

**ISA 240 (Redrafted)****THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD  
IN AN AUDIT OF FINANCIAL STATEMENTS****CONTENTS**

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## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to consider fraud, and to design and perform procedures to detect material misstatement due to fraud, in an audit of financial statements.
2. Other ISAs deal with various aspects of the audit, such as risk assessment (ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement"), and responses to identified risks (ISA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks"), or specific topics, such as accounting estimates (ISA 540, "Audit of Accounting Estimates"). These and other ISAs deal with the risk of material misstatement of the financial statements due to fraud as well as to error. This ISA expands on how ISA 315 (Redrafted) and ISA 330 (Redrafted) are to be applied in relation to the risk of material misstatement due to fraud, and deals specifically with procedures that the auditor is required to perform in relation to fraud and the auditor's responses to material misstatement of the financial statements resulting from fraud or suspected fraud.

### Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 200x.

### Objectives to be Achieved

4. In relation to the subject matter of this ISA, the objectives of the auditor are:
  - To address the risks of material misstatement of the financial statements due to fraud by planning and performing the audit with an attitude of professional skepticism, recognizing the possibility that a material misstatement due to fraud could exist;
  - To perform procedures specified by this ISA; and
  - To respond appropriately to identified fraud.

### Definitions

5. The following terms are introduced in this ISA:
  - (a) Fraud – 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, for the purposes of the ISAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred.
  - (b) Fraud risk factors – Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

- (c) Fraudulent financial reporting – Intentional misstatements, including omissions of amounts or disclosures in financial statements to deceive financial statement users.
- (d) Misappropriation of assets – The theft of an entity’s assets, which 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.

## **Requirements**

### **Professional Skepticism**

- 6. In accordance with ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance. Due to the characteristics of fraud and the potential for management override of controls, the auditor’s attitude of professional skepticism is particularly important in considering the risks of material misstatement due to fraud. (Ref: Para. A19-A20)

### **Risk Assessment Procedures and Related Activities**

- 7. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment required by ISA 315 (Redrafted), the auditor shall perform procedures to obtain information for use in identifying the risks of material misstatement due to fraud. The required procedures, the objective of which is to obtain information about relevant risks from those with primary responsibility for the prevention and detection of fraud, are as follows:
  - (a) Make inquiries of management regarding:
    - (i) Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A21)
    - (ii) 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; (Ref: Para. A22)
    - (iii) Management’s process for responding to internal or external allegations of fraud affecting the entity;
    - (iv) 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
    - (v) Management’s communication, if any, to employees regarding its views on business practices and ethical behavior.

- (b) Make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A23-A25)
  - (c) For those entities that have an internal audit function, make inquiries of internal audit regarding:
    - (i) Their knowledge of any actual, suspected or alleged fraud affecting the entity;
    - (ii) Their views about the risks of fraud; and
    - (iii) Procedures performed, if any, by the internal auditors during the year to detect fraud, and whether management has satisfactorily responded to any findings resulting from those procedures.
  - (d) 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. Such an understanding may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of such internal control and the competency and integrity of management. (Ref: Para. A26-A28)
  - (e) Make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.
8. In performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment required by ISA 315 (Redrafted), the auditor shall consider:
- (a) Unusual or unexpected relationships that have been identified in performing analytical procedures as risk assessment procedures that may indicate risks of material misstatement due to fraud, including those relationships identified from analytical procedures related to revenue accounts that may indicate fraudulent financial reporting.
  - (b) Whether other information obtained indicates risks of material misstatement due to fraud. (Ref: Para. A29)
9. The discussion amongst the members of the engagement team required by ISA 315 (Redrafted) shall place particular emphasis on the susceptibility of the entity's financial statements to material misstatement due to fraud. (Ref: Para. A30-A31)

