

HKSA 240  
Issued October 2004

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Effective for audits of financial statements  
for periods beginning on or after 15 December 2004

*Hong Kong Standard on Auditing 240*

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# **The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements**



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

**HONG KONG STANDARD ON AUDITING 240**  
**THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD**  
**IN AN AUDIT OF FINANCIAL STATEMENTS**

(Effective for audits of financial statements  
for periods beginning on or after 15 December 2004)

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Hong Kong Standard on Auditing (HKSA) 240, "The Auditor's Responsibility To Consider Fraud in an Audit of Financial Statements" should be read in the context of the "Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services" which sets out the application and authority of HKSAs.

## Introduction

1. The purpose of this Hong Kong Standard on Auditing (HKSA) is to establish basic principles and essential procedures and to provide guidance on the auditor's responsibility to consider fraud in an audit of financial statements<sup>1</sup> and expand on how the standards and guidance in HKSA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" and HKSA 330, "The Auditor's Procedures in Response to Assessed Risks" are to be applied in relation to the risks of material misstatement due to fraud. The standards and guidance in this HKSA are intended to be integrated into the overall audit process.
2. This standard:
  - Distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor, that is, misstatements resulting from misappropriation of assets and misstatements resulting from fraudulent financial reporting; describes the respective responsibilities of those charged with governance and the management of the entity for the prevention and detection of fraud, describes the inherent limitations of an audit in the context of fraud, and sets out the responsibilities of the auditor for detecting material misstatements due to fraud;
  - Requires the auditor to maintain an attitude of professional skepticism recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance;
  - Requires members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud and requires the engagement partner to consider which matters are to be communicated to members of the engagement team not involved in the discussion;
  - Requires the auditor to:
    - Perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud;
    - Identify and assess the risks of material misstatement due to fraud at the financial statement level and the assertion level; and for those assessed risks that could result in a material misstatement due to fraud, evaluate the design of the entity's related controls, including relevant control activities, and to determine whether they have been implemented;
    - Determine overall responses to address the risks of material misstatement due to fraud at the financial statement level and consider the assignment and supervision of personnel; consider the accounting policies used by the entity and incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed;
    - Design and perform audit procedures to respond to the risk of management override of controls;
    - Determine responses to address the assessed risks of material misstatement due to fraud;
    - Consider whether an identified misstatement may be indicative of fraud;
    - Obtain written representations from management relating to fraud; and
    - Communicate with management and those charged with governance;
  - Provides guidance on communications with regulatory and enforcement authorities;

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<sup>1</sup>The auditor's responsibility to consider laws and regulations in an audit of financial statements is established in HKSA 250, "Consideration of Laws and Regulations".

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- Provides guidance if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit; and
  - Establishes documentation requirements.
3. **In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.**

### Characteristics of Fraud

4. Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
5. The term "error" refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as the following:
- 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.
6. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, for the purposes of this HKSA, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud;" fraud involving only employees of the entity is referred to as "employee fraud." In either case, there may be collusion within the entity or with third parties outside of the entity.
7. Two types of intentional misstatements are relevant to the auditor, that is, misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
8. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. 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.
9. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:
- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives;
  - Inappropriately adjusting assumptions and changing judgments used to estimate account balances;
  - Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period;

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- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements;
  - Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity; and
  - Altering records and terms related to significant and unusual transactions.
10. Fraudulent financial reporting can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.
11. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:
- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts);
  - Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment);
  - Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees); and
  - Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

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

12. Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Individuals may have an incentive to misappropriate assets for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target – particularly since the consequences to management for failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control. Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

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

13. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. The respective responsibilities of those charged with governance and of management may vary by entity and from country to

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country. In some entities, the governance structure may be more informal as those charged with governance may be the same individuals as management of the entity.

14. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a culture of honesty and ethical behavior. Such a culture, based on a strong set of core values, is communicated and demonstrated by management and by those charged with governance and provides the foundation for employees as to how the entity conducts its business. Creating a culture of honesty and ethical behavior includes setting the proper tone; creating a positive workplace environment; hiring, training and promoting appropriate employees; requiring periodic confirmation by employees of their responsibilities and taking appropriate action in response to actual, suspected or alleged fraud.
15. It is the responsibility of those charged with governance of the entity to ensure, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Active oversight by those charged with governance can help reinforce management's commitment to create a culture of honesty and ethical behavior. In exercising oversight responsibility, those charged with governance consider the potential for management override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.
16. It is the responsibility of management, with oversight from those charged with governance, to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes establishing and maintaining controls pertaining to the entity's objective of preparing financial statements that give a true and fair view (or are presented fairly in all material respects) in accordance with the applicable financial reporting framework and managing risks that may give rise to material misstatements in those financial statements. Such controls reduce but do not eliminate the risks of misstatement. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

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

17. As described in HKSA 200, "Objective and General Principles Governing an Audit of Financial Statements", the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with HKSA's.
18. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential

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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.

19. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist in carrying out a fraud, with or without the employees' knowledge.
20. The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with HKSA's. This is particularly the case for certain kinds of intentional misstatements, since audit procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or that involves falsified documentation. Whether the auditor has performed an audit in accordance with HKSA's is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence.

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

21. An auditor conducting an audit in accordance with HKSA's obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit evidence available to the auditor is persuasive rather than conclusive in nature.
22. When obtaining reasonable assurance, an auditor maintains an attitude of professional skepticism throughout the audit, considers the potential for management override of controls and recognizes the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of material misstatement due to fraud. The remainder of this HKSA provides additional guidance on considering the risks of fraud in an audit and designing procedures to detect material misstatements due to fraud.

### **Professional Skepticism**

23. As required by HKSA 200, the auditor plans and performs an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. Due to the characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.
24. **The auditor should maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.**
25. As discussed in HKSA 315, the auditor's previous experience with the entity contributes to an understanding of the entity. However, although the auditor cannot be expected to fully disregard past experience with the entity about the honesty and integrity of management and

those charged with governance, the maintenance of an attitude of professional skepticism is important because there may have been changes in circumstances. When making inquiries and performing other audit procedures, the auditor exercises professional skepticism and is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. With respect to those charged with governance, maintaining an attitude of professional skepticism means that the auditor carefully considers the reasonableness of responses to inquiries of those charged with governance, and other information obtained from them, in light of all other evidence obtained during the audit.

26. An audit performed in accordance with HKSAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. Furthermore, an auditor may not discover the existence of a modification to the terms contained in a document, for example through a side agreement that management or a third party has not disclosed to the auditor. During the audit, the auditor considers the reliability of the information to be used as audit evidence including consideration of controls over its preparation and maintenance where relevant. Unless the auditor has reason to believe the contrary, the auditor ordinarily accepts records and documents as genuine. However, 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, the auditor investigates further, for example confirming directly with the third party or considering using the work of an expert to assess the document's authenticity.

### Discussion Among the Engagement Team

27. **Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.**
28. HKSA 315 requires members of the engagement team to discuss the susceptibility of the entity to material misstatement of the financial statements. This discussion places particular emphasis on the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion includes the engagement partner who uses professional judgment, prior experience with the entity and knowledge of current developments to determine which other members of the engagement team are included in the discussion. Ordinarily, the discussion involves the key members of the engagement team. The discussion 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.
29. **The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.** All of the members of the engagement team do not necessarily need to be informed of all of the decisions reached in the discussion. For example, a member of the engagement team involved in audit of a component of the entity may not need to know the decisions reached regarding another component of the entity.
30. The discussion occurs with a questioning mind setting aside any beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. The discussion ordinarily includes:
- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated;
  - A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting;
  - A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the



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opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;

- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation;
  - A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team;
  - An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud;
  - A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud;
  - A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed;
  - A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatements due to fraud and whether certain types of audit procedures are more effective than others;
  - A consideration of any allegations of fraud that have come to the auditor's attention; and
  - A consideration of the risk of management override of controls.
31. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud is an important part of the audit. It enables the auditor to consider an appropriate response to the susceptibility of the entity's financial statements to material misstatement due to fraud and to determine which members of the engagement team will conduct certain audit procedures. It also permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, the engagement partner, having personally conducted the planning of the audit, considers the susceptibility of the entity's financial statements to material misstatement due to fraud.
32. It is important that after the initial discussion while planning the audit, and also at intervals throughout the audit, engagement team members continue to communicate and share information obtained that may affect the assessment of risks of material misstatement due to fraud or the audit procedures performed to address these risks. For example, for some entities it may be appropriate to update the discussion when reviewing the entity's interim financial information.

