

Fraud – Phase II – Issues Paper**Convergence with US Fraud Standard**

1. In March 2001, the IAPC approved revisions to ISA 240 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements.” At the same time, the IAPC accepted an invitation from the Auditing Standards Board of the United States to participate in the US Task Force to revise SAS 82 “Consideration of Fraud in a Financial Statement Audit,” after which time ISA 240 would be further revised as appropriate.
2. In June 2002, the IAASB submitted a letter commenting on the US Fraud Exposure Draft. This action was taken in light of the previous decision that IAASB would adopt the principles contained in the final revised US standard modified as appropriate for an international environment. In October 2002, the US issued SAS 99 “Consideration of Fraud in a Financial Statement Audit.”
3. SAS 99 is a lengthy document and contains far more detailed guidance than would generally be contained in an ISA. Consequently, the Task Force believes that the appropriate way to achieve convergence with the principles in the SAS is to maintain the structure of existing ISA 240 (other than separating fraud and error, see below) and incorporate the basic principles and essential procedures contained in SAS 99. Therefore, the starting point will be ISA 240 rather than SAS 99.
4. The basic principles and essential procedures that the Task Force will consider for inclusion are as follows (the SAS 99 paragraph references are provided in brackets):
 - Expanded discussion on professional skepticism – “The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity.” (SAS 99.13)
 - Expanded discussion among members of the audit team – including discussion among team members about how and where they believe the entity’s financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting and how assets of the entity could be misappropriated; and the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud. (SAS 99.14)

- Expanded inquiries including:
 - i. Inquiries of management – including inquiring whether management is aware of allegations of fraud or suspected fraud. (SAS 99.20)
 - ii. Requiring the auditor to communicate with those charged with governance. (SAS 99.22). ISA 240.28 encourages the auditor to communicate with those charged with governance.
 - iii. Requiring the auditor to communicate with internal audit personnel, when the entity has an internal audit function. (SAS 99.23)
 - iv. Guidance on the types of other individuals within the entity to whom the auditor might direct inquiries. (SAS 99.24)
- Expanded guidance with respect to analytical procedures – requiring the auditor to consider the results of analytical procedures performed when identifying the risks of material misstatement due to fraud (SAS 99.28) and requiring performance of analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships that may indicate a material misstatement due to fraudulent financial reporting (SAS 99.29).
- Fraud risk factors – Expanding the examples of fraud risk factors contained in Appendix 1 of ISA 240 and categorizing the factors between the three conditions that are present when a fraud occurs: incentives/pressures, opportunities and attitudes/rationalizations.
- A presumption that there is a risk of material misstatement due to fraud relating to revenue recognition (SAS 99.41) and expanding the discussion of procedures the auditor may perform in response to an identified risk material misstatement due to fraud relating to revenue recognition (SAS 99.54).
- Discussion of procedures the auditor may perform if there is an identified risk of material misstatement due to fraud involving the development of management estimates. (SAS 99.54)
- A requirement for the auditor to perform procedures to address the risk of management override of controls:
 - i. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud. (SAS 99.58)
 - ii. Reviewing accounting estimates for biases that could result in material misstatement due to fraud. (SAS 99.63)
 - iii. Evaluating the business rationale for significant unusual transactions. (SAS 99.66)
- Expanded documentation requirements:
 - i. The discussion among engagement personnel regarding the susceptibility of the entity's financial statements to material misstatement due to fraud.
 - ii. The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud.

- iii. If the auditor has not identified improper revenue recognition as a risk of material misstatement due to fraud the reasons supporting the auditor's conclusions.
- iv. The results of the procedures performed to address the risk of management override of controls.

Action Required by IAASB

Does the IAASB support the approach to convergence with SAS 99?

Does the IAASB believe there are any factors that would indicate that any of the basic principles and essential procedures outlined above are not appropriate for an international environment?

Separation of Fraud and Error

- 5. The current ISA 240 deals with both fraud and error. The Task Force believes that there should be an ISA that deals only with fraud. The Task Force believes this is appropriate because:
 - It will result in greater emphasis on the auditor's responsibility for fraud; and
 - The distinction between fraud and error is intent; by separating fraud and error the document will be able to provide a greater focus on intent.
- 6. Therefore, the Task Force proposes to re-draft ISA 240 to deal only with fraud and also develop a separate ISA to deal with error. Appendix 1 of this agenda paper identifies the paragraphs of existing ISA 240 that relate to error.

Action Required by IAASB

Does the IAASB support the proposal to separate fraud and error?

Earnings Management

- 7. The Task Force believes that the revised ISA 240 should place greater emphasis on earnings management than SAS 99. The Task Force proposes that the revised ISA will contain a discussion on how the incentives/pressures on management may lead to fraudulent financial reporting. It will alert the auditor to the continuum of earnings management that covers a wide variety of actions ranging from legitimate managerial activities at one end of the spectrum to fraudulent financial reporting at the other end. It will be necessary for the Task Force to liaise closely with the Task Force dealing with Audit of Accounting Estimates.

Action Required by IAASB

Does the IAASB support the proposal that the revised ISA 240 place greater emphasis on earnings management?

Recommendations for Others

8. The primary responsibility for the prevention and detection of fraud rests with those charged with governance of the entity and management of the entity. The revised ISA 240 will continue to emphasize this fact.
9. The Task Force believes that it is appropriate to be alert to opportunities to make recommendations to improve corporate governance practices. In particular, the Task Force plans to consider whether there are other organizations with which the IAASB could work jointly to develop best practices in this area and promote the cause of good governance.
10. SAS 99 contains an exhibit on Management Antifraud Programs and Controls that is being jointly issued by several organizations.¹ The document identifies the key participants in the “antifraud effort”, including the board of directors, management, internal and independent auditors and certified fraud examiners. The document identifies measures entities can implement to prevent, deter, and detect fraud.

Action Required by IAASB

Does the IAASB agree that as a by-product of this project the Task Force should be alert to opportunities to make recommendations for others in the area of good corporate governance?

Does the IAASB believe that the exhibit in SAS 99, or elements of it, should be included in the revised ISA 240?

¹ AICPA, the Association of Certified Fraud Examiners, the Financial Executives Institute, the Information Systems Audit and Control Association, The Institute of Internal Auditors, the Institute of Management Accountants and the Society of Human Resource Management.

Appendix 1

Paragraphs of ISA 240 that relate to error

3. Misstatements in the financial statements can arise from fraud or error. The term “error” refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:
 - A mistake in gathering or processing data from which financial statements are prepared.
 - An incorrect accounting estimate arising from oversight or misinterpretation of facts.
 - A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
- 10 The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary by entity and from country to country. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity.
14. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements will be detected.
20. **In planning the audit, the auditor should discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.**
22. **When planning the audit, the auditor should make inquiries of management:**
 - (b) **to obtain knowledge of management’s understanding regarding the accounting and internal control systems in place to prevent and detect error;**
 - (d) **to determine whether management has discovered any material errors.**
28. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of how management has discharged its responsibilities. In such circumstances, auditors are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management.

51. The auditor should obtain written representations from management that:
 - (a) it acknowledges its responsibility for the implementation and operations of accounting and internal control systems that are designed to prevent and detect fraud and error;
 - (b) it believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;
56. When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor's responsibility to communicate that information to management, those charged with governance and, in some circumstances, to regulatory and enforcement authorities.
59. If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260, "Communication of Audit Matters with Those Charged with Governance."
60. The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
61. The auditor should communicate to management any material weaknesses in internal control related to the prevention or detection of fraud and error, which have come to the auditor's attention as a result of the performance of the audit.