### **Identification and Assessment of the Risks of Material Misstatement Due to Fraud**

10. In accordance with ISA 315 (Redrafted), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

In identifying and assessing the risks of material misstatements due to fraud, the auditor shall consider whether the information obtained from the risk assessment procedures and activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. (Ref: Para. A32-A36)

The auditor shall treat those assessed risks that could result in a material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall understand the entity's related controls, including relevant control activities. (Ref: Para. A37)

11. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues or an understatement of revenues. Therefore, the auditor shall presume that there are risks of fraud in revenue recognition and shall consider which types of revenue, revenue transactions or assertions may give rise to such risks. (Ref: Para. A38)

Those assessed risks of material misstatement due to fraud related to revenue recognition shall be treated as significant risks.

If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor shall document the reasons supporting the auditor's conclusion as required by paragraph 30.

## **RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD**

### **OVERALL RESPONSES**

12. In accordance with ISA 330 (Redrafted), the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. (Ref: Para. A39)
13. In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level, the auditor shall:
  - (a) Consider the assignment and supervision of personnel, including whether 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; (Ref: Para. A40-A41)
  - (b) Consider the accounting policies used by the entity, particularly those related to subjective measurements and complex transactions, and whether the selection and application of accounting policies may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
  - (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. An element of unpredictability is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. (Ref: Para. A42)

### **AUDIT PROCEDURES RESPONSIVE TO RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD AT THE ASSERTION LEVEL**

14. In accordance with ISA 330 (Redrafted), the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks at the assertion level. (Ref: Para. A43-A45)

**AUDIT PROCEDURES RESPONSIVE TO RISKS RELATED TO MANAGEMENT OVERRIDE OF CONTROLS**

15. 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. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a significant risk of material misstatement due to fraud.
16. Accordingly, the auditor shall design and perform audit procedures to respond to the risk of management override of controls to:

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

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.

In designing and performing audit procedures to test the appropriateness of journal entries and other adjustments made in the preparation of the financial statements, the auditor shall:

- (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments; and
- (ii) Consider the need to test journal entries and other adjustments both at the end of a reporting period as well as throughout the period. (Ref: Para. A46-A48)
- (b) Review accounting estimates for biases and evaluate whether the circumstances producing such a bias represent a risk of material misstatement due to fraud.<sup>1</sup> (Ref: Para. A49-A50)
- (c) Obtain an understanding of the business rationale of significant transactions of which the auditor becomes aware that:
- are outside the normal course of business for the entity, or
  - otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit.

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<sup>1</sup> [Note to IAASB: Subject to the finalization of ISA 540 (Revised), this requirement could be replaced by the following (or similar): "Evaluate whether the circumstances giving rise to indicators of possible management bias in accounting estimates, as determined in accordance with the requirements of ISA 540 (Revised), represents a risk of material misstatement due to fraud."]

In doing so, the auditor shall evaluate 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. (Ref: Para. A51)

17. The auditor shall consider whether there are risks of management override of controls for which the auditor needs to perform procedures other than those specifically referred to above.

**Evaluation of Audit Evidence** (Ref: Para. A52-A56)

18. The auditor shall 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 statements as a whole are consistent with the auditor's knowledge of the business indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A53)
19. When the auditor identifies a misstatement, whether material or not, the auditor shall consider whether such a misstatement may be indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A54-A56)
20. If the auditor believes that a misstatement, whether material or not, is or may be the result of fraud and the matter involves higher-level management, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.
21. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall consider the implications for the audit report.

**Auditor Unable to Continue the Engagement** (Ref: Para. A57-A60)

22. 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 shall:
  - (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.

**Management Representations** (Ref: Para. A61-A62)

23. The auditor shall obtain written representations from management that:

- (a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud;
- (b) 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;
- (c) It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:
  - (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
- (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.