### **Risk Assessment Procedures**

33. As required by HKSA 315, to obtain an understanding of the entity and its environment, including its internal control, the auditor performs risk assessment procedures. As part of this work the auditor performs the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud:
- (a) Makes inquiries of management, of those charged with governance, and of others within the entity as appropriate and obtains an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks.
  - (b) Considers whether one or more fraud risk factors are present.
  - (c) Considers any unusual or unexpected relationships that have been identified in performing analytical procedures.
  - (d) Considers other information that may be helpful in identifying the risks of material misstatement due to fraud.

## **Inquiries and Obtaining an Understanding of Oversight Exercised by Those Charged With Governance**

34. **When obtaining an understanding of the entity and its environment, including its internal control, 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;**
  - (b) **Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist;**
  - (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.**
35. As management is responsible for the entity's internal control and for the preparation of the financial statements, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal and less frequent. In some entities, particularly smaller entities, the focus of the assessment may be on the risks of employee fraud or misappropriation of assets. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.
36. In a small owner managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity, thereby compensating for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because of the informal system of internal control. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.
37. When making inquiries as part of obtaining an understanding of management's process for identifying and responding to the risks of fraud in the entity, the auditor inquires about the process to respond to internal or external allegations of fraud affecting the entity. For entities with multiple locations, the auditor inquires about the nature and extent of monitoring of operating locations or business segments and whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist.
38. **The auditor should make inquiries of management, internal audit, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.**
39. Although the auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud, 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 be useful in providing the auditor with a perspective that is different from management and those responsible for the financial reporting process. Such inquiries may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated. The auditor uses professional judgment in determining those others within the entity to whom inquiries are directed and the extent of such inquiries. In making this determination the auditor considers

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whether others within the entity may be able to provide information that will be helpful to the auditor in identifying the risks of material misstatement due to fraud.

40. The auditor makes inquiries of internal audit personnel, for those entities that have an internal audit function. The inquiries address the views of the internal auditors regarding the risks of fraud, whether during the year the internal auditors have performed any procedures to detect fraud, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any actual, suspected or alleged fraud.
41. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:
  - Operating personnel not directly involved in the financial reporting process;
  - Employees with different levels of authority;
  - Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees;
  - In-house legal counsel;
  - Chief ethics officer or equivalent person; and
  - The person or persons charged with dealing with allegations of fraud.
42. When evaluating management's responses to inquiries, the auditor maintains an attitude of professional skepticism recognizing that management is often in the best position to perpetrate fraud. Therefore, the auditor uses professional judgment in deciding when it is necessary to corroborate responses to inquiries with other information. When responses to inquiries are inconsistent, the auditor seeks to resolve the inconsistencies.
43. **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.**
44. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the internal control the entity has established to mitigate specific risks of fraud that the entity has identified. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.<sup>2</sup> Those charged with governance include management when management performs such functions, such as may be the case in smaller entities.
45. Obtaining 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, may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of such internal control and the competence and integrity of management. The auditor may obtain this understanding by performing procedures such as attending meetings where such discussions take place, reading the minutes from such meetings or by making inquiries of those charged with governance.
46. **The auditor should make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.**

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<sup>2</sup> HKSA 260, "Communication of Audit Matters With Those Charged With Governance" paragraph 8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

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47. The auditor makes inquiries of those charged with governance in part to corroborate the responses to the inquiries from management. When responses to these inquiries are inconsistent, the auditor obtains additional audit evidence to resolve the inconsistencies. Inquiries of those charged with governance may also assist the auditor in identifying risks of material misstatement due to fraud.

#### Consideration of Fraud Risk Factors

48. **When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present.**
49. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, when obtaining an understanding of the entity and its environment, including its internal control, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Such events or conditions are referred to as "fraud risk factors." For example:
- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
  - The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and

An ineffective control environment may create an opportunity to commit fraud. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of the risks of material misstatement.

50. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the auditor exercises professional judgment in determining 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.
51. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1 to this HKSA. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists: an incentive or pressure to commit fraud; a perceived opportunity to commit fraud; and an ability to rationalize the fraudulent action. Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist. The auditor also has to be alert for risk factors specific to the entity that are not included in Appendix 1. Not all of the examples in Appendix 1 are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances.
52. 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, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance and of the internal audit function and the existence and enforcement of a formal code of conduct. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by

management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.

### **Consideration of Unusual or Unexpected Relationships**

53. **When performing analytical procedures to obtain an understanding of the entity and its environment, including its internal control, the auditor should consider unusual or unexpected relationships that may indicate risks of material misstatement due to fraud.**
54. Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures the auditor develops expectations about plausible relationships that are reasonably expected to exist based on the auditor's understanding of the entity and its environment, including its internal control. When a comparison of those expectations with recorded amounts, or with ratios developed from recorded amounts, yields unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement due to fraud. Analytical procedures include procedures related to revenue accounts with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting, such as, for example, fictitious sales or significant returns from customers that might indicate undisclosed side agreements.

