# KAEG-I [INTL VERSION 2024]: ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

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# ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

View the Full Chapter for this Standard

# ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

(Effective for audits of financial statements for periods beginning on or after December 15, 2009)

**International Standard on Auditing (ISA) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.***

# Scope of this ISA and Characteristics of Fraud

## International Standards on Auditing: ISA 240.01-03

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised)[1] and ISA 330[2] are to be applied in relation to risks of material misstatement due to fraud.

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1 ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

2 ISA 330, *The Auditor's Responses to Assessed Risks*

## Characteristics of Fraud

2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

3. Although fraud is a broad legal concept, for the purposes of the ISAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor - misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A7)

# ISA Application and Other Explanatory Material: ISA 240.A1-A7

# Application and Other Explanatory Material

## **Characteristics of Fraud** (Ref: Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

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

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions 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 entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial 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.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as intentionally:

- 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.
- Omitting, obscuring or misstating disclosures required by the applicable financial reporting framework, or disclosures that are necessary to achieve fair presentation.
- Concealing facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

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.

## Responsibility for the Prevention and Detection of Fraud

### Responsibilities of the Auditor (Ref: Para. 9)

A6. Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the *International Ethics Standards Board for Accountants' International Code of Ethics for Professional Accountants (*including International Independence Standards) (IESBA Code) requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed. Such steps may include the communication of identified or suspected non-compliance with laws and regulations between auditors within the engagement team or other auditors performing work at entities or business units of a group for purposes other than the audit of the group financial statements.[15]

15 See paragraphs R360.16-360.18 A1 of the IESBA Code.

### *Considerations Specific to Public Sector Entities*

A7. The public sector auditor's responsibilities relating to fraud may be a result of law, regulation or other authority applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

# Responsibilities for the Prevention and Detection of Fraud

## International Standards on Auditing: ISA 240.04-09

### Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

### *Responsibilities of the Auditor*

5. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.[3]

3 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* paragraphs A53 - A54

6. As described in ISA 200,[4] the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

4 ISA 200, paragraph A53

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override controls designed to prevent similar frauds by other employees.

8. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

9. The auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, including fraud, which may differ from or go beyond this and other ISAs, such as: (Ref: Para. A6)

(a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed;

(b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g., in an audit of group financial statements); and

(c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the auditor's work in accordance with this and other ISAs (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

# How do we comply with the Standards?

[ISA | KAEGHDWC]

# 1 Plan and perform the audit to obtain reasonable assurance [ISA | 780]

## What do we do?

Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud

## Why do we do this?

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. We plan and perform our audit to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

## Execute the Audit

### What is the difference between fraud and error? [ISA | 780.11451]

The primary factor that distinguishes fraud from error is whether the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, we are concerned with fraud that causes a material misstatement in the financial statements. Specifically:

- misstatements resulting from fraudulent financial reporting; and
- misstatements resulting from misappropriation of assets.

Although the auditor may suspect or, in some cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

### Who has the primary responsibility for the prevention and detection of fraud? [ISA | 780.1300]

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of an entity and management.

Management, with the oversight of those charged with governance, should place a strong emphasis on fraud prevention, including:

- setting a proper tone at the top, creating a positive workplace environment, hiring, training and promoting appropriate employees, requiring periodic confirmation from employees of their responsibilities and taking appropriate action in response to actual, suspected, or alleged fraud as part of the control environment component of ICFR;

- considering the potential for fraud in assessing risks to achievement of objectives and identifying and assessing changes that could significantly impact the potential for fraud and anti-fraud controls as part of the entity's risk assessment component of ICFR;
- selecting and developing control activities which address fraud risks as part of the entity's information and communication component of ICFR;
- establishing processes by which information related to fraud or ethical matters are communicated as part of the entity's information and communication component of ICFR; and
- selecting, developing, and performing ongoing and/or separately evaluating whether fraud related controls within other components of ICFR are present and functioning, evaluating and communicating fraud related control deficiencies in a timely manner.

#### What is our responsibility related to fraud? [ISA | 780.1400]

We are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Our primary concern is fraud that causes a material misstatement to the financial statements.

We meet this responsibility by:

- identifying and assessing the risks of material misstatement of the financial statements due to fraud;
- obtaining sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- responding appropriately to fraud or suspected fraud identified during the audit.

We may identify misstatements arising from fraud that are not material to the financial statements. When we identify misstatements arising from fraud that are not material to the financial statements, we have additional responsibilities related to considering the effect of the identified or suspected fraud on our audit, evaluating audit evidence, and communicating findings related to these matters .

#### What are additional responsibilities we may have related to fraud? [ISA | 780.11452]

We may have additional responsibilities regarding an entity's non-compliance with laws and regulations, including fraud, such as:

(a) Responding to identified or suspected non-compliance with laws and regulations, including specific communications with management and those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed;
(b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g., in an audit of group financial statements); and
(c) Documentation regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to our audit (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

# Effective Date, Objectives and Definitions

## International Standards on Auditing: ISA 240.10-12

### Effective Date

10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

## Objectives

11. The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement of the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to fraud or suspected fraud identified during the audit.

## Definitions

12. For purposes of the ISAs, the following terms have the meanings attributed below:

(a) Fraud - 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.

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

# Professional Skepticism

## International Standards on Auditing: ISA 240.13-15

## Requirements

### Professional Skepticism

13. In accordance with ISA 200[5], the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A8- A9)

5 ISA 200, paragraph 15

14. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A10)

15. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

# ISA Application and Other Explanatory Material: ISA 240.A8-A10

## **Professional Skepticism** (Ref: Para. 13-15)

A8. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and identified controls in the control activities component, if any, over its preparation and maintenance. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A9. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A10. An audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication.[16] However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

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16 ISA 200, paragraph A49

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Apply professional skepticism [ISA | 788]

## What do we do?

Apply professional skepticism in gathering and evaluating audit evidence.

## Why do we do this?

Professional skepticism plays a key role in the audit and is integral to our skill set. Our due professional care requires that we exercise professional skepticism throughout the audit. Exercising professional skepticism can be particularly relevant when considering our fraud risk assessment or response to identified fraud risks because fraud often involves sophisticated and carefully organized schemes designed to conceal it.

## Execute the Audit

What is professional skepticism? [ISA | 788.1300]

Professional skepticism involves having a questioning mind that critically assesses audit evidence. It includes watching out for conditions or evidence that may indicate a possible misstatement due to error or fraud.

### What are examples of instances where we may apply a heightened degree of professional skepticism?

[ISA | 788.7958]

Examples of potential red flags relevant to our understanding of the entity and its environment

- A lack of clarity regarding the identity of the counterparties and the nature of their relationship to the reporting entity;
- Reliance on a small number of business partners for significant volumes of revenues or profits;
- Transactions or arrangements that lack a clear business purpose or economic substance;
- Significant operations or business activities conducted through, or assets held in, offshore jurisdictions or jurisdictions with limited regulation/transparency;
- Complex or high volumes of related party transactions;
- Financial relationships/key performance indicators (KPIs) that are inconsistent with the entity's peers or our expectations, such as: – A significant and persistent or unusual gap between profitability and operating cashflows;
- The entity holds more interest-bearing debt than appears to be necessary given its holdings of liquid financial asset; or
- The entity has significantly increased its debt to finance assets that may be challenging to obtain audit evidence with respect to the existence assertion, such as material goods in transit, loans receivable, prepayments or assets under construction
- Excessively complex contractual arrangements;
- Media coverage or analyst reports which raise concerns, such as questions about the appropriateness of the entity's business or accounting practices;
- Commentary in the entity's Other Information, e.g. MD&A, which may highlight concerns about an entity's performance and future plans; and
- The existence of significant short positions held in the entity's shares.

If any of the above are identified, we understand the facts and circumstances, including consideration of the source of the information and its reliability, in determining whether there is an impact on our identification and assessment of the RMMs.

Examples of potential red flags relevant to other aspects of the audit

- Are there unusual delays in providing requested information?
- Is documentation only available as copies or electronically transmitted documents when documents in original form are expected to exist?
- Is electronic evidence missing or unavailable, and is this inconsistent with the entity's record retention practices or policies or legal booking keeping requirements?
- Does management attempt to restrict access to records, facilities, certain employees, customers, suppliers or others from who audit evidence may be sought?
- Is there an unwillingness to provide key electronic files for testing using computer-assisted audit techniques?
- Is information frequently presented at the last minute leaving little time to appropriately verify its contents?

- Are there indications of deficient controls or less than robust governance for the size of the business?
- Do management's explanations evolve over time, which may indicate they are not being transparent or presenting the full picture?
- Are responses from management and employees arising from our inquiries or analytical procedures inconsistent, vague or implausible?
- Is management dominant and/or aggressive when dealing with external or internal auditors? Do they question why we need to perform certain procedures or push back when we seek to obtain additional corroborating audit evidence?
- Does management take an unusual interest in the selection of accounting policies, how estimates are made, or transactions are accounted for? Does management appear to be more focused on a desired outcome than on ensuring the accounting treatment is appropriate?
- Is there an unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable?
- Is management involved in making journal entries, particularly when they would not normally do so, or need to override controls in order to do so?

We do not only think about the indicators individually, but also in the aggregate. When more than one indicator is present, collectively they may indicate a pattern of collusion and concealment, which may cause us to evaluate the implications for our audit.

### How do we apply professional skepticism? [ISA | 788.1400]

We apply professional skepticism by being alert to matters such as:

- audit evidence that contradicts other audit evidence we have obtained;
- information that brings into question the reliability of documents and responses to inquiries we plan to use as audit evidence; and
- conditions that may indicate possible fraud.

Professional skepticism also involves remaining alert to our biases and other circumstances that can cause us to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than interests of external users throughout the audit.

We maintain professional skepticism by asking whether the information and audit evidence we gather suggests that a material misstatement due to fraud may exist.

Applying professional skepticism does not mean that we assume management is dishonest or not. Rather, we exercise professional skepticism with balance. We do not accept less persuasive evidence merely because we believe management to be honest.

### What are examples of biases that may impede our ability to apply professional skepticism? [ISA | 788.1500]

Common biases that can undermine professional skepticism and ways to mitigate them include:

| **Bias/trap and potential impact:** | **Ways to mitigate:** |
|---|---|
| Rush-to-solve trap | • Awareness |

| | |
|---|---|
| The tendency due to time pressures to want to solve a problem by making a quick judgement.<br><br>Potential impact<br><br>Can lead to a limited understanding of a problem or alternative resulting in inappropriate conclusions. | • Plan your audit to allow sufficient time for the performance and appropriate review of audit procedures<br>• Document work performed routinely and in a timely manner to facilitate critical thinking and capture a more accurate and complete reflection of how the conclusions were reached<br>• Start working on the key decisions early in the process |
| Availability bias<br><br>The tendency to place more weight on events or experiences that immediately come to mind or are readily available than on those that are not.<br><br>Potential impact<br><br>Can lead to limited alternatives considered or evidence gathered related to those alternatives | • Awareness<br>• Consider why something comes to mind<br>• Vividness<br>• Recent events<br>• Make the opposing case<br>• Seek advice from others<br>• Obtain and consider objective data |
| Overconfidence bias<br><br>The tendency to overestimate one's own ability to make accurate assessment of risks or other judgements or decisions.<br><br>Potential impact<br><br>Can lead to underinvesting in understanding issues, insufficient challenging of management views or limited consideration of potential alternatives. | • Awareness<br>• Challenge management's estimates and:<br>  - Ask about potential causes of unexpected outcomes<br>  - Ask for estimate or likelihood of unexpected outcomes<br>• Challenge extremely high or low estimates<br>• Maintain professional skepticism |
| Confirmation bias<br><br>The tendency to seek confirming information or to favor conclusions that are consistent with initial beliefs.<br><br>Potential impact | • Awareness<br>• Consider alternatives provided by others or yourself<br>• Seek disconfirming or more complete information<br>• Explicitly acknowledge and consider your preferences or motives |

| | |
|---|---|
| Can lead to only seeking evidence that is consistent with a client's explanation or a preferred outcome. | |
| Anchoring bias<br>The tendency to make assessments in evaluating information by starting with an initial value and then adjusting sufficiently away from initial value in forming a final judgment.<br>Potential impact<br>Can lead to a lack of objectivity in assessing transactions, estimates and account balances. | • Awareness<br>• Make an independent judgement or estimate void of an anchor<br>• Solicit input from others, being careful not to provide anchor for their thinking<br>• Take steps to make judgements or formulate expectations prior to seeing preliminary outcomes<br>• Obtain benchmarking information |
| Groupthink<br>The tendency to think or make decisions as a group that discourages creativity or individual responsibility.<br>Potential impact<br>Can lead to limited alternatives considered or evidence gathered related to those alternatives. | • Awareness<br>• Communicate individual opinions and thoughts<br>• Encourage others to communicate their opinions and thoughts |
| Automation bias<br>The tendency to favor output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose.<br>Potential impact<br>Can lead to inappropriate reliance on information. | • Awareness<br>• Involve specific team members with expertise in IT |

## What are examples of additional impediments on exercising professional skepticism? [ISA | 788.157463]

Additional examples include but are not limited to:

| Impediments | Potential impact |
|---|---|
| Budget constraints | Discourage the use of sufficiently experienced or technically qualified resources for the effective understanding, assessment of and responses to risks and informed questioning of management. |
| Tight deadlines | Negatively affect the behavior of those who perform the work as well as those who direct, supervise and review. For example, external time pressures may create restrictions to analyze complex information effectively. |
| Lack of cooperation or undue pressures imposed by management | Negatively affect the engagement team's ability to resolve complex or contentious issues. |
| Insufficient understanding of the entity and its environment, its system of internal control and the applicable financial reporting framework | Constrain the ability of the engagement team to make appropriate judgments and an informed questioning of management's assertions. |
| Difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others | Cause us to bias the selection of sources of audit evidence and seek audit evidence from sources that are more easily accessible. |
| Overreliance on automated tools and techniques | Result in the engagement team not critically assessing audit evidence. |

### What are possible actions that we can take to mitigate impediments in applying professional skepticism?

[ISA | 788.157464]

Possible actions to mitigate impediments may include:

- Remaining alert to changes in the nature or circumstances of the audit engagement that necessitate additional or different resources for the engagement, and requesting additional or different resources from those individuals within the firm responsible for allocating or assigning resources to the engagement.
- Explicitly alerting the engagement team to instances or situations when vulnerability to unconscious or conscious auditor biases may be greater (e.g. areas involving greater judgment) and emphasizing the importance of seeking advice from more experienced members of the engagement team in planning and performing audit procedures.

- Changing the composition of the engagement team, for example, requesting that more experienced individuals with greater skills or knowledge or specific expertise are assigned to the engagement.
- Involving more experienced members of the engagement team when dealing with members of management who are difficult or challenging to interact with.
- Involving specific team members or KPMG specialists to assist the engagement team with complex or subjective areas of the audit.
- Modifying the nature, timing and extent of direction, supervision or review by involving more experienced engagement team members, more in-person oversight on a more frequent basis or more in-depth reviews of certain working papers for:
  - Complex or subjective areas of the audit;
  - Areas that pose risks to achieving quality on the audit engagement;
  - Areas with a fraud risk; and
  - Identified or suspected instance of non-compliance with laws or regulations, including illegal acts.
- Setting expectations for:
  - Less experienced members of the engagement team to seek advice frequently and in a timely manner from more experienced engagement team members or the engagement partner; and
  - More experienced members of the engagement team to be available to less experienced members of the engagement team throughout the audit engagement and to respond positively and in a timely manner to their insights, requests for advice or assistance.
- Communicating with those charged with governance when management imposes undue pressure or the engagement team experiences difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others from whom audit evidence may be sought.

#### What is contradictory, or disconfirming audit evidence? [ISA | 788.11474]

Contradictory, or disconfirming audit evidence is evidence obtained in the audit that seems to contradict the evidence on which we based our original risk assessments (and in some cases, the amount or disclosure being audited). We may come across contradictory audit evidence while performing procedures on a specific account balance, or in an unrelated manner.

> Example: Contradictory audit evidence may exist in the form of information that an entity is insolvent, and therefore it may not be able to repay the outstanding accounts receivables balance, and the client has not created an allowance for doubtful accounts related to this receivable. The evidence is "contradictory" because it contradicts the client's premise, i.e. that the amount is collectible and no allowance is necessary.

### Who is responsible for applying professional skepticism? [ISA | 788.1600]

It is the responsibility of each individual involved in the engagement to appropriately apply professional skepticism throughout the audit, including when identifying and assessing risks of material misstatement (RMMs), including RMMs due to fraud - i.e., fraud risks, performing tests of controls and substantive procedures to respond to identified RMMs, and evaluating the results of the audit.

The engagement partner is responsible for setting an appropriate tone that promotes:

- emphasizing the importance of each engagement team member to exercise and maintain a questioning mind throughout the audit; and
- exercising professional skepticism in gathering and evaluating audit evidence.

### When do we apply professional skepticism? [ISA | 788.1700]

We apply professional skepticism throughout the audit, including when we respond to RMMs, particularly fraud risks. We apply professional skepticism particularly when we:

- perform engagement acceptance or continuance, including evaluating the integrity of management;
- identify and assess RMMs;
- design and perform audit procedures to address RMMs, including the nature, timing and extent of our audit procedures;
- evaluate management judgments; and
- determine our overall conclusion on the audit evidence obtained.

### Why do we apply professional skepticism when responding to fraud risks? [ISA | 788.1800]

Applying professional skepticism can be particularly relevant when responding to fraud risks as it enhances the effectiveness of our audit procedures. We also reduce the risk that we may:

- overlook unusual transactions or circumstances;
- misinterpret audit results and reach the wrong conclusion; and
- use inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results.

### How do we apply professional skepticism when we review documents and records? [ISA | 788.1900]

When we review documents and records, we apply professional skepticism by considering their reliability, as fraud, including fraudulent financial reporting and 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. We may accept records and documents as genuine unless we have a reason to believe the contrary.

If we doubt the reliability of information or find indications of possible fraud - e.g. if conditions identified during the audit lead us to believe that a document is inauthentic or its terms have been falsified - we investigate further and determine whether to modify or add new audit procedures to resolve the matter.

> For example, when designing our response to an assessed RMM related to the risk of management override of controls, we inspect a selection of manual journal entries that have certain characteristics that could indicate a higher risk of fraud. If we examine the supporting documentation for those entries and find them vague or unclear, we apply professional skepticism by obtaining more persuasive audit evidence - e.g. from a third party - before we conclude

> whether fraud is indicated, rather than by obtaining other potentially less reliable internal evidence or inquiry alone.

## To what extent do we rely on representations from management? [ISA | 788.11475]

As part of evaluating audit results, we conclude on whether sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. In order to accomplish this, we do not simply rely on explanations from management or those charged with governance. A common pitfall of auditors is to 'audit by conversation', which means to obtain evidence merely from discussions with the entity's representatives, without appropriate audit evidence; this does not display professional skepticism. Instead, we don't just accept the entity's explanation but seek to obtain appropriately persuasive audit evidence.

Representations from management or those charged with governance are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base our audit opinion(s).

### What conditions may cause us to believe that a document may be inauthentic or has been modified? [ISA | 788.11476]

The following conditions may cause us to believe that a document may be inauthentic or has been modified:

- significant delays in management providing requested documents;
- evidence of alterations to documents;
- documents missing signatures or that are incomplete;
- discrepancies in accounting records and documents; or
- conflicting or missing documents.

### How do we "investigate further", if we identify conditions that cause us to believe that a document may not be authentic or has been modified? [ISA | 788.11477]

When we identify conditions that cause us to believe that a document may not be authentic, that terms in a document have been modified but not disclosed to us, or that undisclosed side agreements may exist, we perform procedures to further investigate such as:

- confirming directly with the third party; and
- using the work of a KPMG specialist to assess the authenticity of a document

An audit rarely involves the authentication of documents, nor are we trained as, or expected to be, an expert in such authentication.

## How do we demonstrate our professional skepticism? [ISA | 788.2000]

We demonstrate our professional skepticism by maintaining the proper mindset and evidencing our application of professional skepticism throughout the audit and our audit documentation.

For example, we can evidence our professional skepticism by documenting:

- our revisions to risk assessment as a result of identified disconfirming evidence;
- significant decisions reached by the engagement team;
- our additional questions in response to inquiries and other information obtained from management and those charged with governance;

- how we incorporate unpredictability in our audit plan;
- how we evaluate disconfirming evidence and the impact to the audit, including changes in our audit strategy; and
- how we evaluate the reasonableness of management assumptions and challenge those assumptions.

# Examples

### How do we respond to contradictory or disconfirming audit evidence? [ISA | 788.11488]

**Fact pattern**

ABC Company recorded accounts receivable from its customer, XYZ Company, in the amount of CU1 million. This balance has been confirmed with the customer. The balance is past due by over 90 days, and no allowance for doubtful accounts has been recorded. Unrelated to our audit procedures, the engagement team comes across an article in the news that indicates that XYZ Company may become insolvent.

**Analysis**

The engagement team does not ignore this information, but questions ABC Company as to why the allowance for doubtful accounts does not include a provision for this customer. If ABC Company provides a plausible explanation, then the engagement team does not rely on the explanation, but investigates further and seeks objective evidence. For example, if ABC Company says that they know XYZ Company well, and have a longstanding relationship with them, and know they are committed to paying the amount, the engagement team documents the conversation and then seeks objective evidence. The evidence the team finds may either confirm (support) the entity's position, such as appropriately sourced subsequent payments on account, or contradict the entity's position, such as no subsequent payments, downgraded credit ratings or other media coverage that are an indication that the customer may not be able to pay.

# 2 If there are inconsistencies or doubts, modify or perform additional audit procedures and evaluate the effect on our audit [ISA | 2703]

## What do we do?

IF conditions are identified that indicate there are inconsistencies or that cause doubts over the reliability of the information used in our audit, THEN modify or perform additional audit procedures AND evaluate the effect on the other aspects of our audit.

## Why do we do this?

Whenever there are inconsistencies in information or in the results of our audit procedures, or doubts over the reliability of the information used in our audit, we modify or perform additional audit procedures to resolve the condition and evaluate the effect on the other aspects of our audit. If these conditions exist and are not addressed in our audit response, the information is not sufficiently reliable, and does not provide the evidence we are trying to obtain.

# Execute the Audit

### What are the conditions that affect the reliability of the information used in our audit? [ISA | 2703.1300]

When performing our audit procedures, we may come across conditions that affect the reliability of the information used in our audit. These conditions include:

(1) information obtained from one source that is inconsistent with information obtained from another.

For example, this can occur when we are performing a particular audit procedure and (i) we obtain information from another source that is inconsistent with or contradicts the information we obtained from management -or- (ii) we identify that the information used in our procedure is inconsistent with or contradicts the same information used in other parts of the audit.

(2) the results of an audit procedure are inconsistent with the results of another audit procedure.

For example, this can occur when we are performing a particular audit procedure and we identify that the results of that procedure contradict the results of our other procedure(s).

(3) circumstances that cause us to have doubt about the reliability of the information.

For example:

- indications that a document may not be authentic;

- indications that a document may have been modified and the modifications were not disclosed to us as the auditor or that undisclosed side agreements may exist; or

- findings identified from the audit procedures we perform to evaluate the reliability of the information / RDEs used in our audit.

### What do we do when we identify conditions that affect the reliability of the information used in our audit? [ISA | 2703.1400]

We modify our planned audit procedures or perform additional procedures to resolve the matter and evaluate the effect, if any, on the other aspects of our audit by performing the activity 'Continue to assess RMMs, and revise audit approach as necessary'.

The effect on our audit varies depending on the condition that was identified and the specific facts and circumstances. We may determine that the information only impacts a particular RMM we are testing or we may identify that there is a more widespread or pervasive issue e.g., indication of fraud that may lead us to question the integrity of management.

#### What if we identify information that is inconsistent with or contradicts our final conclusions? [ISA | 2703.11649]

Whenever we identify information related to significant findings or issues that is inconsistent with or contradicts our final conclusions (e.g. disconfirming evidence), we retain documentation of the resolution (see activity 'Document how we addressed information that is inconsistent with conclusions on significant matters').

#### What if we doubt the authenticity of information or believe that it has been inappropriately modified? [ISA | 2703.11650]

Whenever we doubt the authenticity of information or believe that it has been inappropriately modified, we investigate further. We understand the specific facts and circumstances surrounding the information in question and, where applicable, obtain additional information that corroborates our understanding. For example, if we identify a document that may not be authentic, we may:

- obtain the same document from another source or directly from the original source, where applicable, and compare them
- use the work of a KPMG specialist to assess the document's authenticity.

What if the information has multiple RDEs and we conclude that one of the RDEs is not reliable? [ISA | 2703.11651]

Although we evaluate and conclude on the reliability of each data element that is relevant (RDE) to our audit procedure, we always 'step-back' and consider the information as a whole. Specifically, we consider whether the findings from our procedures (i.e. a deficient RDE) is indicative of issues with the other RDEs in the information. This is because data elements in the information are often inter-dependent.

If we conclude that one of the RDEs is not reliable and determine that there is an inter-dependency with other RDEs in the information, we conclude that the information as a whole is not reliable and evaluate the effect on our audit, including the impact on all the procedures in which that information is used in our audit.

Do we authenticate all information that we use in our audit? [ISA | 2703.1500]

No, we are not experts in document authentication. However, we maintain an awareness and apply professional skepticism when we inspect information obtained from the entity or third parties that is used in our audit. We perform appropriate audit procedures to determine whether the information used in our audit is sufficiently reliable.

# 3 Evaluate responses to fraud inquiries and corroborate if necessary [ISA | 560]

## What do we do?

Evaluate responses of management, those charged with governance and others to our fraud inquiries and determine when it is necessary to corroborate such responses.

## Why do we do this?

Evaluating the responses to our fraud risk inquiries helps us identify whether they indicate a fraud risk.

And corroborating responses that aren't in line with our expectations, which we hadn't anticipated or which may conflict with other information we've received helps us:

- determine whether the response we received is complete or accurate; and
- identify independent information that either confirms or contradicts those responses.

## Execute the Audit

How do we evaluate responses to our fraud inquiries? [ISA | 560.1300]

We evaluate responses from our inquiries by determining whether they are consistent with our understanding and satisfactory.

We do so by remaining alert for:

- potential inconsistencies;
- responses which are otherwise unsatisfactory — e.g. vague or implausible;
- items that seem unusual; or
- situations where additional details may help us evaluate responses to fraud inquiries.

Inconsistencies or unsatisfactory responses may result from:

- an individual trying to cover up the facts of an event or transaction;
- a simple mistake; or
- lack of knowledge about the situation.

#### What if we identify actual or suspected instances of fraud?

We perform further procedures as outlined in the chapter on fraud. We also perform the procedures outlined in the chapter on laws and regulations.

### When do we corroborate responses to our fraud inquiries? [ISA | 560.1400]

We corroborate the responses to our inquiries when:

- they are outside our expectations;
- they provide information which we had not previously anticipated;
- we determine that they are not complete or accurate;
- we note inconsistencies either:
  - between the responses to our inquiries and other information; or
  - between responses to the same inquiry of multiple individuals; and
- management provide information that is pertinent to our assessment of a fraud risk, since they have a unique ability to perpetrate fraud.

We do not corroborate trivial facts or unimportant details.

### How do we corroborate the responses of management, those charged with governance and others related to our fraud inquiries? [ISA | 560.1500]

We corroborate responses to fraud inquiries by inspecting relevant support, such as:

- executed agreements;
- correspondence with regulators or legal counsel; or
- public records,

depending on the nature of the matter and any inconsistencies we identify.

We may obtain the supporting documentation from an independent source. We may also inquire of, or confirm the information with, third parties or others within the entity.

# Examples

### When and how might we corroborate management's responses to inquiries about fraud? [ISA | 560.11566]

**Example 1 | Revenue Recognition**

The Director of Market Development informed the engagement team that the entity had executed a contract on the last day of the quarter, supporting its recognition of a significant amount of revenue.

The team were aware that the entity would not have met analysts' expectations without recognizing this revenue, so they considered whether the information presented a fraud risk over accounting for revenue.

Rather than rely on the responses from the Director of Market Development, the team inspected the signed agreement and chose to corroborate this information directly with the customer.

**Example 2 | Insurance Coverage**

Following arson attacks at two of the entity's manufacturing facilities, its General Counsel asserted that its insurance carriers had not threatened to litigate claims.

The team were aware that local law enforcement had questioned whether management was somehow connected to the events. So the team considered whether this information presented a fraud risk over accounting for fire losses and insurance coverage.

As a result, the team decided to corroborate this information by inspecting reports issued by local law enforcement and through direct confirmation with the insurance carriers.

### How might we corroborate management's responses to fraud risk inquiries when we receive contradictory or conflicting responses? [ISA | 560.11567]

**Example 1 | Different perspectives**

**Fact pattern:**

Near the end of the period, a sales manager asked the payroll accountant to pay an additional amount to an employee in the sales department, outside of the normal payroll process.

When the engagement team inquired of the manager, she said she wasn't aware of fraudulent activities. But when the team inquired of the payroll accountant, he described the additional payment as being 'unusual' but not related to anything inappropriate.

The information from the payroll accountant seemed inconsistent with the information received from the manager.

**Analysis:**

Due to this inconsistency, the team decided to perform additional procedures, which included inspecting the supporting documentation for the transaction.

