

EXPOSURE DRAFT

ED XX 240
(April 2008)

**Proposed Auditing Standard
ASA 240 (Redrafted)**
*The Auditor's Responsibilities
Relating to Fraud in an Audit
of a Financial Report
(Re-issuance of ASA 240)*

Prepared and Issued for Comment by the **Auditing and Assurance
Standards Board**

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Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be forwarded so as to arrive by no later than 30 June 2008. Comments should be addressed to:

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A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au.

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Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

CONTENTS

PREFACE

AUTHORITY STATEMENT

	<i>Paragraphs</i>
Application	1
Effective Date	3
Introduction	
Scope of this ASA.....	4-11
Objectives	12
Definitions	13
Requirements	
Professional Scepticism	14-16
Discussion Among the Engagement Team	17
Risk Assessment Procedures and Related Activities	18-26
Identification and Assessment of the Risks of Material Misstatement Due to Fraud	27-29
Responses to the Assessed Risks of Material Misstatement Due to Fraud	30-35
Evaluation of Audit Evidence	36-39
Auditor Unable to Continue the Engagement	40
Management Representations	41
Communications To Management and With Those Charged With Governance	42-44
Communications to Regulatory and Enforcement Authorities ...	45
Documentation	46-49
Application and Other Explanatory Material	
Characteristics of Fraud	A1-A6
Professional Scepticism	A7-A9
Discussion Among the Engagement Team	A10-A11
Risk Assessment Procedures and Related Activities	A12-A27

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud	A28-A32
Responses to the Assessed Risks of Material Misstatement Due to Fraud	A33-A47
Evaluation of Audit Evidence	A48-A52
Auditor Unable to Continue the Engagement	A53-A57
Management Representations	A58-A59
Communications To Management and With Those Charged With Governance	A60-A65
Communications to Regulatory and Enforcement Authorities ...	A66-A68
Conformity with International Standards on Auditing.....	A69

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

PREFACE

Reasons for Issuing ED 240

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standards under section 336 of the *Corporations Act 2001* for the purposes of the corporations legislation and formulates auditing and assurance standards for other purposes.

The AUASB issues Auditing Standard ASA 240(Redrafted) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* pursuant to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001* (ASIC Act), as from 1 July 2004. Under section 227B of the ASIC Act, the AUASB may formulate Assurance Standards for other purposes.

The International Auditing and Assurance Standards Board (IAASB) has undertaken a programme to redraft, in clarity format, the entire suite of International Standards on Auditing (ISAs). In some cases, and in accordance with normal practice, the ISAs have been revised in addition to being redrafted. The redrafted ISAs are effective for audits of financial statements for periods beginning on or after 15th December 2009.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required to have regard to any programme initiated by the IAASB for the revision and enhancement of ISAs and to make appropriate consequential amendments to the Australian Auditing Standards. Accordingly, the AUASB has decided to revise and redraft the Australian Standards on Auditing (ASAs) using the revised and redrafted ISAs as a base.

ED XX conforms with ISA 240 (Redrafted) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. Differences between this proposed Auditing Standard and ISA 240 (Redrafted) are noted in paragraph A69 of the ED.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Main Proposals

This proposed Auditing Standard establishes mandatory requirements and provides Application and Other Explanatory Material regarding the auditor's responsibilities relating to fraud in an audit of a financial report.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative from 1 January 2010.

Main changes from existing ASA 240 (April 2006) ***The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report***

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the AUASB that it supersedes, ASA 240 (April 2006) *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*, are that in this proposed Auditing Standard:

1. A number of requirements were contained in the previous standard as explanatory guidance. Details are included in the Tables of Differences provided as an attachment to the Exposure Draft.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (ASA 240) *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* by no later than 30 June 2008. The AUASB is seeking comments ~~on the main changes from the existing AUS 240. In addition,~~ from respondents who are asked to consider and respond, with supporting details, to the following questions:

1. Are there any laws or regulations that may, or do, prevent or impede the application of the proposed standard?
2. Are there any laws or regulations that conflict with the proposed standard?
3. Have applicable laws and regulations been appropriately addressed in the proposed standard?
4. Are there any references to laws or regulations which have been omitted?

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

5. What, if any, are the additional significant costs to/benefits for assurance practitioners and the business community for compliance with this proposed Auditing Standard?
6. Are there any significant public interest matters that constituents wish to raise?

