

## AU-C Section 240 \*

# Consideration of Fraud in a Financial Statement Audit

Source: SAS No. 122.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

## Introduction

### Scope of This Section

.01 This section addresses the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, are to be applied regarding risks of material misstatement due to fraud.

### Characteristics of Fraud

.02 Misstatements in the financial statements 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 statements is intentional or unintentional.

.03 Although fraud is a broad legal concept, for the purposes of generally accepted auditing standards (GAAS), the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. 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: par. .A1–.A8)

### Responsibility for the Prevention and Detection of Fraud

.04 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, places 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 behavior, which can be reinforced by active oversight by those

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\* This section has been codified using an "AU-C" identifier instead of an "AU" identifier. "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections, which will remain in AICPA *Professional Standards* through 2013. The "AU-C" identifier will revert to "AU" in 2014, by which time substantially all engagements for which the "AU" sections were still effective are expected to be completed.

charged with governance. Oversight by those charged with governance includes considering 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 financial statement users regarding the entity's performance and profitability.

### **Responsibilities of the Auditor**

**.05** An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.<sup>1</sup>

**.06** As described in section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud.<sup>2</sup> 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 depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. Although 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.

**.07** 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.

**.08** When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls, and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this section 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.

### **Effective Date**

**.09** This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

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<sup>1</sup> Paragraphs .A55–.A56 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

<sup>2</sup> Paragraph .A55 of section 200.

## Objectives

- .10 The objectives of the auditor are to
- a. identify and assess the risks of material misstatement of the financial statements due to fraud;
  - b. obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
  - c. respond appropriately to fraud or suspected fraud identified during the audit.

## Definitions

.11 For purposes of GAAS, the following terms have the meanings attributed as follows:

**Fraud.** An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.

**Fraud risk factors.** Events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. (Ref: par. .A11, .A30, and .A56)

## Requirements

### Professional Skepticism

.12 In accordance with section 200, the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.<sup>3</sup> (Ref: par. .A9–.A10)

.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 should investigate further. (Ref: par. .A11)

.14 When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), the auditor should further investigate the inconsistencies or unsatisfactory responses.

### Discussion Among the Engagement Team

.15 Section 315 requires a discussion among the key engagement team members, including the engagement partner, and a determination by the engagement partner of which matters are to be communicated to those team

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<sup>3</sup> Paragraph .17 of section 200.

members not involved in the discussion.<sup>4</sup> This discussion should include an exchange of ideas or brainstorming among the engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The discussion should occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity, and should, in particular, also address (Ref: par. .A12–.A13)

- a. 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;
- b. the risk of management override of controls;
- c. consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting;
- d. the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud; and
- e. how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Communication among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new facts during the audit.

## Risk Assessment Procedures and Related Activities

**.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 section 315, the auditor should perform the procedures in paragraphs .17–.24 to obtain information for use in identifying the risks of material misstatement due to fraud.<sup>5</sup>

### *Discussions With Management and Others Within the Entity*

- .17** The auditor should make inquiries of management regarding
- a. management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent, and frequency of such assessments; (Ref: par. .A14–.A15)
  - b. management's process for identifying, responding to, and monitoring 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: par. .A16)

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<sup>4</sup> Paragraph .11 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

<sup>5</sup> Paragraphs .05–.25 of section 315.

- c. management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- d. management's communication, if any, to employees regarding its views on business practices and ethical behavior.

.18 The auditor should 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: par. .A17–.A20)

.19 For those entities that have an internal audit function,<sup>6</sup> the auditor should make inquiries of internal audit to obtain its views about the risks of fraud; determine whether it has knowledge of any actual, suspected, or alleged fraud affecting the entity; whether it has performed any procedures to identify or detect fraud during the year; and whether management has satisfactorily responded to any findings resulting from these procedures.

### ***Those Charged With Governance***

.20 Unless all of those charged with governance are involved in managing the entity,<sup>7</sup> the auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: par. .A21–.A23)

.21 Unless all of those charged with governance are involved in managing the entity, the auditor should make inquiries of those charged with governance (or the audit committee or, at least, its chair) to determine their views about the risks of fraud and whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity. These inquiries are made, in part, to corroborate the responses received from the inquiries of management.