They found that the payment was for overtime work performed by the sales employee, and determined that this did not necessarily indicate a fraud risk or actual instance of fraud.

**Alternative analysis:**

The team may instead have discovered that this was a fraudulent payment to the sales employee.

In either case, the additional procedures provided evidence that helped the team address the inconsistencies they identified.

**Example 2 | Conflicting responses**

**Fact pattern:**

During the inquiry, the chairman of the audit committee told the engagement team he was unaware of any transactions with related parties.

When the team asked the same question of the Chief Accounting Officer, she mentioned a debt financing arrangement with an entity owned by an audit committee member.

**Analysis:**

This information appeared inconsistent, so the team performed additional procedures to corroborate management's responses.

In looking at the details and documentation around the debt financing, the team found that the audit committee member disposed of the investment and terminated his relationship with the financing entity in a previous period.

**Alternative analysis:**

In inspecting the documentation, the team may have determined that the entity's related party list was not accurate, and that:

- there was a previously undisclosed related party transaction (regardless of whether it was fraudulent); or
- the entity was being used to perpetrate fraud.

In both these analyses, the additional procedures provided evidence that:

- helped the team address the inconsistencies they identified; and
- informed them about RMMs due to both fraud and error.

# Discussion Among the Engagement Team

## International Standards on Auditing: ISA 240.16

### Discussion among the Engagement Team

16. ISA 315 (Revised 2019) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.[6] This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A11-A12)

6 ISA 315 (Revised 2019), paragraph 17-18

## ISA Application and Other Explanatory Material: ISA 240.A11-A12

### **Discussion Among the Engagement Team** (Ref: Para. 16)

A11. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A12. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements (including the individual statements and the disclosures) 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 risk that management may attempt to present disclosures in a manner that may obscure a proper understanding of the matters disclosed (for example, by including too much immaterial information or by using unclear or ambiguous language).
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- 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 misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Discuss matters affecting the identification and assessment of RMMs among the engagement team [ISA | 552]

## What do we do?

Conduct a discussion among engagement team members regarding the risks of material misstatement

## Why do we do this?

Holding a discussion among team members allows us to share experience, insights and opinions, and to generate questions about the entity and its risks of material misstatement (RMMs). Considering these questions helps us make our initial risk assessment and planning decisions.

## Execute the Audit

### Why do we discuss matters affecting the identification and assessment of RMMs among engagement team members? [ISA | 552.1300]

The engagement team discussion is an opportunity for us to understand and discuss possible RMMs with the key members of the engagement team. At KPMG, we call this the Risk Assessment and Planning Discussion (RAPD).

The RAPD allows us to harness the collective knowledge and different views of the engagement team regarding RMMs. Hearing others' points of view helps spur ideas and thinking, and helps engagement team members:

- give appropriate thought to the audit areas, events or matters which may indicate RMMs; and
- understand how the results of our audit procedures may affect other aspects of the audit — including decisions about the nature, timing and extent of further audit procedures.

The RAPD is a means to gather key engagement team members early in the audit, and collectively analyze what we know about the entity. It's most effective when all the key team members have been sufficiently involved in the risk assessment procedures and are fully engaged in the discussion.

We conduct the RAPD in an environment where all team members feel free to speak up and express their thoughts and concerns. This allows us to consider all their different viewpoints and observations.

Our RAPD is not merely a 'check-the-box' exercise — it's a key element of our overall risk assessment procedures, and of identifying and assessing the relevant RMMs up-front.

#### Who are the key members of the engagement team? [ISA | 552.11510]

The key members of the engagement team are, at the minimum, the engagement partner and engagement manager. The engagement partner may decide to involve other members of the engagement team in the RAPD or equivalent discussion.

#### Group Audit | Do we include component auditors in the RAPD? [ISA | 552.160035]

Yes, we include, at a minimum, the component engagement partner and component engagement manager in the RAPD. This can be achieved through a single RAPD with component engagement partners and component engagement managers or through a series of RAPDs.

### When do we hold this discussion? [ISA | 552.1400]

The RAPD is most effective:

- after we've obtained an understanding of the entity and its environment — including all components of its internal control; but
- before we start designing and executing the remainder of our audit plan.

This information provides a better knowledge base for our discussion.

The auditing standards don't prevent us from holding engagement team discussions and communications more than once during an audit — in fact they promote it. The RAPD is a key element of risk assessment, but we can communicate information and risk factors at any time.

Risk assessment is an iterative process, so we remain alert throughout the audit to matters that may affect our identification and assessment of RMMs. Circumstances may arise, or we may obtain information, indicating that our identification and assessment of RMMs may be different from that determined in the RAPD.

We *may* discuss RMMs due to error separately from fraud risks. However, it's usually more convenient to hold the two discussions together — especially as all of the relevant members are already participating, and it leverages the same information we have gathered.

### Who participates in the discussion? [ISA | 552.1500]

The lead engagement partner always participates in the discussion. Key engagement team members also participate in the discussion, but don't all have to participate at the same time.

The engagement partner may decide to involve other members of the engagement team in the RAPD or equivalent discussion by using professional judgment, prior experience with the entity and knowledge of current developments.

The other participants in the discussion may include:

- other partner(s)
- other audit senior manager(s)/manager(s)
- audit senior associate(s)/in-charge auditor(s)
- audit associate(s)
- tax partner(s) and manager(s)
- IT Audit partner(s) and manager(s)
- other specific team members and/or employed KPMG specialists partner(s) and manager(s) of member firms that are participating in the audit.
- In addition, the engagement quality review (EQR) partner and their delegates may attend the discussion to gain the necessary understanding of the entity.

### Are there certain matters that we always discuss at the RAPD? [ISA | 552.1600]

Yes. At a minimum, we discuss the items included in the RAPD agenda https://alex.kpmg.com/AROWeb/document/lfc/GO_AR_KCW_AR_205900_RAPD_Agenda_LP template, unless the item is indicated as optional. We may add additional items.

### What other topics may be discussed during our discussion? [ISA | 552.1700]

When the key engagement team members are gathered together, we may take this opportunity to discuss other important matters related to planning and organizing the audit — for example:

- the overall responsibilities of each key engagement team member;
- topics we may want to discuss throughout the audit with the EQR, specific team members, and other reviewers;
- whether the results of the latest Quality Performance Review apply to the audit, and any matters to pay close attention; and
- our preliminary thoughts on potential audit responses for other identified RMMs.

### Group Audit | How may we incorporate group audit considerations in the RAPD? [ISA | 552.8079]

When we hold a RAPD for a group audit, we think about the items included in the RAPD agenda template in the context of the group audit and discuss those items not only for the group entity but for its components as relevant. We customize the RAPD agenda, as necessary, to document the contents of our discussion including: the significant decisions reached, how and when the discussion occurred, and the audit team members who participated.

Examples of items that we may discuss from a group audit perspective include:

- How the accounting principles have been communicated to management of entities or business units and how differences in accounting principles are identified and adjusted
- Fraud risk factors that are present across components that may indicate a fraud risk or non-compliance with national laws or regulations to the extent relevant to the group financial statements
- Significant risks to the group financial statements and the components where we plan to perform work to address those significant risks
- Financial statement level risks and the risk of management override and the components where we plan to perform work to address those
- Significant unusual transactions and related parties at the components
- Any other relevant group audit scoping considerations
- The overall responsibilities of component auditors

# 1.1 Discuss the potential for material misstatement due to fraud [ISA | 554]

## What do we do?

Discuss the potential for material misstatement due to fraud.

## Why do we do this?

A material misstatement due to fraud could be present, regardless of our past experience with the entity and regardless of our belief about management's honesty and integrity.

Questioning what we think we know, particularly in an open discussion, may highlight risks of fraud that we would not otherwise have considered. In addition, brainstorming encourages us to share views and may generate new ideas about fraud risk.

# Execute the Audit

### When do we discuss the potential for material misstatement due to fraud? [ISA | 554.1300]

Our discussion about fraud doesn't have to take place as part of the risk assessment and planning discussion (RAPD). We may discuss RMMs due to error separately from fraud risks. However, it's usually more convenient to hold the two discussions together — especially as all of the relevant members are already participating.

Also, a fraud risk may relate to the same account or disclosure as a risk due to error. So, given how the risks may interrelate, discussing the risks at the same time may be more effective.

If we decide to discuss fraud separately from the RAPD, we conduct our discussion in a very similar manner - i.e., with similar attendees and documentation. Regardless of how or when this happens, we hold a robust discussion about the potential for material misstatement due to fraud.

### How do we prepare for and participate in the fraud discussion? [ISA | 554.1400]

To make the discussion more effective, it may be useful to inspect items that help us to brainstorm — including:

- our past audit experience with the entity
- current-period information obtained during planning
- experience on other audits
- KPMG guidance and training
- the entity's internal fraud risk assessment
- the entity's board minutes
- the entity's earnings calls and press releases.

These can help identify matters and events that are relevant to considering risks of fraud.

### What ideas do we exchange about the possible occurrence of fraud? [ISA | 554.1500]

When we discuss the potential for material misstatement due to fraud, it's helpful to start with understanding the three categories of fraud risk factors (i.e., 1. Incentive / Pressure, 2. Attitude or Rationalization, 3. Opportunity), which forms the fraud triangle (refer to activity on identifying fraud risk factors for further discussion on the fraud risk factors and illustration of the fraud triangle). Then brainstorming how and where we believe the entity's financial statements (including individual statements and disclosures) may be susceptible to fraud. We specifically exchange ideas about:

- how and where management could perpetrate and conceal fraudulent financial reporting;
- how the entity's assets could be misappropriated;
- the susceptibility of the financial statements to material misstatement through related party transactions;
- how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;
- how the financial statements could be manipulated through management bias in accounting estimates in significant accounts and disclosures;

- what incentives, pressures or opportunities are present to enable fraud;
- whether management could rationalize committing fraud;
- circumstances that might indicate earnings management or manipulation of other financial measures; and
- practices that management might follow to manage earnings or manipulate other financial measures.

## How do we exchange ideas about the possible occurrence of fraud? [ISA | 554.1600]

The exchange of ideas works in combination with thinking about fraud risk factors and fraud risks. Our discussions are intended to be an iterative process among team members in which we exchange ideas and information.

These discussions go beyond simply inspecting a list of fraud risks from the prior period and confirming which of them still apply to the current period. We do include considerations from prior periods, but we use a fresh lens to identify and assess:

- new circumstances that might indicate the potential for fraud; and
- when fraud risks may have changed.

All participants bring their thoughts to the table and discuss the fraud risks that may exist for the current period audit.

> Suppose that an audit manager on the engagement team knows that the entity is implementing a new payroll system during the fourth quarter of its fiscal year.
>
> They also know, from past audits, that the entity has previously given inappropriate access to users during system implementations, and didn't promptly revoke that access after implementation.
>
> Therefore, the engagement team may discuss the potential for a fraud risk in the current period over inappropriate access to the new payroll system implemented. This information may help the team discuss fraud risks in the current period that weren't fraud risks in the prior period.

## What do we emphasize to all engagement team members during our fraud discussions? [ISA | 554.1700]

During our discussion of fraud risk, we stress to all engagement team members that throughout the audit we:

- maintain a questioning mind and exercise professional skepticism in gathering and evaluating evidence;
- remain alert for information or other conditions that might affect our assessment of fraud risks — e.g. contradictory or inconsistent evidence; and
- consider any contradictory or inconsistent information we identify by:
    - probing the issues;
    - obtaining additional evidence, as necessary; and
    - consulting with other team members and others in the firm — including specialists and/or specific team members, if appropriate.

### Why do we consider contradictory or inconsistent information? [ISA | 554.11533]

Contradictory or inconsistent information identified during the audit may suggest other fraud risks that we haven't yet identified or, possibly, actual instances of fraud.

If we gather evidence that is inconsistent or seems to contradict our initial conclusions, we do not want to — nor is it appropriate for us to — brush it off or stop there.

To reach a conclusion about the matter, we probe, obtain additional evidence and involve others.

It is helpful to remind engagement team members of the matters that might affect our assessment of fraud risks.

### Why do we set aside prior beliefs about management's honesty and integrity and maintain a questioning mind? [ISA | 554.1800]

Sometimes, we can develop a high degree of trust or confidence in management, which can have negative consequences. For example, we do not just accept management representations at face value but corroborate them and seek both confirming and disconfirming evidence.

Our goal is to approach our fraud discussion with the mindset that a material misstatement due to fraud could be present, regardless of our past experience with the entity and our belief about management's honesty and integrity.

In practice, this means that:

- we assume that management are neither honest nor dishonest; and
- we don't trust management blindly, or without gathering and objectively evaluating evidence, where appropriate.

We act with professional skepticism.

This questioning frame of mind allows us to carefully and objectively consider areas where there is potential for material misstatement due to fraud.

### What do we focus on when discussing the risk of material misstatement from related party relationships and transactions? [ISA | 554.1900]

Our RAPD may include the following matters in relation to related party relationships and transactions.

- The nature and extent of the entity's relationships and transactions with related parties — using, for example, our record of identified related parties, which we update after each audit.
- An emphasis on maintaining professional skepticism throughout the audit about the potential for material misstatement from related party relationships and transactions.
- Entity-specific circumstances that may indicate related party relationships or transactions that management has not identified or disclosed to us — for example:
  - a complex organizational structure;
  - use of special-purpose entities for off-balance sheet transactions; or
  - an inadequate information system.
- Records or documents that may indicate related party relationships or transactions.
- The importance that management and those charged with governance attach to:
  - identifying, appropriately accounting for, and disclosing related party relationships and transactions (if the entity is subject to related party accounting and disclosure requirements); and

- the related risk of management override of relevant controls.

### Why do we discuss related party relationships and related party transactions? [ISA | 554.2000]

Transactions with related parties are common, but they may give rise to fraud risks. This is because related parties are not independent of each other. For example:

- special-purpose entities controlled by management might be used for earnings management; or
- transactions could be arranged between the entity and the business partner of a key member of management, to misappropriate the entity's assets.

### Why do we discuss the risk of management override, and what do we discuss? [ISA | 554.2100]

We discuss risk of management override because:

- fraud can be perpetrated through override of management's controls; and
- this risk is present in all entities.

We put aside beliefs we have had in prior periods and discuss thoroughly where we believe the risk of management override may occur in the current period.

Entities operate in a dynamic environment, so significant changes may have occurred from prior periods, especially significant changes in the entity — e.g. new revenue streams, new management, or new pressures or incentives — that may change or elevate the risks of management override that existed in prior periods.

### Why do we discuss our potential audit responses to fraud? [ISA | 554.2200]

Discussing our potential audit responses to fraud — including the nature, timing and extent of procedures — can help us better identify and assess fraud risks.

This discussion will also help us begin to formulate our audit plan, including detailed audit procedures to address these fraud risks.

# 1.2 Communicate important matters to team members not involved in the RAPD [ISA | 555]

## What do we do?

The lead engagement partner determines which matters are to be communicated to engagement team members not involved in the Risk Assessment and Planning Discussion. The lead engagement partner or other key engagement team members communicate those matters accordingly.

## Why do we do this?

Key members of the engagement team may be unable to participate in the Risk Assessment and Planning Discussion (RAPD).

The lead engagement partner is responsible for making sure they are informed of the important matters that were discussed, as these will impact the procedures we perform in response to the risks of material misstatement (RMMs) identified.

# Execute the Audit

### Who attends the RAPD? [ISA | 555.1300]

Whether we hold one or multiple discussions with the key engagement team members, the lead engagement partner — or another key engagement team member, such as the lead engagement manager — participates in each discussion.

They do this to help maintain consistency, consider each of the key points raised and communicate important matters across the engagement team.

As we plan and conduct the discussion, we think about the overriding objective — to share knowledge and inform team members about important matters that can affect our audit.

### Do all key team members participate in the RAPD? [ISA | 555.1400]

It's helpful to have all the key team members in the same place, so we try to find a time where everyone can gather in one place to have the discussion.

However, this may not always be practical, and we may choose to hold separate discussions with some members of the team. For example, an employed KPMG specialist may not be available at the same time as the rest of the team.

Rather than postpone the meeting and potentially delay the planning process, we may meet with those team members separately.

### What if key engagement team members are unable to participate in the RAPD? [ISA | 555.1500]

When key engagement team members are unable to participate in the RAPD:

- the lead engagement partner determines which matters to discuss with them; and
- the lead engagement partner (or another key engagement team member) discusses those matters.

A communications plan, agreed by the engagement partner, may be useful.

### How else might we hold the RAPD, so that all key engagement team members can be involved? [ISA | 555.1600]

When key engagement team members are unable to participate in person — e.g. if they're in multiple locations — there may be other ways to involve them in the RAPD.

For example, we may use conference calls and/or video-conferencing so that all appropriate people can participate in one discussion.

# 1.3 Communicate significant matters among team members throughout the audit [ISA | 556]

## What do we do?

Communicate significant matters affecting risks of material misstatement among engagement team members, throughout the audit, including when conditions change

# Why do we do this?

Any engagement team member may obtain significant information, or become aware of events, that could affect our identification and assessment of risks of material misstatement (RMMs).

These include changes in the entity that happened during the audit, and after our risk assessment and planning discussion (RAPD).

We communicate these matters among the engagement team promptly, to keep them informed about the matters and how they may impact the audit.

# Execute the Audit

### What types of significant matters or changes in the entity do we communicate? [ISA | 556.1300]

We communicate those matters or changes in the entity that occur and affect our identification and assessment of RMMs.

Examples of significant matters we communicate include:

- planned acquisitions or dispositions;
- changes in the operation of the entity or its business lines; and
- potential impacts to the entity's results due to changes in market conditions.

Changes in the entity may relate to a variety of matters, including:

- new transactions the entity enters into;
- control deficiencies that occur; or
- changes in the entity's processes or controls.

> For example, a senior associate on the team may learn, through inquiries with the assistant treasurer, that the entity is negotiating a new financing arrangement.
>
> In this case, the senior associate is expected to tell the engagement manager, so they can consider the effect, and discuss the matter with the engagement partner.

### How do we communicate significant matters that occur during the audit? [ISA | 556.1400]

There is no one way to communicate significant matters that arise during the audit among the engagement team. We can use a meeting, a conference call or some other means.

Ultimately, the engagement partner is responsible for determining that changes affecting our risk assessment decisions are promptly communicated among the engagement team.

# Risk Assessment Procedures and Related Activities - Overall

# International Standards on Auditing: ISA 240.17

## Risk Assessment Procedures and Related Activities

17. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, required by ISA 315 (Revised 2019), the auditor shall perform the procedures in paragraphs 23-43 to obtain information for use in identifying the risks of material misstatement due to fraud.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Design and perform risk assessment procedures

[ISA | 341]

## What do we do?

Design and perform procedures to identify and assess risks of material misstatements.

## Why do we do this?

Our risk assessment aims to identify risks of misstatement (RM) and assess those that are risks of material misstatement (RMMs) so we can design and execute responses.

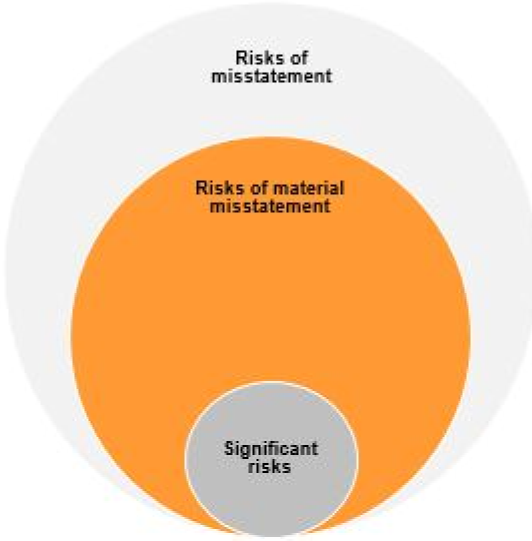
Risk assessment is essential to an audit. The appropriateness and sufficiency of our audit response - e.g. tests of controls, substantive procedures - depend on our ability to identify and assess the relevant RMMs. If we don't, we can't design and perform audit procedures that will address these risks.

## Execute the Audit

### What is a risk of material misstatement? [ISA | 341.1300]

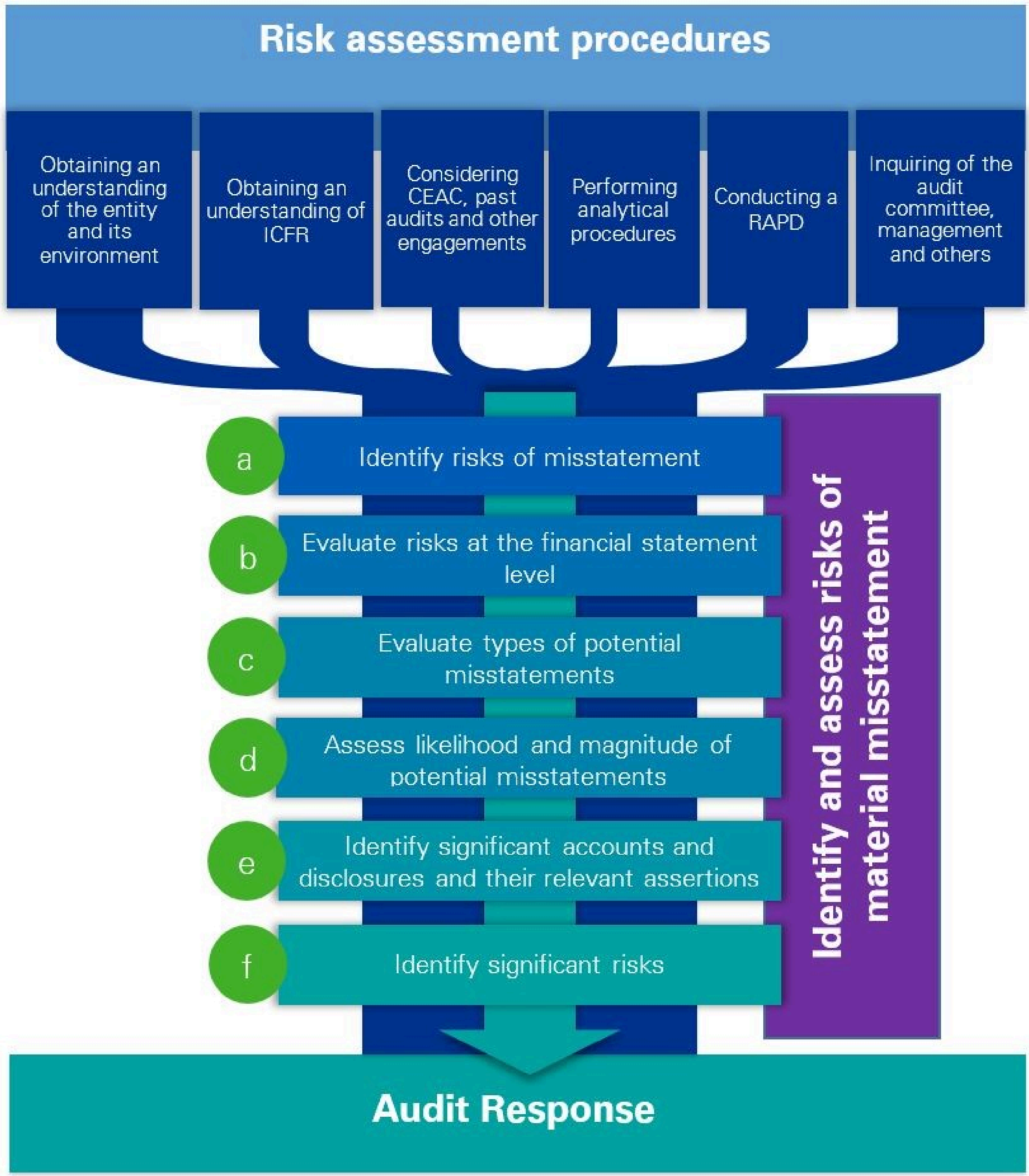
A risk of material misstatement (RMM) is a risk that could result in a *material* misstatement to the financial statements.

In practice, RMMs represent a subset of the total population of risks of misstatement. They are more broadly defined as those risks with a 'reasonable possibility' of resulting in misstatements, individually or in combination with others, that are material to the financial statements. 'Reasonable possibility' means a more than remote possibility, and is therefore a low threshold. We assess both risks due to error and risks due to fraud.




### What risk assessment procedures do we design and perform? [ISA | 341.1500]

Our risk assessment procedures are outlined in the visual below. We design and perform our risk assessment procedures with a specific purpose in mind: to collect information to identify and assess risks of material misstatement and to enable us to design appropriate audit procedures in response to the identified risks. These risks will then drive our audit responses.




Our risk assessment procedures also include observation and inspection. For example, observing or inspecting the entity's operations, premises and facilities, documents and reports such as meeting minutes, business plans etc.

We design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

Why do we obtain audit evidence in an unbiased manner? [ISA | 341.6692]

Obtaining audit evidence in an unbiased manner is important as it may assist us in identifying potentially contradictory information, which may assist us in exercising professional skepticism in identifying and assessing the risks of material misstatement.

See 'Apply professional skepticism' for more information related to professional skepticism.

What incremental risk assessment procedures do we perform over accounting estimates? [ISA | 341.8433]

When assessing risk related to accounting estimates, we perform the incremental procedures at Perform risk assessment procedures related to accounting estimates.

# Risk Assessment Procedures and Related Activities - Management, Others and Those Charged With Governance

## International Standards on Auditing: ISA 240.18-22

### *Management and Others within the Entity*

18. The auditor shall make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A13-A14)

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A15)

(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.

19. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A16-A18)

20. For those entities that have an internal audit function, the auditor shall make inquiries of appropriate individuals within the function to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A19)

### *Those Charged with Governance*

21. Unless all of those charged with governance are involved in managing the entity,[8] the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the controls that management has established to mitigate these risks. (Ref: Para. A20-A22)

8 ISA 260 (Revised), *Communication with Those Charged with Governance,* paragraph 13

22. Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

# ISA Application and Other Explanatory Material: ISA 240.A13-A22

## Risk Assessment Procedures and Related Activities

### *Inquiries of Management*

#### Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 18(a))

A13. Management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

#### Considerations specific to smaller entities

A14. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

#### Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 18(b))

A15. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

### *Inquiry of Management and Others within the Entity* (Ref: Para. 19)

A16. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A17. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

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

A18. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

## *Inquiry of Internal Audit* (Ref: Para. 20)

A19. ISA 315 (Revised 2019) and ISA 610 (Revised 2013) establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.[17] In carrying out the requirements of those ISAs in the context of fraud, the auditor may inquire about specific activities of the function including, for example:

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

17 ISA 315 (Revised 2019), paragraphs 14(a) and 24(a)(ii), and ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

## *Obtaining an Understanding of Oversight Exercised by Those Charged with Governance* (Ref: Para. 21)

A20. Those charged with governance of an entity oversee the entity's 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 the controls that address such risks. 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.[18]

18 ISA 260 (Revised), paragraphs A1 - A8, discuss with whom the auditor communicates when the entity's governance structure is not well defined.

A21. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of controls that address risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

### Considerations Specific to Smaller Entities

A22. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1.C Core and Less Complex | Inquire of management and others about RMMs [ISA | 7737]

## What do we do?

Inquire of management, the internal audit function and others about risks of material misstatement

## Why do we do this?

We inquire of individuals we deem likely to have information and perspectives relevant to our risk assessment. In making these inquiries, we seek to:

- better understand their personal views;
- identify and assess additional risks we may not have considered yet; and
- confirm our understanding of the risks we've already identified.

## Execute the audit

### Core and Less Complex | Who do we inquire of? [ISA | 7737.6233]

We inquire of individuals whom we reasonably expect to have information that could lead us to identify and assess a risk of material misstatement (RMM). These include:

- key members of management;
- members of internal audit (if an internal audit function exists); and
- individuals in other positions who could have insight and information about RMMs, we may, for example, inquire of those charged with governance

> Suppose we're seeking information on a home repair project.
>
> We would likely ask others with previous experience, or perhaps someone who works in home improvement. Asking a doctor, despite holding them in high esteem, is unlikely to help (unless they, too, have experience in home repairs).
>
> Similarly, during risk assessment, if we're looking for information on the entity's plans for implementing accounting policies, asking the Vice President of Operations may not be as effective as inquiring of the Chief Accounting Officer.
>
> This isn't to say that we limit our inquiries to only those individuals in the accounting department. Individuals throughout the entity may have different views and information that can help us identify and assess RMMs.

It doesn't hurt to inquire of someone who ultimately has no useful information, but it *can* hurt if we omit someone who could provide helpful information.

So as a general rule of thumb: when in doubt, inquire.

#### Core and Less Complex | Who are 'those charged with governance' for a private entity? [ISA | 7737.6234]

A private entity may or may not have an audit committee, board of directors or equivalent body. In that case, if we choose to inquire of those charged with governance we inquire of the person(s) who oversee the entity's accounting and financial reporting processes and audits of the entity's financial statements. Those charged with governance could include management personnel — e.g. executive members of a governance board — or an owner-manager.

### When do we make our inquiries? [ISA | 7737.1500]

We make our inquiries:

- early enough in the audit to help us identify and assess RMMs; and
- as necessary throughout the audit.

Our aim is to gather information for our risk assessment — so making our inquiries too late in the audit will be ineffective, and the information may not help us plan the audit.