The AUASB would prefer that respondents express a clear overall opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on the above matters. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

(PROPOSED) AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) formulates this proposed Auditing Standard ASA 240(Redrafted) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* as set out in paragraphs 1 to A69, pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001*.

This proposed Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards*, which sets out the intentions of the AUASB on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this proposed Auditing Standard are set out in paragraphs 14 to 49 under the heading "Requirements".

AUDITING STANDARD ASA 240(REDRAFTED)

The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report

Application

- 1 This Auditing Standard applies to:
 - (a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the Corporations Act 2001; and
 - (b) an audit of a financial report for any other purpose.
- 2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Effective Date

- 3 This Auditing Standard is effective for financial reporting periods commencing on or after 1 January 2010.

Introduction

Scope of this ASA

- 4 This Australian Standard on Auditing (ASA) deals with the auditor's responsibilities relating to fraud in an audit of a financial report. Specifically, it expands on how ASA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," and ASA 330 (Redrafted), "The Auditor's Responses to Assessed Risks," **are to be applied** in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

- 5 Misstatements in the financial report can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial report is intentional or unintentional.
- 6 Although fraud is a broad legal concept, for the purposes of the ASAs, the auditor is concerned with fraud that causes a material

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

misstatement in the financial report. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

Responsibility for the Prevention and Detection of Fraud

- 7 The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. 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 commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for 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.

Responsibilities of the Auditor

- 8 An auditor conducting an audit in accordance with ASAs **is responsible for obtaining reasonable assurance** that the financial report taken as a whole are free from material misstatement, whether caused by fraud or error. As described in ASA 200 (Redrafted), "Objective and General Principles Governing an Audit of Financial Report," owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial report will not be detected, even though the audit is properly planned and performed in accordance with the ASAs.
- 9 The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

depends on factors such as the skilfulness 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.

- 10 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, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
- 11 When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional scepticism 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 effective in detecting fraud. The requirements in this ASA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Objectives

- 12 The objectives of the auditor are:
- (a) to identify and assess the risks of material misstatement of the financial report due to fraud;
 - (b) to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
 - (c) to respond appropriately to identified or suspected fraud.

Definitions

- 13 For purposes of the ASAs, the following terms have the meanings attributed below:
- (a) Fraud – An intentional act by one or more individuals among management, those charged with governance,

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

- (b) Fraud risk factors – Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Requirements

Professional Scepticism

- 14 In accordance with ASA 200 (Redrafted), the auditor shall maintain an attitude of professional scepticism 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. (Ref: Para. A7- A8)
- 15 Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)
- 16 Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion Among the Engagement Team

- 17 ASA 315 (Redrafted) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial report may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Risk Assessment Procedures and Related Activities

- 18 When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by ASA 315

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

(Redrafted), the auditor shall perform the procedures in paragraphs 19-26 to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

- 19 The auditor shall make inquiries of management regarding:
- (a) Management's assessment of the risk that the financial report may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13).
 - (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14).
 - (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity.
 - (d) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
- 20 The auditor shall 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. A15-A17)
- 21 For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Those Charged with Governance

- 22 Unless all of those charged with governance are involved in managing the entity, the auditor shall 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. (Ref: Para. A19-A21)

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 23 The auditor shall 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.

Unusual or Unexpected Relationships Identified

- 24 The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Other Information

- 25 The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

- 26 The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related 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 and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

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

- 27 In accordance with ASA 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.
- 28 When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 49 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30).

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 29 The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

- 30 In accordance with ASA 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. A33)
- 31 In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:
- (a) assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement. (Ref: Para. A34-A35);
 - (b) evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, 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. (Ref: Para. A36)

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

- 32 In accordance with ASA 330(Redrafted), the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. (Ref: Para. A37-A40).

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Audit Procedures Responsive to Risks Related to Management Override of Controls

- 33 Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial reports 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 risk of material misstatement due to fraud and thus a significant risk.
- 34 Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:
- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial report. In designing and performing audit procedures for such tests, 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;
 - (ii) select journal entries and other adjustments made at the end of a reporting period; and
 - (iii) consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)
 - (b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:
 - (i) evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial report, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- re-evaluate the accounting estimates taken as a whole; and
 - (ii) perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial report of the prior year. (Ref: Para. A45-A46)
 - (c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A47).
- 35 The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 34).