**Communications With Management and Those Charged With Governance**

24. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters as soon as practicable to the appropriate level of management. Those with primary responsibility for the prevention and detection of fraud are thereby informed of matters relevant to their responsibilities. (Ref: Para. A63)
25. If the auditor has identified fraud involving
- (a) management;
  - (b) employees who have significant roles in internal control; or
  - (c) others where the fraud results in a material misstatement in the financial statements,
- the auditor shall communicate these matters to those charged with governance as soon as practicable. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A64-A65)
26. The auditor shall consider whether there are any other matters related to fraud to be discussed with those charged with governance of the entity. (Ref: Para. A66)

## **Communications to Regulatory and Enforcement Authorities**

27. The auditor shall consider whether there is a responsibility to report fraud to a party outside the entity. (Ref: Para. A67-A68)

## **Documentation**

28. In addition to the documentation requirements of ISA 315 (Redrafted) and ISA 330 (Redrafted), the auditor shall document the results of the audit procedures designed to address the risk of management override of controls.
29. The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.
30. 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 shall document the reasons for that conclusion.

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## **Application Material**

### **Characteristics of Fraud**

- A1. As explained in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” 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.
- A2. Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. A perceived opportunity to commit fraud may exist when an 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.
- A3. 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.
- A4. Two types of intentional misstatements are relevant to the auditor— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

### **FRAUDULENT FINANCIAL REPORTING**

- A5. Fraudulent financial reporting may be accomplished by the following:
  - 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.
- A6. 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:
- 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.
- A7. 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.

#### MISAPPROPRIATION OF ASSETS

- A8. Individuals may have an incentive to misappropriate assets for example, because they are living beyond their means. Misappropriation of assets can be accomplished in a variety of ways including:
- 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).

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.

### **Responsibilities of Those Charged with Governance and of Management**

- A9. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management.
- A10. 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.
- A11. Those charged with governance of the entity are responsible 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.
- A12. Management, with oversight from those charged with governance, is responsible to establish a control environment and to establish and maintain controls pertaining to the preparation of the entity's financial statements 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.

### **Inherent Limitations of an Audit in the Context of Fraud**

- A13. As described in ISA 200, 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.

- A14. 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.
- A15. 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.
- A16. 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.

### **Responsibilities of the Auditor for Detecting Material Misstatement Due to Fraud**

- A17. 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.

- A18. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing 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.

**Professional Skepticism** (Ref: Para. 6)

- A19. 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.
- A20. As discussed in ISA 315 (Redrafted), the auditor's previous experience with the entity contributes to an understanding of the entity. However, although the auditor cannot be expected to fully disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the maintenance of an attitude of professional skepticism is important because there may have been changes in circumstances.

**Risk Assessment Procedures and Related Activities**

INQUIRIES AND OBTAINING AN UNDERSTANDING OF OVERSIGHT EXERCISED BY THOSE CHARGED WITH GOVERNANCE

Management's Assessment of the Risk of Fraud (Ref: Para. 7(a)(i))

- A21. Management is responsible for the entity's internal control and for the preparation of the financial statements. Accordingly, it is appropriate for the auditor to 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 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.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 7(a)(ii))

- A22. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others Within the Entity (Ref: Para. 7(b))

- A23. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, 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 may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.
- A24. 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.
- A25. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 7(d))

- A26. 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 relevant internal control. Since the responsibilities of those charged with governance and management may 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.<sup>1</sup>
- A27. The auditor may obtain an understanding of how those charged with governance exercise this oversight in a number of ways, such as attending meetings where such discussions take place, reading the minutes from such meetings or by making inquiries of those charged with governance.

*Considerations specific to smaller entities*

- A28. In some cases, all of those charged with governance are involved in managing the entity, such as may be the case in a small entity where a single owner manages the entity and no

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<sup>1</sup> ISA 260 discusses with whom the auditor communicates when the entity's governance structure is not well defined.

one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

CONSIDERATION OF OTHER INFORMATION (Ref: Para. 8)

A29. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members described below 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 relevant in the identification of the risks of material misstatement due to fraud.