However, risk assessment is an iterative process — so making these inquiries is not a 'check the box' exercise that we complete and then file away.

We may find it appropriate to make additional inquiries, or to probe into a matter we inquired about previously. For example, if we become aware of a new material claim against the entity, we'll likely inquire about it again — even though we've already discussed litigations, claims and assessments.

Further, we try to make all our inquiries of a specific individual at once. So we think about other inquiries that other standards ask us to make, or which are relevant to include — e.g. fraud, related party transactions, significant transactions etc.

For example, when meeting with the CEO, we may take the opportunity to inquire about several matters at once — rather than hold a series of meetings. However, it may be necessary to inquire again when we obtain new or conflicting information.

### Who makes the inquiries? [ISA | 7737.1600]

Inquiries are made by an engagement team member with the appropriate level of knowledge, experience and stature for both:

- the matter(s) we are inquiring about; and
- the person of whom we are inquiring.

> For example, we wouldn't ask a first-year associate to inquire of the audit committee chair or owner-manager. Similarly, if there is a going concern risk, then a more senior team member — e.g. the engagement partner — is likely the best person to inquire.

To the extent possible, we make inquiries in person - observing nonverbal communication can help us evaluate the inquiree's response.

# 1.E Enhanced | Inquire of those charged with governance, management and others about RMMs [ISA | 557]

## What do we do?

Inquire of those charged with governance, management, the internal audit function and others about risks of material misstatement

## Why do we do this?

We inquire of individuals we deem likely to have information and perspectives relevant to our risk assessment. In making these inquiries, we seek to:

- better understand their personal views;
- identify and assess additional risks we may not have considered yet; and
- confirm our understanding of the risks we've already identified.

## Execute the Audit

### Enhanced | Who do we inquire of? [ISA | 557.1300]

We inquire of individuals whom we reasonably expect to have information that could lead us to identify and assess a risk of material misstatement (RMM). These include:

- those charged with governance;
- key members of management;
- members of internal audit (if an internal audit function exists); and
- individuals in other positions who could have insight and information about RMMs.

> Suppose we're seeking information on a home repair project.
>
> We would likely ask others with previous experience, or perhaps someone who works in home improvement. Asking a doctor, despite holding them in high esteem, is unlikely to help (unless they, too, have experience in home repairs).
>
> Similarly, during risk assessment, if we're looking for information on the entity's plans for implementing accounting policies, asking the Vice President of Operations may not be as effective as inquiring of the Chief Accounting Officer.
>
> This isn't to say that we limit our inquiries to only those individuals in the accounting department. Individuals throughout the entity may have different views and information that can help us identify and assess RMMs.

It doesn't hurt to inquire of someone who ultimately has no useful information, but it *can* hurt if we omit someone who could provide helpful information.

So as a general rule of thumb: when in doubt, inquire.

### Enhanced | Who are 'those charged with governance' for a public entity versus a private entity? [ISA | 557.1400]

Many public entities have an audit committee or equivalent body, established by and among the board of directors. When we audit a public entity, 'those charged with governance' will often mean the audit committee or equivalent (or its chair).

A private entity may or may not have an audit committee, board of directors or equivalent body. In that case, we inquire of the person(s) who oversee the entity's accounting and financial reporting processes and audits of the entity's financial statements. Those charged with governance could include management personnel — e.g. executive members of a governance board — or an owner-manager.

### When do we make our inquiries? [ISA | 557.1500]

We make our inquiries:

- early enough in the audit to help us identify and assess RMMs; and
- as necessary throughout the audit.

Our aim is to gather information for our risk assessment — so making our inquiries too late in the audit will be ineffective, and the information may not help us plan the audit.

However, risk assessment is an iterative process — so making these inquiries is not a 'check the box' exercise that we complete and then file away.

We may find it appropriate to make additional inquiries, or to probe into a matter we inquired about previously. For example, if we become aware of a new material claim against the entity, we'll likely inquire about it again — even though we've already discussed litigations, claims and assessments.

Further, we try to make all our inquiries of a specific individual at once. So we think about other inquiries that other standards ask us to make, or which are relevant to include — e.g. fraud, related party transactions, significant transactions etc.

For example, when meeting with the CEO, we may take the opportunity to inquire about several matters at once — rather than hold a series of meetings. However, it may be necessary to inquire again when we obtain new or conflicting information.

### Who makes the inquiries? [ISA | 557.1600]

Inquiries are made by an engagement team member with the appropriate level of knowledge, experience and stature for both:

- the matter(s) we are inquiring about; and
- the person of whom we are inquiring.

> For example, we wouldn't ask a first-year associate to inquire of the audit committee chair or owner-manager. Similarly, if there is a going concern risk, then a more senior team member — e.g. the engagement partner — is likely the best person to inquire.

To the extent possible, we make inquiries in person - observing nonverbal communication can help us evaluate the inquiree's response.

# 1.1 Determine the nature of inquiries about RMMs

[ISA | 558]

## What do we do?

Determine the nature of the inquiries about risks of material misstatement using our knowledge of the entity and its environment, as well as information from other risk assessment procedures and our understanding of internal controls

## Why do we do this?

Our knowledge of the entity and information from other risk assessment procedures may indicate the existence of risks of material misstatement (RMMs).

We therefore use this knowledge to determine the nature of our inquiries with those charged with governance, management, the internal audit function (where it exists) and others about RMMs that may exist.

## Execute the Audit

### How do we determine the nature of our inquiries about RMMs? [ISA | 558.1300]

We determine the nature of our inquiries about RMMs by:

- drawing on our knowledge of the entity and its environment, and information from other risk assessment procedures; and
- tailoring our questions to the individual of whom we are inquiring.

Our knowledge from other risk assessment procedures can help us specifically tailor our inquiries to learn additional information about topics that are relevant to the audit and the identification and assessment of RMMs.

#### How may we tailor our questions? [ISA | 558.11548]

To get the best results, we tailor our questions to the subject of our inquiry.

Our goal is to ask questions about topics relevant to the individual and their role at the entity, and to obtain information relevant to identifying and assessing RMMs.

When planning our questions, we remember that not every inquiry needs to be an invasive interrogation.

For example, suppose we're inquiring of the Financial Controller. We may ask questions that focus on the accounting for specific transactions.

But when we inquire of those charged with governance, we may ask questions that focus on the overall entity.

Alternatively, when thinking about risks in revenue accounts, we may want to make specific inquiries of:

- the VP of Sales, about sales arrangements with multiple elements or complex terms; but

- the Chief Operations Officer, about technological feasibility, and research and development costs.

### What inquiries do we make? [ISA | 558.1400]

At minimum, we make those inquires in the 'Inquiries agenda'. Some inquiries of specific parties are presumed mandatory — including management, those charged with governance, those within the internal audit function and others. These inquiries are summarized in the '[Inquiries agenda](https://alex.kpmg.com/AROWeb/document/lfc/GO_KCW_Links_required_inquiries_documents) https://alex.kpmg.com/AROWeb/document/lfc/GO_KCW_Links_required_inquiries_documents'.

However, we use our knowledge of the entity and its environment, as well as information from our other risk assessment procedures, to determine the nature of our inquiries.

# Example

### What inquiries may we make about RMMs? [ISA | 558.11549]

The table below sets out examples of inquiries we may make, responses we may receive, and how we might evaluate those responses.

| Inquiry of | Question asked | Response received | RMM(s) identified in relation to... |
|---|---|---|---|
| **Audit Committee Chair** | How do you comply with laws and regulations, and have you received any violation notices? | We received a notice that we violated an environmental remediation law. | An unrecorded liability for environmental remediation for the period of non-compliance |
| **Chief Executive Officer** | What have been the significant changes in the business or environment? | We recently finished testing a new product that will be released this year. | Revenue recognition for the new product and how the entity capitalizes and amortizes product development costs |
| **Chief Financial Officer** | How do you budget or forecast financial performance? | We recently reviewed our budgeting process and found that management has compiled fairly aggressive forecasts. | Estimates that are based on the entity's forecasts and projected financial information |
| **General Counsel** | What litigation, claims, or | Recently, there's been an increase in inquiry claims | The entity's returns allowance and/or its |

| | | | |
|---|---|---|---|
| | assessments is the entity involved with? | about sales of defective machinery. | accrual for liabilities arising from these claims |
| **Chief Information or Technology Officer** | Have there been any significant changes in your IT systems? | We recently implemented a new general ledger IT system. | The entity's implementation and use of the new general ledger IT system |

# 1.2 Inquire about fraud and fraud risks [ISA | 559]

## What do we do?

Inquire of those charged with governance, management, internal audit personnel and others about fraud and fraud risks

## Why do we do this?

Management are responsible for designing and implementing programs and controls to prevent, deter and detect fraud. This means they often have their own views and an in-depth knowledge about instances of fraud and the fraud risks affecting the entity.

Similarly, those charged with governance often have a more comprehensive or top-down view of the risks affecting the entity as a whole. They may therefore have different views about the fraud risks that affect the entity.

As a result, management, along with others, are likely to have information and perspectives that are relevant to our fraud risk assessment.

## Execute the Audit

### What information do we seek in our inquiries about fraud and fraud risks? [ISA | 559.1300]

When we inquire about fraud, we are seeking to:

- identify and assess additional fraud risks we may have yet to consider;
- confirm our understanding of fraud risks that we have already identified; and
- identify actual, alleged or suspected fraudulent acts.

These inquiries may lead us to identify fraud risk factors that we take into account when identifying and assessing fraud risks. So we focus on specific matters that will increase our knowledge about fraud risks and fraud risk factors.

### When do we make our specific fraud inquiries? [ISA | 559.1400]

We sometimes talk about making specific inquiries for fraud risks — but in practice, we plan to inquire about risks of material misstatement (RMMs) due to error and fraud risks at the same time.

We inquire about these with the same entity personnel, so it can be more effective to address both types of inquiry during the same meeting.

Inquiries are part of risk assessment, so they're most effective when we perform them before we develop our audit plan.

### Who do we inquire of when we make our specific fraud inquiries? [ISA | 559.1500]

The standards tell us to make specific fraud risk inquiries of:

- management;
- those charged with governance; and
- internal audit (where one exists).

We also inquire of individuals who we believe may have relevant information about fraud risks. To identify them, we consider who might:

- have additional knowledge about fraud, alleged fraud or suspected fraud; or
- be able to corroborate fraud risks identified in our other discussions.

It may be useful to inquire of individuals in other departments and at different levels throughout the entity — including positions such as:

- accounting managers;
- segment/location managers;
- the chief compliance officer;
- key members of the human resources department;
- in-house counsel;
- employees involved in initiating, processing or recording complex or unusual transactions;
- the Chief Ethics Officer;
- persons charged with dealing with allegations of fraud; and
- key position holders throughout the operations group.

### What fraud inquiries do we make of management? [ISA | 559.1600]

At a minimum, our inquiries of management about fraud risks include the following topics.

| | |
|---|---|
| 1 | Whether they know about fraud, alleged fraud or suspected fraud affecting the entity. |
| 2 | Their assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessment. |
| 3 | Their process for identifying and responding to fraud risks, including:<br>• any specific fraud risks management has identified or that has been brought to its attention; or<br>• account balances or disclosures for which a fraud risk is likely to exist,<br>and the nature, extent and frequency of their fraud risk assessment process. |
| 4 | Controls established to address identified fraud risks, or that otherwise help to prevent and detect fraud — including how management monitor those controls. |

| | |
|---|---|
| 5 | For an entity with multiple locations:<br>• the nature and extent of monitoring of operating locations or business segments; and<br>• whether there are particular operating locations or business segments for which a fraud risk might be more likely to exist. |
| 6 | Whether and how they communicate to employees their views on business practices and ethical behavior. |
| 7 | Whether they have received tips or complaints about the entity's financial reporting — including through an internal whistleblower program if such a program exists — and, if so, their responses. |
| 8 | Whether they have reported to those charged with governance on how the entity's internal control prevents and detects material misstatements due to fraud (unless all of those charged with governance are in charge of managing the entity). |
| 9 | Whether the entity has entered into any significant unusual transactions and, if so:<br>• the nature, terms and business purpose (or lack thereof) of those transactions; and<br>• whether those transactions involved related parties. |

These are the minimum inquiries we make. They don't preclude us making any additional inquiries we deem necessary, based on our knowledge of the entity or considering the answers we receive to our initial inquiries.

For example, we may ask management if they are aware of fraud, alleged fraud, or suspected fraud. If they reply that there is 'nothing material', we might then probe further, and inquire about specific instances of which they may be aware.

### What fraud inquiries do we make of those charged with governance? [ISA | 559.1700]

At a minimum, our inquiries of those charged with governance about fraud risks include the following topics.

| | |
|---|---|
| 1 | Their views about fraud risks, including risk of management override of controls, in the entity and whether they have taken any actions to respond to these risks. |
| 2 | Whether they know about fraud, alleged fraud, or suspected fraud affecting the entity. |
| 3 | Whether they have received tips or complaints about the entity's financial reporting — including through an internal whistleblower program, if such a program exists — and, if so, their responses. |

| | |
|---|---|
| 4 | How they oversee fraud risk assessments and the establishment of controls to address fraud risks. |
| 5 | Whether the entity has entered into any significant unusual transactions. |

These are the minimum inquiries we make. They don't preclude us making any additional inquiries we deem necessary based on our knowledge of the entity or considering the answers we receive to our initial inquiries.

## What fraud inquiries do we make of the internal audit function (when one exists)? [ISA | 559.1800]

At a minimum, our inquiries of the internal audit function (when one exists) about fraud risks include the following topics. We make these inquiries even when we don't plan to use the work of internal audit in our audit:

| | |
|---|---|
| 1 | Their views about fraud risks in the entity. |
| 2 | Whether they know about fraud, alleged fraud or suspected fraud affecting the entity. |
| 3 | Whether they have performed procedures to identify or detect fraud during the period and whether management have satisfactorily responded to their findings. |
| 4 | Whether they are aware of instances of management override of controls, and the nature and circumstances of such overrides. |
| 5 | Whether the entity has entered into any significant unusual transactions. |

These are the minimum inquiries we make. They don't preclude us making any additional inquiries we deem necessary based on our knowledge of the entity or considering the answers we receive to our initial inquiries.

## What fraud inquiries do we make of others who may have relevant information? [ISA | 559.1900]

At a minimum, our inquiries of others who may have relevant information about fraud risks include the following topics.

| | |
|---|---|
| 1 | Their views regarding fraud risks in the entity |
| 2 | Whether they know about fraud, alleged fraud, or suspected fraud affecting the entity. |

These are the minimum inquiries we make. They don't preclude us making any additional inquiries we deem necessary based on our knowledge of the entity or considering the answers we receive to our initial inquiries.

### What if we identify actual or suspected instances of fraud? [ISA | 559.2000]

We perform further procedures as outlined in the chapter on fraud. We also perform the relevant procedures outlined in the chapter on laws and regulations.

# Example

### What inquiries might we make related to fraud risks? [ISA | 559.11563]

The table below sets out examples of questions we may ask, responses we may receive and how we might evaluate those responses during risk assessment.

| Inquiry of | Question asked | Response received | Evaluation of response |
|---|---|---|---|
| **Management** | Do you know of any fraud, alleged fraud or suspected fraud affecting the entity? | I am not aware of anything material. | There may have been a fraud, which management are trying to pass off as 'not material'. This could have a material effect on the financial statements, or provide insight into RMMs we may consider in our audit.<br><br>We may ask follow-on questions to probe the matter and identify instances of fraud management are aware of — regardless of whether management determine that the fraud is material. |
| **Audit committee** | Are you aware of any tip-offs or complaints about the entity's financial reporting? And if | We received a complaint last month. We investigated it and dismissed the | We may want to obtain more information about this complaint and understand whether |

| | | | |
|---|---|---|---|
| | so, how did you respond? | individual charged with the fraud based on the evidence we discovered. | improprieties were detected/ corrected and the thoroughness of management's investigation. We may also seek to understand more about any RMMs we want to consider in our audit. |
| **Internal audit** | Has the entity entered into significant unusual transactions? | We recently made a significant investment in an entity operating in an industry unrelated to our own. | We may want to obtain more information about the transaction and the business purpose — including who authorized and approved the transaction — to determine whether RMMs exist or whether this may create a fraud risk. |

# Risk Assessment Procedures and Related Activities - Unusual or Unexpected Relationships

## International Standards on Auditing: ISA 240.23

### *Unusual or Unexpected Relationships Identified*

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

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Perform analytical procedures [ISA | 547]

## What do we do?

Perform analytical procedures

# Why do we do this?

Analytical procedures allow us to examine relationships that exist among both financial and non-financial data.

We perform these procedures during risk assessment to help us understand the entity's business and significant transactions that have occurred.

They also help us identify areas that might represent risks of material misstatement (RMMs) relevant to the audit.

# Execute the Audit

### What do we consider when we perform analytical procedures? [ISA | 547.11465]

We consider the below. Details of each is outlined in the respective activities:

- Perform analytical procedures, including those related to revenue;
- Use the PA capability when electronic data is available;
- Evaluate the Account Analysis results when AA capability is used;
- Consider the analytical procedures applied during interim review engagements;
- Use our understanding of the entity to develop expectations about plausible relationships; and
- Consider unusual or unexpected results in identifying and assessing RMMs.

# 1.1 Perform analytical procedures, including those related to revenue [ISA | 548]

# What do we do?

Perform analytical procedures, including analytical procedures related to revenue

# Why do we do this?

Performing analytical procedures allows us to analyze unusual or unexpected trends, relationships and changes that:

- have happened since the prior period end; and
- may give rise to potential risks of material misstatement (RMMs) whether due to fraud or error.

Performing analytical procedures as part of our risk assessment may also identify aspects of the entity we were unaware of. This analysis draws on our existing knowledge about the entity and its environment, and helps us:

- better understand the entity; and
- identify areas that might represent specific RMMs relevant to the audit, such as:
  - the existence of unusual transactions and events; and
  - amounts, ratios and trends that warrant investigation.

We refer to the analytical procedures we perform during risk assessment as 'planning analytical procedures'.

To help identify fraud risks, we also include specific analytical procedures over revenue. We therefore analyze unusual or unexpected relationships between revenue and other accounts.

# Execute the Audit

### How do we perform planning analytical procedures? [ISA | 548.1300]

Performing analytical procedures during risk assessment involves the following.

- Enhancing our understanding of the client's business and the significant transactions and events that have occurred since the prior year end.
- Identifying areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.
- Using our understanding of the entity to develop expectations about relationships that we expect to exist among certain financial and non-financial data.

  For example, there may be a relationship between headcount and payroll expense, so if we learn that the workforce decreased, we may expect payroll expense to decrease.

- Comparing our expectations with the actual amounts recorded in the financial statements (and with non-financial data, if relevant).
- Identifying areas in which the amounts are different from our expectations, and inquiring of management to understand the reason for the difference.

Our goal is not to simply compare the amounts and identify changes — i.e. perform a 'flux' analysis. Relationships among data can be understood and analyzed in many ways, including:

- comparing the movement of specific financial statement accounts with our expectations;
- drawing on our overall understanding of the entity and its industry; and
- drawing on past experience.

These relationships can be based on simple comparisons of recorded amounts, but may also be expressed as financial ratios that we can compare.

In addition, when we analyze income statement amounts, it may be helpful to estimate the full-period results by:

- annualizing the period-to-date results, adjusting for seasonality if needed; or
- using a combination of actual and forecasted results.

#### Do we perform planning analytical procedures with a specific level of precision? [ISA | 548.11490]

We do not compare our expectation of plausible relationships among recorded amounts with a specific level of precision, and we do not set an acceptable difference. In this respect, planning analytical procedures differ from those we perform to obtain substantive audit evidence (also known as 'substantive analytical procedures' or 'SAPs').

When performing planning analytical procedures, our analysis may be as simple as forming a general expectation about the direction and/or basic level of an expected change - e.g. expecting that when sales increase, accounts receivable should increase.

For example, we may develop a broader expectation of how much revenue might change in the current period — e.g. 2-4% increase from the prior period — based on industry statistics or information available about an entity's competitors.

Or we may expect the current-period days' sales outstanding (DSO) to remain consistent with historical DSO — and any deviations from that expectation may lead us to inquire further of management to understand the change. Ultimately, we may identify or assess an RMM differently if it is not consistent with historical DSO.

### What are some of the common planning analytical procedures that we may perform? [ISA | 548.1400]

In performing planning analytical procedures, comparisons may help us identify results that do not align with our expectations. Common comparisons include:

- the balance sheet at the most recent, available period end with that of the prior period end;
- the income statement, cash flow statement and statement of comprehensive income for the most recent, available period (including period-to-date results), with those of the prior corresponding period;
- key financial ratios for the most recent, available period with those of the prior period; and/or
- budgeted information for the most recent, available period with actual amounts.

As part of our planning analytical procedures, we may use

- the Planning Analytics capability to automate certain types of comparisons and other types of analysis to help us perform planning analytical procedures; and
- the Account Analysis capability to help us identify the existence of unusual or unexpected relationships between accounts that might indicate the existence of potential risks of material misstatement.

### Why do we perform analytical procedures specific to revenue? [ISA | 548.1500]

Revenue recognition is a presumed fraud risk, so we perform revenue-specific analytical procedures to identify unusual or unexpected relationships involving revenue accounts that are relevant to our audit and our risk assessment.

Financial statement users often consider revenues in total, but revenue is also a component of many key financial ratios, such as gross margin and profit margin. And revenue is often disaggregated and tracked by operating segment, such as line of business or even product line. Given its importance, revenue is also an account that may be more susceptible to fraud.

### What are some of the common revenue-specific analytical procedures that we may perform? [ISA | 548.1600]

Our revenue-specific analytical procedures may include:

- specific analysis of revenue by product line, division or location;
- analysis of key ratios, such as DSO, gross margin or inventory turnover; and
- examining and analyzing revenue trends over several historical periods - e.g. monthly or quarterly.

In addition, revenue-related metrics reported by the entity, including non-GAAP metrics, may be useful in our risk assessment.

We may also use Account Analysis as part of our planning analytical procedures related to revenue.

## How can we use D&A routines to enhance our analytical procedures? [ISA | 548.8076]

We may use data and analytics (D&A) routines to support our understanding of the entity and our identification and assessment of RMMs.

When relevant data is available in electronic format, we may use the Planning Analytics capability. Additionally, when relevant data is available in electronic format and certain conditions are met, we may also use the Account Analysis capability as part of our planning analytical procedures.

Before using a D&A routine in the audit we ask ourselves some basic questions:

- what is the purpose for using it?
- what is the nature of the data it uses?
- what is the nature of the audit evidence it is expected to provide?

Answering these questions helps us to understand how a D&A routine fits into our audit approach (see question 'How may we use D&A routines to obtain audit evidence or supplement our judgment?'). If we are unsure how to answer these questions, we risk using a routine which is not fit for the purpose, failing to appropriately consider the reliability of the data used, or placing inappropriate reliance on the results.

## What is the Account Analysis capability? [ISA | 548.1610]

Account Analysis capability (AA capability) is a risk assessment tool that performs an automated analysis of an entity's journal entries, comparing them with pre-determined expectations and determining whether those entries reflect "expected", "unexpected" or other types of account combinations.

The AA capability offers several visualizations of the analysis performed, including the "Visual Ledger" that provides a graphical representation of the journal entries flow for selected accounts and processes.

AA capability results assist us in obtaining an understanding of the entity's accounting processes and recording of transactions, while identifying and assessing potential risks of material misstatement and enabling the determination of an audit approach specifically responsive to such risks.

### What is an account combination? [ISA | 548.11491]

The AA capability analysis is based on the consideration of simple "one debit/one credit" account pairings - e.g. debit to Trade Receivables / credit to Revenue.

Some journal entries are already in the "one debit/one credit" format and can be directly evaluated by the capability. For journal entries with multiple line items, the AA capability uses a pre-defined set of rules to break down such entries into a number of 'one debit/one credit' account pairings, where possible.

For example, the entity may record the following journal entry:

| | |
|---|---|
| Debit (Dr) Trade receivables | 120 |

| | | |
|---|---|---|
| Credit (Cr) Revenue | | 100 |
| Credit (Cr) Sales tax, payable or receivable | | 20 |

When this journal entry is processed by the AA capability, it is broken down into the following 'one debit/one credit' pairings:

| | | |
|---|---|---|
| **Pairing 1** | | |
| Debit (Dr) Trade receivables | 100 | |
| Credit (Cr) Revenue | | 100 |
| **Pairing 2** | | |
| Debit (Dr) Trade receivables | 20 | |
| Credit (Cr) Sales tax, payable or receivable | | 20 |

We refer to these 'one debit/one credit' account pairings as 'account combinations'.

What are primary/secondary accounts and primary/secondary account combinations? [ISA | 548.11492]

The AA capability allows us to select the specific accounts that we want to analyze. When we do so, only journal entries that contain the selected accounts are analyzed. However, since journal entries may contain multiple line items, once these entries are processed, we may obtain results for account combinations that do not include the accounts we specifically selected.

For example, we use the AA capability only on Revenue and all journal entries including Revenue are processed. These include the following journal entry:

| | | |
|---|---|---|
| Debit (Dr) Trade receivables | 120 | |
| Credit (Cr) Revenue | | 100 |
| Credit (Cr) Sales tax, payable or receivable | | 20 |

When this journal entry is processed by the AA capability, it is broken down into the following 'one debit/one credit' pairings:

| | | |
|---|---|---|
| **Account combination 1** | | |

| | | |
|---|---|---|
| Debit (Dr) Trade receivables | 100 | |
| Credit (Cr) Revenue | | 100 |
| **Account combination 2** | | |
| Debit (Dr) Trade receivables | 20 | |
| Credit (Cr) Sales tax, payable or receivable | | 20 |

Even though account combination 2 does not include the Revenue account, it is also displayed as part of the Account Analysis results.

For the purpose of the AA capability:

- the accounts we select to analyze are primary accounts (e.g. Revenue in the example above) and any account combinations which involve those primary accounts are primary account combinations (e.g., account combination 1 in the example above).
- the other accounts displayed in the AA capability results are secondary accounts (e.g. Trade receivables and Sales tax, payable or receivable in the example above) and any account combinations which only involve secondary accounts are secondary account combinations (e.g. account combination 2 in the example above).

### What are pre-determined expectations? [ISA | 548.11493]

For the purpose of the AA capability analysis, each possible account combination is assigned a "pre-determined expectation" with results of "expected" or "unexpected". These pre-determined expectations are based on general assumptions on how transactions are recorded, considering the specific industry and financial reporting framework.

For example, we expect a basic sales transaction to originate as a 'debit to Trade Receivables / credit to Revenue' account combination. Accordingly, this account combination is pre-determined as "expected" by the AA capability.

We can modify pre-determined expectations so that these represent a more accurate description of an entity's specific circumstances based on our understanding of the entity's process (see activity 'Confirm the pre-determined expectations').

## When may we use the Account Analysis capability? [ISA | 548.1620]

We may use the Account Analysis capability (AA capability) as part of our planning analytical procedures when relevant data is available in electronic format and certain conditions for use of the capability are met.

Relevant data for the use of the AA capability include:

- General Ledger accounts,

- General ledger account balances (prior period ending account balances, current period opening balances, and current period ending balances), and,
- Journal Entries for the current period.

Determining whether "certain conditions for use of the AA capability are met" refers to:

- How an entity's accounting system records transactions in the General Ledger and whether the analysis performed by the AA capability will result in meaningful output,
- Whether pre-determined expectations related to the industry and financial reporting framework relevant to the entity are available in the AA capability, so that the analysis is performed using such expectations. When unavailable, we may still consider whether we can effectively modify existing pre-determined expectations to make them more accurate for the entity's specific circumstances, without requiring excessive customization.

Examples of where conditions for use of the AA capability may not be met:

- entities that use large batch journal entries to record a variety of transaction types in a single journal entry (e.g. transactions related to revenue, inventory purchases and other procurement and expenses activity may all be recorded daily in one single large batch entry)
- entities that make extensive use of 'suspense accounts' to record revenue and other relevant transactions temporarily before they are allocated to the primary general ledger accounts

We may determine the accounts to analyze through the AA capability by using our knowledge of the entity/industry and thinking about:

- the type of analysis performed by the AA capability and the nature of the entity's journal entries,
- the nature and characteristics of the account and the specific circumstances of the entity and its suitability to such type of analysis, and
- other planning analytical procedures that we may perform over the account.

Examples of scenarios that may support the use of the AA capability include:

- for accounts with a high volume of transactions where there is a history of misstatements arising from incorrect postings of journal entries, the AA capability could help us identify the existence of similar journal entries during the current period
- in situations where an entity has adopted a new accounting treatment/standard that impacts certain accounts, the AA capability may help confirm our understanding of how such transactions are recorded in the general ledger
- where a fraud risk may be present that would arise from specific entries through a specific account, the AA capability over that account may help us gather additional information related to that risk
- where an entity has experienced significant turnover in the accounting department, the AA capability being applied to the complete population of accounts may help us identify specific accounts that could be impacted as a result of this pervasive financial statement level risk.

If we use the AA capability over interim data, we apply professional judgment in determining an appropriate response to the identified risks, which may include using the AA capability at a later stage in the audit over period end data.

### What is the Planning Analytics capability? [ISA | 548.12800]

The Planning Analytics capability (PA capability) is a risk assessment tool that automates certain analyses over an entity's data to help us perform planning analytical procedures.