Evaluation of Audit Evidence (Ref: Para. A48)

- 36 The auditor shall evaluate whether analytical procedures that are performed when forming an overall conclusion as to whether the financial report as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49).
- 37 When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is 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. A50).
- 38 If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51).

- 39 When the auditor confirms that, or is unable to conclude whether, the financial report is materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52).

Auditor Unable to Continue the Engagement

- 40 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) determine 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 whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; 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) determine 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. (Ref: Para. A53-A57)

Management Representations

- 41 The auditor shall obtain written representations from management that:

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- (a) it acknowledges its responsibility for the design, implementation and maintenance 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 report 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 report; and
- (d) it has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial report communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A58-A59).

Communications To Management and With Those Charged With Governance

- 42 If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A60)
- 43 Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects 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 report,

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

the auditor shall communicate these matters to those charged with governance on a timely basis. 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. A61-A64)

- 44 In accordance with ASA 260 (Revised and Redrafted), "Communication with Those Charged with Governance,"¹ the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A65).

Communications to Regulatory and Enforcement Authorities

- 45 If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A66-A68).

Documentation

- 46 The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by ASA 315 (Redrafted) shall include:
- (a) the significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial report to material misstatement due to fraud; and
 - (b) the identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
- 47 The auditor's documentation of the responses to the assessed risks of material misstatement required by ASA 330 (Redrafted) shall include:
- (a) the overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and

¹ Close off document approved May 2006.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- (b) the results of the audit procedures, including those designed to address the risk of management override of controls.
- 48 The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.
- 49 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.

* **

Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 6)

- A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:
- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
 - 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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.
- A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial report to deceive financial statement users. It 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 report. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.
- A3. 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 report are prepared.
 - Misrepresentation in, or intentional omission from, the financial report of events, transactions or other significant information.
 - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.
- A4. 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:

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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 report 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 report.
 - Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
 - Altering records and terms related to significant and unusual transactions.
- A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:
- 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).
 - 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).

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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.

Considerations Specific to Public Sector Entities

- A6. The public sector auditor's responsibilities relating to fraud may be a result of legislation and regulation, ministerial directives, government policy requirements and resolutions of the legislature applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial report, but may also include a broader responsibility to consider risks of fraud.

Professional Scepticism (Ref: Para. 14-16)

- A7. Professional scepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Maintaining an attitude of professional scepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's attitude of professional scepticism is particularly important when considering the risks of material misstatement due to fraud.
- A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional scepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.
- A9. As explained in ASA 200 (Redrafted), an audit performed in accordance with ASAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:
- Confirming directly with the third party.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- Using the work of an expert to assess the document's authenticity.

Discussion Among the Engagement Team (Ref: Para. 17)

A10. Discussing the susceptibility of the entity's financial report to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial report may be susceptible to material misstatement due to fraud.
- 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.
- 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.

A11. 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 report 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- A consideration of any unusual or unexplained changes in behaviour 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 misstatement 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.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 19(a))

- A12. Management is responsible for the entity's internal control and for the preparation of the financial report. 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 may 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 structured and less frequent. 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 19(b))

A14. 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. 20)

A15. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial report resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial report 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.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional scepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 21)

A18. ASA 610 (Redrafted), "Considering the Work of Internal Audit," establishes requirements and provides guidance in audits of those entities that have an internal audit function. In carrying out the requirement of ASA 610 (Redrafted) in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 22)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many jurisdictions, 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 jurisdiction, **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.**²

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

² ISA 260 (Revised) discusses with whom the auditor communicates when the entity's governance structure is not well defined.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no 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. 25)

A22. 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 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.

Evaluation of Fraud Risk Factors (Ref: Para. 26)

A23. 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
- a control environment that is not effective may create an opportunity to commit fraud.

A24. 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 report due to fraud requires the exercise of professional judgment.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

A25. 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.

A26. 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.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. 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 behaviour 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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.

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

Risks of Fraud in Revenue Recognition (Ref: Para. 28)

- A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results 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.
- A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.
- A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 29)

- A31. As explained in ASA 315 (Redrafted), management may make 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. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial report 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

to the reduction in the risks of material misstatement due to fraud to be achieved.

- A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained 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. 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 report may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 30)

- A33. 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 scepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- 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 31, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 31(a))

- A34. 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.
- A35. 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Unpredictability in the Selection of Audit Procedures (Ref: Para. 31(c))

A36. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed 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. This can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 32)

A37. 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. For example:
 - ◆ 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.
 - ◆ 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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 assessed 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.

