



International Federation of Accountants

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Agenda Item

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Committee: IAASB
Meeting Location: New York
Meeting Date: February 16-18, 2004

Auditor's Responsibility to Consider Fraud In an Audit of Financial Statements

Objectives of Agenda Item

To review and approve for release as a standard revisions to ISA 240 *Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* and conforming amendments.

Background

At the July 2003 meeting, the IAASB approved the release of an exposure draft to revise ISA 240 *Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*. The comment period ended on November 15, 2003.

Activities Since Last IAASB Discussions

The Task Force met on January 5-6, 2004 and held a conference call on January 19, 2004 to discuss the changes to the ED in response to comments received on exposure.

OVERALL COMMENTS

There were 35 responses to the ED, the vast majority of which were supportive of the ED:

"We believe the issuance of this revised standard is an important step forward in global harmonization and are strongly supportive of the development of this guidance."

Deloitte Touche Tohmatsu

"We believe that the ISA will make a positive contribution towards the furtherance of convergent and acceptable auditing standards within the current international environment."

INTOSAI

"FEE is generally supportive of the proposed revised ISA as it is an improvement in comparison with the existing standard. We agree that a more active search to detect material misstatement due to fraud is appropriate in the current climate."

FEE

REASONABLE ASSURANCE

Several respondents (including FEE, PwC, FSR, APB and IOSCO) commented on the different meanings that can be ascribed to the concept of reasonable assurance. It was noted that some view reasonable assurance as meaning a high level of assurance that the financial statements are free of material misstatement – whether due to fraud or error. However, others view the auditor's report as conveying different levels of assurance in relation to what is reasonable for different aspects of the financial statements and types of misstatements. Respondents stated that the matter should be clarified.

These comments have not been addressed in the proposed standard because, as agreed at the start of the project to revise ISA 240, the concept of reasonable assurance should be addressed its entirety and should be the subject of a separate project.

EARNINGS MANAGEMENT

Several respondents (including D&T, PwC, ICAEW, IAA and ACCA) commented that additional guidance should be provided in the standard on the subject of earnings management. While the Task Force has made a stronger link between earnings management and fraudulent financial reporting (see paragraph 10), the Task Force has not provided more detailed guidance. The Task Force believes that if additional guidance is necessary it should be addressed in individual standards or through a separate standard addressing all aspects of earnings management.

ALIGNMENT WITH THE RISK MODEL

The Audit Risk Model Standards were issued in final form after the ED was released. Several respondents (including IOSCO, KPMG, AIPCA and PwC) questioned whether the fraud ED was appropriately aligned with the risk model and offered useful suggestions.

The Task Force has made the following changes to the proposed standard to properly align it with the risk model:

- Risk assessment procedures – cross-referencing from paragraph 31 to ISA 315 to make it clear that the risk assessment procedures referred to in proposed ISA 240 are part of the risk assessment procedures required by ISA 315.
- Inquiries – moving the inquiries about management's communications to those charged with governance and employees (paragraph 33 c & d) from the section dealing with evaluating the design and implementation of control to the section dealing with risk assessment.
- Significant risks – requiring the auditor, to the extent not already done so, to evaluate the design of the entity's related controls for significant risks (paragraph 55).

The ED, and the proposed final standard, includes a presumption that there is risk of material misstatement due to fraud related to revenue recognition. This is considered to be a significant risk. In accordance with ISA 330.44, if an auditor plans to rely on the operating effectiveness of controls intended to mitigate a significant risk, the auditor is required to test the controls in the current period. That is the auditor is not permitted, if the controls have not changed, to test the operating effectiveness every three years. No comments were received on this point on exposure but, because the matter was not explicitly discussed when the ED was approved, Board members are asked to confirm the position taken in the proposed final standard.

MISAPPROPRIATION OF ASSETS

Several respondents (including SMTP, AICPA and MICPA) commented that ED emphasized fraudulent financial reporting and did not provide sufficient guidance on misappropriation of assets. These respondents were concerned that users of the standard might infer that detecting misappropriation of assets was not difficult. The Task Force has provided the following additional guidance on misappropriation of assets:

- Paragraph 11 has been expanded to provide additional examples.
- The matters that are ordinarily included in the discussion of the engagement team have been expanded (paragraph 28)
- Specific responses to a risk of misstatement due to fraud relating to misappropriation of assets have been added to Appendix 2.
- Additional examples of circumstances that indicate the possibility of fraud relating to misappropriation of assets have been added to Appendix 3.

ALIGNMENT WITH SAS 99

Several respondents (including KPMG, CICA and D&T) commented that the ED was not well aligned with SAS 99 in certain areas. To address these comments, the Task Force has included the following additional black letter requirements in the proposed standard:

- Requiring the auditor to incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed (paragraph 65).
- Requiring the auditor to consider whether analytical procedures that are performed at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business indicate a previously unrecognized risk of material misstatement due to fraud (paragraph 83)
- Requiring the auditor to consider whether an identified misstatement may be indicative of fraud, and if there is such an indication, to consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management's representations (paragraph 84).

OTHER MATTERS

SAS 99 contained a useful exhibit *Management Antifraud Programs and Control: Guidance to Help Prevent, Deter, and Detect Fraud*. This exhibit has been posted on the IFAC web-site under the Professional Accountants in Business section (<http://www.ifac.org/PAIB/#Publications>).

Material Presented

Agenda Item 7-A Proposed standard (mark-up)
(Pages 199 –238)

Agenda Item 7-B Proposed standard (clean)
(Pages 239 –278)

While a clean and a mark-up copy have been provided for the convenience of the IAASB members, the mark-up copy will be used at the meeting.

Action Requested

IAASB is asked to review the proposed standard and approve it for release with an effective date of December 15, 2004.

Appendix 1**Exposure Draft “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”****Respondent Summary**

- 1 American Institute of Certified Public Accountants
- 2 Association of Chartered Certified Accountants
- 3 Auditing Practices Board
- 4 Australian Auditing and Assurance Standards Board
- 5 Canadian Institute of Chartered Accountants
- 6 Certified General Accountants - Canada
- 7 Commission des normes de revisions (IRE Belgium)
- 8 Compagnie Nationale des Commissaires aux Comptes and the Conseil Supérieur de l'Ordre des Experts-Comptables (CNCC)
- 9 Controller and Auditor General – New Zealand
- 10 Deloitte Touche Tohmatsu
- 11 Ernst & Young
- 12 Fédération des Experts Comptables Européens – European Federation of Accountants (FEE)
- 13 Foreningen af Statsautoriserede Revisorer
- 14 Foreningen Auktoriserade Revisorer
- 15 Grant Thornton
- 16 Hong Kong Society of Accountants
- 17 IOSCO
- 18 Institut Der Wirtschaftsprüfer
- 19 Institute of Certified Public Accountants of Cyprus
- 20 Institute of Chartered Accountants of England and Wales
- 21 Institute of Chartered Accountants in Ireland
- 22 Institute of Chartered Accountants of New Zealand
- 23 Institute of Internal Auditors
- 24 International Actuarial Association
- 25 INTOSAI Auditing Standards Committee
- 26 The Japanese Institute of Certified Public Accountants
- 27 KPMG
- 28 London Society of Chartered Accountants
- 29 Malaysian Institute of Chartered Accountants
- 30 Norwegian Institute of Public Accountants
- 31 PricewaterhouseCoopers
- 32 RSM International
- 33 Small and Medium Practices Task Force – Rapid Response Team
- 34 South African Institute of Chartered Accountants
- 35 Southern Society of Chartered Accountants of England and Wales
- 36 International Organization of Securities Organizations (received January 13, 2004)