The PA capability offers several analyses, such as:

- a comparison of prior year balances to current year balances, for both the statement of financial position and statement of profit or loss (e.g., balance sheet and income statement); this analysis is provided at the financial statement caption level, with drill down functionality to the general ledger level;
- a visualization of the monetary amount and number of journal entry postings to selected accounts by period, such as day, month or quarter – for example, the total amount of credit and debits entries posted to Revenue by month.

### When may we use the Planning Analytics capability? [ISA | 548.12801]

When relevant data is available in electronic format, we may use the Planning Analytics capability (PA capability) as part of the planning analytical procedures performed to identify and assess RMMs. Relevant data for the use of the PA capability include:

- General Ledger accounts
- General Ledger account balances (current and prior period), and
- Journal Entries for the current period.

### What is our responsibility regarding the relevance and reliability of data used in a D&A routine? [ISA | 548.1630]

Our responsibility over the relevance and reliability of the data used in a D&A routine is based on the same guidance that we follow when we use data in other audit procedures. We determine the nature and extent of effort to evaluate the relevance and reliability of the information used by thinking about how we intend to use the D&A routine in our audit. See question 'How is information used in a D&A routine?' and activity 'Evaluate the relevance and reliability of information used in our audit' for further information.

# Examples

### How might the information from our planning analytical procedures affect the identification of RMMs? [ISA | 548.1700]

The table below sets out examples of information we may gather from our planning analytical procedures, and how that might help us identify and assess RMMs.

| What our planning analytical procedures identified | How that might help us identify and assess RMMs |
|---|---|
| An increase in other accrued liabilities as compared to the prior period | The entity may have accrued for a probable loss. |

| | |
|---|---|
| | We may identify an RMM related to the accounting for new litigation or other loss contingency. |
| A decrease in revenue and gross margin for a particular product as compared to the prior period | The entity may have lost a significant customer.<br>We may identify an RMM related to the accounting for related intangibles, such as trademarks or customer relationships. |
| An increase in transportation expense as compared to the prior period | The entity may have:<br>• entered a new transportation agreement;<br>• changed its methodology to accrue for transportation expense; or<br>• failed to accrue for transportation expense in the prior period.<br>We may identify an RMM related to the accounting for transportation costs. |
| An increase in IT expense as compared to the prior period | The entity may have expensed costs that are capital in nature.<br>We may identify an RMM related to the accounting for software developed for internal use. |
| A significant increase in the relationship between sales and square footage of selling pace compared to the prior period | The entity may have recognized revenue in the wrong period.<br>We may identify an RMM related to revenue recognition. |
| An unexpected account combination crediting revenue, as identified by the Account Analysis capability. | The entity may not have accurately recorded revenue.<br>We may identify an RMM related to revenue recognition. |

### What D&A routines might we use to identify and assess RMMs for further analysis? [ISA | 548.8078]

Depending on the granularity of the analysis performed and the data used, D&A routines may provide us with detailed information that is relevant to support our risk assessment.

The table below sets out examples of analyses we may perform and the data we may use, and the RMMs we may identify.

| Example of analysis performed and the data used | RMMs we may identify based on the analysis performed |
|---|---|
| **The D&A routine is designed to provide detailed information about...** | **We may identify an RMM related to:** |
| Cash by financial institution and country location | • The disclosure of concentrations of cash in a particular financial institution or country<br>• The accounting and disclosure of the tax liability for the repatriation of cash from overseas |
| Long-term investments by investee and month incurred, as compared to the prior period | • The accounting and disclosure for a recent investment in a limited liability company<br>• The accounting and disclosure for an equity method investee where the entity has acquired additional interest |
| Capital expenditures by project, type and month incurred | • The accounting for capitalized interest<br>• The accounting for internal time |
| Revenue by product and month recognized, including amount accrued, as compared to the previous period | • The recoverability of certain intangibles — e.g. customer relationships and/ or trademarks — due to a significant decrease in revenue from an existing product line that may otherwise have been masked by a significant increase in revenue following the introduction of a new product line<br>• The estimate to accrue for a new product line |

# 1.2 Evaluate the Account Analysis results when AA capability is used [ISA | 4576]

## What do we do?

IF Account Analysis is used THEN we evaluate its results according to the Account Analysis results evaluation approach

# Why do we do this?

When we use the Account Analysis capability, we evaluate its results by using a specific Account Analysis results evaluation approach. The approach provides a phased analysis of the results to facilitate our identification and assessment of potential risks of material misstatement, and our determination of an audit approach that is specifically responsive to such risks.

# Execute the Audit

### What are the results from the Account Analysis capability? [ISA | 4576.1300]

After analyzing journal entries for the period, the Account Analysis capability (AA capability) uses the pre-determined expectations to determine whether those entries reflect "expected", "unexpected" or other account combinations.

Through this analysis, the AA capability facilitates our identification and assessment of potential risks of material misstatement and provides us with additional insight into the entity's business processes and how transactions are recorded by the entity. The following table identifies the different types of account combination classifications that may result from the AA capability, and the expected nature and extent of analysis over such results:

| Account combination classification | Description | Expected nature and extent of analysis over Account Analysis results |
|---|---|---|
| *'Expected'* (color-coded in the tool as "green cells") | Account combinations that are expected to occur under the applicable financial reporting framework for the respective industry. | Prior to using the AA capability, we review the pre-determined expectations to confirm that the expected account combinations are appropriate for the entity.<br>The expected account combinations may support our understanding of the entity's accounting processes in recording transactions through the general ledger.<br>For further information about how we review the pre-determined expectations, see activity 'Confirm the pre-determined expectations'. |
| *'Unexpected'* (color-coded in the tool as "red cells") | Account combinations that are not expected to occur under the applicable financial reporting framework for | The analysis, understanding and audit response to an 'unexpected' account combination vary depending on the underlying cause. |

| | | |
|---|---|---|
| | the respective industry could be due to:<br>• Entity's accounting treatments that differ from those considered in the pre-determined expectations,<br>• Previously unknown process activities at the entity, or<br>• Misstatements. | For further information about how we address unexpected account combinations, see activities:<br>• 'Confirm the pre-determined expectations';<br>• 'Determine consequential unexpected account combinations'; and<br>• 'Analyze consequential unexpected account combinations'. |
| *'Unique'* (color-coded in the tool as "grey cells") | Account combinations involving accounts for which no pre-determined expectations have been defined, such as:<br>• accounts with increased complexity (e.g. Derivatives) and/or<br>• accounts where the extent of possible account combination relationships is too broad to provide meaningful results (e.g. Intercompany receivables and payables) | We use our understanding of the entity, including our assessment of fraud risk factors, and apply professional judgment in determining whether to perform any specific analysis of 'unique' account combinations. |
| *'Same account'* (color-coded in the tool as "black cells") | Account combinations resulting from debits and credits to the same account. | We use our understanding of the entity, including our assessment of fraud risk factors, and apply professional judgment in determining whether to perform any further analysis of 'same account' account combinations. |
| *'Unbifurcated'* (color-coded in the tool as "purple cells") | Journal entries or components of journal entries that could not be further disaggregated into | Unbifurcated entries are not associated with any pre-determined expectations regarding the level of risk in the underlying entries. |

| | | |
|---|---|---|
| | account combinations are identified as 'unbifurcated'.<br><br>For every account, all debits and all credits to the account resulting from unbifurcated journal entries are summarized and displayed separately in a credit and a debit cell and labeled as 'unbifurcated'. | We apply our understanding of the entity and our professional judgment in determining whether to perform any specific analysis of unbifurcated journal entries. |

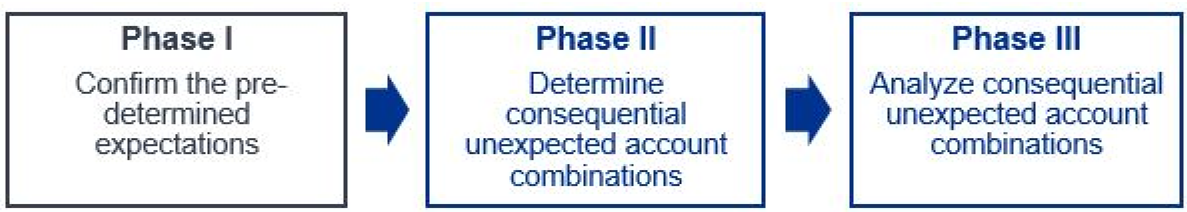
### How do we address the Account Analysis capability results? [ISA | 4576.1400]

We address the results of the Account Analysis capability (AA capability) by following the Account Analysis results evaluation approach. This is a phased approach that includes a logical sequence of activities to facilitate our:

- understanding the entity's accounting processes and recording of transactions,
- identifying and assessing potential risks of material misstatement, and
- determining an audit approach that is specifically responsive to such risks.

### What are the phases in the Account Analysis results evaluation approach? [ISA | 4576.1500]

The Account Analysis results evaluation approach includes the following three sequential phases:




# 1.2.1 Confirm the pre-determined expectations [ISA | 4577]

## What do we do?

Confirm the applicability of the pre-determined expectations used in the Account Analysis capability to the entity's specific circumstances in Phase I of the Account Analysis results evaluation approach

## Why do we do this?

The Account Analysis capability determines whether the processed journal entries reflect "expected", "unexpected" or other account combinations. This determination is based on pre-determined expectations about how transactions are recorded, generally relevant to the entity's industry and financial reporting framework. Phase I of the Account Analysis results evaluation approach allows us to confirm that the pre-determined expectations are applicable to the specific entity's circumstances, and to modify the related account combinations classifications — i.e. expected or unexpected as appropriate.

# Execute the Audit

### How do we confirm the pre-determined expectations? [ISA | 4577.1300]

To confirm the pre-determined expectations, we:

- Understand what the pre-determined expectations are.
- Based on our understanding of the entity's processes, identify differences between how the entity accounts for transactions and the pre-determined expectations.
- Determine how those differences affect the related pre-determined account combinations classifications — i.e. "expected" or "unexpected" and modify such classifications as appropriate.

#### When is it appropriate to modify the pre-determined classifications?

The purpose of a classification modification is for the AA capability results to represent a more accurate alignment to an entity's specific circumstances.

- We modify pre-determined classifications when we identify pre-determined expectations that do not apply to the entity's specific circumstances.

  *For example, the pre-determined expectation for our entity's industry and financial reporting framework assumes that all recognized revenue generates trade receivables. However, under one of the entity's specific business operations, revenue is recognized only through cash sales. In these circumstances, we modify 'debit to Cash and cash equivalents / credit to Revenue' to "expected".*

- When modifying a pre-determined classification for an account combination, we also consider modifying any other 'related' account combination classifications as appropriate.

  *Referring to the previous example, when we modify 'debit to Cash and cash equivalents / credit to Revenue' to "expected", at the same time we modify the 'related' account combination 'debit to Trade receivables / credit to Revenue' to "unexpected" for this particular business operation.*

- When the entity's accounting treatment relative to certain transactions is not appropriate under the relevant accounting framework, we do not modify the pre-determined classification.

  *For example, if the entity capitalizes advertising costs in inventory when this is not considered appropriate under the relevant financial reporting framework, the corresponding pre-determined "unexpected" account combination (debit to Inventory / credit to Advertising and marketing expenses) should NOT be modified to "expected".*

### What are some differences between the entity's business and accounting processes and the account analysis pre-determined expectations? [ISA | 4577.1400]

- Differences may exist regarding pre-determined expectations as to how transactions are recorded for the respective industry as compared to how these are actually recorded by the entity.

  *For example, pre-determined expectations assume that inventories are recorded through the balance sheet and 'debit to Inventory / credit to Trade Payables' is the "expected" account* *combination to record purchases of inventory. However, the entity may record purchases of Inventory throughout the year by 'debiting Cost of Sales / crediting Trade Payables' and adjust the related inventory account against Cost of Sales based on periodic inventory counts.*

- Differences may exist due to transactions that pre-determined expectations assume as atypical for the industry's business operations which are, in fact, typical for the particular entity.

  *For example, pre-determined expectations for the entity's industry may assume that recognized revenue generates a trade receivable; accordingly, the account combination 'debit to Cash and cash equivalents / credit to Revenue' is pre-determined as "unexpected". However, the entity may instead have cash sales and the referred account combination is in fact "expected" for the entity.*

- Pre-determined expectations focus mainly on transactions resulting from 'routine' processes — e.g. sales, purchases, payroll, etc.; as a result, transactions from 'non-routine' processes are "unexpected" by default.

  *For example, transactions regarding convertible bonds are not specifically considered in pre-determined expectations. As a result, the account combination 'debit to Loans and borrowing / credit to Share capital' is "unexpected". Where the entity transacts with convertible bonds on a recurring basis, the referred account combination is in fact "expected".*

# 1.2.2 Determine consequential unexpected account combinations [ISA | 4578]

## What do we do?

Determine consequential unexpected account combinations for further analysis in Phase II of the Account Analysis results evaluation approach.

## Why do we do this?

When using the Account Analysis capability and evaluating its results, we focus our analysis on unexpected account combinations that may result in risks of material misstatement. Accordingly, we determine which of those unexpected account combinations are consequential for the purpose of our audit.

## Execute the Audit

### How do we determine which unexpected account combinations are consequential? [ISA | 4578.1300]

When determining whether unexpected account combinations are consequential individually or in the aggregate, we consider both relevant quantitative and qualitative factors, including:

- unexpected account combinations with amounts above AMPT are ordinarily considered consequential
- unexpected account combinations whose characteristics may be considered as indicative of a fraud risk (see chapter on fraud (ISA 240, AU-C 240, AS 2401), bias and/or ineffective controls,

maybe determined to be consequential, even when their monetary amount is quantitatively inconsequential.

> For example, there is an unexpected account combination that shows a total amount below AMPT, which we may initially consider to be inconsequential. However, let's assume we have identified a fraud risk related to revenue recognition and that the unexpected account combination includes a credit to Revenue. In this instance, we may instead consider this unexpected account combination as consequential, given its connection to a fraud risk, and subject it to further analysis.

When there is uncertainty about whether an unexpected account combination is inconsequential or not, the account combination is considered consequential.

For unexpected account combinations that are inconsequential, we do not perform further analysis for the purpose of the Account Analysis capability.

How do we determine whether an unexpected "secondary account combination" is quantitatively consequential?

Secondary account combinations do not represent a population resulting from a complete processing of all journal entries for the analyzed period, accordingly, the quantitative assessment is not possible solely from the results of this analysis. The evaluation of unexpected secondary account combinations may involve the use of additional information to assist in the quantification assessment — e.g. we may use the Journal Entry Analysis capability to assess the existence of additional entries involving the same accounts as those involved in the secondary account combinations.

Absent additional information to allow for the quantification assessment of unexpected secondary account combinations, these are treated as consequential and subject to further analysis.

# 1.2.3 Analyze consequential unexpected account combinations [ISA | 4579]

## What do we do?

Analyze consequential unexpected account combinations in Phase III of the Account Analysis results evaluation approach.

## Why do we do this?

When using the Account Analysis capability and evaluating its results, we obtain an understanding of the nature and cause of these account combinations after we determine which unexpected account combinations are consequential. This understanding facilitates our identification and assessment of potential risks of material misstatement and our determination of an audit approach that is specifically responsive to those risks.

## Execute the Audit

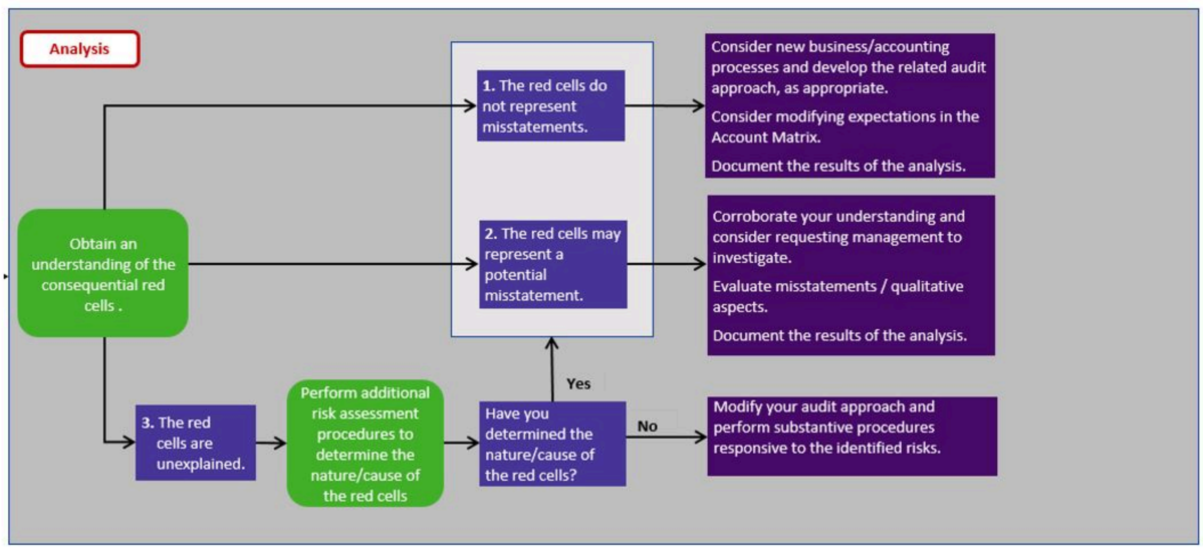
## How do we obtain an understanding of the nature and cause of consequential unexpected account combinations? [ISA | 4579.1300]

In obtaining our understanding of an unexpected account combination, we consider relevant aspects of the original journal entries resulting in such account combinations and use a combination of risk assessment procedures that include inquiry, observation and inspection, as appropriate. Inquiry alone may not be sufficient to achieve our understanding.

Based on the evidence obtained from this analysis and our knowledge of the entity, we determine whether an unexpected account combination:

- does not represent a misstatement,
- may represent a potential misstatement, or
- remains unexplained.

The flowchart below illustrates the activities we perform and our responses when analyzing consequential unexpected account combinations:




### What do we do when an unexpected account combination does not represent a misstatement?

When an unexpected account does not represent a misstatement, it may be due to either:

| Potential cause | How we respond |
|---|---|
| A business/accounting process previously unknown | • Update our understanding of the process activities and consider whether there are new RMMs to identify and assess as part of our audit plan.<br>• Modify related pre-determined expectations to adapt those to the specific entity's business/accounting process that were previously unknown (see activity 'Confirm the pre-determined expectations'). |

| | |
|---|---|
| Other causes, for example:<br>• An inappropriate mapping of the entity's general ledger accounts to the accounts used by the Account Analysis capability (AA capability)<br>• A non-recurring transaction we do not normally expect in the entity/industry, but may be determined appropriate in the circumstances | • Modify mapping accordingly and reprocess Account Analysis when the cause is inappropriate mapping<br>• Consider whether it is appropriate to modify expectations<br>• Think about qualitative aspects, if any<br>• Consider whether it is appropriate to modify expectations<br>• Think about qualitative aspects, if any |

### What do we do when an unexpected account combination is likely to represent a misstatement?

When an unexpected account combination is likely to represent a misstatement, we:

- Identify relevant RMMs, as appropriate
- Consider corroborating our understanding by performing additional inspection of supporting evidence over the journal entries leading to the unexpected account combination
- Consider requesting that management investigate and make necessary adjustments
- Evaluate the misstatement(s)
- Consider including the originating journal entries in the relevant population of 'high-risk' journal entries and test them accordingly when the characteristics of the unexpected account combination are associated to high-risk criteria. See activity 'Identify and select journal entries and other adjustments for testing'.

### What do we do when an unexpected account combination remains unexplained?

There may be instances where our initial analysis may not be conclusive and the unexpected account combination remains unexplained. In these circumstances, we perform additional risk assessment procedures to determine the nature and cause of the unexpected account combination.

After performing the additional risk assessment procedures, we may be able to determine the nature and cause of the unexpected account combination. This will allow us to determine whether an unexpected account combination may represent a potential misstatement or not, and follow the additional steps, as applicable.

If after performing the additional risk assessment procedures, we are not able to determine the nature and cause of the unexpected account combination, we identify relevant RMMs, as appropriate, and respond to the identified risks by modifying the audit approach and planning substantive procedures over the transactions leading to the unexpected account combination.

### When do we perform substantive procedures responding to unexpected account combinations?

We may perform substantive procedures responding to unexpected account combinations:

- at the time the AA capability is used and the combination is identified, or
- later in the audit when we perform other planned procedures over the related RMMs.

For example:

- The Account Analysis results include the following unexplained unexpected account combination: 'Debit to PPE - Credit to Advertising and marketing expenses'.
- As part of the audit procedures responding to RMMs related to Existence and Accuracy of PPE, we planned to perform a substantive test of PPE additions and we now decide to specifically include the transactions captured in the unexpected account combination in the items to be tested.
- After performing the planned procedure, we determine whether the items and amounts in the unexpected account combination have been appropriately addressed.

### What substantive procedures may we perform to test the journal entries that led to the unexpected account combinations?

Substantive procedures performed to test the journal entries that led to the unexpected account combinations may include:

- Obtaining appropriate supporting evidence as to the validity of the transactions.
- Comparing to the prior period and assessing whether it remains appropriate, when the item is a recurring journal entry.
- Assessing whether the journal entry:
  - Reflects the underlying events and transactions
  - Has been recorded in the correct accounting period at appropriate amounts
  - Has been recorded to the correct general ledger accounts (or has been included in the appropriate financial statement captions)
  - Is consistent with the entity's accounting policies.
- Identifying and addressing any qualitative considerations, if applicable (e.g., indication of potential control failure, potential fraud risk). If the characteristics of the unexpected account combinations are associated to high-risk criteria, we include the related journal entries in the relevant population of 'high-risk' journal entries and test them accordingly. See activity 'Identify and select journal entries and other adjustments for testing'.
- Consider requesting management to specifically investigate the journal entries resulting in the unexpected account combinations.

### What do we think about when analyzing an unexpected "secondary account combination"?

"Secondary account combinations" do not represent a population resulting from a complete processing of all journal entries for the analyzed period. As part of the analysis over an unexpected secondary account combination, we evaluate the risk of other journal entries resulting in the same account combination and respond accordingly. This may be achieved by performing additional analysis, including:

- using the Journal Entry Analysis capability to identify and analyze additional journal entries involving the same accounts in the secondary account combination (see activity 'Use the JEA capability when electronic data is available');

- performing other risk assessment procedures, as appropriate to the specific entity and engagement circumstances — e.g. other types of planning analytical procedures; or
- where we believe Account Analysis is able to provide relevant and/or meaningful information on the specific accounts involved in the unexplained secondary account combination, selecting those accounts to be analyzed through the AA capability.

### What may we consider when analyzing the nature and cause of the unexpected account combinations?

[ISA | 4579.1400]

| Relevant aspect to consider | Examples and other considerations |
|---|---|
| Nature of the account involved in an unexpected account combination | For example, unexpected account combinations involving:<br>• accounts with a history of misstatements in the prior year(s)<br>• accounts related to potential fraud risks — e.g. Revenue, Cash. |
| Risk of potential misstatement resulting from an unexpected account combination | For example, consider if the unexpected account combination may:<br>• potentially overstate Income — i.e. unexpected credits to Income accounts<br>• potentially overstate Assets — i.e. unexpected debits to Asset accounts<br>• potentially understate Expenses — i.e. unexpected credits to Expense accounts<br>• potentially understate Liabilities — i.e. unexpected debits to Liability accounts. |
| Characteristics of journal entries resulting in an unexpected account combination | • For example, and depending on the data imported from the entity's system:<br>- Posting period — e.g. unexpected account combinations resulting from journal entries posted at period end<br>- Entry type — i.e. automated/manual<br>- JE line items — e.g. unexpected account combinations resulting from journal entries with > XX line items<br>- Underlying entity's general ledger accounts<br>- User name — e.g. unexpected account combinations resulting from journal entries recorded by a specific user.<br>• The characteristics of the original journal entries resulting in unexpected account combinations is also relevant in determining the appropriate extent of the investigation:<br>- Where the original journal entries show identifiable common patterns — e.g. resulting from an automated |

| | |
|---|---|
| | batch entry processed at each month-end for the same amount, it may be sufficient to test one or a limited number of such journal entries in order to obtain understanding over all of them.<br>- Otherwise, where the original journal entries have different characteristics — e.g. manual and automated entries recorded on non-recurring dates and for different amounts we may consider testing individually, each different type of journal entry.<br>• Where patterns identified for the original entries resulting in unexpected account combinations include indicators of potential management bias or fraud, the extent of our investigation is increased and we include the related journal entries in the relevant population of 'high-risk' journal entries and test them as appropriate. |

# 1.3 Consider the analytical procedures applied during interim review engagements [ISA | 549]

## What do we do?

IF we performed an interim review, THEN take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures

## Why do we do this?

We perform many of the more common planning analytical procedures as part of our interim reviews.

These analytics can help us identify items that appear to be unusual and that indicate a potential RMM. We use our interim findings when we plan our risk assessment procedures, and supplement them with additional procedures as necessary.

## Execute the Audit

How do our interim review analytical procedures differ from those performed for risk assessment? [ISA | 549.1300]

Our interim review analytical procedures and our planning analytical procedures are quite similar. They both involve comparisons of recorded amounts - or ratios developed from recorded amounts - to expectations that we develop.

However, the objectives of our analyses during an interim review (identifying items that may reflect material misstatements) may be different from those of our planning analytical procedures (identifying areas that might represent specific RMMs relevant to the audit).

Can we simply use our interim review analytical procedures for risk assessment? [ISA | 549.1400]

The analytical procedures from our interim review may be sufficient for risk assessment, depending on the timing of those procedures and the specific analyses we perform.

Because of the differences in objectives of our analyses, if interim review analytical procedures are not performed with risk assessment in mind, we may need to perform additional planning analytical procedures to meet the objective for risk assessment.

In addition, our interim review analytical procedures may be performed too late in the year to be helpful during risk assessment, e.g. interim review on half-year numbers when risk assessment was done earlier in the year.

### What if we learn new information during a subsequent interim review? [ISA | 549.1500]

Similar to other information, we consider what we learn and whether it contradicts or corroborates our original risk assessment.

This includes information we learn during interim reviews we perform after our risk assessment procedures.

# Example

### How might the results of analytical procedures performed during our interim reviews impact our risk assessment? [ISA | 549.1600]

The table below sets out examples of information we may gather from our interim reviews, and how that might help us identify and assess RMMs.

| What our review of analytical procedures identified | How that might help us identify and assess RMMs |
|---|---|
| An increase in debt or equity balances | The entity may have issued new debt during the period, or entered into an equity transaction.<br>We may identify an RMM related to the accounting for new debt or equity instruments. |
| Significant swings in revenue between quarters | We may identify that revenue is recognized based on subjective criteria, and increases in periods in which a bonus is calculated.<br>We may identify an RMM that revenue is not being recognized appropriately, or a fraud risk related to revenue recognition. |
| An increase in professional fees in a quarter | The entity may not have accrued costs for the outcome of litigation, or it might be connected to a tax investigation.<br>We may identify an RMM related to the valuation of uncertain tax position liabilities. |

# 1.4 Use our understanding of the entity to develop expectations about plausible relationships [ISA | 550]

## What do we do?

Use our understanding of the entity to develop expectations about plausible relationships among the data to be used in the analytical procedure

## Why do we do this?

Relationships can exist between financial data and other financial data, and between financial and non-financial data.

Where plausible relationships exist, we expect them to continue to exist, unless something disturbs the relationship. This allows us to develop an expectation.

If, when we compare our expectations to recorded amounts, we get unusual or unexpected results, this can yield information that's relevant when we identify and assess the risks of material misstatement (RMMs).

## Execute the Audit

### What data might we use in our analytical procedures? [ISA | 550.1300]

We may use both financial and non-financial data when we perform analytical procedures. For example, we may use financial data from the entity's financial statements, and we may also use non-financial data such as the locations in which it operates, number of employees, etc.

### How do we identify relevant data to consider in our analytical procedures? [ISA | 550.1400]

We consider our understanding of the entity and the results of our other risk assessment procedures to identify relevant data we can use in our analytical procedures.

We may have access to a significant amount of data, but not all of it will be relevant or have a plausible relationship that will help us perform our analytical procedures. So we focus on data where relationships are likely to exist. In many cases, the measures that have the biggest impact on the entity are the same measures analyzed by the entity and its stakeholders.

For example, by performing our risk assessment procedures we understand performance measures including those which are:

- followed by management, analysts and other third parties; and
- used in compensation arrangements and through covenants included in debt arrangements.

These performance measures are likely to point us to relevant data we can use in our analytical procedures.

For example, after observing a retail entity's earnings calls and having read several analysts' reports, the engagement team learned that the entity's investors and analysts are focused on the same store sales.

> Consequently, the team identified sales and the number of stores as relevant data to be used in their analytical procedures.

### What is a 'plausible relationship'? [ISA | 550.1500]

A plausible relationship is an expected relationship between financial data and other financial data, or financial data and non-financial data.

We base an expected relationship on our understanding of the entity, the industry or past experience. These relationships can be expressed in various ways, including for example:

- simple comparisons of recorded amounts;
- financial ratios that we can compare; or
- predetermined expectations around account combinations used in the Account Analysis capability.