### ***Unusual or Unexpected Relationships Identified***

.22 Based on analytical procedures performed as part of risk assessment procedures,<sup>8</sup> the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatement due to fraud. To the extent not already included, the analytical procedures, and evaluation thereof, should include procedures relating to revenue accounts. (Ref: par. .A24–.A26 and .A46)

### ***Other Information***

.23 The auditor should consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: par. .A27)

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<sup>6</sup> Section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance in audits of those entities that have an internal audit function. Statement on Auditing Standards (SAS) No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, is currently effective and codified as AU section 322. SAS No. 65 has been included in section 610, as designated by SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, and will be superseded when it is redrafted for clarity and convergence with International Standard on Auditing 610 (Revised), *Using the Work of Internal Auditors*, as part of the Clarification and Convergence project of the Auditing Standards Board. Until such time, section 610 has been conformed to reflect updated section and paragraph cross references but has not otherwise been subjected to a comprehensive review or revision.

<sup>7</sup> Paragraph .09 of section 260, *The Auditor's Communication With Those Charged With Governance*.

<sup>8</sup> Paragraphs .06(b) and .A7–.A10 of section 315.

### **Evaluation of Fraud Risk Factors**

.24 The auditor should evaluate whether the information obtained from the risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which frauds have occurred and, therefore, may indicate risks of material misstatement due to fraud. (Ref: par. .A28–.A32)

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

.25 In accordance with section 315, the auditor should 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.<sup>9</sup> The auditor's risk assessment should be ongoing throughout the audit, following the initial assessment.

.26 When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. Paragraph .46 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: par. .A33–.A35)

.27 The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks. (Ref: par. .A36–.A37)

### **Responses to the Assessed Risks of Material Misstatement Due to Fraud**

#### **Overall Responses**

.28 In accordance with section 330, the auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.<sup>10</sup> (Ref: par. .A38)

.29 In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should

- a. assign and supervise personnel, taking into account 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: par. .A39–.A40)

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<sup>9</sup> Paragraph .26 of section 315.

<sup>10</sup> Paragraph .05 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

- 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, or a bias that may create a material misstatement; and (Ref: par. .A41)
- c. incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures. (Ref: par. .A42)

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

**.30** In accordance with section 330, the auditor should 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.<sup>11</sup> (Ref: par. .A43–.A46)

### ***Audit Procedures Responsive to Risks Related to Management Override of Controls***

**.31** 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.

**.32** Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing 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 statements, including entries posted directly to financial statement drafts. In designing and performing audit procedures for such tests, the auditor should (Ref: par. .A47–.A50 and .A55)
  - i. obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments,<sup>12</sup> and the suitability of design and implementation of such controls;
  - ii. 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;
  - iii. consider fraud risk indicators, the nature and complexity of accounts, and entries processed outside the normal course of business;
  - iv. select journal entries and other adjustments made at the end of a reporting period; and

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<sup>11</sup> Paragraph .06 of section 330.

<sup>12</sup> Paragraph .19 of section 315.

- v. consider the need to test journal entries and other adjustments throughout the period.
- 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 should
  - i. evaluate whether the judgments and decisions made by management in making 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 should reevaluate 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 statements of the prior year. Estimates selected for review should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. (Ref: par. .A51–.A53)
- c. evaluate, 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, 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: par. .A54)

### **Other Audit Procedures**

**.33** The auditor should 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 previously (that is, when specific additional risks of management override exist that are not covered as part of the procedures performed to address the requirements in paragraph .32). (Ref: par. .A55)

### **Evaluation of Audit Evidence (Ref: par. .A56)**

**.34** The auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures (including analytical procedures that were performed as substantive tests or when forming an overall conclusion) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud. If not already performed when forming an overall conclusion, the analytical procedures relating to revenue, required by paragraph .22, should be performed through the end of the reporting period. (Ref: par. .A57–.A58)

**.35** If the auditor identifies a misstatement, the auditor should evaluate whether such a misstatement is indicative of fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, particularly the auditor's evaluation of materiality, management and employee integrity, and the reliability of management

representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: par. .A59–.A62)

**.36** 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 should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained. (Ref: par. .A60)

**.37** If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit. (Ref: par. .A61)

### **Auditor Unable to Continue the Engagement**

**.38** If, as a result of identified fraud or suspected fraud, the auditor encounters circumstances that bring into question the auditor's ability to continue performing the audit, the auditor should