A38. 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include 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.
- A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, 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. 34(a))

- A41. Material misstatement of financial report due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial report that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.
- A42. Further, 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 to the financial reporting system. Furthermore, when IT is used to transfer

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. 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 report 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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.*

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 34(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial report due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 34(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 34(b))

A45. In preparing financial report, 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. This may be achieved 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.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial report of the prior year is to determine whether there is an indication of a possible bias on the

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

part of management. 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. 34(c))

- A47. 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 or 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. 36-39)

- A48. ASA 330 (Redrafted) requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Analytical Procedures Performed in the Overall Review of the Financial Report (Ref: Para. 36)

- A49. 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. 37-39)

- A50. 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 is unlikely to 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.
- A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior 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.
- A52. ASA 450 (Redrafted), "Evaluation of Misstatements Identified during the Audit,"³ and ASA 700 (Redrafted), "The Independent Auditor's Report on General Purpose Financial Report,"⁴ establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement (Ref: Para. 40)

- A53. 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

³ Close off document approved May 2006.

⁴ Close off document approved October 2006.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- circumstances, even when the fraud is not material to the financial report;
- (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.
- A54. 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.
- A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by jurisdiction. In some jurisdictions, 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.⁵
- A56. For an engagement under the *Corporations Act 2001*, the possibility of withdrawing from the engagement or resigning from the appointment as an auditor can only be made in accordance with the provisions of section 329 of the *Corporations Act 2001*, including obtaining consent to resign from the Australian Securities and Investments Commission (ASIC). For guidance on resignation of auditors under the *Corporations Act 2001*, see ASIC Regulatory Guide 26 "Resignation of auditors" and Regulatory Guide 43 "Accounts and audit relief".

⁵ The *Code of Ethics for Professional Accountants* (APES 110) provides guidance on communications with a proposed successor auditor.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Considerations Specific to Public Sector Entities

A57. 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. 41)

A58. ASA 580 (Redrafted), "Management Representation" establishes requirements and provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial report, it is important that, irrespective of the size of the entity, management acknowledge its responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A59. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial report resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to the auditor:

- (a) the results of management's assessment of the risk that the financial report may be materially misstated as a result of fraud; and
- (b) its knowledge of actual, suspected or alleged fraud affecting the entity.

Communications To Management and With Those Charged With Governance

Communication To Management (Ref: Para. 42)

A60. 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Communication With Those Charged With Governance (Ref: Para. 43)

- A61. Legislation may require the auditor or a member of the audit team to maintain the confidentiality of information disclosed to the auditor by a person regarding contraventions or possible contraventions of the law.⁶ In such circumstances, the auditor or a member of the audit team may be prevented from communicating that information to management or those charged with governance in order to protect the identity of the person who has disclosed confidential information that alleges a breach of the law. Consequently, the auditor may need to consider the implications for the audit engagement.
- A62. The auditor's communication with those charged with governance may be made orally or in writing. ASA 260 (Revised and Redrafted) 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 report, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.**
- A63. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud 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.
- A64. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: Para. 44)

- A65. 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 report may be misstated.

⁶ See, for example, Part 9.4AAA Protection for whistleblowers of the *Corporations Act 2001*.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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. 45)

- A66. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary, in certain circumstances, and the duty of confidentiality may be overridden by statute, the law or courts of law. In some circumstances, the auditor of a financial institution may have a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some circumstances the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.
- A67. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

Considerations Specific to Public Sector Entities

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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Conformity with International Standards on Auditing

- A69 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 240 (Redrafted), issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The main differences between this Auditing Standard and ISA 240 (Redrafted) are:
- This Auditing Standard includes Application and Other Explanatory Material on the following matters not contained in ISA 240 (Redrafted):
 - ◆ Guidance relating to circumstances pursuant to the *Corporations Act 2001*, when the auditor may not be permitted to withdraw from the engagement (paragraph A56). ISA 240 (Redrafted) does not provide detailed guidance for exceptions where withdrawal from an engagement may not be permitted.
 - ◆ Legislation may require the auditor to maintain the confidentiality of information disclosed to the auditor by a person regarding contraventions or possible contraventions of the law. In such circumstances, the auditor may be prevented from communicating that information to management or those charged with governance in order to protect the identity of the person who has disclosed confidential information that alleges a breach of the law. Consequently, the auditor may need to consider the implications for the audit engagement (paragraph A61). ISA 240 (Redrafted) does not provide detailed guidance for exceptions on communicating on matters of fraud with those charged with governance.