### **Consideration of Other Information**

55. **When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether other information obtained indicates risks of material misstatement due to fraud.**
56. In addition to information obtained from applying analytical procedures, the auditor considers other information obtained about the entity and its environment that may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members described in paragraphs 27-32 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.

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

57. **When identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor should identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented.**
58. To assess the risks of material misstatement due to fraud the auditor uses professional judgment and:
  - (a) Identifies risks of fraud by considering the information obtained through performing risk assessment procedures and by considering the classes of transactions, account balances and disclosures in the financial statements;
  - (b) Relates the identified risks of fraud to what can go wrong at the assertion level; and

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- (c) Considers the likely magnitude of the potential misstatement including the possibility that the risk might give rise to multiple misstatements and the likelihood of the risk occurring.
59. It is important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud because in designing and implementing such controls, management may make informed judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. The auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. This may often be the case in small entities where the owner provides day-to-day supervision of operations. Information from obtaining this understanding may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

### **Risks of Fraud in Revenue Recognition**

60. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor ordinarily presumes that there are risks of fraud in revenue recognition and considers which types of revenue, revenue transactions or assertions may give rise to such risks. Those assessed risks of material misstatement due to fraud related to revenue recognition are significant risks to be addressed in accordance with paragraphs 57 and 61. Appendix 2 includes examples of responses to the auditor's assessment of the risk of material misstatement due to fraudulent financial reporting resulting from revenue recognition. If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor documents the reasons supporting the auditor's conclusion as required by paragraph 110.

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

61. **The auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks at the assertion level.**
62. HKSA 330 requires the auditor to perform substantive procedures that are specifically responsive to risks that are assessed as significant risks.
63. The auditor responds to the risks of material misstatement due to fraud in the following ways:
- (a) A response that has an overall effect on how the audit is conducted, that is, increased professional skepticism and a response involving more general considerations apart from the specific procedures otherwise planned.
  - (b) A response to identified risks at the assertion level involving the nature, timing and extent of audit procedures to be performed.
  - (c) A response to identified risks involving the performance of certain audit procedures to address the risks of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.
64. The response to address the assessed risks of material misstatement due to fraud may affect the auditor's professional skepticism in the following ways:
- (a) Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
  - (b) Increased recognition of the need to corroborate management explanations or representations concerning material matters.

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65. The auditor may conclude that it would not be practicable to design audit procedures that sufficiently address the risks of material misstatement due to fraud. In such circumstances the auditor considers the implications for the audit (see paragraphs 89 and 103).

### Overall Responses

66. **In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level the auditor should:**
- (a) **Consider the assignment and supervision of personnel;**
  - (b) **Consider the accounting policies used by the entity; and**
  - (c) **Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.**
67. The knowledge, skill and ability of the individuals assigned significant engagement responsibilities are commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement. For example, the auditor may respond to identified risks of material misstatement due to fraud by assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement. In addition, 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.
68. The auditor considers management's selection and application of significant accounting policies, particularly those related to subjective measurements and complex transactions. The auditor considers whether the selection and application of accounting policies may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
69. Individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. Therefore, the auditor incorporates an element of unpredictability in the selection of the nature, extent and timing of audit procedures to be performed. 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, and performing audit procedures at different locations or at locations on an unannounced basis.

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

70. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:
- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files. In addition, the auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find

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it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement, for example a misstatement involving improper revenue recognition, may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
  - The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.
71. 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.
72. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.
73. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud are presented in Appendix 2 to this HKSA. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

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

74. As noted in paragraph 19, management is in a unique position to perpetrate fraud because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. While the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and is a significant risk of material misstatement due to fraud. Accordingly, in addition to overall responses to address the risks of material misstatement due to fraud and responses to address the assessed risks of material misstatement due to fraud at the assertion level, the auditor performs audit procedures to respond to the risk of management override of controls.
75. Paragraphs 76-82 set out the audit procedures required to respond to risk of management override of controls. However, the auditor also considers whether there are risks of management override of controls for which the auditor needs to perform procedures other than those specifically referred to in these paragraphs.



