p>		A49.	Explanatory in nature.
<p>Audit Procedures Responsive to Management Override of Controls</p>			
<p>74. 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 and is a significant risk of material misstatement due to fraud.</p> <p>Accordingly, in addition to overall responses to address the risks of material misstatement due to fraud and responses to address the assessed risks of material misstatement due to fraud at the assertion level, the auditor performs audit procedures to respond to the risk of management override of controls.</p>	<p>18.</p> <p>18.</p>		<p>Positioned within the standards as it is essential in establishing context.</p> <p>Reconstituted as a "should" statement.</p>
<p>75. Paragraphs 75 to 81 set out the audit procedures required to respond to risk of management override of controls. However, the auditor also considers whether there are risks of management override of controls for which the auditor needs to perform procedures other than those specifically referred to in these paragraphs.</p>	19.		Reconstituted as a "should" statement.
<p>76. To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:</p> <ul style="list-style-type: none"> (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; and (c) Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business for the entity, 	20.		Essential explanatory guidance has been added for each identified procedures.

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<p>or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.</p>			
<p>Journal Entries and Other Adjustments</p>			
<p>77. Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries throughout the year or at period end, or making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments and reclassifications.</p> <p>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 statements the auditor:</p> <ul style="list-style-type: none"> (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) 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. (d) Determines the timing of the testing; and (e) Identifies and selects journal entries and other adjustments for testing; 	<p>20(a)</p> <p>21.</p>		<p>Included within the standards as essential explanatory guidance.</p> <p>Reconstituted as a "should" statement.</p>
<p>78. For the purposes of identifying and selecting journal entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor considers:</p> <ul style="list-style-type: none"> • <i>The assessment of the risks of material misstatement due to fraud</i> – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing. • <i>Controls that have been implemented over journal entries and other adjustments</i> – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls. • <i>The entity's financial reporting process and the nature of evidence that can be obtained</i> – for many entities routine processing of transactions involves a combination of manual and automated 		A50.	Explanatory in nature.

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<p>steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.</p> <ul style="list-style-type: none"> • The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have 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 consistent ending numbers. • 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 misstatements 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 – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements. 			
<p>79. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. Because fraudulent journal entries and other adjustments are often made at the end of a reporting period, the auditor ordinarily selects the journal entries and other adjustments made at that time.</p> <p>However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, the auditor considers whether there is also a need to test journal entries and other adjustments throughout the period.</p>	21(e)	A51.	<p>Explanatory in nature.</p> <p>Reconstituted as part of the “should” statement of new para. 21(e)</p>
<p>Accounting Estimates</p>			
<p>80. 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 is often accomplished through intentional misstatement of accounting estimates. In reviewing accounting estimates for biases that could result in</p>		A52.	<p>Positioned as application material, with a cross-reference to the requirements of proposed revised ISA 540 added.</p>

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<p>material misstatement due to fraud the auditor:</p> <p>(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</p> <p>(b) Performs a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. The objective of this review is to determine whether there is an indication of a possible bias on the part of management, and it is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.</p>			
<p>81. 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 actions 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 in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.</p>	20(b)		Reconstituted as a "should" statement.
<p>Business Rationale for Significant Transactions</p>			
<p>82. The auditor obtains an understanding of the business rationale for significant 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 and other information obtained during the audit. The purpose of obtaining this understanding is to consider whether the rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. In gaining such an understanding the auditor considers:</p> <ul style="list-style-type: none"> Whether the form of such transactions appears 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, and whether there is adequate documentation. 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 non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance of the 	20(c)	<p>A53.</p> <p>A53.</p>	<p>Explanatory in nature.</p> <p>Reconstituted as a "should" statement for the auditor to evaluate management's rationale.</p> <p>Redrafted to set up list of "factors" or "indicators" that may suggest concern over management's rationale for the transaction. The list is intended to be illustrative and therefore explanatory in nature.</p>

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<p>entity.</p> <ul style="list-style-type: none"> 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. 			
Evaluation of Audit Evidence			
<p>83. As required by ISA 330, “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. This evaluation is primarily a qualitative matter based on the auditor’s judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor considers whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.</p>		A54.	Explanatory in nature. A reference to <i>New ISA</i> para. 13 has been added to hook this guidance back to the new “should” statement for the engagement team to communicate throughout the audit.
<p>84. 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 the risks of material misstatement due to fraud was based. For example, the auditor may become aware of discrepancies in accounting records or conflicting or missing evidence. Also relationships between the auditor and management may become problematic or unusual. Appendix 3 to this ISA contains examples of circumstances that may indicate the possibility of fraud.</p>		A55.	Explanatory in nature.
<p>85. The auditor should consider whether analytical procedures that are performed at or near the end of the audit when forming an overall conclusion as to whether the financial statement as a whole are consistent with the auditor’s knowledge of the business indicate a previously unrecognized risk of material misstatement due to fraud.</p> <p>Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.</p>	22.	A56.	Unchanged. Explanatory in nature.
<p>86. 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.</p>	23.		Positioned within the standards, and amended as noted below.