- a. determine the professional and legal responsibilities applicable in the circumstances, including whether a requirement exists for the auditor to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities;
- b. consider whether it is appropriate to withdraw from the engagement, when withdrawal is possible under applicable law or regulation; 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 a professional or legal requirement exists to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: par. .A63–.A66)

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

**.39** If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should 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: par. .A67)

**.40** 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, when the fraud results in a material misstatement in the financial statements,

the auditor should communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor should 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: par. .A68–.A70)

.41 The auditor should communicate with those charged with governance any other matters related to fraud that are, in the auditor's professional judgment, relevant to their responsibilities. (Ref: par. .A71)

## Communications to Regulatory and Enforcement Authorities

.42 If the auditor has identified or suspects a fraud, the auditor should determine whether the auditor has 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: par. .A72–.A74)

## Documentation

.43 The auditor should include in the audit documentation<sup>13</sup> of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by section 315 the following:<sup>14</sup>

- a. The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, and how and when the discussion occurred and the audit team members who participated
- b. The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level (See paragraphs .16–.27.)

.44 The auditor should include in the audit documentation of the auditor's responses to the assessed risks of material misstatement required by section 330 the following:<sup>15</sup>

- 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 the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level
- b. The results of the audit procedures, including those designed to address the risk of management override of controls

.45 The auditor should include in the audit documentation communications about fraud made to management, those charged with governance, regulators, and others.

.46 If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, the auditor should include in the audit documentation the reasons for that conclusion.

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<sup>13</sup> Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.

<sup>14</sup> Paragraph .33 of section 315.

<sup>15</sup> Paragraph .30 of section 330.

## Application and Other Explanatory Material

### Characteristics of Fraud (Ref: par. .03)

**.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, as follows:

- 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 because 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 deficiencies in internal control).
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

**.A2** Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements 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 about 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 expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

**.A3** An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Accordingly, the auditor is primarily concerned with fraud that causes a material misstatement of the financial statements. However, in conducting the audit, the auditor may identify misstatements arising from fraud that are not material to the financial statements. Paragraphs .35–.36 and .39–.42 address the auditor's responsibilities in such circumstances in evaluating audit evidence and in communicating audit findings, respectively.

**.A4** Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor's objective is to obtain

reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.<sup>16</sup>

**.A5** Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

**.A6** Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as the following:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances
- Omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity
- Altering records and terms related to significant and unusual transactions

**.A7** 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 is usually better 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 the following:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts from 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, or 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 approving payment at inflated prices, or payments to fictitious employees)

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<sup>16</sup> Paragraph .12 of section 200.

- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party)

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

### **Considerations Specific to Governmental Entities and Not-for-Profit Organizations**

**.A8** The auditor of governmental entities and not-for-profit organizations may have additional responsibilities relating to fraud

- as a result of being engaged to conduct an audit in accordance with law or regulation applicable to governmental entities and not-for-profit organizations,
- because of a governmental audit organization's mandate, or
- because of the need to comply with *Government Auditing Standards*.

Consequently, the responsibilities of the auditor of governmental entities and not-for-profit organizations 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.

### **Professional Skepticism (Ref: par. .12–.14)**

**.A9** Maintaining professional skepticism 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 when relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

**.A10** 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 professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

**.A11** An audit performed in accordance with GAAS rarely involves the authentication of documents, nor is the auditor trained as, or expected to be, an expert in such authentication.<sup>17</sup> However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic, that terms in a document have been modified but not disclosed to the auditor, or that undisclosed side agreements may exist, possible procedures to investigate further may include

- confirming directly with the third party.
- using the work of a specialist to assess the document's authenticity.

Appendix C, "Examples of Circumstances That Indicate the Possibility of Fraud," contains examples of circumstances that may indicate the possibility of fraud.

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<sup>17</sup> Paragraph .A51 of section 200.

## Discussion Among the Engagement Team (Ref: par. .15)

**.A12** Discussing the susceptibility of the entity's financial statements 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 statements 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 during the audit.

**.A13** The discussion may lead to a thorough probing of the issues, acquiring of additional evidence as necessary, and consulting with other team members and, if appropriate, specialists in or outside the firm. The discussion may include the following matters:

- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees that have come to the attention of the engagement team
- 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 statements 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 number of factors may influence the extent of the discussion and how it may occur. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. Another factor in planning the discussions is whether to include specialists assigned to the audit team.