76. **To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:**
- (a) **Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;**
  - (b) **Review accounting estimates for biases that could result in material misstatement due to fraud; and**
  - (c) **Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of 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.**

### **Journal Entries and Other Adjustments**

77. Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries throughout the year or at period end, or making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments and reclassifications. In designing and performing audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements the auditor:
- (a) Obtains an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments;
  - (b) Evaluates the design of the controls over journal entries and other adjustments and determines whether they have been implemented;
  - (c) Makes inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
  - (d) Determines the timing of the testing; and
  - (e) Identifies and selects journal entries and other adjustments for testing.
78. For the purposes of 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 auditor considers the following:
- *The assessment of the risks of material misstatement due to fraud* – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
  - *Controls that have been implemented over journal entries and other adjustments* – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
  - *The entity's financial reporting process and the nature of evidence that can be obtained* – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
  - *The characteristics of fraudulent journal entries or other adjustments* – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the

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financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.

- *The nature and complexity of the accounts* – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
  - *Journal entries or other adjustments processed outside the normal course of business* – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.
79. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. Because fraudulent journal entries and other adjustments are often made at the end of a reporting period, the auditor ordinarily selects the journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, the auditor considers whether there is also a need to test journal entries and other adjustments throughout the period.

### Accounting Estimates

80. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. In reviewing accounting estimates for biases that could result in material misstatement due to fraud the auditor:
- (a) Considers whether differences between estimates best supported by audit evidence and the estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor reconsiders the estimates taken as a whole; and
  - (b) Performs a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. The objective of this review is to determine whether there is an indication of a possible bias on the part of management, and it is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.
81. If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor evaluates whether the circumstances producing such a bias represent a risk of material misstatement due to fraud. The auditor considers whether, in making accounting estimates, management's actions appear to understate or overstate all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

### Business Rationale for Significant Transactions

82. The auditor obtains an understanding of the business rationale for significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit. The purpose of obtaining this understanding is to

consider whether the rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. In gaining such an understanding the auditor considers the following:

- Whether the form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Whether management has discussed the nature of and accounting for such transactions with those charged with governance of the entity, and whether there is adequate documentation.
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Whether transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance of the entity.
- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

## Evaluation of Audit Evidence

83. As required by HKSA 330, the auditor, based on the audit procedures performed and the audit evidence obtained, evaluates whether the assessments of the risks of material misstatement at the assertion level remain appropriate. This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor considers whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.
84. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures information may come to the auditor's attention that differs significantly from the information on which the assessment of the risks of material misstatement due to fraud was based. For example, the auditor may become aware of discrepancies in accounting records or conflicting or missing evidence. Also, relationships between the auditor and management may become problematic or unusual. Appendix 3 to this HKSA contains examples of circumstances that may indicate the possibility of fraud.
85. **The auditor should 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 statement as a whole are consistent with the auditor's knowledge of the business indicate a previously unrecognized risk of material misstatement due to fraud.** Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example, uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.
86. **When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.**
87. The auditor cannot assume that an instance of fraud is an isolated occurrence. The auditor also considers whether misstatements identified may be indicative of a higher risk of material misstatement due to fraud at a specific location. For example, 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.

88. If the auditor believes that a misstatement is or may be the result of fraud, but the effect of the misstatement is not material to the financial statements, the auditor evaluates the implications, especially those dealing with the organizational position of the individual(s) involved. For example, fraud involving a misappropriation of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risks of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a non-management employee. Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor re-evaluates the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing, and extent of audit procedures to respond to the assessed risks. The auditor also reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence.
89. **When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should consider the implications for the audit.** HKSA 320, "Audit Materiality" and HKSA 700, "The Auditor's Report on Financial Statements" provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's report.

## Management Representations

90. **The auditor should obtain written representations from management that:**
- (a) **It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud;**
  - (b) **It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;**
  - (c) **It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:**
    - (i) **Management;**
    - (ii) **Employees who have significant roles in internal control; or**
    - (iii) **Others where the fraud could have a material effect on the financial statements; and**
  - (d) **It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.**
91. HKSA 580, "Management Representations" provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledges its responsibility for internal control designed and implemented to prevent and detect fraud.
92. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtains a written representation from management confirming that it has disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud and its knowledge of actual, suspected or alleged fraud affecting the entity.