For example, we normally expect a relationship between sales and accounts receivable, whereby accounts receivable increase as sales increase. Similarly, we expect a revenue transaction to generate a debit to accounts receivable and a credit to revenue. And in a brick and mortar retail environment, we may expect a relationship between sales and retail square feet.

Where these plausible relationships exist, we expect them to continue to exist, unless something happens to disturb the relationship. This means that if the types of sales-generating activities remain the same, we might expect accounts receivable to increase as sales increase. Conversely, we might expect accounts receivable to decrease as sales decrease.

### How do we develop our expectations of plausible relationships? [ISA | 550.1600]

We develop our expectations of plausible relationships by using our understanding of the entity, including any information we may have learned from our other risk assessment procedures — e.g. changes that have happened in the business.

> For example, we may compare sales from the current and prior periods, and develop a general expectation for the accounts receivable balance.
>
> If, however, our risk assessment procedures revealed that the entity was making significantly more cash sales than in the past, we would likely adjust our expectation of the relationship between sales and accounts receivable accordingly.

### What do we do with our expectations of plausible relationships? [ISA | 550.1700]

We compare our expectations of plausible relationships with relationships derived from the entity's recorded amounts.

We consider whether our expectations align with the relationships from the entity's recorded amounts, or if they produce unusual or unexpected results.

Plausible relationships are expected to exist and continue unless something disturbs the relationship. Therefore, a relationship based on recorded amounts that does not match our expectation might suggest an RMM or unusual event that may warrant investigation.

> Consider an entity that has historically generated most of its sales through wholesale distribution channels. If that entity begins to sell its products through retail stores, it may generate significantly more cash sales than in the past.
>
> This change may disturb the relationship between sales and accounts receivable, because the entity will now have more sales without corresponding accounts receivables (since the sale was made for cash).

### How do we determine the relevance and reliability of the data we use? [ISA | 550.1800]

#### How do we determine relevance? [ISA | 550.11503]

We determine the relevance of the data we use to develop plausible relationships based on our understanding of the entity and the financial statement data that is key to the entity's operations.

'Relevance' connects back to the nature of our analytical procedures, and whether the data helps us understand a plausible relationship that exists. We do not use data unless it's relevant to our procedure.

#### How do we determine reliability? [ISA | 550.11504]

We determine the reliability of the data through inquiry with management, or through other procedures to consider the source of the information.

Inquiry of management may sometimes be sufficient - e.g. it may help us confirm that the data we are using came directly from the entity's general ledger system, which has general IT controls in place.

For other data, we may perform additional procedures to determine its source and establish its reliability before we use it, such as observing management generating the data. For additional guidance, refer to the following guidance in the Audit Evidence chapter - 'Determine the appropriate audit procedures to address the reliability of the information'.

#### What level of evidence do we use to determine relevance and reliability in a risk assessment procedure? [ISA | 550.11505]

The evidence we use to determine the relevance and reliability of the data in a risk assessment procedure may be less than what we use when testing a control or performing a substantive procedure (including a substantive analytical procedure).

# Example

### What plausible relationships might exist between data? [ISA | 550.2000]

The table below sets out examples of plausible relationships that may be relevant to our analytical procedures.

| Example of plausible relationship | Type of relationship |
|---|---|
| Sales and accounts receivable:<br>• as sales increase, we expect accounts receivable to increase | General relationship between accounts |

| | |
|---|---|
| • as sales decrease, we expect accounts receivable to decrease | |
| Accounts receivable turnover:<br>• sales ÷ accounts receivable | Financial ratio |
| Personnel cost per employee — average payroll-related costs per employee:<br>• personnel cost ÷ number of employees | Ratio based on financial and non-financial data |
| Days' sales outstanding:<br>• (accounts receivable ÷ sales) x days in period | Financial ratio |
| Sales and cost of sales:<br>• as sales increase, we expect the cost of sales to increase | General relationship between accounts |
| Gross profit margin - i.e. gross profit as a percentage of sales:<br>• (sales - cost of sales) ÷ sales<br>• we expect gross profit margin to remain constant, absent known changes — e.g. an increase in sales prices | Financial ratio |
| Selling price per unit - average selling price per sales unit:<br>• sales ÷ number of items sold | Ratio based on financial and non-financial data |
| Inventory turnover:<br>• sales ÷ inventory | Financial ratio |
| Days sales in inventory:<br>• (inventory ÷ cost of sales) x days in period | Financial ratio |

# 1.5 Consider unusual or unexpected results in identifying and assessing RMMs [ISA | 551]

## What do we do?

IF comparison of our expectations with the recorded amounts yields unusual or unexpected results, THEN take those results into account in identifying and assessing risks of material misstatement.

## Why do we do this?

We compare our expectations of plausible relationships that exist between data with relationships derived from recorded amounts.

When the comparison yields unusual or unexpected results, this may indicate the existence of a potential RMM.

We therefore consider unusual or unexpected results, so that:

- we don't fail to identify and assess an RMM; and
- we develop an appropriate audit response.

## Execute the Audit

### How do we consider or take into account unusual or unexpected results in identifying and assessing RMMs? [ISA | 551.1300]

We consider unusual or unexpected results by:

- understanding the reasons for the results - e.g. inquiring of management or other relevant entity personnel; and/or
- obtaining additional evidence to explain the reasons for the results; and
- identifying possible RMMs, as necessary.

Unusual or unexpected results may mean that there is an RMM we have not previously identified.

For example, we may be prompted to investigate if we notice that:

- sales increased without a corresponding increase in accounts receivable; or
- there was an increase in accounts receivable that did not correspond with the increase in sales.

We may inspect additional documentation and inquire of management to help us:

- better understand why the results differ from our expectations; and
- identify and assess RMMs that are relevant to the audit.

This helps us to figure out the 'why?' — i.e. we seek the information that tells us *why* the recorded amounts did not meet our expectations.

When using the Account Analysis capability, we analyze unexpected account combinations according to the Account Analysis results evaluation approach (see activity '<u>Evaluate the Account Analysis results when the AA capability is used</u>'.

## Example

### How might the results of our planning analytical procedures affect our identification and assessment of RMMs? [ISA | 551.1400]

The table below sets out examples of how the results from our planning analytical procedures might affect how we identify and assess RMMs.

| Results of planning analytical procedures | How these might affect our identification and assessment of RMMs |
|---|---|
| Revenue has decreased and accounts receivable have increased when we would have expected them to also decrease | • This may indicate that the entity has trouble collecting certain debts, and we may identify an RMM related to the recording of the allowance for doubtful accounts.<br>• This may also indicate that the entity has entered a new line of business, and may have changed the customer base or methods of distribution. These changes may affect the way the entity recognizes revenue, and we may identify an RMM related to the recording of revenue. |
| Gross margin percentage has increased from the prior period (revenue increased by 35%; cost of sales decreased by 10%) | • We may identify an RMM that revenue is being recognized in advance of meeting the requirements under the accounting standards.<br>• Alternatively, this may indicate that there is an issue with how costs are recorded/accrued, and we may identify RMMs related to the recording of expenses and liabilities.<br>• Or we may find out that this is simply because the entity raised its prices while costs remained the same — in which case we may not identify additional RMMs. |
| Gross margin has decreased from the prior period (revenue increased by 10%; cost of sales increased by 20%) | • This could result from many circumstances, such as introducing a new product line that is not profitable. In that case, the entity may feel pressure to meet certain sales targets, and may want to recognize revenue without meeting the criteria.<br>• We may identify this as a fraud risk factor or an RMM that revenue is being recognized before the accounting standards' requirements are met. |
| Unfavorable change in the inventory turnover ratio from the prior period | • The entity may have released a new product, indicating that other inventory items are obsolete and need to be written off. Therefore, we may identify an RMM related to the valuation of inventory.<br>• Alternatively, this may indicate that sales are slower than in the past, and that there is an excess of inventory that may need to be covered by a valuation reserve. Therefore, we |

| | |
|---|---|
| | may identify a separate RMM related to the valuation of inventory. |
| Payroll expense has increased from the prior period, and this increase is not commensurate with either sales or headcount | • This may indicate that the entity has awarded bonuses or has other payroll-related expenditures that we were previously unaware of.<br>• We may identify RMMs based on the terms of the bonus, relating to:<br>- the timing of recognition<br>- the calculation of the amount<br>- the fraud risk related to the targets on which the bonus is based, etc. |

# Risk Assessment Procedures and Related Activities - Other Information

## International Standards on Auditing: ISA 240.24

### *Other Information*

24. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A23)

## ISA Application and Other Explanatory Material: ISA 240.A23

### *Consideration of Other Information* (Ref: Para. 24)

A23. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment, the applicable financial reporting framework and the entity's system of internal control may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks.
In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Consider other information relevant to identifying and assessing RMMs [ISA | 540]

# What do we do?

Consider whether information from the client and engagement acceptance and continuance process, audit planning, past audits and other engagements is relevant to identifying and assessing risks of material misstatement

# Why do we do this?

Information that can help us during risk assessment can come from a variety of sources other than the entity, its environment and its internal controls. For example, we may learn useful information through:

- our client acceptance and continuance (retention) process;
- audit planning; and
- our experience with the entity on past audits or other engagements.

We use this additional information to help us identify and assess risks of material misstatement (RMMs).

# Execute the Audit

### How do we consider other information relevant to identifying and assessing RMMs? [ISA | 540.11439]

We follow the below steps. Details of each step is outlined in the respective activities:

- Consider information from the CEAC process and audit planning in identifying and assessing RMMs;
- Consider information from past audits in identifying and assessing RMMs;
- Evaluate the relevance and reliability of information from past audits; and
- Consider information from other engagements in identifying and assessing RMMs.

The types of risks of material misstatement considered are due to fraud and/or error.

# Evaluation of Fraud Risk Factors and Identification and Assessment of the Risks of Material Misstatement Due to Fraud

# International Standards on Auditing: ISA 240.25-28

## *Evaluation of Fraud Risk Factors*

25. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A24-A28)

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

26. In accordance with ISA 315 (Revised), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.[9]

9 ISA 315 (Revised), paragraph 25

27. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 48 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A29-A31)

28. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A32-A33)

# ISA Application and Other Explanatory Material: ISA 240.A24-A33

## *Evaluation of Fraud Risk Factors* (Ref: Para. 25)

A24. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A25. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A26. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Fraud risk factors may relate to incentives, pressures or opportunities that arise from conditions that create susceptibility to misstatement, before consideration of controls. Fraud risk factors, which include intentional management bias, are, insofar as they affect inherent risk, inherent risk factors.[98] Fraud risk factors may also relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalize fraudulent actions. Fraud 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 through, for example, the required understanding of the entity's control environment.[99] 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.

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98 ISA 315 (Revised 2019), paragraph 12(f)

99 ISA 315 (Revised 2019), paragraph 21

A27. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

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

### Considerations Specific to Smaller Entities

A28. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

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

## *Risks of Fraud in Revenue Recognition* (Ref: Para. 27)

A29. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A30. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A31. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where a there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

### *Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls* (Ref: Para. 28)

A32. Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.[19] 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.

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19 ISA 315 (Revised), paragraph A56

A33. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In identifying the controls that address the risks of material misstatement due to fraud, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from identifying these controls, and evaluating their design and determining whether they have been implemented, may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Identify fraud risks [ISA | 568]

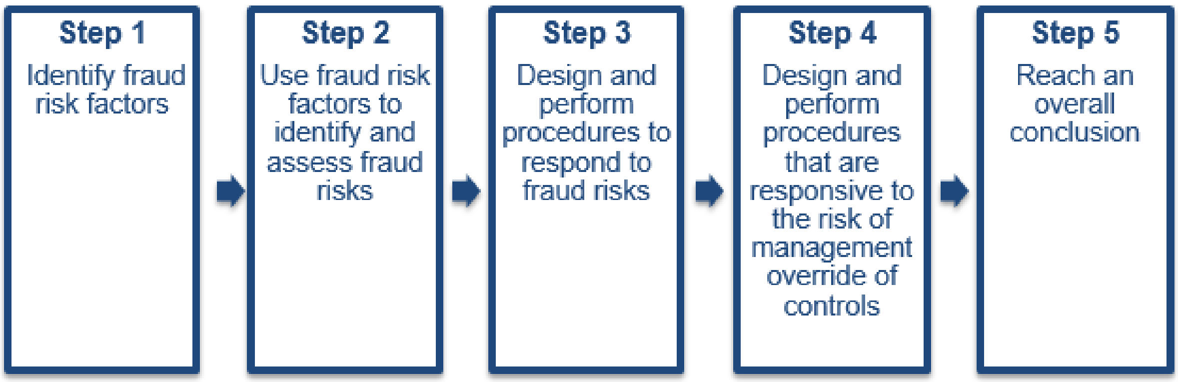
## What do we do?

Identify fraud risks using a five-step process

## Why do we do this?

Identifying fraud risks is a specific part of how we identify and assess RMMs. We take the information we gathered through our risk assessment procedures and use it to focus in on those risks that represent fraud risks.

We use a five-step process to identify, assess and respond to fraud risks in the audit.




Steps 1 and 2 help us to identify fraud risks: first we identify fraud risk factors; then we consider whether those factors indicate the presence of a fraud risk, and whether other fraud risks may be present.

We treat fraud risks differently than risks of error. So our conclusions about fraud risks drive a different audit approach that includes evaluating the design and implementation of controls, and performing tests of details that specifically respond to those fraud risks.

# Execute the Audit

### How do we identify fraud risks? [ISA | 568.11458]

We follow the below steps. Details of each step are outlined in the respective activities:

- Identify fraud risk factors;
- Use fraud risk factors to identify and assess fraud risks;
- Presume that there is a fraud risk involving improper revenue recognition;
- Identify the risk of management override of controls as a fraud risk.

# 1.1 Identify fraud risk factors [ISA | 569]

## What do we do?

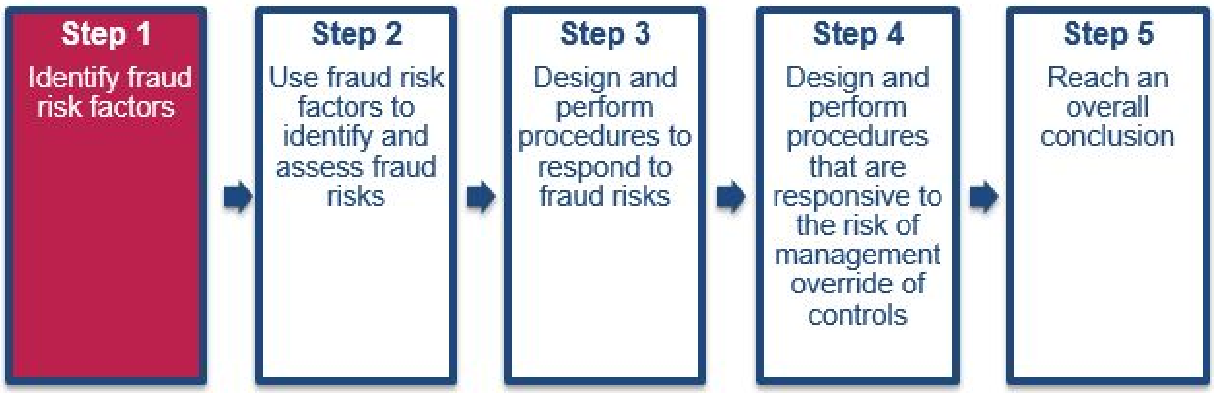
Evaluate whether the information obtained from the risk assessment procedures indicates that one or more fraud risk factors are present.

## Why do we do this?

As auditors, we have a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Therefore, our audits focus on risks not only related to error, but also to fraud.

Fraud may be difficult for us to detect because it is intentional and can be concealed by management. Evaluating circumstances that might lead to a fraud helps us better identity the fraud risks we will address in our audit.

The first step in our five-step process for identifying and responding to fraud risks is to identify fraud risk factors.




# Execute the Audit

## What are fraud risk factors? [ISA | 569.11964]

Fraud risk factors can cover a broad range of events and conditions. They are specific events and conditions we observe or identify that promote or foster an environment where fraud could occur.

Understanding these factors helps us consider where fraud risks may exist that call for a specific audit response.

Identifying fraud risk factors does not necessarily mean that fraud exists or will eventually occur. But these factors are often present in circumstances in which fraud exists.

| Category of fraud risk factor | Description | Example |
|---|---|---|
| Incentive or pressure | Why someone might commit fraud | An employee may be in financial distress (internal incentive), or management may be under extreme pressure to meet financial targets (external incentive). These situations can be a catalyst for committing the fraud, and could be internal or external to the entity or the person committing the fraud. |
| Opportunity | The 'setting' that helps someone commit fraud | Deficiencies in CERAMIC or poorly designed control activities can make it easier for an individual to carry out fraud. |
| Attitude or rationalization | The state of mind that helps justify | Management's attitude that the entity will meet its targets at all costs, or a justification claiming that the fraud doesn't really harm anybody. |

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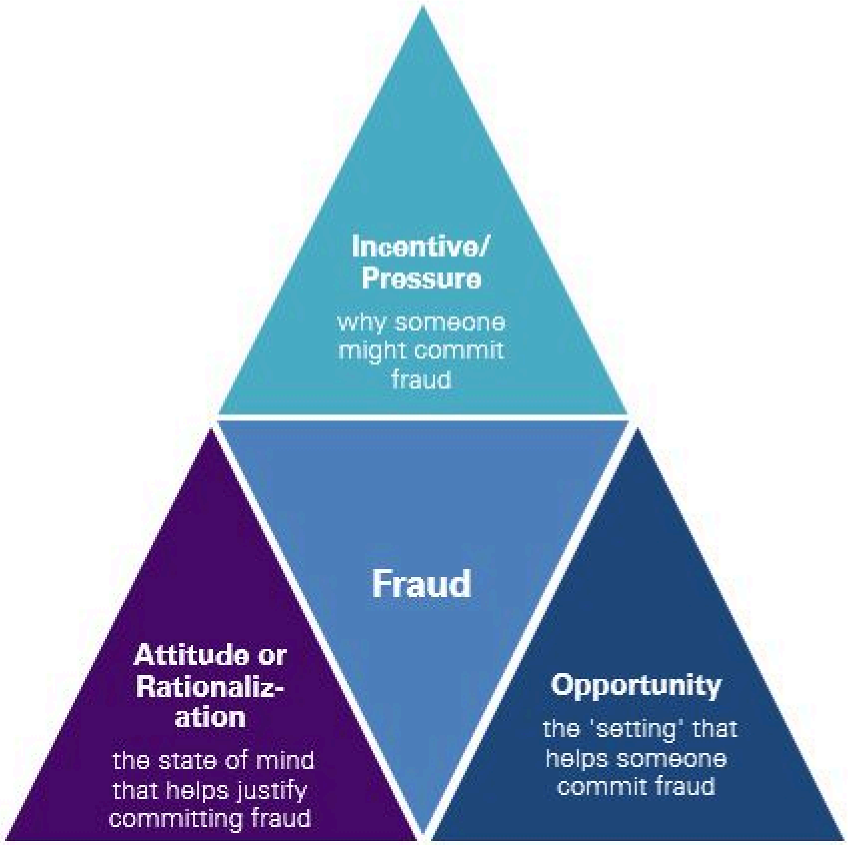
| | committing fraud | |

These three categories of fraud risk factors form the fraud triangle.




What are the examples of fraud risk factors related to fraudulent financial reporting? [ISA | 569.7462]

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

| Conditions for fraud | Types of fraud risk factors | Examples of fraud risk factors |
|---|---|---|
| **Incentives / pressures** | Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by): | High degree of competition or market saturation, accompanied by declining markets |
| | | 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 |

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| | | Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent |
| | | Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth |
| | | Rapid growth or unusual profitability especially compared to that of other companies in the same industry |
| | | New accounting, statutory, or regulatory requirements |
| | Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following: | Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages |
| | | Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures |
| | | Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements |
| | | Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards |
| | | A need to achieve financial targets required in bond covenants |
| | | Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both |

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| | | Significant transactions with no economic justification, intended to meet short-term earnings goals |
| | | For listed entities: demonstrated history of closely meeting earnings estimates, unusually high price/earnings ratios for its industry, or unexplained trend or pattern in short positions in the entity's stock |
| | 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<br>(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) |
| | | Personal guarantees of debts of the entity |
| | | Large individual sales of the entity's shares by senior management (e.g., insider trading) |
| | | Significant related party loans without a clear business purpose |
| | 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 | Management's past performance indicates they are rarely able to meet goals and are consistently managing by crisis |

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| **Opportunities** | The nature of the industry, the entity's significance/ influence in its local and regional economy/ government, 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 or geographic region 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 |
| | | Overly complex banking arrangements given the nature and size of operations, including significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification |
| | | Contractual arrangements lacking a business purpose |
| | | The entity engages in bill and hold or other non-standard transactions |
| | | Significant, unusual, or highly complex investments, including equity method investees, joint ventures and variable interest entities, especially those that pose difficult 'substance over form' questions |

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| | The monitoring of management is not effective as a result of the following: | Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls |
| | | Oversight by those charged with governance over the financial reporting process and internal control is not effective |
| | | The exertion of dominant influence by or over a related party |
| | | Failure by those charged with governance and key members of the finance function to act as a control in the event that senior management seeks to override established controls or take overly aggressive financial reporting positions, including an inadequate response to significant matters reported in the discussion on financial reporting quality |
| | | The internal audit function is not independent of, or is inappropriately influenced by, management (for example, management determines the scope of the function's work and they are directed to not focus on high risk areas) |
| | 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, internal auditors, legal counsel, those charged with governance, or individuals with significant roles in the financial reporting process |
| | | Senior management or individuals with significant roles in the financial reporting process are from another region or country and may lack knowledge of the local language and the company's business practices |

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| | Internal control components are deficient as a result of the following: | Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required) |
| | | High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective |
| | | Accounting and information systems that are not effective, including situations involving significant deficiencies (or material weaknesses) in internal control |
| | | Weak controls over budget preparation and development and compliance with law or regulation |
| | | A history of significant adjustments or passed audit adjustments |
| | | Failure to implement controls to prevent, detect or deter fraud in areas which have been previously reported to those charged with governance |
| | | Inadequate or no policies relating to the prevention of non-compliance with laws and regulations, including illegal acts |
| | Cultural norms in the business and regulatory environments provide opportunities for management to override controls or intentionally misstate the financial statements | Criticizing or questioning a figure of authority is contrary to the local culture |
| | | Whistle blowing channels and protections may be less developed |
| **Attitudes / rationalizations** | Communication, implementation, | Evidence of significant ethical shortfalls and appropriate personnel actions have not been taken |

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| | support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective | |
| | Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates | |
| | Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or non-compliance with laws and regulations, including illegal acts | |
| | Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend | |

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| The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts | |
| Management failing to remedy known significant deficiencies (or material weaknesses) in internal control on a timely basis | |
| An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons | |
| Low morale among senior management or lack of skills and experience | An evaluation of management indicates low or moderate quality management |
| The owner-manager makes no distinction between personal and business transactions | |
| Dispute between shareholders in a closely held entity | |

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| Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality | Failure to take appropriate action in response to significant restatements (for example, dismissal of key individuals involved or the installing of appropriate controls) |
| | There is an indication that a restatement may have been due to a possible intentional manipulation. |
| The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: | Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters |
| | Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditors' report(s) |
| | 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. |
| Management has a history of earnings management or inaccurate estimates | Indication that management has provided unreasonable, unreliable or inaccurate estimates or other representations, or management has been less than forthright |
| | There are concerns of apparent earnings management. |
| There are issues regarding integrity of individuals who have significant influence over financial reporting or are expected to sign | |

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| | the representation letter | |
| | There is an indication that management has sought to unduly influence the reporting of audit findings to those charged with governance. | |

Although these fraud risk factors cover a broad range of situations, they are only examples and, accordingly, we may identify additional or different fraud 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.

What are the examples of fraud risk factors related to misappropriation of assets? [ISA | 569.7463]

The following are examples of fraud risk factors relating to misstatements arising from misappropriation of assets:

| Conditions for fraud | Types of fraud risk factors | Examples of fraud risk factors |
|---|---|---|
| **Incentives / pressures** | Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets | |
| | Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: | Known or anticipated future employee layoffs |
| | | Recent or anticipated changes to employee compensation or benefit plans |
| | | Promotions, compensation, or other rewards inconsistent with expectations. |

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| **Opportunities** | Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following: | Large amounts of cash on hand or processed |
| | | Inventory items that are small in size, of high value, or in high demand |
| | | Easily convertible assets, such as bearer bonds, diamonds, or computer chips |
| | | Fixed assets which are small in size, marketable, or lacking observable identification of ownership. |
| | Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following: | Inadequate segregation of duties or independent checks |
| | | Inadequate oversight of senior management expenditures, such as travel and other re-imbursements |
| | | Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations |
| | | Inadequate job applicant screening of employees with access to assets |
| | | Inadequate record keeping with respect to assets (e.g., fixed assets register) |
| | | Inadequate system of authorization and approval of transactions (for example, in purchasing) |
| | | Inadequate physical safeguards over cash, investments, inventory, or fixed assets |

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| | | Lack of complete and timely reconciliations of assets (e.g., comparison of inventory records to inventory counts) |
| | | 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 (e.g., blank checks left signed when on vacation) | |
| | Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control | |
| | Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee | |

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| | Changes in behavior or lifestyle that may indicate assets have been misappropriated | |
| | The belief by some government or other officials that their level of authority justifies a certain level of compensation and personal privileges | |
| | Tolerance of petty theft | |

Although these fraud risk factors cover a broad range of situations, they are only examples and, accordingly, we may identify additional or different fraud 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.

## How do we identify fraud risk factors? [ISA | 569.1400]

We identify fraud risk factors by evaluating the information gathered from all of our risk assessment procedures — including the fraud discussion held during our Risk Assessment and Planning Discussion. We think about whether any of this information indicates:

- an incentive or pressure to perpetrate fraud;
- an opportunity to carry out fraud; or
- an attitude or rationalization that justifies fraud.

Some factors may be easier to identify than others. However, maintaining our professional skepticism helps us critically and objectively evaluate the information we have gathered. We don't let past experience with the entity, or our beliefs about management's honesty and integrity, affect our ability to recognize potential fraud risk factors or fraud risks.

### Enhanced | What information do we consider? [ISA | 569.11460]

We obtain a variety of information from our risk assessment procedures that may be relevant when identifying fraud risk factors. We specifically consider whether the understanding of the entity's financial relationships and transactions with executive officers we obtained during risk assessment indicates the presence of fraud risk factors.

Types of information that may be particularly helpful include:

- external or internal factors impacting the entity's financial stability or profitability
- information we may have learned about management, such as compensation arrangements and turnover
- our understanding over CERAMIC
- unusual or unexplained changes in the behavior or lifestyle of management or employees
- related party relationships — in particular, those that are complex, outside the normal course of business, or that involve management or those charged with governance
- allegations of fraud

- accounting policies — in particular, those that are subject to judgment or can be manipulated.

### Core and Less Complex | What information do we consider? [ISA | 569.160096]

We obtain a variety of information from our risk assessment procedures that may be relevant when identifying fraud risk factors.

Types of information that may be particularly helpful include:

- external or internal factors impacting the entity's financial stability or profitability
- information we may have learned about management, such as compensation arrangements and turnover
- our understanding over CERAMIC
- unusual or unexplained changes in the behavior or lifestyle of management or employees
- related party relationships — in particular, those that are complex, outside the normal course of business, or that involve management or those charged with governance
- allegations of fraud
- accounting policies — in particular, those that are subject to judgment or can be manipulated

### How might the nature of the entity affect this assessment? [ISA | 569.11461]

The size, complexity and ownership characteristics of the entity greatly influence our consideration of fraud risk factors. For example, at a large entity we might see factors that constrain improper conduct by management, such as:

- effective oversight by those charged with governance
- an effective internal audit function
- the existence and enforcement of a written code of conduct.

When we consider fraud risk factors at a business segment operating level, we may gain different insights to those we obtain at an entity-wide level.

### How does our understanding of CERAMIC help us identify fraud risk factors? [ISA | 569.11462]

Understanding CERAMIC can give us insight into the entity's assessment of risks, including fraud risks, as well as management's overall attitude about maintaining internal controls. This includes management's judgments about the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. This information may highlight potential fraud risk factors at the entity. For example, management may conclude that it is not cost effective to implement and maintain a particular control to address a potential fraud risk (e.g., segregation of duties), increasing the opportunity for individuals at the entity to carry out fraud.

## What do we consider in describing the fraud risk factors? [ISA | 569.1500]

When we describe fraud risk factors relevant to the audit, we clearly articulate the event or condition causing:

- the incentive/pressure;
- the attitude/rationalization;
- the opportunity; and
- the potential outcome or fraud that could result.

Properly describing the fraud risk factors allows us to make a clear connection to the fraud risks we identify.

### What resources can help us identify possible fraud risk factors? [ISA | 569.1600]

The auditing standards provide a number of example fraud risk factors — e.g. AS 2401.85, ISA 240 Appendix 1 and AU-C 240 Appendix A (see questions 'What are the examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting?' and 'What are the examples of fraud risk factors relating to misstatements arising from misappropriation of assets?'). We think about these examples as we identify fraud risk factors.

Other interpretive guidance from standard setters may contain helpful guidance on assessing fraud risk factors and fraud risks — e.g. PCAOB Staff Audit Practice Alert (SAPA) No. 8 on entities that operate in emerging markets, and SAPA No. 9 on challenging economic conditions.