DISCUSSION AMONG THE ENGAGEMENT TEAM (Ref: Para. 9)

A30. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team enables the auditor to consider an appropriate response to such susceptibility 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. An attitude of professional skepticism is particularly important when discussing the susceptibility of the entity's financial statements to material misstatement due to fraud.

A31. The discussion may include such matters as:

- 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 rationalize committing fraud;
- 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.

### **Identification and Assessment of the Risks of Material Misstatement Due to Fraud**

#### **CONSIDERATION OF FRAUD RISK FACTORS (Ref: Para. 10)**

A32. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- 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.

A33. 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 determination of 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 requires the exercise of professional judgment.

A34. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. 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.

A35. 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, there may be factors that generally constrain improper conduct by management, such as effective oversight by those charged with governance, an effective internal audit function or

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.

Considerations specific to smaller entities

A36. 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 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.

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENTS DUE TO FRAUD AND UNDERSTANDING THE ENTITY'S RELATED CONTROLS (Ref: Para. 10)

A37. As explained in ISA 315 (Redrafted), 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. It is therefore important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud. In doing so, 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 risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

RISKS OF FRAUD IN REVENUE RECOGNITION (Ref: Para. 11)

A38. Material misstatements due to fraudulent financial reporting relating to revenue recognition may result from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period. 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.

**Responses to the Risks of Material Misstatement Due to Fraud****OVERALL RESPONSES (Ref: Para. 12)**

A39. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example through increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions or increased recognition of the need to corroborate management explanations or representations concerning material matters. It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 13, which are discussed below.

**Consideration of the Assignment and Supervision of Personnel (Ref: Para. 13(a))**

- A40. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.
- A41. 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.

**Unpredictability in the Selection of Audit Procedures (Ref: Para. 13(c))**

- A42. Incorporating an element of unpredictability in the selection of the nature, extent and timing of audit procedures to be performed 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.
  - Performing audit procedures at different locations or at locations on an unannounced basis. For example, 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.

**AUDIT PROCEDURES RESPONSIVE TO RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD AT THE ASSERTION LEVEL (Ref: Para. 14)**

- A43. 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:
- 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.

A44. 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, 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.

- A45. Examples of possible audit procedures, including those that illustrate the incorporation of an element of unpredictability, to address the assessed risks of material misstatement due to fraud are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

#### AUDIT PROCEDURES RESPONSIVE TO RISKS RELATED TO MANAGEMENT OVERRIDE OF CONTROLS

##### Journal Entries and Other Adjustments (Ref: Para. 16(a))

- A46. The auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.
- A47. When 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 following matters are of relevance:
- *The assessment of the risks of material misstatement due to fraud* – 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.
  - *Controls that have been implemented over journal entries and other adjustments* – 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.
  - *The entity's financial reporting process and the nature of evidence that can be obtained* – 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 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.
  - *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.

A48. 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. 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, it is important to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 16(b))

A49. 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 by, for example, understating or overstating 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.

A50. <sup>1</sup>The auditor's review of accounting estimates for biases that could result in material misstatement due to fraud include:

- (a) Considering 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 estimates are reconsidered taken as a whole; and
- (b) Performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior

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<sup>1</sup> [Note to IAASB: Subject to finalization of ISA 540 (Revised), paragraph A50 could be replaced by the following (or similar): "ISA 540 (Revised) provides requirements and guidance on the auditor's responsibilities to consider bias in the making of accounting estimates."]

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.

**Business Rationale for Significant Transactions (Ref: Para. 16(c))**

A51. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include :

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed nor approved by those charged with governance of the entity.
- 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 (Ref: Para. 18-21)**

A52. As required by ISA 330 (Redrafted), 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. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

**ANALYTICAL PROCEDURES PERFORMED IN THE OVERALL REVIEW AT OR NEAR THE END OF THE AUDIT (Ref: Para. 18)**

A53. 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.