## Communications With Management and Those Charged With Governance

93. **If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters as soon as practicable to the appropriate level of management.**
94. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.
95. **If the auditor has identified fraud involving:**
- (a) **Management;**
  - (b) **Employees who have significant roles in internal control; or**
  - (c) **Others where the fraud results in a material misstatement in the financial statements,**
- the auditor should communicate these matters to those charged with governance as soon as practicable.**
96. The auditor's communication with those charged with governance may be made orally or in writing. HKSA 260, "Communication of Audit Matters With Those Charged With Governance" identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters as soon as practicable and considers whether it is necessary to also report such matters in writing. If the auditor suspects fraud involving management, the auditor communicates these suspicions to those charged with governance and also discusses with them the nature, timing and extent of audit procedures necessary to complete the audit.
97. If the integrity or honesty of management or those charged with governance is doubted, the auditor considers seeking legal advice to assist in the determination of the appropriate course of action.
98. At an early stage in the audit, the auditor reaches an understanding with those charged with governance about the nature and extent of the auditor's communications regarding fraud that the auditor becomes aware of involving employees other than management that does not result in a material misstatement.
99. **The auditor should make those charged with governance and management aware, as soon as practicable, and at the appropriate level of responsibility, of material weaknesses in the design or implementation of internal control to prevent and detect fraud which may have come to the auditor's attention.**
100. If the auditor identifies a risk of material misstatement of the financial statements due to fraud, which management has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgment there is a material weakness in management's risk assessment process, the auditor includes such internal control deficiencies in the communication of audit matters of governance interest (see HKSA 260).
101. **The auditor should consider whether there are any other matters related to fraud to be discussed with those charged with governance of the entity.**<sup>3</sup> Such matters may include for example:

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<sup>3</sup> For a discussion of these matters, see HKSA 260, "Communication of Audit Matters With Those Charged With Governance" paragraphs 11-12.

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- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified material weaknesses in internal control.
- A failure by management to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

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

102. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. The auditor considers obtaining legal advice to determine the appropriate course of action in such circumstances. The auditor's legal responsibilities vary by country and in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law<sup>3a</sup>. For example, in some countries, the auditor of a financial institution has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.

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

103. **If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit the auditor should:**
- (a) **Consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;**
  - (b) **Consider the possibility of withdrawing from the engagement; and**
  - (c) **If the auditor withdraws:**
    - (i) **Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and**
    - (ii) **Consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.**
104. Such exceptional circumstances can arise, for example, when:
- (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;

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<sup>3a</sup> Additional guidance is provided in paragraphs 112 to 124 below.

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- (b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
  - (c) The auditor has significant concern about the competence or integrity of management or those charged with governance.
105. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.
106. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.<sup>4</sup>

## Documentation

107. **The documentation of the auditor's understanding of the entity and its environment and the auditor's assessment of the risks of material misstatement required by paragraph 122 of HKSA 315 should include:**
- (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**
  - (b) **The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.**
108. **The documentation of the auditor's responses to the assessed risks of material misstatement required by paragraph 73 of HKSA 330 should include:**
- (a) **The overall responses to the assessed risks of material misstatements 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; and**
  - (b) **The results of the audit procedures, including those designed to address the risk of management override of controls.**
109. **The auditor should document communications about fraud made to management, those charged with governance, regulators and others.**
110. **When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor should document the reasons for that conclusion.**
111. The extent to which these matters are documented is for the auditor to determine using professional judgment.

## Communications to Regulatory and Enforcement Authorities

112. Paragraphs 113 to 124 below provide guidance to an auditor on the circumstances in which to report to third parties who have a proper interest in receiving such information. In addition, an auditor of entities in regulated industries, who is required to report certain information direct to

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<sup>4</sup> HKICPA *Professional Ethics Statement 1.207* provides guidance on communications with a proposed successor auditor.

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the relevant regulators, has separate responsibilities. Guidance on the auditor's responsibility to report direct to regulators in regulated industries is provided in Practice Note 820 "The audit of licensed corporations and associated entities of intermediaries", Practice Note 620.2 "Communications between auditors and the Insurance Authority", Practice Note 860.1 "The audit of retirement schemes" and Auditing Guideline 3.401 "Authorized institutions in Hong Kong" or Practice Note 830 "Reporting responsibilities of auditors under the Banking Ordinance" when it is finalized.