## Risk Assessment Procedures and Related Activities

### *Inquiries of Management*

*Management's Assessment of the Risk of Material Misstatement Due to Fraud*  
(Ref: par. .17a)

**.A14** Management accepts responsibility for the entity's internal control and for the preparation and fair presentation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of

management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent, and frequency of management's assessment of such risk and controls 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 fraud may, in some circumstances, be indicative of the lack of importance that management places on internal control.

**.A15** *Considerations specific to smaller, less complex entities.* 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: par. .17b)

**.A16** 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.

### **Discussions With Management and Others Within the Entity** (Ref: par. .17-.19)

**.A17** Inquiries of management and others within the entity are generally most effective when they involve an in-person discussion. The auditor may also determine it useful to provide the interviewee with specific questions and obtain written responses in advance of the discussion.

**.A18** The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity, in addition to management, may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated. It may be useful in providing the auditor with a perspective that is different from that of individuals in the financial reporting process. The responses to these other inquiries might serve to corroborate responses received from management or, alternatively, might provide information regarding the possibility of management override of controls. The auditor may also obtain information about how effectively management has communicated standards of ethical behavior throughout the organization.

**.A19** Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include the following:

- 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

**.A20** Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

### ***Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: par. .20)***

**.A21** Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control, and compliance with the law. In some circumstances, 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. Because the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the respective responsibilities of those charged with governance and management to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.<sup>18</sup>

**.A22** 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 during which such discussions take place, reading the minutes from such meetings, or making inquiries of those charged with governance.

#### *Considerations Specific to Smaller, Less Complex Entities*

**.A23** In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity in which a single owner manages the entity, and no one else has a governance role. In these cases, ordinarily, no action exists on the part of the auditor because no oversight exists separate from management.

### ***Unusual or Unexpected Relationships Identified (Ref: par. .22)***

**.A24** Analytical procedures may include data analysis techniques ranging from a high-level review of data patterns, relationships, and trends to highly sophisticated, computer-assisted investigation of detailed transactions using electronic tools, such as data mining, business intelligence, and file query tools. The degree of reliance that can be placed on such techniques is a function primarily of the source (for example, financial, nonfinancial), completeness and reliability of the data, the level of disaggregation, and the nature of the analysis.

**.A25** Analytical procedures relating to revenue that are performed with the objective of identifying unusual or unexpected relationships that may indicate a material misstatement due to fraudulent financial reporting may include

- a. a comparison of sales volume, as determined from recorded revenue amounts, with production capacity. An excess of sales volume over production capacity may be indicative of recording fictitious sales.

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<sup>18</sup> Paragraphs .A6–.A12 of section 260 discuss with whom the auditor communicates when the entity's governance structure is not well defined.

- b. a trend analysis of revenues by month and sales returns by month, during and shortly after the reporting period. This may indicate the existence of undisclosed side agreements with customers involving the return of goods, which, if known, would preclude revenue recognition.
- c. a trend analysis of sales by month compared with units shipped. This may identify a material misstatement of recorded revenues.

**.A26** Analytical procedures performed during planning may be helpful in identifying the risks of material misstatement due to fraud. However, if such analytical procedures use data aggregated at a high level, generally the results of those analytical procedures provide only a broad initial indication about whether a material misstatement of the financial statements may exist. Accordingly, the results of analytical procedures performed during planning may be considered along with other information gathered by the auditor in identifying the risks of material misstatement due to fraud.

### ***Other Information (Ref: par. .23)***

**.A27** 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: par. .24)***

**.A28** 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), such as the following:

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

**.A29** 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 in which the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

**.A30** Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in appendix A, "Examples of Fraud Risk Factors." 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
- An ability to rationalize the fraudulent action

The inability to observe one or more of these conditions does not necessarily mean that no risk of material misstatement due to fraud exists.

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 A cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

**.A31** 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, Less Complex Entities*

**.A32** 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 deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control because an opportunity exists for management override of controls.

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

### ***Risks of Fraud in Revenue Recognition (Ref: par. .26)***

**.A33** 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.

**.A34** 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 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.

**.A35** The presumption that risks of fraud exist in revenue recognition may be rebutted. For example, the auditor may conclude that no risk of material misstatement due to fraud relating to revenue recognition exists in the case in which a single type of simple revenue transaction exists, 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: par. .27)***

**.A36** 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.<sup>19</sup> In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

**.A37** 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 statements may contain material misstatement due to fraud.