CONSIDERATION OF IDENTIFIED MISSTATEMENTS (Ref: Para. 19-21)

- A54. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud may not be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.
- A55. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves higher-level management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.
- A56. ISA 320, “Audit Materiality” and ISA 700, “The Auditor’s Report” provide standards and guidance on the evaluation and disposition of misstatements and the effect on the auditor’s report.

**Auditor Unable to Continue the Engagement** (Ref: Para. 22)

- A57. Examples of exceptional circumstances that may arise and that may bring into question the auditor’s ability to continue performing the audit include:
- (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 risks of material misstatement due to 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.
- A58. 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.
- A59. 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 may consider it appropriate to seek 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.<sup>1</sup>

- A60. In many cases in the public sector, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate or public interest considerations.

### **Management Representations (Ref: Para. 23)**

- A61. ISA 580, “Management Representations,” provides standards and 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.
- A62. 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.

### **Communications With Management and Those Charged With Governance**

#### **COMMUNICATION WITH MANAGEMENT (Ref: Para. 24)**

- A63. 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.

#### **COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE (Ref: Para. 25)**

- A64. The auditor’s communication with those charged with governance may be made orally or in writing. ISA 260 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 may consider it necessary to also report such matters in writing.
- A65. In some cases, the auditor may consider it appropriate to communicate with those charged with governance about those circumstances when the auditor becomes aware of fraud

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

involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

**Other Matters Related to Fraud (Ref: Para. 26)**

A66. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified material weaknesses in internal control, or 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 (Ref: Para. 27)**

A67. 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 may consider it appropriate to obtain legal advice to determine the appropriate course of action in such circumstances, the objective of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud. 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. 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.

A68. In the public sector, requirements for reporting fraud, whether or not discovered through the audit process, often may be subject to specific provisions of the audit mandate or related legislation or regulation.

## Appendix 1

(Ref: Para. A34)

### Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be 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/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify 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*

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.

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.

Information available indicates that the personal financial situation of management or those charged with governance 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 flow<sup>1</sup>.
- Personal guarantees of debts of the entity.

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

### *Opportunities*

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.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

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<sup>1</sup> 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.

There is ineffective monitoring of management as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Ineffective oversight by those charged with governance over the financial reporting process and internal control.

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.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

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 material weaknesses in internal control.

#### *Attitudes/Rationalizations*

- 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 policies 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 those charged with governance 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 material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.

- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- 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 those charged with governance.
  - 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/rationalization. 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*

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

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*

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 which are small in size, marketable, or lacking observable identification of ownership.

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 oversight of senior management expenditures, such as travel and other reimbursements.
- 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 record keeping 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/Rationalizations*

- 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 entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

## Appendix 2

(Ref: Para. A45)

### **Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud**

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

#### **Consideration at the Assertion Level**

Specific responses to the auditor's assessment of the risks of material misstatement due to 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.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting 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.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting 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, 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 to a financial statement item for which the risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing 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.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing 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 due to fraudulent financial reporting are as follows:

##### *Revenue recognition*

- 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 and basis for rebates or the period to which they relate are often poorly documented. 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*

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts 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.
- Performing 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 an expert may be helpful in this regard.
- Comparing the 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.
- 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*

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

#### **Specific Responses—Misstatements Due to Misappropriation of Assets**

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement due to 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.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.

- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

## Appendix 3

(Ref: Para. A52)

### Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

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
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example receivables growing faster than revenues,
- 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
- Large numbers of credit entries and other adjustments made to accounts receivable records
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement
- Missing inventory or physical assets of significant magnitude
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies

- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated
- 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 engagement 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 understandable
- An unwillingness to address identified weaknesses in internal control on a timely basis

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance
- Accounting policies that appear to be at variance with industry norms
- Frequent changes in accounting estimates that do not appear to result from changes circumstances
- Tolerance of violations of the entity's Code of Conduct

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