Compliance with this Auditing Standard enables compliance with ISA 240 (Redrafted).

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

APPENDIX 1

(Ref: Para. A25)

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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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.⁷
- Personal guarantees of debts of the entity.

⁷ 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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.

The monitoring of management is not effective 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.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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 accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving material weaknesses in internal control.

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial 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.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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 unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - ◆ 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 behaviour 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

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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, monitoring of management and weaknesses in internal control that is not effective 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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 re-imbursements.
- 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
- Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

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Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

APPENDIX 2

(Ref: Para. A40)

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 classes of transactions, account balances, disclosures 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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 report of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed 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 assessed 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 analyse selected opening balance sheet accounts of previously audited financial report 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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 risks of material misstatement 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

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 labelled, 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. **Ordinarily**, the audit response to an assessed 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.
- Analysing recoveries of written-off accounts.
- Analysing 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.
- Analysing 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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

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APPENDIX 3

(Ref: Para. A48)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial report 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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.

Proposed Auditing Standard ASA 240 (Redrafted)
The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report (Re-issuance of ASA 240)

- 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 report 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 changed circumstances.
 - Tolerance of violations of the entity's Code of Conduct.

Tables of Differences —ASA 240 (Revised and Redrafted) and Extant ASA 240
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Base Standard

ISA 240 (Redrafted) (*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) is used as the base standard for the purpose of re-drafting this proposed ASA. The base standard has been amended to account for the following matters:

- Australian Laws and Regulations;
- Changes considered necessary because the Auditing Standard is a legislative instrument made under the *Corporations Act 2001*; and
- Changes considered necessary in the public interest.

Summary of Differences—ASA 240 (Redrafted) and Extant ASA 240

The tables below detail the main differences between the proposed standard and extant ASA 240 (excluding editorial changes and amendments to reflect Australian terminology and references to Australian laws, regulations and standards).

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ISA Requirements not in extant ASA

ITEM #	ISA Paragraph #	ISA Requirements (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
Professional Scepticism				
1	13	Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.	NEW REQUIREMENT 1: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 29—equivalent explanatory guidance)	Y
2	14	Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.	NEW REQUIREMENT 2: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 46—equivalent explanatory guidance)	Y
3	15	ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity’s financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity.	Unshaded wording more comprehensive and expressed differently to the ASA equivalent but have similar meanings. NEW REQUIREMENT 3: Shaded wording is elevation of explanatory guidance (Extant ASA 240 para 34—equivalent explanatory guidance)	Y Y

ITEM #	ISA Paragraph #	ISA Requirements (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
Discussion Among the Engagement Team				
4	16	When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity’s internal control, required by ISA 315, the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.	Elevation of (ISA) explanatory guidance (Extant ASA 240 para 37—equivalent explanatory guidance) <u>Note:</u> Although not specifically anchored to ASA 315, the extant guidance broadly reflects the requirements in ASA 315.	Y
Responses to the Assessed Risks of Material Misstatement Due to Fraud				
5	29(a)	Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor’s assessment of the risks of material misstatement due to fraud for the engagement.	NEW REQUIREMENT 4: Shaded words are elevation of (ISA) explanatory guidance (Extant ASA 240 para 71—equivalent explanatory guidance)	Y
6	29(b)	Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management’s effort to manage earnings.	Shaded words are elevation of (ISA) explanatory guidance (Extant ASA 240 para 72—equivalent explanatory guidance— <i>anchored</i> to para 70)	Y
Identification and Assessment of the Risks of Material Misstatement Due to Fraud				
7	26	When identifying and assessing the risks of material	Elevation of (ISA) explanatory guidance	Y

ITEM #	ISA Paragraph #	ISA Requirements (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
		<p>misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.</p>	<p>(Extant ASA 240 para 64—equivalent explanatory guidance—conditional <i>anchoring</i> to paragraphs 61 & 65)</p>	
<p>Reponses to the Assessed Risks of Material Misstatement Due to Fraud</p>				
8	30	<p>In accordance with ISA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.</p>	<p>Elevation of (ISA) explanatory guidance (Extant ASA 240 para 66—equivalent explanatory guidance— <i>anchored</i> to ASA 330)</p>	Y
9	31	<p>Management is in a unique position to perpetrate fraud because of management’s ability to 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 risk of material misstatement due to fraud and thus a significant risk.</p>	<p>NEW REQUIREMENT 5: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 78—equivalent explanatory guidance). This elevation is on the basis that the requirement is a “Basic Principle” (i.e. there is no “auditor shall” clause).</p>	Y
10	32	<p>... (a) Test the ... In designing and performing audit</p>		