#### Group Audit | What sources of information can help us assess RMMs due to fraud in a group audit? [ISA | 569.11463]

The following sources of information may be helpful when we, as the group auditor, identify risk factors and assess fraud risks for the group financial statements:

- group management's assessment of the fraud risks
- group management's process for identifying and responding to the fraud risks in the group
- whether there are particular components for which a fraud risk is likely
- how those charged with governance of the group monitor group management's processes for identifying and responding to the fraud risks in the group, and the controls group management has established to mitigate these risks
- responses of our inquiries whether those charged with governance of the group, group or component management or others within the group have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.

### What specific procedures apply when considering whether specified fraud risk factors are present? [ISA | 569.7464]

We complete the 'Fraud Risk Factors - Required Work Paper' to document the consideration of whether specified fraud risk factors derived from the auditing standards are present. We also consider whether there are any fraud risk factors that may be present in addition to the examples in the work paper.

For audits performed using the KPMG Clara workflow - Standard or the KPMG Clara workflow - Small Entity, the fraud risk factors are considered in the relevant workflow and the 'Fraud Risk Factors - Required Work Paper' is not completed.

#### Enhanced | Can a KPMG member firm develop an equivalent work paper(s)? [ISA | 569.7465]

Yes. The 'Fraud Risk Factors - Required Work Paper' is used unless a KPMG member firm has an equivalent work paper(s) (i.e. one that addresses the purpose of this work paper and, at a minimum, includes all the items in this work paper), or has requirements that address the purpose and documentation of the items included in this work paper directly in the KPMG Clara workflow screens.

# Example

### How might information gathered from our risk assessment procedures indicate potential fraud risk factors? [ISA | 569.1700]

The table below sets out examples of conditions or events that we may identify as part of our risk assessment procedures, and the factors we consider to determine whether they may result in entity-specific fraud risk factors.

| Condition or event present at the entity | Potential fraud risk factors |
|---|---|
| Gross revenue, a key metric followed by external analysts covering the entity, has decreased for two consecutive periods due to growth in competitors' market share. | This may indicate pressure on the entity's management to fraudulently overstate gross revenue - due to concern that decreasing revenue may result in a lower analyst rating. |
| Management project that the entity will significantly exceed external analysts' revenue expectations for the current fiscal year. | This may indicate an incentive to defer revenue to the next fiscal year. |
| A significant portion of management's compensation includes incentive bonuses dependent on achieving certain predetermined income targets. The entity is projecting that it will narrowly miss this target. | This may create an incentive to fraudulently overstate income to be eligible for a bonus in the current period. |
| An entity sells to customers worldwide and recognizes revenue at the time of delivery.<br><br>The entity records revenue when the products are shipped, and manually reverses any revenue transactions not yet delivered at the end of each reporting period. | The manual process to reverse sales of products not yet delivered may indicate an opportunity to manipulate revenue by fraudulently failing to reverse all transactions not yet delivered. |
| An entity's inventory comprises a low number of high-value specialized products, which cannot be easily moved. The entity has adequate controls over segregation of duties and safeguarding of assets. | This may indicate that there are no entity-specific fraud risk factors associated with misappropriation of inventory. |
| The entity has foreign subsidiaries that operate in jurisdictions where corruption is more widespread and accepted. | The ethical environment in the foreign jurisdiction may foster an attitude among the subsidiary's employees that fraud is acceptable or a normal part of doing business. |

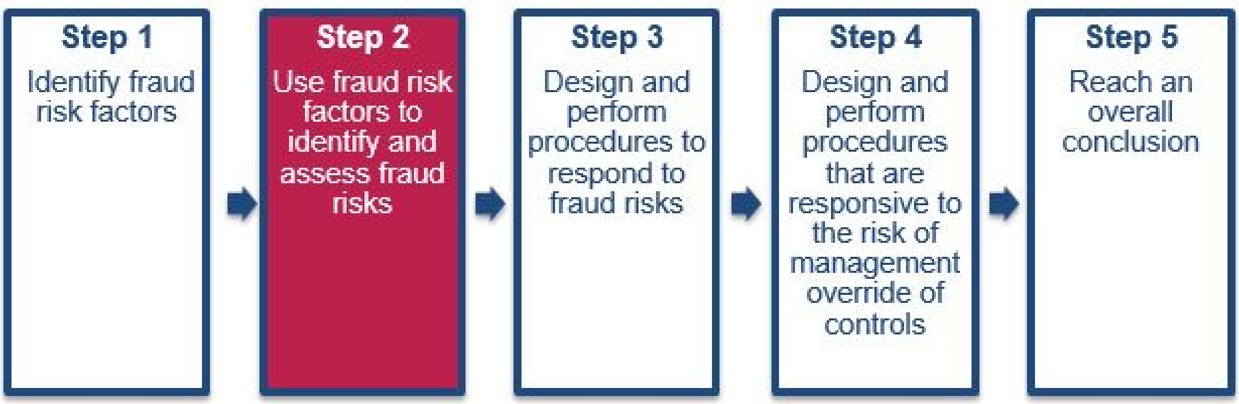
# 1.2 Use fraud risk factors to identify and assess fraud risks [ISA | 570]

## What do we do?

Take the fraud risk factors identified into account when identifying and assessing fraud risks

## Why do we do this?

Now that we have identified the fraud risk factors that are relevant to the entity, we next evaluate these factors to identify the fraud risks relevant to our audit. This affects our audit response, so we give it careful consideration. However, identifying fraud risk factors does not necessarily mean that fraud exists or will eventually occur.




## Execute the Audit

### How do we identify fraud risks? [ISA | 570.1300]

We apply professional judgment to our experience and knowledge of the entity as we evaluate whether the identified fraud risk factors, individually or in combination, indicate that a fraud risk is present.

As part of this evaluation, we ask ourselves:

**How could fraud be perpetrated given the fraud risk factors?**

When we answer this question, we consider the types of misstatements that could arise. This helps us better identify and define the fraud risk.

Our analysis includes thinking about those accounts that could be misstated or manipulated. We also consider how an individual could perpetrate or conceal fraud by presenting incomplete or inaccurate disclosures, or by omitting necessary disclosures.

Remember: fraud is not always the result of a grand plan or conspiracy, and can often be difficult to spot. For example, management may commit fraud by rationalizing an overly aggressive accounting position in a judgmental accounting area, as opposed to doing something that clearly violates an accounting rule. Or, management could commit fraud by simply creating a temporary misstatement that they expect to correct later when operational results improve.

### When do we identify fraud risks? [ISA | 570.11467]

The risk assessment is ongoing throughout the audit, following the initial assessment.

### How does this activity relate to the RMs we identified earlier in the audit? [ISA | 570.1400]

When we identify risks of misstatement (RMs) , we consider all of the information that might indicate a risk. This includes risks related to both error and fraud.

We may have already identified and assessed an RMM that represents a fraud risk during our risk assessment procedures. Evaluating the fraud risk factors could:

- confirm our assessment; or
- lead us to identify a fraud risk that we had not yet identified.

### Are we looking to identify all fraud risks? [ISA | 570.1500]

We don't necessarily seek to identify every instance of fraud across the entity. Our aim is to focus on and identify those risks with a reasonable possibility that the financial statement effect could be material.

This includes thinking about both quantitative and qualitative factors. For example, misstatements resulting from fraud may be considered material, even when they are less than the materiality we established for the audit, because of qualitative factors.

### Will every fraud risk factor we identify result in a fraud risk? [ISA | 570.1600]

No. Identifying fraud risk factors does not necessarily mean that fraud exists or will eventually occur. However, these factors are often present when fraud exists.

#### How might a fraud risk factor not result in a fraud risk? [ISA | 570.11468]

Consider a small entity with limited controls and segregation of duties. The *opportunity* for fraud may exist — however, the engagement team may conclude that no fraud risk exists if:

- there is no incentive — e.g. the business is small, without pressures, and has one primary owner; and
- management's attitude does not foster fraud — e.g. there is an ethical business culture.

#### How might only one or two fraud risk factors contribute to fraud risk? [ISA | 570.11469]

Assume the same facts as in the previous example. However, this time the engagement team have identified a single fraud risk factor that most executive management salaries are exclusively tied to earnings. If certain earnings targets are not met, management receive an extremely low salary.

Here, the team might conclude that despite management's ethical attitude and a strong control environment, the incentive is so great that it, alone, indicates the presence of a fraud risk - especially when the earnings targets are aggressive.

### What types of misstatements are relevant to our consideration of fraud risks? [ISA | 570.1700]

Two basic types of misstatements are relevant when we consider fraud risks.

| Type | Description | How it's accomplished |
|---|---|---|
| **Fraudulent financial reporting** | Intentional misstatements or omissions of amounts or disclosures designed to deceive financial statement users | • Manipulating, falsifying or altering accounting records or supporting documentation<br>• Misrepresenting or intentionally omitting events, transactions or other significant information from the financial statements<br>• Intentionally misapplying accounting policies or principles |
| **Misappropriation of assets** | Theft of an entity's assets, causing the financial statements to be misstated | • Embezzling receipts<br>• Stealing assets<br>• Causing an entity to pay for goods or services that have not been received and may be accompanied by false or misleading records or documents, possibly created by circumventing controls |

### What do we consider when identifying and describing fraud risks? [ISA | 570.1800]

The table below sets out principles we may consider when identifying and describing fraud risks.

| Basic principle | Discussion |
|---|---|
| **Document the link between fraud risk factors and identified fraud risks** | Fraud risk factors help us identify fraud risks, so we evidence how each fraud risk factor is associated with an identified fraud risk(s).<br><br>This includes providing a rationale for fraud risk factors that didn't lead us to identify a fraud risk. Evidencing this thought process helps us demonstrate that our risk assessment process was thorough, and how we applied professional skepticism in the audit. |
| **Be specific in defining each fraud risk** | As with any risk, we define fraud risks in a manner that is not overly broad or too narrow. Our description aims to capture the nature of the fraud risk and make it easy to see the types of potential misstatements that could arise from it. Specifying the nature of the fraud risk helps us design audit procedures that respond to it.<br><br>And thinking about the components of a particular significant account or disclosure may help us to better define the fraud risk. We specify whether the fraud risk relates to the entire significant |

| | |
|---|---|
| | account/disclosure or a certain subset of transactions within the account.<br>A fraud risk may not always apply to the entire entity. In those cases, we also specify the locations or business units where the fraud risk is present and relevant to the audit. |
| **Link fraud risks to the specific accounts, disclosures, and assertions affected** | When we link the risk to the specific accounts, disclosures and assertions that it could affect, we are able to provide a clear link to our audit response.<br>In the unusual case that we cannot associate a fraud risk with a specific set of account(s)/disclosure(s), and assertions, we may have identified an overly broad fraud risk. |
| **Don't just stop at one** | We don't necessarily stop once we have identified one fraud risk. We consider *all* of the fraud risk factors and whether they suggest that other fraud risks may also be present. |

What do we do for those fraud risk factors that don't result in a fraud risk? [ISA | 570.11470]

A fraud risk factor doesn't always lead to a fraud risk. In these instances, we document our rationale as to why that was the case.

Evidencing this thought process helps us demonstrate that our risk assessment process was thorough, and how we applied professional skepticism in the audit.

When might a fraud risk be overly broad or too narrow? [ISA | 570.11471]

The table below sets out some examples of fraud risks that are overly broad or too narrow, alongside appropriately defined fraud risks.

| Example of overly broad or too narrow fraud risk | Example of appropriately specific fraud risk |
|---|---|
| Risk of fraud over revenue recognition due to rebuttable presumption (Overly broad) | Using side agreements to sell Product A could alter the terms and conditions of recorded sales transactions and may result in a risk of overstatement of revenue recognized |
| Risk of overstating net income by understating expenses related to manufacturing employee incentive compensation (Too narrow) | Understating the accrual for annual employee incentive costs for all eligible employees may result in a risk of overstatement of net income |

How might portions of an account or class of transactions help us identify a fraud risk? [ISA | 570.11472]

**Fact pattern:**

A manufacturing entity sells only one product and recognizes revenue on all sales transactions when ownership and legal title have transferred.

It records all revenue transactions in a single significant account (revenue). However, there are different shipping terms for different transactions within the account — e.g. FOB shipping versus FOB delivery.

**Analysis:**

Here, we may determine that different transaction types within the significant account are subject to slightly different risks.

We may identify a fraud risk factor related to management's incentive to manipulate revenue cut-off — i.e. the period in which it recognizes revenue. However, considering the risks for each type of transaction may lead us to identify a fraud risk over period-end revenue recognition, but only for FOB delivery transactions.

This is a narrower risk, resulting from the increased opportunity for management to manipulate the timing of revenue recognition for those specific transactions.

### How do we consider the risk of omitted, incomplete or inaccurate disclosures? [ISA | 570.1900]

As we evaluate fraud risk factors, we remember that an entity can perpetrate or conceal fraud by presenting incomplete or inaccurate disclosures, or by omitting necessary disclosures.

It can often be more challenging to identify disclosures that are misstated than amounts recorded in the financial statements. This is because the wording or presentation of a disclosure can often be subjective or prepared in more than one way. So, it can sometimes be easier for management to commit and conceal fraud by manipulating or omitting disclosures.

As part of our risk assessment procedures, we develop expectations about the disclosures necessary for the entity's financial statements to be presented fairly to conform with the applicable financial reporting framework. Our expectations can be particularly helpful when we consider the possible fraud risks. This is especially true of those disclosures that are more subjective or provide increased opportunities to perpetrate fraud.

When we assess the risk of omissions of, or incomplete or inaccurate, disclosures, we are particularly concerned with the risks that:

- disclosures may intentionally contain insufficient information, or omit relevant facts — e.g. they fail to disclose a significant claim against the entity;
- disclosures may be intentionally inaccurate — e.g. segment data is altered to hide the fact that a prominent segment incurred a significant loss; and
- the entity may deliberately disclose too much to distract the reader from what the entity wants to obscure — e.g. many trivial and less important details make it hard to understand the amount of a particular claim, and the potential risk to the entity.

### What are common types of fraud risks that we may consider? [ISA | 570.2000]

A common area of fraud risk is revenue recognition. In fact, we presume a fraud risk related to improper revenue recognition.

Other common fraud risks include:

- manipulating cost of goods sold or other expenses, which may be understated/deferred to later periods to achieve current earnings targets
- inappropriately capitalizing costs to present higher net income
- intentionally not recognizing expenses/liabilities by not consolidating an entity that meets the accounting criteria to be consolidated
- intentionally recognizing assets in the wrong period or when they have not met all the recognition criteria from the accounting framework
- using inappropriate assumptions in estimates to intentionally understate costs/liabilities
- intentionally not recognizing impairment losses on impaired assets.

# Examples

### How might fraud risk factors contribute to fraud risk? [ISA | 570.2100]

**Scenario 1 | Pressure to meet analyst expectations**

**Fact pattern:**

An entity is preparing its period-end financial statements. Several analysts have documented that its business is booming.

Over the last few periods, the entity has experienced a slowdown, but is still under significant pressure to meet analysts' expectations. It derives its revenue from construction contracts that include variable consideration.

Estimating this variable consideration involves judgments and subjectivity from management. Based on past experience, we know that management have a history of taking more aggressive positions when determining these estimates.

**Analysis:**

When the engagement team analyze this set of facts and circumstances, they may identify these risk factors:

| Category | Identified risk factor |
|---|---|
| Incentive or pressure | The recent slowdown, combined with the strong analyst focus, could create an incentive for management to manipulate earnings |
| Opportunity | The estimated variable consideration, which is based on subjective estimates, provides an opportunity for the entity to manipulate the estimates/judgments and materially affect earnings |
| Attitude or rationalization | Management's past attitude of aggressive forecasting and estimating sets the stage |

| | |
|---|---|
| | for potential rationalization of manipulating revenue |

The team may therefore conclude that a fraud risk exists over the Valuation/Allocation assertions of estimated variable consideration, since the inputs into the variable consideration calculation depend on management estimates.

**Scenario 2 | Additional financing needed for a business expansion**

**Fact pattern:**

The entity has a fully-drawn, revolving credit facility with a community bank. The amount that the entity may borrow under the facility — i.e. the borrowing base — is based on the net inventory balance recorded at December 31.

Through their risk assessment procedures, the engagement team learn that the entity plans to expand its business, financed through additional borrowings under the revolving facility. Management therefore need a large enough inventory balance at December 31 to enable them to increase the borrowing base of the facility, and to allow for additional borrowing. Management have often stated that their expansion plans will provide a huge benefit to shareholders.

**Analysis:**

When the engagement team analyze this set of facts and circumstances, they may identify the following risk factors.

| Category | Identified risk factor |
|---|---|
| Incentive or pressure | The entity is relying on an increase in the borrowing base of the credit facility for additional financing, which is critical for its expansion plans. Therefore, the entity has an incentive to overstate its inventory balance. |
| Opportunity | The inventory balance is based on several variables, including:<br>• the physical inventory on hand;<br>• the recorded price/value of the inventory items; and<br>• the amount of the inventory reserve (which offsets the gross value of inventory).<br>There is therefore an opportunity to manipulate and misstate the inventory balance by intentionally adjusting the results of the inventory count, altering the inventory |

| | |
|---|---|
| | pricing, or manipulating the inventory reserve (which is based on judgment). |
| Attitude/rationalization | Management may try to rationalize their actions by saying that the funding is necessary for expansion, which is in the shareholders' best interest. |

The team may therefore conclude that fraud risks exist related to the Existence and Valuation assertions of inventory recorded as of the period end.

# 1.3 Presume that there is a fraud risk involving improper revenue recognition [ISA | 571]

## What do we do?

Presume that there is a fraud risk involving improper revenue recognition, and evaluate which types of revenue, revenue transactions or assertions may give rise to such risks.

## Why do we do this?

In many industries, revenue is a key metric and an area of focus for investors and financial statement users, as it directly affects earnings and other key metrics. Therefore, an entity often has a greater incentive or pressure to manipulate revenue.

## Execute the Audit

### What does it mean to presume there is a fraud risk involving improper revenue recognition? [ISA | 571.1300]

Initially, we expect there to be a fraud risk involving improper revenue recognition.

However, we may rebut the presumed fraud risk involving improper revenue recognition — but only after we've carefully evaluated the specific facts and circumstances. For example:

- facts and circumstances may indicate limited incentives, rationalizations, and/or opportunities to fraudulently adjust revenue recognition; or
- there may be only a single type of simple revenue transaction.

We may, therefore, conclude that there is no fraud risk related to revenue recognition.

If we do rebut the presumed fraud risk involving improper revenue recognition, we evidence our conclusions — including the specific facts and circumstances that led us to overcome the presumed fraud risk.

### How do we identify and define fraud risks involving improper revenue recognition? [ISA | 571.1400]

The standards presume we will identify a fraud risk related to revenue recognition; however, we don't just identify a general fraud risk that broadly covers improper revenue recognition. Like when we identify and define other fraud risks, we define revenue fraud risks specifically, and in a manner that is not overly broad or too narrow.

To achieve this, we evaluate which specific revenue transactions may give rise to a fraud risk. As with other fraud risks, this includes using what we learned during risk assessment and thinking about the specific fraud risk factors relevant to improper revenue recognition.

If we identify only a general risk of improper revenue recognition without trying to assess *how* revenue could be intentionally misstated, then we may have difficulty developing meaningful responses to the identified fraud risks.

### What do we consider in identifying fraud risks involving improper revenue recognition? [ISA | 571.1500]

Identifying fraud risks involving revenue recognition is very similar to identifying and defining any other fraud risk. We consider the fraud risk factors that could be relevant to manipulating revenue recognition, and each type of revenue or specific revenue transactions.

But remember: fraud may not only occur by overstating revenue — e.g. recognizing revenue early or recording fictitious revenue. It can also occur by understating or deferring revenue.

For example, if an entity has already exceeded expectations in the current period, but is concerned that the next period's revenue may be lower, it may try to shift revenue from the current period to next period. This would result in an understatement of current period revenue.

### What are some examples of common fraud techniques? [ISA | 571.1600]

Some examples of more common fraud techniques involving improper revenue recognition include:

- sham sales
- recording transactions even though the sales involved unresolved contingencies
- 'round-tripping' — i.e. selling an asset to another entity with an agreement to buy it back at the same price
- recording loans as sales
- improperly recording sales from bill and hold transactions that do not meet the criteria for revenue recognition
- recording revenue before all the terms of the sales are complete
- improper sales cut-off
- improperly accelerating the estimated percentage of completion method for projects in process
- shipping goods that a customer did not order
- shipping defective products and recording revenue at full, rather than discounted, prices
- recording revenue for consignment shipments, or shipments of goods for customers to consider on a trial basis.

Thinking about these techniques for each of the entity's revenue streams can help us identify opportunities or incentives for management to use them.

# Examples

### What is an example of rebutting the presumed fraud risk involving improper revenue recognition? [ISA | 571.1700]

**Fact pattern:**

RST Investments' sole source of revenue is from a manufacturing facility leased to a single entity over seven years. The lease payments are fixed for the duration of the lease so that the lease revenues are the same from year to year, and match directly to the lease agreement.

**Analysis:**

Given the lack of complexity and ability to manipulate revenue, we may consider rebutting the presumption of fraud risk over revenue recognition.

# 1.4 Identify the risk of management override of controls as a fraud risk [ISA | 572]

## What do we do?

Identify the risk of management override of controls as a fraud risk

## Why do we do this?

Even though internal controls may appear to be well-designed and effective, controls that are otherwise effective may be overridden by management. Because management is in this unique position to perpetrate fraud, we identify a fraud risk related to management override of controls. We then design audit responses to address this risk.

## Execute the Audit

### How might management be able to override controls? [ISA | 572.1300]

Management may be able to override controls in several ways — including:

- creating, or instructing an employee to record, fictitious manual journal entries to circumvent the regular process for approving and recording journal entries
- applying bias when making estimates and judgments
- accounting for significant unusual transactions.

These are the common types of override we focus on as part of our audit.

### Do smaller entities have specific considerations related to management override? [ISA | 572.1400]

Smaller entities often have fewer employees, which can make segregation of duties impracticable. Management may be more able to override controls because the system of internal control is less structured. We take this into account when identifying RMMs due to fraud.

### Do we identify the risk of management override of controls as a fraud risk in every audit? [ISA | 572.1500]

Yes. The level of risk of management override of controls may vary from entity to entity, but the risk is present in all entities.

# 2 Determine significant risks [ISA | 573]

## What do we do?

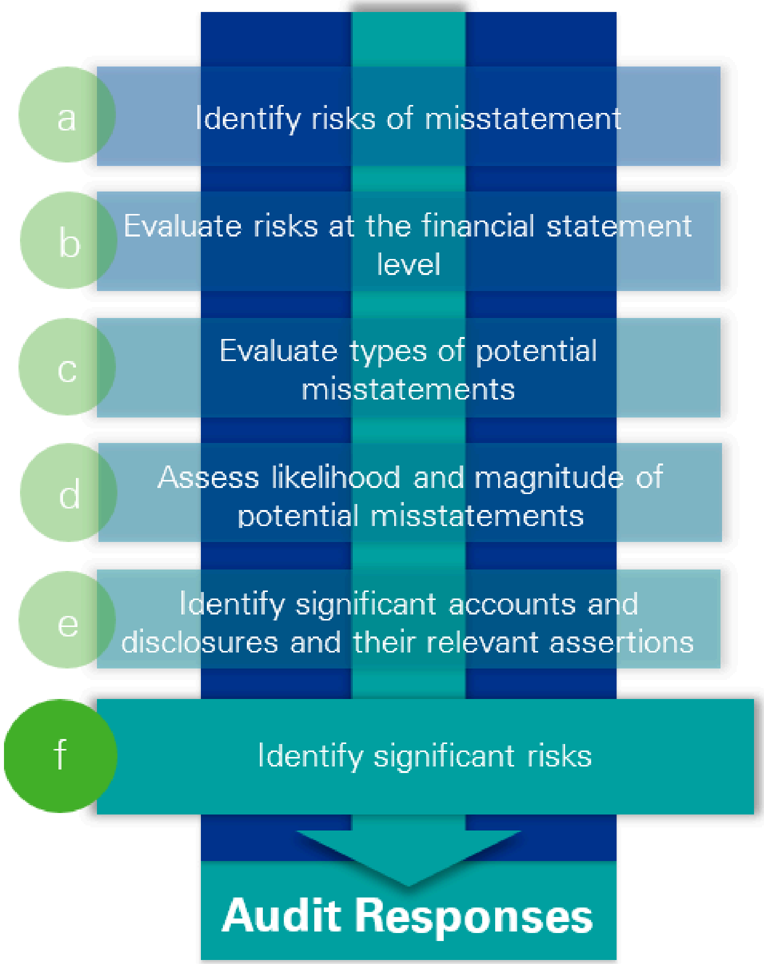
Determine whether any of the identified and assessed risks of material misstatement are significant risks

# Why do we do this?

The determination of significant risks allows for the auditor to focus more attention on those risks that are on the upper end of the continuum of inherent risk. If we fail to assess the inherent risk as Significant, we could perform the wrong audit procedures to address the risk.


# Execute the Audit

Where are we in our risk assessment? [ISA | 573.1300]




### What is a significant risk? [ISA | 573.1400]

A significant risk is a risk of material misstatement (RMM) which is:

- close to the upper end of the continuum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
- fraud risks; or
- significant unusual transactions with related parties.

We document special audit considerations in response to significant risks.

#### What does 'special audit consideration' mean? [ISA | 573.8652]

'Special audit consideration' means focusing more attention on those risks that are on the upper end of the continuum of inherent risk, through the performance of certain procedures including:

- Evaluating design and implementation of control activities that address the RMM (see 'Evaluate the design and implementation of relevant control activities');
- Designing and performing substantive procedures that specifically respond to the significant risk (see 'Perform substantive procedures that respond to significant risks');
- Obtaining more persuasive audit evidence as our assessment of inherent risk increases (see 'Design and perform substantive procedures whose nature is responsive to CAR');

- Communicating with those charged with governance about the significant risks we identified (see 'Communicate planned scope and timing of the audit').
- Taking into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters (see 'Determine if there are any KAMs in the current audit period')
- Required review of audit documentation related to significant risks and our audit response thereto by the engagement partner (see 'Perform minimum required review')
- For group audits, increased involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the necessary work at the component by the component auditor (see 'Group Audit | Be involved in the component auditor's risk assessment when they perform an audit of a significant component' and 'Group Audit | Evaluate the appropriateness of, and determine whether to be involved in, the component auditor's planned audit procedures over group significant risks').
- In addition, where we plan to rely on the operating effectiveness of control activities that address significant risks, we cannot rely on prior period testing of such controls.

We think carefully about how we identify and describe significant risks and include the 'what, where, why and how' associated with each significant risk.

Being specific helps us to better tailor our responses to these risks and apply 'special audit consideration'. With this in mind, it may be useful to take a second look at the population of significant risks, and carefully think about whether we've identified them with enough specificity.

### How do we determine whether any of the identified and assessed RMMs are significant risks? [ISA | 573.11802]

In addition to considering those risks that are closer to the upper end of the continuum of inherent risk noted in question 'What are the inherent risk factors?' the following table shows the factors we consider to determine whether any identified and assessed RMMs are significant risks:

| Factors | Example of being lower on the inherent risk continuum | Example of being higher on the inherent risk continuum |
|---|---|---|
| **Whether the risk is a fraud risk** | A risk that is not a fraud risk. | An identified fraud risk.<br>Remember: a fraud risk is a significant risk. |
| **Whether the risk relates to recent significant economic, accounting or other developments** | Risks related to the valuation of certain assets, when:<br>• a commodity price is a primary input in the valuation model; and<br>• the commodity's prices have been relatively | Risks related to the valuation of certain assets, when:<br>• a commodity price is a primary input in the valuation model; and<br>• there has been significant volatility in |

| | | |
|---|---|---|
| | stable in the current period. | the commodity's prices in the current period.<br>Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions. |
| **The complexity of transactions** | Risks associated with the issuance of new debt when the debt instrument is simple and does not have unique or complex features. | Risks associated with the issuance of new debt when the debt instrument has multiple conversion features and embedded derivatives.<br>Complexity in data collection and processing to support account balances.<br>Accounting policies or principles that may be subject to differing interpretation.<br>Accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for revenue with multiple performance obligations that are difficult to value). |
| **Whether the risk involves significant transactions with related parties** | Risks associated with accounting for and disclosing a transaction between an entity and an unrelated third party for the purchase of land to be used to build a new corporate headquarters. | Risks associated with accounting for and disclosing a transaction between an entity and a board member, to buy land to build a new corporate headquarters.<br>Remember: significant unusual transactions with related parties are assessed as a significant risk. (see activity 'Identify and assess RMMs, including significant risks, associated with |

| | | |
|---|---|---|
| | | related parties' for additional considerations) |
| **The degree of complexity or judgment in recognizing or measuring financial information related to the risk** | Risks related to the valuation of investment securities that are exchange-traded, and for which published prices are available in active markets — i.e. Level 1. | Risks related to the valuation of investment securities that are valued using multiple unobservable inputs — i.e. Level 3.<br>Accounting policies or principles that may be subject to differing interpretation.<br>Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved. |
| **Whether the risk involves significant unusual transactions** | Risks related to a transaction that is routine and in the normal course of business — e.g. processing monthly payroll transactions. | Risks related to a transaction that is (or could be) many times greater than materiality and outside of the normal course of business — e.g. a large, speculative investment in a business unrelated to the entity's core operations.<br>Not *all* risks related to significant unusual transactions will be significant risks, however, these risks may be higher on the inherent risk continuum because they may involve one or more of the following:<br>• greater management intervention to specify the accounting treatment<br>• greater manual intervention for data collection and processing<br>• more complex calculations or |

| | | |
|---|---|---|
| | | accounting policies or principles<br>• non-routine transactions, whose nature may make it difficult for the entity to implement effective processes to account for the transactions<br><br>Remember: significant unusual transactions with related parties are assessed as a significant risk. (see activity 'Identify and assess RMMs, including significant risks, associated with related parties' for additional considerations) |

We consider these factors as a whole, which means that no individual factor determines where a risk falls on the inherent risk continuum. We identify significant risks based on inherent risk, without regard to control activities.