113. Where the auditor becomes aware of a suspected or actual instance of fraud which could have a material effect on the financial statements, he would:
  - a. consider whether the matter may be one that ought to be reported to a proper authority in the public interest; and where this is the case
  - b. except when he is prohibited by law from informing any party other than the proper authority or when the matter casts doubt on the integrity of those charged with governance, discuss the matter with those charged with governance, including any audit committee.
114. Where having discussed an identified suspected or actual instance of fraud which could have a material effect on the financial statements with those charged with governance and considered any views expressed on behalf of the entity and in the light of any legal advice obtained, the auditor concludes that the matter ought to be reported to a proper authority in the public interest, he would, except in the circumstances covered in paragraph 116(b) below, notify those charged with governance in writing of his view. If the entity does not voluntarily report the matter to a proper authority itself or is unable to provide evidence that the matter has been reported, the auditor would consider reporting it himself.
115. Confidentiality is an implied term of the auditor's contract. The duty of confidentiality, however, is not absolute. In certain exceptional circumstances an auditor is not bound by the duty of confidentiality and may report a suspected or actual instance of fraud which could have a material effect on the financial statements to a proper authority in the public interest. An auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to a proper authority. Determination of where the balance of public interest lies requires careful consideration. An auditor whose suspicions has been aroused needs to use his professional judgment to determine whether his misgivings justify him in carrying the matter further or are too insubstantial to deserve reporting.
116. In respect of an identified suspected or actual instance of fraud which could have a material effect on the financial statements, the auditor would make a report direct to a proper authority in the public interest without delay and without informing those charged with governance in advance in situations where:
  - a. the auditor concludes that the matter ought to be reported to a proper authority in the public interest; and
  - b. the auditor is prohibited by law from informing any party other than the proper authority or the matter casts doubt on the integrity of those charged with governance.
117. Examples of circumstances which may cause the auditor no longer to have confidence in the integrity of those charged with governance include situations:
  - a. where he suspects or has evidence of the involvement or intended involvement of those charged with governance in possible fraud which could have a material effect on the financial statements; or



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- b. where he suspects or has evidence that those charged with governance are aware of such fraud and, contrary to regulatory requirements or the public interest, have not reported it to a proper authority within a reasonable period.
118. An auditor is protected from the risk of liability for breach of confidence or defamation provided that:
- a. in the case of breach of confidence:
    - i. disclosure is made in the public interest;
    - ii. such disclosure is made to a proper body or person; and
    - iii. there is no malice motivating the disclosure; and
  - b. in the case of defamation:
    - i. disclosure is made in his capacity as an auditor of the entity concerned; and
    - ii. there is no malice motivating the disclosure.

In addition, an auditor is protected from such risks where he is expressly permitted for example, under section 381 of the Securities and Futures Ordinance (SFO) or required by legislation to disclose information. Section 381 of the SFO provides immunity to a person who is or was an auditor of a company which is listed, or any associated company of the company, who reports to the Securities and Futures Commission (SFC) suspected fraud or misconduct committed by a listed company.

119. "Public interest" is a concept that is not capable of general definition. Each situation must be considered individually. Matters to be taken into account when considering whether disclosure is justified in the public interest may include:
- a. the extent to which the suspected or actual fraud is likely to affect members of the public;
  - b. whether those charged with governance have rectified the matter or are taking, or are likely to take, effective corrective action;
  - c. the extent to which non-disclosure is likely to enable the suspected or actual fraud to recur with impunity;
  - d. the gravity of the matter; and
  - e. the weight of evidence and the degree of the auditor's suspicion that there has been an instance of fraud.
120. When reporting to proper authorities in the public interest it is important that an auditor only reports to one which has a proper interest to receive the information. Which body or person is the proper authority in a particular instance depends on the nature of the suspected or actual fraud. Proper authorities could include the Independent Commission Against Corruption, the Police, the Customs and Excise Department, Hong Kong Exchanges and Clearing Limited, the SFC, the Hong Kong Monetary Authority, the Insurance Authority or the Mandatory Provident Fund Schemes Authority. In cases of doubt as to the appropriate authority an auditor is advised to seek legal advice.
121. An auditor receives the same protection even if he only has a reasonable suspicion that fraud has occurred. An auditor who can demonstrate that he has acted reasonably and in good faith in informing an authority of an instance of fraud which he thinks has been committed would

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not be held by the court to be in breach of duty to the client even if, an investigation or prosecution having occurred, it were found that there has been no offence.

122. An auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.
123. An auditor needs to remember that his decision as to whether to report, and if so to whom, may be called into question at a future date, for example on the basis of:
- a. what he knew at the time;
  - b. what he ought to have known in the course of his audit;
  - c. what he ought to have concluded; and
  - d. what he ought to have done.