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[illegible]

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<p>(c) It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:</p> <ul style="list-style-type: none"> (i) management; (ii) employees who have significant roles in internal control, or (iii) others where the fraud could have a material effect on the financial statements; and <p>(d) It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.</p>			
<p>91. 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, irrespective of the size of the entity, management acknowledges its responsibility for internal control designed and implemented to prevent and detect fraud.</p>		A63.	Explanatory in nature.
<p>92. 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 obtains a written representation from management confirming that it 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 and its knowledge of actual, suspected or alleged fraud affecting the entity.</p>		A64.	Explanatory in nature.
<p>Communications With Management and Those Charged With Governance</p>			
<p>93. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters as soon as practicable to the appropriate level of management.</p>	28.		Unchanged.
<p>94. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. 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 likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.</p>		A65.	Explanatory in nature.
<p>95. If the auditor has identified fraud involving</p> <ul style="list-style-type: none"> (a) management; 	29.		Unchanged.

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<p>(b) employees who have significant roles in internal control; or</p> <p>(c) others where the fraud results in a material misstatement in the financial statements, the auditor should communicate these matters to those charged with governance as soon as practicable.</p>			
<p>96. The auditor's communication with those charged with governance may be made orally or in writing. ISA 260, "Communication of Audit Matters with Those Charged with Governance" identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters as soon as practicable and considers whether it is necessary to also report such matters in writing. If the auditor suspects fraud involving management, the auditor communicates these suspicions to those charged with governance and also discusses with them the nature, timing and extent of audit procedures necessary to complete the audit.</p>		A66.	Explanatory in nature.
<p>97. If the integrity or honesty of management or those charged with governance is doubted, the auditor considers seeking legal advice to assist in the determination of the appropriate course of action.</p>	30.		Reconstituted as a "should" statement.
<p>98. At an early stage in the audit, the auditor reaches an understanding with those charged with governance about the nature and extent of the auditor's communications regarding fraud that the auditor becomes aware of involving employees other than management that does not result in a material misstatement.</p>		A67.	Explanatory in nature.[N.B. A cross reference may be need to the new ISA 260 under development]
<p>99. The auditor should make those charged with governance and management aware, as soon as practicable, and at the appropriate level of responsibility, of material weaknesses in the design or implementation of internal control to prevent and detect fraud which may have come to the auditor's attention.</p>	31.		Unchanged.
<p>100. If the auditor identifies a risk of material misstatement of the financial statements due to fraud, which management 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 management's risk assessment process, 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."</p>		A68.	Explanatory in nature, and appropriately cross-referenced to ISA 260.
<p>101. The auditor should consider whether there are any other matters related to fraud to be discussed with those charged with governance of the entity.</p> <p>Such matters may include for example:</p> <ul style="list-style-type: none"> Concerns about the nature, extent and frequency of management's assessments of the controls in 	32.	A69.	Unchanged. Explanatory in nature.

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<p>place to prevent and detect fraud and of the risk that the financial statements may be misstated.</p> <ul style="list-style-type: none"> • A failure by management to appropriately address identified material weaknesses in internal control. • A failure by management to appropriately respond to an identified fraud. • The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management. • Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. • Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business. 			
Communications to Regulatory and Enforcement Authorities			
<p>102. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. The auditor considers obtaining legal advice to determine the appropriate course of action in such circumstances. 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 to supervisory authorities. Also, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.</p>		A70.	Explanatory in nature, and modified to state "The auditor may consider it appropriate..."
Auditor Unable to Continue the Engagement			
<p>103. 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:</p> <ul style="list-style-type: none"> (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: <ul style="list-style-type: none"> (ii) discuss with the appropriate level of management and those charged with 	26.		Unchanged, but repositioned for drafting purposes.

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<p>governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and</p> <p>(iii) 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.</p>			
<p>104. Such exceptional circumstances can arise, for example, when:</p> <p>(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;</p> <p>(b) The auditor’s consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or</p> <p>(c) The auditor has significant concern about the competence or integrity of management or those charged with governance.</p>		A60.	Explanatory in nature.
<p>105. 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 a continuing association with the entity.</p>		A61.	Explanatory in nature.
<p>106. 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, including the possibility of reporting to shareholders, regulators or others.¹</p>		<p>A62.</p> <p>A62.</p>	<p>Explanatory in nature.</p> <p>Explanatory in nature, and modified to state “The auditor may consider it appropriate...”</p>
Documentation			
<p>107. The documentation of the auditor’s understanding of the entity and its environment and the auditor’s assessment of the risks of material misstatement required by paragraph 122 of ISA 315 “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement”, should include:</p>	33.		Unchanged.

¹ The “IFAC Code of Ethics for Professional Accountants” provides guidance on communications with a proposed successor auditor.

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<p>(a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and</p> <p>(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.</p>			
<p>108. The documentation of the auditor's responses to the assessed risks of material misstatement required by paragraph 73 of ISA 330 "The Auditor's Procedures in Response to Assessed Risks" should include:</p> <p>(a) The overall responses to the assessed risks of material misstatements due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and</p> <p>(b) The results of the audit procedures including those designed to address the risk of management override of controls</p>	34.		Unchanged.
<p>109. The auditor should document communications about fraud made to management, those charged with governance, regulators and others.</p>	35.		Unchanged.
<p>110. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor should document the reasons for that conclusion.</p>	36.		Unchanged.
<p>111. The extent to which these matters are documented is for the auditor to determine using professional judgment.</p>	37.		Unchanged.
<p>Effective Date</p>			
<p>112. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.</p>	38.		Unchanged.

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