# 3 Understand relevant control activities that address significant risks [ISA | 576]

## What do we do?

IF we determine that a significant risk, including a fraud risk, exists, THEN obtain an understanding of the relevant control activities that are intended to address the risks, by evaluating the design and implementation of those controls

## Why do we do this?

As part of our risk assessment procedures, we obtain an understanding of a process to help us identify risks of material misstatement (RMMs). When we have a significant risk, including a fraud risk, we go even further, and evaluate the design and implementation of relevant control activities. This helps us better understand the risk, and informs our overall assessment of significant risks and how best to respond to them.

## Execute the Audit

### How do we identify relevant control activities that address a significant risk? [ISA | 576.1400]

We identify relevant control activities that address a significant risk by:

- understanding ICFR, including the entity's processes and CERAMIC;
- identifying all the process risk points related to the significant risk;
- identifying and obtaining an understanding of the control activities that address the relevant process risk points and risks arising from IT.

Not all control activities related to a significant risk may be relevant. Relevant control activities are those that address the PRP/RAFITs related to an RMM.

### How do we identify controls that address fraud risks? [ISA | 576.1500]

All fraud risks are significant risks, so we identify relevant control activities that address fraud risks in the same manner as all other significant risks.

We describe process control activities that address process risk points related to a fraud risk as anti-fraud controls. There are specific considerations about the nature, timing and extent of audit procedures we design and perform to test anti-fraud controls.

A process control activity is an anti-fraud control when:

- we have identified a fraud risk at the assertion level or financial statement level; and
- that process control activity directly mitigates the identified fraud risk, either individually or when combined with other controls.

#### Can anti-fraud controls also address a risk of error? [ISA | 576.11815]

Yes. Some process control activities are designed to address the risk of fraud (anti-fraud controls) and the risk of error simultaneously.

An example of this might relate to an estimate that:

- has a high degree of judgment (risk of error); and
- creates an opportunity for management to intentionally manipulate assumptions to achieve a desired result (risk of fraud).

Management may implement process control activities that address risks related to determining the key assumptions, and evaluating the potential for management bias in selecting those assumptions. If so, the identified control may respond to the fraud risk and the risk of error for the estimate.

### What if control activities are not designed and implemented for significant risks? [ISA | 576.2000]

Failure of the design or implementation of control activities addressing a significant risk is a deficiency in internal control and may indicate a significant deficiency. We evaluate deficiencies like this, and communicate them, as appropriate — even if we're performing a financial statement audit in which we do not intend to test the operating effectiveness of such control activities.

# Examples

### How may anti-fraud controls be designed to address the risk of management override for an accounting estimate? [ISA | 576.11816]

**Fact pattern:**

An entity prepares a cash flow forecast to support its going concern assessment. The Financial Controller prepares the forecast and the CFO reviews it.

During the engagement team's fraud planning meeting — i.e. the RAPD — they identified incentives, opportunities and rationalizations that caused them to identify a fraud risk associated with the going concern disclosures. The team determined it may be easy for the CFO to tweak the revenue or expenses in the forecast, so that the entity's cash appeared sufficient for the relevant assessment period required by the financial reporting framework.

The entity has introduced a process control activity that is an anti-fraud control to address the risk of management override, whereby the board — i.e. those charged with governance — review the components of the going concern assessment. The board receive an analysis of each estimate used in the forecast, including:

- the range of reasonableness of each estimate;
- how that range was determined;
- how the range compares to prior periods; and
- where within the range management's estimate fell in this period compared to prior periods.

The board also receive an analysis of how the estimates as a whole affected earnings.

**Analysis**:

In this case, the review of each estimate by those charged with governance is an anti-fraud control designed to mitigate the risk of management bias in the estimates.

Bias may be evident in management's changes to:

- how the range of reasonable results is determined;
- where within that range their estimate falls (at the lower end, in the middle, or at the higher end); and
- how the relative placement of the point estimate changed period over period.

As this example illustrates, process control activities that are anti-fraud controls addressing the risk of management override in estimates can involve the board or audit committee. In many cases, estimates are reviewed by senior management — but that's where the risk of fraud due to management override lies. Involving the board in the review of certain assumptions can be an effective way for an entity to introduce anti-fraud controls.

# 4 Evaluate the design and implementation of process control activities over journal entries and other adjustments [ISA | 798]

## What do we do?

Evaluate the design and implementation of the entity's process control activities over journal entries and other adjustments.

## Why do we do this?

We identify and evaluate the design and implementation of process control activities over journal entries with a double objective:

- as part of our procedures to address the risk of management override of controls through the recording of journal entries, and
- as part of our risk assessment procedures, to address any risk identified that journal entries are susceptible of unauthorized or inappropriate intervention or manipulation due to error.

# Execute the Audit

## What are journal entries? [ISA | 798.1300]

Journal entries are any entries made directly within the general ledger system that are used to record transactions, allocations, adjustments and corrections. They include:

- standard journal entries used to record recurring transactions and adjustments; and
- non-standard journal entries used to record non-recurring, unusual transactions, or adjustments.

### What are standard journal entries? [ISA | 798.13373]

Standard journal entries are journal entries used to record:

- recurring transactions - e.g., the day to day activities of the entity such as recurring sales, purchases, and cash disbursements; and
- recurring adjustments - e.g., adjustments related to accounting estimates that are made at each period-end such as changes in the estimate of uncollectible accounts receivable.

### What are automated journal entries? [ISA | 798.13374]

Automated journal entries are standard journal entries that are automatically initiated, authorized, recorded and processed in the general ledger. The use of automated journal entries can reduce the risk of management override of controls because automated journal entries are less likely to be susceptible to unauthorized or inappropriate intervention or manipulation.

### What are non-standard journal entries? [ISA | 798.13375]

Non-standard journal entries are journal entries used to record:

- non-recurring or unusual transactions - e.g., business combinations or disposals; and
- non-recurring adjustments - e.g., adjustments related to accounting estimates that are typically not made at each period-end such as the impairment of an asset.

The process and procedures used to record non-standard journal entries are typically manual journal entries.

### What are manual journal entries? [ISA | 798.13376]

Manual journal entries are journal entries that are initiated by an individual and manually entered into the general ledger system. The use of manual journal entries can increase the risk of management override of controls because manual journal entries are more likely to be susceptible to unauthorized or inappropriate intervention or manipulation.

### What are other adjustments? [ISA | 798.13378]

Other adjustments are adjustments made to the general ledger accounts outside of the general ledger system to determine the amounts presented on the face of the financial statements. Entities often use a spreadsheet to support other adjustments. Other times, entities may make other adjustments directly in the financial statements or disclosures themselves. Other adjustments are most often seen in period-end financial reporting through post-closing adjustments.

Similar to manual journal entries, the use of other adjustments can increase the risk of management override of controls because there is more opportunity for manual intervention in the process and procedures.

### How do we evaluate the design and implementation of process control activities over journal entries and other adjustments? [ISA | 798.1301]

We evaluate the design and implementation of process control activities over journal entries and other adjustments through inquiry in combination with observation and/or inspection, in the same way we evaluate the design and implementation of other relevant process control activities (refer to activity 'Evaluate the design and implementation of relevant process control activities' for more information).

### In what circumstances do we evaluate the design and implementation of process control activities over journal entries and other adjustments? [ISA | 798.157909]

We identify and evaluate the design and implementation of process control activities over journal entries and other adjustments that are relied on by management that sufficiently address:

- the risk of management override of controls; and, if identified,
- the risk that journal entries are susceptible to unauthorized or inappropriate intervention or manipulation due to error.

#### How do we address the risk that journal entries are susceptible to unauthorized or inappropriate intervention or manipulation due to fraud? [ISA | 798.157910]

The risk that journal entries are susceptible to unauthorized or inappropriate intervention or manipulation due to fraud is addressed as part of our response to the risk of management override of controls.

#### What is the difference between the risk of management override of controls through journal entries and the risk of unauthorized or inappropriate intervention or manipulation of journal entries and how we address these risks? [ISA | 798.157911]

The difference between the risk of management override of controls through journal entries and the risk of unauthorized or inappropriate intervention or manipulation of journal entries and how we address these risks is shown in the table below:

| Risk | Characteristics | Risk addressed by |
|---|---|---|
| Management override of controls through journal entries | Fraud risk (i.e., significant risk) present in all entities, although the level of risk may vary from entity to entity | Testing the appropriateness of journal entries and other adjustments, which includes evaluating the design and implementation of process control activities over journal entries and other adjustments |

| | | |
|---|---|---|
| Unauthorized or inappropriate intervention or manipulation of journal entries | Presumed to be a fraud risk since the unauthorized or inappropriate intervention or manipulation of journal entries will derive from an intentional act in most cases.<br><br>However, in certain cases, we may determine that the risk also derives from an unintentional act and therefore be considered a risk due to error. | Addressing the fraud risk as part of our response to the risk of management override of controls.<br><br>If we determine there is also a risk due to error, we:<br>• determine whether there is a risk of material misstatement at the assertion level and, if there is, we<br>• identify and evaluate the design and implementation of process control activities over journal entries that address the risk due to error.<br><br>We also take this into account in our substantive procedures to select and test high-risk journal entries that address both the risk of management override of controls and the risk that journal entries are susceptible to unauthorized or inappropriate intervention or manipulation due to error, for example, we may consider unusual account combinations when determining the high-risk criteria. |

### What journal entries may be susceptible to unauthorized or inappropriate intervention or manipulation?

[ISA | 798.157922]

These journal entries include:

- non-standard journal entries, where the journal entries are automated or manual and are used to record non-recurring, unusual transactions or adjustments;
- standard journal entries, where the journal entries are automated or manual and are susceptible to unauthorized or inappropriate intervention or manipulation.

Due to their nature, non-standard journal entries are typically manual journal entries and, therefore, more likely to be susceptible to unauthorized or inappropriate intervention or manipulation.

Standard journal entries can be used to record:

- recurring transactions (e.g., daily routine sales)

  In this case, in today's environment where there are significant automated processes, these standard journal entries are typically automated journal entries and therefore less likely to be susceptible to unauthorized or inappropriate intervention or manipulation.

  In particular, for system-generated journal entries that are directly and routinely processed to the general ledger, we may judgmentally determine that there is little or no susceptibility to unauthorized or inappropriate intervention or manipulation and therefore would not give rise to a risk of material misstatement and we would not identify controls over those journal entries to evaluate their D&I.

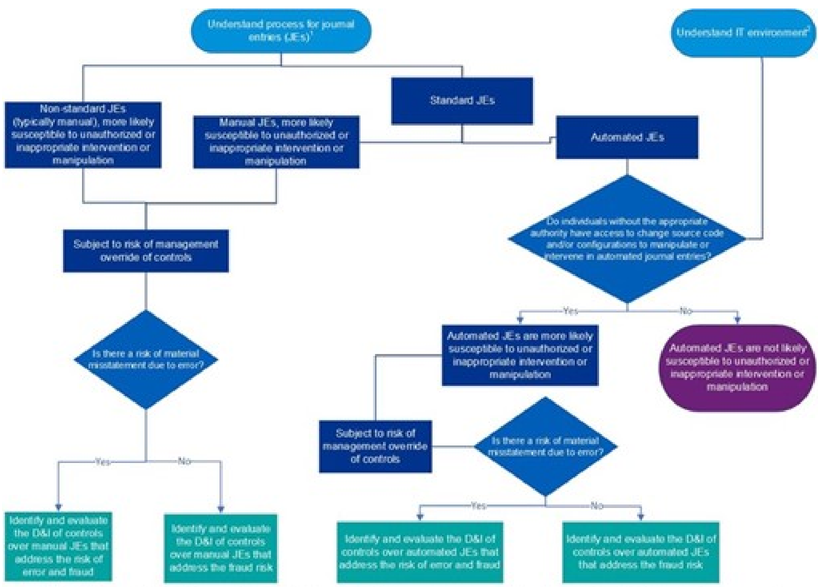
However, there could be other scenarios where a journal entry, although automated, could be manipulated. For example, if individuals without the appropriate authority have access to the source code or are able to make inappropriate changes to configurations.

See questions "What is an example scenario that indicates likely susceptibility versus little to no susceptibility to unauthorized or inappropriate intervention or manipulation of automated journal entries?" and "What do we do when it is not clear whether automated journal entries are susceptible to unauthorized or inappropriate intervention or manipulation?" for more information on automated journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation.

- recurring adjustments (e.g., adjustments related to accounting estimates that are made at each period-end such as changes in the estimate of uncollectible accounts receivable).

  In this case, these standard journal entries are more likely to be manual journal entries and therefore more likely to be susceptible to unauthorized or inappropriate intervention or manipulation

The following diagram depicts the process we follow to determine the journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation and how we address any related risk of material misstatement identified:




[1] This includes understanding the types of journal entries, i.e. standard and non-standard, manual and automated. See activity "Understand processes and procedures for journal entries and other adjustments"[797] for further guidance.
[2] This includes understanding the IT process to manage changes. See activity "Understand IT processes"[7842] for further guidance.

For guidance on the decisions to be made regarding what controls over journal entries to identify when we do not plan to test their operating effectiveness, refer to the decision tree in the question "How do we identify process control activities over journal entries and other adjustments over which to evaluate their design and implementation?".

### What is an example scenario that indicates likely susceptibility versus little to no susceptibility to unauthorized or inappropriate intervention or manipulation of automated journal entries? [ISA | 798.157942]

The table below shows an example scenario that indicates likely susceptibility versus little to no susceptibility to unauthorized or inappropriate intervention or manipulation of automated journal entries:

| Factor | Likely susceptibility | Little to no susceptibility |
|---|---|---|
| Type of general ledger IT system | Entity uses a custom in-house built system or a highly customized ERP system. | Entity uses a standard off the shelf general ledger IT system. |
| Access to source code/system configuration | Individuals within the entity without the appropriate authority have access to the general ledger IT system's source code. | Individuals within the entity do not have access to the general ledger IT system source code and the entity does not have the ability to change system configurations related to how journal entries are posted to general ledger IT system (i.e., access to configurations or source code to change how journal entry general ledger accounts, dates, amounts, journal entry type are recorded in the general ledger). |

When there is likely susceptibility to unauthorized or inappropriate intervention or manipulation of automated journal entries, we identify and evaluate the design and implementation of process control activities over those automated journal entries. If the process control activities are automated, we also identify the relevant layers of technology, RAFITs and GITCs, and evaluate the D&I of GITCs that support the continued effective operation of those automated process control activities.

What do we do when it is not clear whether automated journal entries are susceptible to unauthorized or inappropriate intervention or manipulation? [ISA | 798.157943]

When it's not clear whether automated journal entries are susceptible to unauthorized or inappropriate intervention or manipulation, we take into account our understanding of the IT environment and business processes. We also think about the following questions to help us determine if automated journal entries are susceptible to unauthorized or inappropriate intervention or manipulation and therefore whether to identify and evaluate the design and implementation of process control activities over automated journal entries as well as relevant GITCs, if the process control activities identified are automated.

1. Does management have access to the general ledger IT system's source code? If yes:

- Who has access?

- Is access restricted to authorized personnel (e.g., only IT personnel have access and there is segregation of duties between IT and accounting)?
- Can the entity provide evidence of who has access to the source code?
- If those in the accounting department have access to the general ledger IT system source code, what are the controls in place to detect unauthorized changes to source code impacting journal entries?

2. Are there any system configurations that impact how journal entries are posted (i.e., how journal entry general ledger accounts, dates, amounts, journal entry type are recorded in the general ledger)? If yes:

- What are the configurations related to journal entries?
- Who has access to change the system configurations?
- Is access restricted to authorized personnel (e.g., only IT personnel have access and there is segregation of duties between IT and accounting)?
- Can the entity provide evidence of who has access to the system configurations?
- What controls over system configurations related to journal entries are in place?

For examples as to how these questions we think about would impact our audit approach, refer to the question "How might an entity's responses to the questions we think about to identify when automated journal entries may be susceptible to unauthorized or inappropriate intervention or manipulation, impact our audit approach?".

### How do we identify process control activities over journal entries and other adjustments over which to evaluate their design and implementation? [ISA | 798.9409]

When understanding the entity's financial reporting process, we use the knowledge obtained to identify, at a minimum, process risk points (PRPs) where management override of controls could occur through the recording of journal entries and other adjustments. Additionally, we consider whether there are any additional PRPs related to the risk associated with journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation.

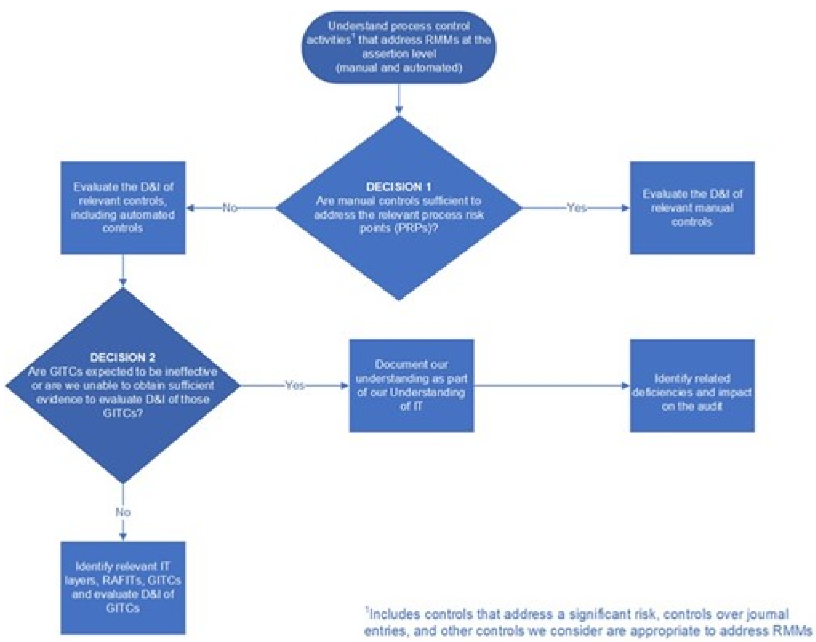
When understanding the entity's business processes, we specifically understand how the transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger and reported in the financial statements. In obtaining this understanding, we obtain knowledge about how transactions and events are processed, and therefore we may identify journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation and PRPs related to those journal entries. Additionally, when we take a controls-based approach to respond to RMMs related to the recording of transactions and events in the business process, we may identify PRPs related to the recording of those transactions in the general ledger through journal entries.

For each PRP identified, we obtain an understanding of the process control activities that are relied on by management to address the PRP.

Most entities maintain their general ledger in an application and posting of journal entries is at least in part performed automatically, so it is likely that control activities over journal entries will include automated controls over the posting of journal entries to the general ledger. However, that does not mean we identify those automated controls as process control activities over journal entries that we will evaluate design and implementation of to address the risk of management override of controls and/or to address the risk associated with journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation. For example, entity management may implement manual controls over the automated posting of journal entries or a review process over manual journal entries such that they do not rely on the automated processing of journal entries to address the risk of management override of controls and/or to address the risk associated with journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation due to error.

In cases where management relies on automated controls to address the risk of management override of controls through journal entries or the risk associated with journal entries that could be susceptible to unauthorized or inappropriate intervention or manipulation, and we evaluate the design and implementation of those automated controls, we also identify relevant IT layers, RAFITs and evaluate the design and implementation of general IT controls that support the continued effective operation of those automated controls.

The following decision tree provides an illustration of the decisions to be made and the implications when we evaluate the design and implementation of process control activities but we do not plan to test their operating effectiveness, including controls over journal entries and other adjustments (see question "Under what circumstances do we evaluate the design and implementation of GITCs" for more information on decision 2 of the decision tree below):




## What are some examples of process control activities over journal entries and other adjustments? [ISA | 798.13524]

Examples of process control activities that may reduce the risk of management override of controls or the risk that journal entries are susceptible to unauthorized or inappropriate intervention or manipulation are:

- the CFO or CEO are prevented from initiating, processing or authorizing journal entries within the IT system;
- objective oversight by personnel independent from the journal entry process reviewing journal entries and supporting documentation;

- all journal entries and supporting documentation are reviewed and approved by an individual separate from the individual posting the journal entry;
- a control exists that prevents the reviewer of a journal entry from posting it.
- accounting manager that neither prepares, reviews nor posts journal entries reviews all manual journal entries posted during the period to the general ledger. If a threshold is applied to this review, the magnitude of those entries not subject to review does not have a risk of material misstatement.
- reconciliation of balance sheet and income statement accounts by an accounting manager that neither prepares, reviews nor posts journal entries by comparing two or more data elements and investigates reconciling items at an appropriate level of precision;
- automated process control activities over journal entries that limit privileged user access to the system to one or two senior IT staff. Only staff with privileged access have the ability to change automated journal entries based on the design of the IT systems or no staff have the ability to change automated journal entries;
- automated control activities that prevent changes in relevant information after a journal entry has been posted, such as preventing management from changing the identity of the person posting a journal entry.

The last two bullets are examples of effective control activities that could suggest that automated journal entries are not a characteristic of high risk journal entries.

#### Core and Less Complex | What is an additional example of process control activities over journal entries and other adjustments in a less-complex entity? [ISA | 798.8909]

An additional example of process control activities that may reduce the risk of management override of controls or the risk that journal entries are susceptible to unauthorized or inappropriate intervention or manipulation in a less-complex entity is:

- Where senior management are closely involved in the day to day operations, senior management review of financial information on a periodic basis to assess if it is in line with expectations, may be relied on and precise enough to identify material misstatements caused by incorrect journal entries.

### Do we evaluate the design and implementation of controls over journal entries and other adjustments for all audit engagements? [ISA | 798.13525]

Yes, for all audit engagements we evaluate the design and implementation of process control activities over journal entries and other adjustments that sufficiently address the risk of management override of controls through the recording of journal entries and other adjustments, which is a fraud risk and thus, a significant risk. Therefore, we evaluate the design and implementation of an entity's process control activities over journal entries and other adjustments as part of our audit that respond to that risk even when we have not identified other controls relevant to our audit.

Additionally, we may identify process control activities that address the risk associated with journal entries that are susceptible to unauthorized or inappropriate intervention or manipulation.

For example, in an audit of a less complex entity, the entity's information system may not be complex and we may not plan to rely on the operating effectiveness of controls. Further, we may not have identified any significant risks or any other risks of material misstatement for which it is necessary for us to evaluate the design and implementation of controls. In such an audit, we may only evaluate the design and implementation of control activities over journal entries and other adjustments that address the risk of management override of controls and, when relevant, the risk that journal entries could be susceptible to unauthorized or inappropriate intervention or manipulation due to error.

At what point in the audit do we evaluate the design and implementation of process control activities over journal entries and other adjustments? [ISA | 798.1700]

We evaluate the design and implementation of the entity's process control activities over journal entries and other adjustments as part of our risk assessment procedures - i.e., as part of the planning phase of the audit.

Do we test the operating effectiveness of process control activities over journal entries and other adjustments when we perform a financial statement audit? [ISA | 798.1800]

Not necessarily. We test the operating effectiveness of process control activities over journal entries and other adjustments when we plan to rely on the operating effectiveness of those controls as part of our response to a particular risk of material misstatement, including our approach to identifying and testing high risk journal entries

We may plan to rely on the operating effectiveness of process control activities over journal entries and other adjustments in order to reduce the extent of our testing of journal entries and other adjustments (e.g., when excluding automated journal entries from the population of journal entries that we apply high risk criteria to).

# Examples

How might an entity's responses to the questions we think about to identify when automated journal entries may be susceptible to unauthorized or inappropriate intervention or manipulation, impact our audit approach? [ISA | 798.157925]

**Fact pattern 1**

Consider an entity that responds as follows:

| Question | Example response |
|---|---|
| Is the general ledger IT system a custom in-house built system or a highly customized purchased general ledger IT system? | No. The general ledger IT system is a standard off the shelf system |
| Does management have access to the general ledger IT system's source code? | No. The entity uses an off-the-shelf accounting software. Source code is compiled, and management does not have access to it. |
| Are there any system configurations (i.e., access to configurations or source code to change how journal entry general ledger | No. |

| | |
|---|---|
| accounts, dates, amounts, journal entry type are recorded in the general ledger) that impact how journal entries are posted? | |

**Analysis**

Given:

- The entity uses a standard off the shelf general ledger IT system;
- Management does not have access to the source code, and
- There are no system configurations (i.e., access to configurations or source code to change how journal entry general ledger accounts, dates, amounts, journal entry type are recorded in the general ledger) that impact how the journal entries are posted,

the engagement team determines that automated journal entries are not likely susceptible to unauthorized or inappropriate intervention or manipulation and therefore the engagement team does not identify or evaluate the design and implementation of process control activities over automated journal entries.

**Fact pattern 2**

Consider an entity that responds as follows:

| Question | Example response |
|---|---|
| Is the general ledger IT system a custom in-house built system or a highly customized purchased general ledger IT system? | Yes. The general ledger IT system is a custom in-house built system. |
| Does management have access to the general ledger IT system's source code? | Yes. IT management has access to the source code. |
| Is access restricted to authorized personnel (e.g., only IT personnel have access and there is segregation of duties between IT and accounting)? | Yes. Only personnel in the IT department with the appropriate authority in accordance with the entity's policies has access to the source code. |
| If those in the accounting department have access to the general ledger IT system, are there controls in place to detect unauthorized changes to source code impacting journal entries? If yes, describe the controls | N/A. The accounting department does not have access to the source code |
| Are there any system configurations (i.e., access to configurations or source code to change how journal entry general ledger | Yes. The system allows the ability to override how journal entry general ledger accounts and |

| | |
|---|---|
| accounts, dates, amounts, journal entry type are recorded in the general ledger) that impact how journal entries are posted? | journal entry type are recorded in the general ledger. |
| Who has access to change the system configurations? | Only personnel in the IT department with the appropriate authority in accordance with the entity's policies has access to change the system configurations. |
| Can the entity provide evidence of who has access to source code and system configurations? | Yes. Management provided a system generated report of users that have access to update source code and system configurations of the general ledger IT system. The engagement team confirmed the controller does not have access to modify source code or system configurations of the general ledger IT system. |

**Analysis**

Given:

- The entity uses a custom in-house built general ledger IT system,
- Only personnel in the IT department with the appropriate authority in accordance with the entity's policies has access to the source code,
- Although the system allows the ability to override how journal entry general ledger accounts and journal entry type are recorded in the general ledger, only personnel in the IT department with the appropriate authority in accordance with the entity's policies has access to change the system configurations, and
- The engagement team obtained and inspected a system-generated report confirming that the controller did not have access to modify source code, system configurations, or journal entries,

the engagement team determines that automated journal entries are not likely susceptible to unauthorized or inappropriate intervention or manipulation and therefore the engagement team does not identify or evaluate the design and implementation of process control activities over automated journal entries.

**Fact pattern 3**

Consider an entity that responds as follows:

| Question | Example response |
|---|---|
| Is the general ledger IT system a custom in-house built system or a highly customized purchased general ledger IT system? | Yes. The general ledger IT system is a custom in-house built system. |

| | |
|---|---|
| Does management have access to the general ledger IT system's source code? | Yes. IT management has access to the source code. |
| Is access restricted to authorized personnel (e.g., only IT personnel have access and there is segregation of duties between IT and accounting)? | Yes. Only personnel in the IT department with the appropriate authority in accordance with the entity's policies has access to the source code |
| If those in the accounting department have access to the general ledger IT system, are there controls in place to detect unauthorized changes to source code impacting journal entries? If yes, describe the controls | N/A. The accounting department does not have access to the source code |
| Are there any system configurations (i.e., access to configurations or source code to change how journal entry general ledger accounts, dates, amounts, journal entry type are recorded in the general ledger) that impact how journal entries are posted? | Yes. The system allows the ability to override how journal entry general ledger accounts and journal entry type are recorded in the general ledger |
| Who has access to change the system configurations? | An Accounting Analyst. |
| Is access restricted to authorized personnel (e.g., only IT personnel have access and there is segregation of duties between IT and accounting)? | No, since an Accounting Analyst has access. |
| Can the entity provide evidence of who has access to source code and system configurations? | Yes. Management provided a system generated report of users that have access to update source code and system configurations of the general ledger IT system. The engagement team confirmed the controller does not have access to modify source code or system configurations of the general ledger IT system |
| Are there manual controls in place over journal entries? | Yes. On a monthly basis, the controller reviews a report of journal entries. |

| | |
|---|---|
| What automated process control activities does the entity have in place over journal entries? | The following automated process control activities are in place over the general ledger IT system:<br>- AC-1: The system is configured to appropriately post journal entries |

**Analysis**

Given:

- The entity uses a custom in-house built general ledger IT system,
- Entity Management has access to the source code,
- The general ledger IT system has a system configuration that impacts how journal entries are posted (i.e., access to configurations or source code to change how journal entry general ledger accounts, dates, amounts, journal entry type are recorded in the general ledger) and the Accounting Analyst has access to change the configuration, and
- The engagement team obtained and inspected a system-generated report confirming that the controller did not have access to modify source code, system configurations, or journal entries,

the engagement team determines that journal entries are likely susceptible to unauthorized or inappropriate intervention or manipulation. Additionally, the engagement team determines that the manual process control activity of the controller reviewing a report of journal entries monthly relied on by management is performed at a sufficient level of precision to address the risk of journal entries being subject to unauthorized or inappropriate intervention or manipulation, even though there are also automated process control activities addressing such risk. Therefore, the engagement team evaluates the design and implementation of the manual process control activity only.