## **Responses to the Assessed Risks of Material Misstatement Due to Fraud**

### ***Overall Responses (Ref: par. .28)***

**.A38** Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism through, for example, increased

- sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- recognition of the need to corroborate management explanations or representations concerning material matters.

Determining overall responses to address the assessed risks of material misstatement due to fraud also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph .29, which are discussed in the following sections.

### ***Assignment and Supervision of Personnel (Ref: par. .29a)***

**.A39** 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 specialists, or by assigning more experienced individuals to the engagement.

**.A40** 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.

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<sup>19</sup> Paragraph .A48 of section 315.

**Accounting Principles (Ref: par. .29b)**

.A41 Management bias in the selection and application of accounting principles may individually or collectively involve matters such as contingencies, fair value measurements, revenue recognition, accounting estimates, related party transactions, or other transactions without a clear business purpose.

**Unpredictability in the Selection of Audit Procedures (Ref: par. .29c)**

.A42 Incorporating an element of unpredictability in the selection of the nature, timing, and extent of audit procedures to be performed is important because individuals within the entity who are familiar with the audit procedures normally performed on engagements may be better 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: par. .30)**

.A43 The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. 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 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 nonfinancial

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.

**.A44** 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.

**.A45** 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 segments of the business), and other significant accrued liabilities (such as pension and other postemployment 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.

**.A46** 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 B, "Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud." 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: par. .32a)*

**.A47** Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (a) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications.

**.A48** The auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important because 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 information automatically, there may be little or no visible evidence of such intervention in the information systems.

**.A49** 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 may be relevant:

- *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 IT 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 postclosing entries that have little or no explanation or description; (d) made either before or during the preparation of the financial statements that do not have account numbers; or (e) containing round numbers or consistent ending numbers.
- *The nature and complexity of the accounts.* Inappropriate journal entries or adjustments may be applied to accounts that (a) contain

transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain intercompany 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.* Nonstandard journal entries, and other entries such as consolidating adjustments, 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.

**.A50** The auditor exercises 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 .32a(iv) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph .32a(v) requires the auditor to consider whether a need also exists to test journal entries and other adjustments throughout the period.

*Accounting Estimates* (Ref. par. .32b)

**.A51** The preparation and fair presentation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and monitor 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 about the entity's performance and profitability.

**.A52** The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether an indication exists of a possible bias on the part of management. This review 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.

**.A53** A retrospective review is also required by section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.<sup>20</sup> That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's prior period estimation process, audit evidence about the outcome, or when applicable, the subsequent reestimation of prior period accounting estimates that is pertinent to making current period accounting estimates, and audit evidence of matters,

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<sup>20</sup> Paragraph .09 of section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this section may be carried out in conjunction with the review required by section 540.

*Business Rationale for Significant Transactions (Ref: par. .32c)*

**.A54** 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 following:

- 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 inadequate documentation exists.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve nonconsolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- Transactions that 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.

***Other Audit Procedures (Ref: par. .32a and .33)***

**.A55** Risks of material misstatement, including misstatements due to fraud, cannot be reduced to an appropriately low level by performing only tests of controls.<sup>21</sup>

**Evaluation of Audit Evidence (Ref: par. .34–.37)**

**.A56** Section 330 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.<sup>22</sup> This evaluation is primarily a qualitative matter based on the auditor's professional judgment. Such an evaluation may provide further insight into the risks of material misstatement due to fraud and whether a need exists to perform additional or different audit procedures. Appendix C contains examples of circumstances that may indicate the possibility of fraud.

***Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion (Ref: par. .34)***

**.A57** 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

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<sup>21</sup> Paragraph .A9 of section 330.

<sup>22</sup> Paragraph .27 of section 330.

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.

**.A58** Some unusual or unexpected analytical relationships may have been identified and may indicate a risk of material misstatement due to fraud because management or employees generally are unable to manipulate certain information to create seemingly normal or expected relationships. Some examples are as follows:

- The relationship of net income to cash flows from operations may appear unusual because management recorded fictitious revenues and receivables but was unable to manipulate cash.
- Changes in inventory, accounts payable, sales, or cost of sales from the prior period to the current period may be inconsistent, indicating a possible employee theft of inventory, because the employee was unable to manipulate all of the related accounts.
- A comparison of the entity's profitability to industry trends, which management cannot manipulate, may indicate trends or differences for further consideration when identifying risks of material misstatement due to fraud.
- A comparison of bad debt write-offs to comparable industry data, which employees cannot manipulate, may provide unexplained relationships that could indicate a possible theft of cash receipts.
- An unexpected or unexplained relationship between sales volume, as determined from the accounting records and production statistics maintained by operations personnel, which may be more difficult for management to manipulate, may indicate a possible misstatement of sales.