An auditor may also wish to consider the possible consequences if financial loss is occasioned as a result of fraud which he suspects (or ought to suspect) has occurred but decides not to report.

124. In addition to the duty of an auditor of entities in regulated industries to report direct to regulators in certain circumstances (see paragraph 112 above), an auditor and others have a statutory duty to take the initiative to disclose to an authorized officer (as defined in the Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crimes Ordinance) knowledge or suspicion that property represents proceeds, etc. of drug trafficking and indictable offence under section 25A of the Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crimes Ordinance respectively. A failure to disclose in these circumstances is itself an offence. Furthermore, it should be noted that if a person, knowing or suspecting that a disclosure has been made about property representing proceeds, etc of drug trafficking or an indictable offence under section 25A of the Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crimes Ordinance respectively, discloses to any other person any matter which is likely to prejudice any investigation which might be conducted in consequence of the first-mentioned disclosure, that person commits an offence under the respective Ordinance.

### **Effective Date**

125. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2004.

### **Conformity and Compliance with International Standards on Auditing**

126. As of October 2004 (*date of issue*), this HKSA conforms with International Standard on Auditing (ISA) 240 (Revised), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" except that a reference in footnote 4 to IFAC Code of Ethics for Professional Accountants is replaced by HKICPA Professional Ethics Statement 1.207. With the exception of the foregoing difference, compliance with the requirements of this HKSA ensures compliance with ISA 240.
127. Additional local guidance is provided in paragraphs 112 to 124.

### **Public Sector Perspective**

1. *HKSA 240 is applicable in all material respects to audits of public sector entities.*
2. *In the public sector the scope and nature of the audit relating to the prevention and detection of fraud may be affected by legislation, regulation, ordinances or ministerial directives. The terms of the mandate may be a factor that the auditor needs to take into account when exercising judgment.*

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3. *Requirements for reporting fraud, whether or not discovered through the audit process often may be subject to specific provisions of the audit mandate or related legislation or regulation in line with paragraph 102 of the HKSA.*
4. *In many cases in the public sector the option of withdrawing from the engagement as suggested in paragraph 103 of the HKSA may not be available to the auditor due to the nature of the mandate or public interest considerations.*

## Appendix 1

### Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

#### Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

##### *Incentives/Pressures*

1. 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.
2. 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.

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3. 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>5</sup>
  - Personal guarantees of debts of the entity.
4. There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

*Opportunities*

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
  - Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
  - A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's length transactions.
  - Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
  - Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
  - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
  - Use of business intermediaries for which there appears to be no clear business justification.
  - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
2. There is ineffective monitoring of management as a result of the following:
  - Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
  - Ineffective oversight by those charged with governance over the financial reporting process and internal control.
3. There is a complex or unstable organizational structure, as evidenced by the following:
  - Difficulty in determining the organization or individuals that have controlling interest in the entity.
  - Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
  - High turnover of senior management, legal counsel, or those charged with governance.
4. Internal control components are deficient as a result of the following:
  - Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).

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<sup>5</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.

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- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
- Ineffective accounting and information systems, including situations involving material weaknesses in internal control.

*Attitudes/Rationalizations*

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to correct known material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
  - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
  - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

**Risk Factors Arising from Misstatements Arising from Misappropriation of Assets**

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

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*Incentives/Pressures*

1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
2. 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*

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
  - Large amounts of cash on hand or processed.
  - Inventory items that are small in size, of high value, or in high demand.
  - Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
  - Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
  - Inadequate segregation of duties or independent checks.
  - Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
  - Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
  - Inadequate job applicant screening of employees with access to assets.
  - Inadequate record keeping with respect to assets.
  - Inadequate system of authorization and approval of transactions (for example, in purchasing).
  - Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
  - Lack of complete and timely reconciliations of assets.
  - Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
  - Lack of mandatory vacations for employees performing key control functions.
  - Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
  - Inadequate access controls over automated records, including controls over and review of computer systems event logs.

*Attitudes/Rationalizations*

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.

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



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

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

### Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.

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- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

**Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting**

Examples of responses to the auditor's assessment of the risk of material misstatements due to fraudulent financial reporting are as follows:

*Revenue recognition*

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

*Inventory Quantities*

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

*Management estimates*

- Using an expert to develop an independent estimate for comparison to management's estimate.

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- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

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

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

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

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

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

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

Discrepancies in the accounting records, including the following:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including 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 sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including 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.

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- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified weaknesses in internal control on a timely basis.

Other includes 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 changes circumstances.
- Tolerance of violations of the entity's code of conduct.