ITEM #	ISA Paragraph #	ISA Requirements (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
		<p>procedures for such tests, the auditor shall:</p> <ul style="list-style-type: none"> (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; (ii) Select journal entries and other adjustments made at the end of a reporting period; and (iii) Consider the need to test journal entries and other adjustments throughout the period. 	<p>NEW REQUIREMENT 6: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 81, 3rd bullet point—equivalent explanatory guidance).</p> <p>NEW REQUIREMENT 7: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 81, 5th bullet point—equivalent explanatory guidance).</p> <p>NEW REQUIREMENT 8: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 83—equivalent explanatory guidance).</p>	<p>Y</p> <p>Y</p> <p>Y</p>
11	32	<p>...</p> <ul style="list-style-type: none"> (b) Review accounting estimates ... In performing this review, the auditor shall: <ul style="list-style-type: none"> (i) Evaluate whether the judgments and decisions made by management in making 	<p>NEW REQUIREMENT 9: Elevation of (ISA) explanatory guidance</p>	<p>Y</p>

ITEM #	ISA Paragraph #	ISA Requirements (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
		<p>the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity’s management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and</p> <p>(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year</p>	<p>(Extant ASA 240 para 84—equivalent explanatory guidance).</p> <p>NEW REQUIREMENT 10: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 84, 2nd bullet point—equivalent explanatory guidance).</p>	<p>Y</p>
12	33	<p>The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).</p>	<p>Elevation of (ISA) explanatory guidance (Extant ASA 240 para 79—equivalent explanatory guidance—<i>anchored</i> to para 80).</p>	<p>Y</p>
Evaluation of Audit Evidence				
13	36	<p>If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor</p>	<p>NEW REQUIREMENT 11: Elevation of (ISA) explanatory guidance</p>	<p>Y</p>

ITEM #	ISA Paragraph #	ISA Requirements (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
		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 whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.	(Extant ASA 240 para 93—equivalent explanatory guidance).	
Communications To Management and With Those Charged With Governance				
14	41	... 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.	Elevation of (ISA) explanatory guidance (Extant ASA 240 para 103, last sentence—equivalent explanatory guidance— <i>anchored</i> to paras 99 & 101).	Y
Communications to Regulatory and Enforcement Authorities				
15	43	If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor’s professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor’s legal responsibilities may override the duty of confidentiality in some circumstances.	NEW REQUIREMENT 12: Elevation of (ISA) explanatory guidance (Extant ASA 240 para 110—equivalent explanatory guidance).	Y

Extant ASA Requirements not in ISA

ITEM #	ASA Paragraph #	ASA Requirement (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
			Not Retained in ASA (Redrafted)	
Introduction				
1	6	In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor shall consider the risks of material misstatements in the financial report due to fraud.	Included elsewhere. See “Overall Objective of the Independent Auditor”—ISA/ASA 200 (Revised and Redrafted) “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.” [Ref: ISA 200 para 5]	N
Identification and Assessment of the Risks of Material Misstatement Due to Fraud				
2	61	When identifying and assessing the risks of material misstatement at the financial report level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor shall identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor shall evaluate the design of the entity’s related controls, including relevant control activities, and determine	ISA equivalent wording to the shaded words is: “... shall obtain an understanding of the entity’s related controls, including control activities, relevant to such risks.” The ASA obligations to <i>evaluate</i> and <i>determine implementation</i> is greater than the ISA obligation to <i>understand</i> . However, the conditional situation is “...to	N

ITEM #	ASA Paragraph #	ASA Requirement (Copy/extract from Standard)	Commentary	Accept Requirement in ASA (Redrafted) Y/N?
		whether they have been implemented.	the extent not already done so...” The requirements in ISA/ASA 315 and 330 are sufficient and the auditor’s obligations are not diminished.	
Communications With Management and Those Charged With Governance				
3	106	The auditor shall make those charged with governance and management aware, as soon as practicable, and at the appropriate level of responsibility, of material weaknesses in the design or implementation of internal control to prevent and detect fraud which may have come to the auditor’s attention.	Included as a Requirement elsewhere. See “Matters to be Communicated” (<i>Significant Findings from the Audit</i>)—ISA/ASA 260 (Revised) “Communication with Those Charged with Governance.” [Ref: ISA 260 para 14 (c) (i)]	N