### ***Consideration of Identified Misstatements (Ref: par. .35–.37)***

**.A59** Because 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.

**.A60** 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 because there may be doubts about the completeness and truthfulness of representations made and the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management, or third parties.

**.A61** Section 450, *Evaluation of Misstatements Identified During the Audit*, and section 700, *Forming an Opinion and Reporting on Financial Statements*, address the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

**.A62** Section 580, *Written Representations*, addresses obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledges its responsibility for internal control designed, implemented, and maintained to prevent and detect fraud.

## Auditor Unable to Continue the Engagement (Ref: par. .38)

**.A63** Examples of circumstances that may arise and bring into question the auditor's ability to continue performing the audit include the following:

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

**.A64** Because of the variety of 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.

**.A65** The auditor has professional and legal responsibilities in such circumstances, and these responsibilities may vary by engagement. In some circumstances, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities. Given the 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 regulators or others.<sup>23</sup>

### ***Considerations Specific to Governmental Entities and Not-for-Profit Organizations***

**.A66** For governmental entities and not-for-profit organizations, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate, public interest considerations, contractual requirements, or law or regulation.

## Communications to Management and With Those Charged With Governance

### ***Communication to Management (Ref: par. .39)***

**.A67** 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 true 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.

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<sup>23</sup> Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, provides guidance on communications with an auditor replacing the existing auditor.

**Communication With Those Charged With Governance (Ref: par. .40)**

**.A68** The auditor's communication with those charged with governance may be made orally or in writing. Section 260, *The Auditor's Communication With Those Charged With Governance*, identifies factors the auditor considers in determining whether to communicate orally or in writing.<sup>24</sup> Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor communicates such matters on a timely basis and may consider it necessary to also communicate such matters in writing.

**.A69** 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.

**.A70** When 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: par. .41)**

**.A71** Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example

- concerns about the nature, extent, and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- a failure by management to appropriately address identified significant deficiencies or 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 concerning 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.
- the absence of programs or controls to address risks of material misstatement due to fraud that are significant deficiencies or material weaknesses.<sup>25</sup>

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<sup>24</sup> Paragraph .A40 of section 260.

<sup>25</sup> See section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

## **Communications to Regulatory and Enforcement Authorities (Ref: par. .42)**

**.A72** The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, in certain circumstances, the duty of confidentiality may be overridden by statute, regulation, courts of law, specific requirements of audits of entities that receive government financial assistance, or waived by agreement. In some circumstances, the auditor has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some circumstances, the auditor has a duty to report misstatements to authorities in those cases when management and those charged with governance fail to take corrective action.

**.A73** 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 Governmental Entities and Not-for-Profit Organizations***

**.A74** For governmental entities and not-for-profit organizations, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related law or regulation.

.A75

## Appendix A—Examples of Fraud Risk Factors (Ref: par. .11, .24, and .A30)

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 and pressures, (b) opportunities, and (c) attitudes and 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 and Pressures*

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for

example, overly optimistic press releases or annual report messages

- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards
- A need to achieve financial targets required in bond covenants
- Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow<sup>1</sup>
- Personal guarantees of debts of the entity

Management or operating personnel are under excessive pressure 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 jurisdictional borders where differing business environments and regulations exist

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<sup>1</sup> Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

- 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 nonowner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

The organizational structure is complex or unstable, 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 (when external reporting is required)
- High turnover rates or employment of accounting, internal audit, or IT staff who are not effective
- Accounting and information systems that are not effective, including situations involving significant deficiencies or material weaknesses in internal control
- Weak controls over budget preparation and development and compliance with law or regulation.

### ***Attitudes and 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.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities law or other law or regulation, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of law or regulation.
- 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.

- Management failing to remedy known significant deficiencies or 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.
- A strained relationship between management and the current or predecessor auditor, 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 behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

## Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

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

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lack observable identification of ownership

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because the following exist:

- Inadequate segregation of duties or independent checks
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements
- Inadequate management oversight of employees responsible for assets (for example, inadequate supervision or monitoring of remote locations)
- Inadequate job applicant screening of employees with access to assets
- Inadequate record keeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions (for example, credits for merchandise returns)
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of IT, which enables IT employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs

### ***Attitudes and Rationalizations***

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets

**General Principles and Responsibilities**

- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated
- The belief by some government or other officials that their level of authority justifies a certain level of compensation and personal privileges
- Tolerance of petty theft

.A76

## Appendix B—Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud (Ref: par. .22 and .A46)

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 to have an unusual nature or amount
- For significant and unusual transactions, particularly those occurring at or near year end, investigating the possibility of related parties and the sources of financial resources supporting the transactions
- Performing substantive analytical procedures using disaggregated data (for example, comparing sales and cost of sales by location, line of business, or month to expectations developed by the auditor)
- Conducting interviews of personnel involved in areas in which a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk, and whether, or how, controls address the risk
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches,

discussing with them the extent of work necessary to be performed to address the 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 analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population
- Testing the integrity of computer-produced records and transactions
- Seeking additional audit evidence from sources outside of the entity being audited

### **Specific Responses—Misstatement Resulting From Fraudulent Financial Reporting**

Examples of responses to the auditor's assessment of the 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 or with revenue related to cash collections (computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions)
- Confirming with customers certain relevant contract terms and the absence of side agreements because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented (for example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances)
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions

- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded

### ***Inventory Quantities***

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period
- Performing additional procedures during the observation of the count; for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals (using the work of an expert may be helpful in this regard)
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts (for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication)

### ***Management Estimates***

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

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

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to 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 preceding two categories may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

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

- Counting cash or securities at or near year end
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit
- Analyzing recoveries of written-off accounts
- Analyzing inventory shortages by location or product type
- Comparing key inventory ratios to industry norm
- Reviewing supporting documentation for reductions to the perpetual inventory records
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers, or bank accounts
- Reviewing personnel files for those that contain little or no evidence of activity; for example, lack of performance evaluations
- Analyzing sales discounts and returns for unusual patterns or trends
- Confirming specific terms of contracts with third parties
- Obtaining evidence that contracts are being carried out in accordance with their terms
- Reviewing the propriety of large and unusual expenses
- Reviewing the authorization and carrying value of senior management and related party loans
- Reviewing the level and propriety of expense reports submitted by senior management

.A77

## Appendix C—Examples of Circumstances That Indicate the Possibility of Fraud (Ref: par. .11, .A11, and .A56)

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

Discrepancies in the accounting records, including the following:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded by 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 the following:

- Missing documents
- Documents that appear to have been altered
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
- Significant unexplained items on reconciliations
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships; for example, receivables growing faster than revenues
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures
- Unusual discrepancies between the entity's records and confirmation replies
- Large numbers of credit entries and other adjustments made to accounts receivable records
- Unexplained or inadequately explained differences between the accounts receivable subledger and the control account, or between the customer statements and the accounts receivable subledger
- Missing or nonexistent cancelled checks in circumstances in which 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

Conditions relating to governmental entities or not-for-profit organizations:

- Significant transfers or transactions between funds or programs, or both, lacking supporting documents
- Abnormal budget conditions, such as
  - significant budget adjustments
  - requests for additional funding
  - budget adjustments made without approval
  - large amounts of over-or-under spending
  - programs with an emphasis on spending money quickly
- Procurement conditions, such as
  - lack of procurement legislation
  - recent changes to procurement legislation
  - complex or unclear legislation
  - involvement of significant monetary amounts (such as in the defense area)
  - investigation by regulatory authorities
  - complaints received from potential suppliers about questionable practices related to awarding of contracts
  - former governmental officials functioning as executives of companies to which contracts have been awarded
- Program conditions, such as
  - newly implemented programs without existing management and accountability structures
  - programs established for political purposes
  - programs established to deal with an immediate emergency or crisis
  - programs experiencing unusual growth due to conditions beyond the control of management
- Grant and donor funding conditions, such as
  - noncompliance with grant requirements
  - unclear grant requirements
  - grants not reaching the intended recipient
  - complaints from intended recipients or interest groups, and lack of monitoring of grantee compliance with applicable law or regulation

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

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought

- Undue time pressures imposed by management to resolve complex or contentious issues
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
- Unusual delays by the entity in providing requested information
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable
- An unwillingness to address identified deficiencies in internal control on a timely basis

Other circumstances, including the following:

- 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
-