Draft

Explanatory Guidance—Significant Differences

ITEM #	ISA/ASA Paragraph #	Guidance	ATG Comment	Accept Guidance in ASA (Redrafted) Y/N?
ISA				
Characteristics of Fraud				
1	A6	The public sector auditor's responsibilities relating to fraud may be a result of legislation and regulation, ministerial directives, government policy requirements and resolutions of the legislature applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.	Adopt in ASA (Redrafted). This guidance does not conflict with Australian practice.	Y
Communications to Regulatory and Enforcement Authorities				
2	A66	In the public sector, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.	Adopt in ASA (Redrafted). This guidance does not conflict with Australian practice.	Y
Risk Assessment Procedures and Related Activities				
3	A13	In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of	Adopt in ASA (Redrafted). This guidance does not conflict with Australian practice.	Y

ITEM #	ISA/ASA Paragraph #	Guidance	ATG Comment	Accept Guidance in ASA (Redrafted) Y/N?
		employee fraud or misappropriation of assets.		
4	A21	In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no 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.	Adopt in ASA (Redrafted). This guidance does not conflict with Australian practice.	Y
5	A27	In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. 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.	Adopt in ASA (Redrafted). This guidance does not conflict with Australian practice.	Y
ASA				

ITEM #	ISA/ASA Paragraph #	Guidance	ATG Comment	Accept Guidance in ASA (Redrafted) Y/N?
			<p>Retained in ASA (Redrafted) [Only when requirement necessary for Australian legislation or regulation reasons]</p>	
1	115	<p>For an engagement under the <i>Corporations Act 2001</i>, the possibility of withdrawing from the engagement or resigning from the appointment as an auditor can only be made in accordance with the provisions of section 329 of the <i>Corporations Act 2001</i>, including obtaining consent to resign from the Australian Securities and Investments Commission (ASIC). For guidance on resignation of auditors under the <i>Corporations Act 2001</i>, see ASIC Policy Statement 26 “Resignation of Auditors”.</p>	<p>Explanatory guidance retained as useful reference to relevant legislation. Not inconsistent with the ISA. See para A56.</p>	Y
			<p>Retained in ASA (Redrafted) [Only when requirement necessary for public interest reasons and no inconsistency with the ISA]</p>	
2	102	<p>Legislation may require the auditor or a member of the audit team to maintain the confidentiality of information disclosed to the auditor by a person regarding contraventions or possible contraventions of the law.³ In such circumstances, the auditor or a member of the audit team may be prevented from communicating that information to management or those charged with governance in order to protect the identity of the person who has disclosed confidential information that alleges a breach of the law. Consequently, the auditor may need to consider the implications for the audit engagement.</p>	<p>Explanatory guidance retained as it contributes to the quality of the standard by alerting the auditor to a relevant matter and potential obligations under Australian legislation. Not inconsistent with the ISA. See para A61.</p>	Y

ITEM #	ISA/ASA Paragraph #	Guidance	ATG Comment	Accept Guidance in ASA (Redrafted) Y/N?
		Footnote 3: See, for example, Part 9.4AAA Protection for whistleblowers of the <i>Corporations Act 2001</i>		
			Not Retained	
3	58	Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial report and audit implications. In performing analytical procedures the auditor ordinarily develops expectations about plausible relationships that are reasonably expected to exist based on the auditor's understanding of the entity and its environment, including its internal control. When a comparison of those expectations with recorded amounts, or with ratios developed from recorded amounts, yields unusual or unexpected relationships, under paragraph 57 of this Auditing Standard, the auditor needs to consider those results in identifying risks of material misstatement due to fraud. Analytical procedures include procedures related to revenue accounts with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting, such as, for example, fictitious sales or significant returns from customers that might indicate undisclosed side agreements.	Included broadly in ISA/ASA 520 (Redrafted) ANALYTICAL PROCEDURES Relates to ISA 240 (Redrafted) para 22 which is a self-explanatory requirement that does not have, or need, guidance material. No need for retention in ASA 240 (Redrafted).	N