**Fact pattern 4**

Consider an entity that responds in the same way to the questions in Fact pattern 3 above, except that the response to the question "Are there manual controls in place over journal entries?" is that there are no manual controls.

**Analysis**

Given:

- The entity uses a custom in-house built general ledger IT system,
- The general ledger IT system has a system configuration (i.e., access to configurations or source code to change how journal entry general ledger accounts, dates, amounts, journal entry type are recorded in the general ledger) that impacts how journal entries are posted and the Accounting Analyst has access to change the configuration,
- There are no manual controls in place over journal entries, and
- The engagement team identified automated process control activities over journal entries,

the engagement team determines that journal entries are likely susceptible to unauthorized or inappropriate intervention or manipulation and there is no manual control in place over journal entries. Therefore, the engagement team identifies and evaluates the design and implementation of automated process control activities over journal entries and the relevant GITCs.

The engagement team identifies the following RAFITs relevant to the above automated process control activities and evaluates the design and implementation of the GITCs listed below.

| RAFIT | GITC |
|---|---|
| 1.4 APD - Logical access to users and accounts (including shared or generic accounts) that can perform privileged tasks and functions within IT systems is inappropriate (i.e., unauthorized or not commensurate with job responsibilities). | Privileged-level access (e.g., configuration, data and security administrators) in the IT system is authorized and appropriately restricted. |
| 2.1 PC - Changes to IT programs were inappropriate (i.e., unapproved or do not function as intended). | Changes to IT system programs are approved prior to implementation into the production environment. |
| 2.2 PC - Changes to IT configurations were inappropriate (i.e., unapproved or do not function as intended). | Changes to IT system configurations are approved prior to implementation into the production environment. |
| 2.3 PC - Logical access to implement changes to IT system program or configurations into the production environment is inappropriate (i.e., unauthorized or not commensurate with job responsibilities). | Changes into the production environment, including configuration changes, are reviewed by IT management personnel to determine if they are appropriately authorized, restricted and segregated from the development environment. |

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

## International Standards on Auditing: ISA 240.29-30

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

#### *Overall Responses*

29. In accordance with ISA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.[10] (Ref: Para. A34)

10 ISA 330, paragraph 5

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

(a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A35-A36)

(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A37)

# ISA Application and Other Explanatory Material: ISA 240.A34-A37

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

### *Overall Responses* (Ref: Para. 29)

A34. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

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

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 30, which are discussed below.

#### Assignment and Supervision of Personnel (Ref: Para. 30(a))

A35. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A36. 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.

#### Unpredictability in the Selection of Audit Procedures (Ref: Para. 30(c))

A37. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.

- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Design and implement audit responses [ISA | 781]

## What do we do?

Design and implement audit responses that address the risks of material misstatement

## Why do we do this?

Our audit responses to identified and assessed risks of material misstatements (RMMs) provide us with sufficient appropriate audit evidence to reduce audit risk to an appropriately low level. We have two types of audit response to these RMMs - overall responses and responses that involve the nature, timing and extent of audit procedures. If our audit responses are not appropriate, we will fail to reduce audit risk to an appropriate level.

## Execute the Audit

### What are the types of audit responses to identified RMMs? [ISA | 781.1400]

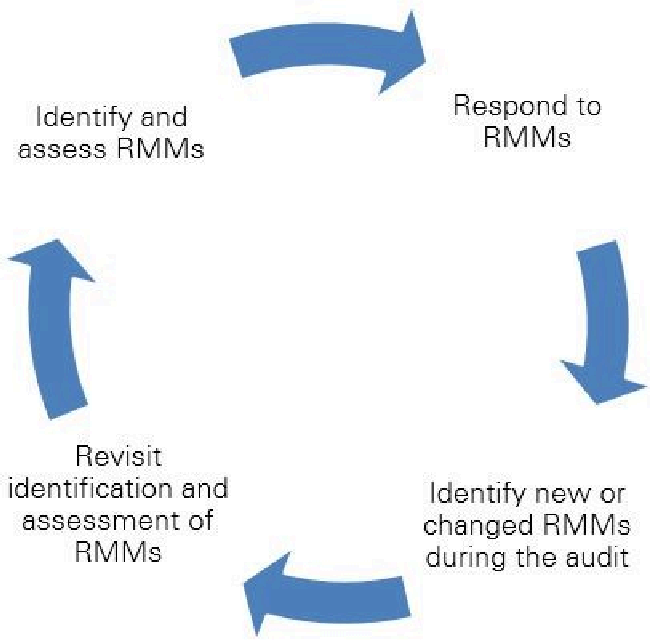
We employ two broad types of audit responses to RMMs.

| | |
|---|---|
| **Overall responses** | Responses that have an overall effect on how the audit is conducted |
| **Assertion-level responses** | Responses involving the nature, timing and extent of audit procedures |

The nature of these two types of audit responses differs, but together they help us to design audit responses that sufficiently address the RMMs we have identified and assessed.

### What if we identify new RMMs or revise our assessment of RMMs? [ISA | 781.1500]

The audit is a continual process, during which we may, and often will, identify new RMMs or revise our assessment of RMMs. In this case, we revisit our risk assessment and revise our planned approach to address these changes.




# 1.1 Design and implement overall responses [ISA | 782]

## What do we do?

Design and implement overall responses to address the risks of material misstatement

## Why do we do this?

Overall responses lay the foundation for the rest of our audit procedures. They also act together with our assertion-level responses to help us obtain sufficient appropriate audit evidence. Overall responses affect how the overall audit is conducted and performed. Whereas, assertion-level responses relate to the nature, timing and extent of the procedures we perform over each assertion-level RMM.

If we fail to design and implement an appropriate overall response to the audit, our assertion-level responses are unlikely to meet our audit objective.

## Execute the Audit

### What are overall responses? [ISA | 782.1300]

We may design and implement two different types of overall responses.

| Type of response | Responses |
|---|---|
| **General overall responses** | • Assigning significant engagement responsibilities appropriately<br>• Providing appropriate supervision<br>• Selecting audit procedures with elements of unpredictability |

| | |
|---|---|
| | • Evaluating the entity's selection and application of significant accounting policies or principles |
| **Other overall responses** - e.g. how we respond to identified pervasive financial statement-level risks | • Making pervasive or general changes to the nature, timing and extent of our audit procedures |

## When do we design and implement overall responses? [ISA | 782.11520]

We always perform the following overall responses to respond to the assessed risks of material misstatement on every audit, regardless of whether we have identified an entity specific financial statement level risk or not:

- Making appropriate assignments of significant engagement responsibilities. The knowledge, skill, and ability of engagement team members with significant engagement responsibilities is to be commensurate with the assessed risks of material misstatement.
- Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.
- Incorporating elements of unpredictability in the selection of audit procedures to be performed. As part of our response to the assessed risks of material misstatement, including the assessed fraud risks, we incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year.
- Evaluating the entity's selection and application of significant accounting policies or principles. We evaluate whether the entity's selection and application of significant accounting policies or principles, particularly those related to subjective measurements and complex transactions, are indicative of bias that could lead to material misstatement of the financial statements.

Overall responses can also help us address risks of material misstatement at the financial statement level and **assertion-level**.

### Can a specific overall response address multiple financial statement level risks?

Yes.

## What effect might the control environment have on our overall responses? [ISA | 782.11521]

An effective control environment may allow us to have more confidence in both internal controls and the reliability of audit evidence generated within the entity.

This can affect our assessment of RMMs and how we respond to them. For example, we may be able to perform some audit procedures at an interim date rather than at the period end.

Deficiencies in the control environment, however, have the opposite effect. For example, we may respond to an ineffective control environment by:

- conducting more audit procedures as of the period end rather than at an interim date;
- obtaining more extensive audit evidence from substantive procedures; and/or
- including more locations in the scope of our audit.

Such considerations, therefore, have a significant bearing on our general approach - for example, whether we take:

- a substantive approach - i.e. placing an emphasis on substantive procedures; or
- a combined approach - i.e. using tests of controls as well as substantive procedures.

#### How are overall responses different from assertion-level responses? [ISA | 782.1500]

Overall responses affect how we conduct the audit broadly. Assertion-level responses are more specific than overall responses, as they focus on tests of controls and substantive procedures designed to address assertion-level RMMs.

#### Why do we apply both overall and assertion-level responses? [ISA | 782.1600]

To illustrate why we apply both overall and assertion-level responses to appropriately respond to risks, consider this non-financial example.

> In our daily lives, we often perform activities whose success depends on a combination of both overall and specific approaches. Consider gardening, for example. We take some actions that are intended to affect only certain plants, such as pruning, relocating a plant to get more or less sun, or watering selectively.
>
> However, we also act in ways that are intended to affect the entire garden. We might change the soil, apply fertilizer or adjust the overall watering schedule. Ultimately, the combination of both types of activity is what helps us maintain a healthy garden.

# 1.1.1 Assign significant engagement responsibilities [ISA | 783]

## What do we do?

Determine overall responses to address risks of material misstatement by appropriately assigning significant engagement responsibilities

## Why do we do this?

We do a number of things to design and implement an overall response to risks of material misstatement (RMMs). Among these activities, we appropriately assign significant engagement responsibilities. If we don't, we do not meet our professional responsibilities and risk not obtaining sufficient appropriate audit evidence to address the RMMs.

## Execute the Audit

#### What significant engagement responsibilities do we assign? [ISA | 783.1400]

Significant engagement responsibilities that we assign include:

- supervision
- review of the audit documentation

- procedures to be performed over RMMs that have higher inherent risk, including fraud risks.

#### Which RMMs are likely to have a higher inherent risk? [ISA | 783.11575]

RMMs associated with matters that are complex and involve judgment and estimation are likely to have a higher inherent risk - e.g. RMMs related to valuation of loan loss reserves, business combinations, actuarial estimates for benefit plans, estimates for warranty reserves.

Fraud risks are also considered significant risks and have a higher inherent risk as well - e.g. revenue recognition at period end, risk of management override through the recording of inappropriate journal entries and other adjustments.

### What do we consider when we assign significant engagement responsibilities? [ISA | 783.1500]

In assigning significant engagement responsibilities, we consider:

- the level of subject matter expertise that is appropriate, including specialists and specific team members; and
- the knowledge, skill and ability of each engagement team member.

We also watch for changes during the audit that may cause us to revise the assignment of significant engagement responsibilities - e.g. we identify a new RMM with Significant or Elevated inherent risk, we identify a new complex transaction entered into by the entity.

When assigning and considering significant engagement responsibilities throughout the audit, we consider the assessed level of risk and the knowledge, skills, and abilities necessary. Responsibilities that involve complex and specialized subject matter for which we lack the necessary knowledge or experiences may also lead us to involve specialists and specific team members.

For example, we may involve specialists and specific team members when we perform:

- procedures over environmental remediation liability estimation
- life insurance benefit reserves
- the valuation of acquired assets in a business combination
- journal entry testing.

### How can we assign significant engagement responsibilities to address a financial statement level risk? [ISA | 783.11576]

We might assign significant engagement responsibilities in response to a financial statement level risk in a number of ways, including:

- changing the overall composition of the engagement team to include team members that have more experience (e.g., assigning an engagement partner with 25 years of experience instead of a partner with 15 years of experience) or specific skills (e.g., significant experience in a particular industry or particular type of transaction);
- including specialists or specific team members - e.g., forensics professionals; and
- considering those accounts, disclosures and assertions that could be impacted by the risk and using more experienced auditors to perform the procedures in those areas - e.g., **journal entry testing.**

# Examples

How do we assign significant engagement responsibilities? [ISA | 783.1600]

**Example 1**

Suppose an entity entered into a business combination during the period we are auditing. A new associate with limited experience may not be the best team member to perform audit procedures related to the business combination. They would lack the relevant experience and background to assess the entity's judgments and estimates. We would likely assign a more experienced team member and consider whether the assumptions and methodologies used to account for the business combination call for the involvement of a specialist.

**Example 2**

Suppose we identify changes in the IT environment that could pervasively affect the audit. We would likely not assign engagement team members without an IT background to assess these changes. These team members may lack the knowledge, experience and skills to identify and assess how all the changes affect the entity's financial reporting process. We may consider involving IT Audit specific team members with the relevant IT expertise.

**Example 3**

Suppose we are assigning engagement responsibilities for the fraud risk associated with management override of controls - i.e. booking inappropriate journal entries. We may assign a lower level engagement team member to test journal entries. However, the increased risk leads us to involve more experienced engagement team members or individuals with specialized skills and knowledge such as those with forensic or relevant IT expertise in planning, supervising and reviewing the procedures perform and evaluating the results.

# 1.1.2 Supervise engagement team members [ISA | 784]

# What do we do?

Determine overall responses to address risks of material misstatement by appropriately supervising engagement team members

# Why do we do this?

We do a number of things to design and implement our overall response to risks of material misstatement (RMMs). Among these activities, we appropriately supervise engagement team members. This is part of our professional responsibilities, and it applies to the entire team, including specialists and specific team members. If we don't supervise them appropriately, we may not obtain sufficient and/or appropriate audit evidence to address the RMMs.

# Execute the Audit

What is appropriate supervision? [ISA | 784.1400]

As part of appropriately supervising personnel, we:

- inform them of their responsibilities;
- direct them to alert supervising engagement team members of significant issues that arise during the audit;

- review their work to evaluate whether:
  - the work was documented appropriately;
  - the objectives were achieved; and
  - the results of the work support the conclusions.

Appropriate supervision also includes:

- tracking the audit engagement's progress;
- considering the competence and capabilities of individual engagement team members, including whether they:
  - have enough time to do their work;
  - understand their instructions; and
  - are doing their work in line with the planned approach to the audit engagement;
- addressing significant matters arising during the audit engagement, considering their significance, and modifying the planned audit approach as needed; and
- identifying matters for more experienced engagement team members to consider during the audit engagement.

### How do we supervise a specialist and/or specific team member? [ISA | 784.1500]

When our engagement includes specialists and specific team members, we direct, supervise and review their work by:

- agreeing with the specialists and specific team members on the nature, scope and objectives of their work;
- agreeing on the roles of the specialists and specific team members and other engagement team members, and on the nature, timing and extent of communication between them; and
- evaluating the adequacy of the specialists and specific team member's work, including whether their findings and conclusions are relevant, reasonable and consistent with other audit evidence.

### What affects the extent of our supervision? [ISA | 784.1600]

We base the extent of our supervision on the audit's facts and circumstances, including:

- the nature of the entity, including its size and complexity;
- the nature of the work assigned to each engagement team member, including the procedures to be performed and the controls or accounts and disclosures to be tested;
- the associated RMM; and
- the knowledge, skills and abilities of each engagement team member.

Our level of supervision also is affected by our assessment of an RMM. We increase the extent of supervision for RMMs that have a higher assessed inherent risk.

### How do we increase the extent of our supervision? [ISA | 784.1700]

We increase the extent of our supervision by:

- dedicating more time and effort to our supervision and review; and
- assigning a more experienced engagement team member to supervise and review.

### What are some ways we can dedicate more time and effort to our supervision and review? [ISA | 784.1800]

We are able to dedicate more time and effort to our supervision and review by:

- setting up time with engagement team members upfront to discuss their responsibilities and expectations;
- planning for status 'check-ins' with engagement team members to provide them opportunities to ask questions;
- performing a more in-depth review of the audit documentation produced;
- conducting more meetings with the other members of the engagement team to discuss the procedures performed, the evidence obtained, and the conclusions reached;
- performing reviews earlier in the process and continue through the conclusions being reached; and
- planning and performing debrief sessions with the engagement team members in-between individual assignments to provide timely feedback.

### Who is responsible for appropriate supervision? [ISA | 784.1900]

The engagement partner is ultimately responsible for properly supervising the work of engagement team members. However, all team members with supervision responsibilities are responsible for exercising appropriate supervision in fulfilling their responsibilities.

### When do we provide supervision? [ISA | 784.2000]

We provide supervision throughout the audit - from engagement acceptance and planning through reviewing engagement team members' work to forming our conclusion and issuing our report.

### How can we supervise engagement members to address a financial statement level risk? [ISA | 784.11577]

We might supervise engagement members in response to a financial statement level risk in a number of ways, including:

- inclusion of certain additional team members in our RAPD meeting, which strategically allows for engagement team members to have a good understanding of more experienced team members' views about risks and how fraud might be perpetrated. This sets helps to set the tone from the top by setting the model of a proper degree of skepticism and set the culture for the engagement;
- increasing the number of reviews - e.g., having both partner and manager review of all audit workpapers;
- broadly altering the timing of reviews of audit documentation to occur at earlier points in the audit - e.g., setting milestone dates for when reviews of certain audit areas are to be completed throughout the audit, completing all reviews at least one week before issuing the audit opinion; and
- performing 'pre-issuance' reviews by professionals that are not a part of the engagement team - e.g., national office monitoring programs, DPP reviews.

# Examples

### What may happen if we don't provide appropriate supervision? [ISA | 784.2100]

**Fact pattern:**

The engagement team identified a fraud risk related to recognition of revenue at period end.

Appropriate supervision was provided over:

- risk assessment, including understanding the process, identifying the applicable process risk points, and evaluating the design and implementation of process control activities;
- the planned nature, timing and extent of control testing to address the applicable process risk points, including manual and automated process control activities and any system-generated reports used to support the process control activities;
- the planned test of operating effectiveness of process control activities and evaluation of results; and
- the planned substantive procedures - i.e. nature, timing and extent - including incorporating elements of unpredictability.

After the team performed their risk assessment procedures and planned their audit approach, a first-year associate joined the engagement team. The associate was assigned to perform both the tests of controls and substantive procedures to address the fraud risk. The associate was not appropriately supervised when performing these procedures.

**Analysis:**

The engagement manager reviewed the process control activities and substantive procedures in detail and determined that the associate did not perform the procedures in line with the planned audit approach.

The engagement manager did not adequately communicate and explain the detailed procedures to the associate responsible for performing them. The engagement manager also did not periodically check in with the associate as the procedures were performed.

The engagement manager therefore did not provide adequate or appropriate supervision in a timely manner.

As a result, additional work was performed by the engagement team to obtain sufficient appropriate audit evidence related to the fraud risk.

# 1.1.3 Incorporate elements of unpredictability [ISA | 785]

# What do we do?

Determine overall responses to address risks of material misstatement by incorporating elements of unpredictability in the selection of audit procedures

# Why do we do this?

If we perform the same procedures year after year, management could fraudulently manipulate financial information in areas they don't expect us to audit. Certain procedures naturally include some elements of unpredictability (e.g. use of audit sampling, in particular MUS, where items are selected haphazardly or at random).

By also deliberately incorporating other unpredictable procedures, we may:

- gain added assurance that the entity's transactions are appropriately accounted for in accounts we have not historically audited;
- identify new RMs or reassess as RMMs;

- identify processes and procedures that are not functioning as intended; and
- uncover attempts to conceal fraudulent actions, particularly by people who are familiar with our techniques and procedures.

# Execute the Audit

### Which RMMs can elements of unpredictability address? [ISA | 785.1400]

The incorporation of an element of unpredictability in every audit can help address any risk of material misstatement, including both assertion-level RMMs and financial statement level risks.

Additionally, we specifically incorporate elements of unpredictability when we address fraud risks.

### How can we incorporate elements of unpredictability into the design of our audit procedures? [ISA | 785.1500]

We can incorporate elements of unpredictability by modifying the nature, timing and extent of our audit procedures.

#### How can we incorporate elements of unpredictability into our substantive audit procedures? [ISA | 785.11578]

The following table sets out examples of ways we might modify our substantive audit procedures to incorporate elements of unpredictability. When we design our substantive audit procedures for different areas of the audit, we may use any of these or other techniques, or a combination of them.

| Changes to the nature, timing or extent of substantive audit procedures | Example |
|---|---|
| Perform audit procedures related to accounts, disclosures and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk | Perform procedures on prepaid expenses or other accounts that do not have a related RMM (i.e., a nonsignificant account) |
| Vary the timing of audit procedures | Send accounts receivable confirmations as of the end of the period as opposed to an interim date |
| Select items for testing that have lower amounts or are otherwise outside customary selection parameters | Reduce the dollar value used to select items to examine when searching for unrecorded liabilities<br><br>Confirm low-balance or bank accounts not tied to a relevant business process.<br><br>Select additional journal entries for testing that do not meet the high-risk criteria |

| | |
|---|---|
| Perform unannounced audit procedures | Perform an inventory observation without announcing the date to management and/or inventory warehouse staff |
| Increase the extent of our substantive procedures | Select a greater sample size than the minimum |
| Perform different types of substantive testing procedures | Perform a substantive analytical procedure (SAP) in addition to sampling, where appropriate, or also perform a substantive test of details where we have traditionally performed a SAP only |
| Varying our selection technique | Performing audit sampling where we may have ordinarily used specific item sampling to select high value items |
| In group audits, vary the location or the nature, timing and extent of audit procedures at related components from year to year | Perform audit procedures for a smaller component where we have not done so historically |

#### How can we incorporate elements of unpredictability into our tests of controls? [ISA | 785.11579]

The following table sets out examples of ways we might modify our tests of controls to incorporate elements of unpredictability. When we design our tests of controls for different areas of the audit, we may use any of these or other techniques, or a combination of them.

| Changes to the nature, timing, and extent of tests of controls | Example |
|---|---|
| Vary the nature of tests of controls | Re-performing the control in addition to observing the control being performed or inspecting evidence produced as part of the operation of the control |
| Vary the timing of tests of controls | Test controls closer to the date of management's assessment as opposed to an interim date, and vary the dates of the control instances selected. |

| | |
|---|---|
| Vary the extent of tests of controls | Selecting a greater sample size than the minimum sample size |
| In group audits, vary the location or the nature, timing and extent of audit procedures at related components from year to year | Perform test of controls at a smaller component where we have not done so historically |

### How do we evidence elements of unpredictability? [ISA | 785.1600]

We document the specific element of unpredictability that we have incorporated into the audit as part of our overall response. When the method of incorporation of the element of unpredictability in the audit is by performing audit procedures over accounts that would not otherwise be tested, we document not only the procedure's results but also why we performed them - i.e. to incorporate unpredictability. This is so an experienced auditor with no previous connection with the engagement does not misunderstand the reason for our procedures or think that we failed to appropriately address an RMM in the audit.

For example, if incorporate an element of unpredictability by identifying and testing controls related to a non significant account, failing to document our reason for the testing could cause a reviewer to believe that there is a RMM related to the account that we failed to design and perform appropriate substantive procedures to address.

### When can adding an element of unpredictability be ineffective? [ISA | 785.1700]

Adding an element of unpredictability can be ineffective if we arbitrarily introduce unpredictability into our procedures that do not provide meaningful audit evidence.

When we design our audit response to incorporate an element of unpredictability, we consider the nature of our identified risks and how unpredictability may increase the persuasiveness of audit evidence.

For example, an engagement team incorporates an element of unpredictability by selecting lower dollar value items and testing whether payments made are accurately recorded as prepaid expenses. This procedure may not provide much additional audit evidence, especially if the balance of the prepaid expense account is small and/or the number of incremental items selected for testing is not meaningful.

By contrast, suppose the balance of the prepaid expense account is larger or could be used by management to record a variety of different types of transactions (i.e., used as a suspense account). In these cases, performing audit procedures over prepaid expenses when the team has not done so historically adds an element of unpredictability and provides meaningful audit evidence.

# Examples

### How can we incorporate an element of unpredictability? [ISA | 785.1800]

**Fact pattern 1**

As part of risk assessment procedures, an engagement team identifies an RMM related to inappropriate revenue recognition at or near period end - i.e. revenue cut-off. In designing their audit responses, the team considers ways to incorporate an element of unpredictability into their audit procedures.

Analysis

The team could choose to incorporate unpredictability through many different procedures. They decide they would gain meaningful audit evidence by:

- confirming the relevant contract terms of accounts receivable, including acceptance criteria, delivery and payment terms, any future vendor obligations, rights of return, cancellation or refund provisions, and the absence of any side agreements;
- performing period-end inventory observations and specific sales cut-off testing for two locations where no audit procedures were performed for the past 3 years because of their size and lack of specific risks - and performing the inventory observations unannounced; and
- selecting contracts with multiple performance obligations that are fulfilled close to year end and inspecting documentation for evidence that all performance obligations have been satisfied at year end.

**Fact pattern 2**

As the engagement team performed its risk assessment procedures, they identified an RMM related to the valuation of alternative investments, which do not have readily available market prices. In designing their audit responses, the team considered ways they might incorporate an element of unpredictability into their audit procedures.

Analysis

The team could choose to incorporate unpredictability through many different procedures. They decided they would gain meaningful audit evidence by having an employed KPMG specialist independently price a selection of the alternative investments and comparing those values to the values reported by the entity, which was not done in the past.

# 1.1.4 Evaluate significant accounting principles and policies [ISA | 786]

## What do we do?

Determine overall responses to address risks of material misstatement by evaluating the entity's selection and application of significant accounting principles and policies for bias

## Why do we do this?

We do a number of things to design and implement an overall response to risks of material misstatement (RMMs). Among these activities, we evaluate the entity's selection and application of significant accounting principles and policies.

Financial reporting frameworks - e.g. US GAAP, IFRS - are not strictly rules-based. They allow management to select and interpret accounting principles and policies in many cases. As a result, management's selection or application of accounting principles and policies may technically comply with the framework, but the selection may be biased toward a particular outcome - e.g. fraudulently increasing short-term net income, masking certain trends or events.

# Execute the Audit

### How do we identify the entity's significant accounting principles and policies? [ISA | 786.1400]

We identify the entity's significant accounting principles and policies by considering which principles and policies:

- have alternatives;
- require judgment on the part of management to apply;
- relate to subjective measurements;
- relate to complex transaction; or
- may indicate management bias - e.g. where there is a pattern of management taking a conservative or aggressive approach or where management may be managing earnings.

### How do we evaluate the entity's selection and application of significant accounting principles and policies? [ISA | 786.1500]

When we evaluate how the entity has selected and applied significant accounting principles and policies, we seek to understand:

- the methods used to account for significant and unusual transactions;
- the effect of significant accounting principles and policies in controversial or emerging areas where authoritative guidance or consensus is lacking;
- changes in the entity's accounting principles and policies; and
- financial reporting standards and laws and regulations that are new to the entity, including when and how the entity will adopt them.

We also evaluate whether the company's selection and application of significant accounting principles and policies may indicate management bias, with focus on:

- accounting principles and policies that relate to subjective measurements and complex transactions; and
- principles and policies that have more than one acceptable accounting method or allow management to select from several alternatives.

In these areas, the possibility increases that management may lack neutrality in selecting and applying accounting principles and policies - intentionally or not.

### What is management bias? [ISA | 786.1600]

Management bias arises when management lacks neutrality in preparing the financial statements.

Management may prefer a certain accounting outcome because of its impact on the entity's financial statements - e.g. increased profit. This may affect management's judgments and decisions when selecting and applying significant accounting principles and policies, leading to financial statements that are biased. This can occur even if management's bias is subconscious and does not intend to mislead the financial statements' users.

If management intends to mislead the users, then the management bias is fraudulent.

Everyone has conscious and subconscious biases that affect our opinions - e.g. in how we interpret news, evaluate political candidates, or even view different cultures. In accounting, management is no different. Some people are relatively conservative, while others are more aggressive, and management styles vary from one entity to another. Some entities set internal goals or targets, whereas others are more focused on external analyst reports.

Management's nature, as well as internal and external targets or pressures, may therefore affect the extent of management bias.

### What do we do when we identify indicators of management bias? [ISA | 786.1700]

When we identify indicators of management bias, including indicators of fraud, it is important that we perform additional procedures. These procedures may include:

- obtaining an understanding of management's accounting principle or policy choice when an alternate principle or policy would have been more appropriate;
- understanding the quantitative and qualitative impact to the financial statements and whether we need to propose any audit adjustments (e.g. when management accounting policy choice is not the most appropriate); and
- communicating indicators of management bias in the selection and application of accounting principles and policies to those charged with governance.

When we identify management bias during the audit, we reassess whether this bias creates a new RMM. We also reassess whether our planned identified RMMs remain appropriate and whether our audit procedures sufficiently address this bias.

The existence of management bias may lead us to identify additional RMMs, particularly fraud risks, or, more probably, lead us to assess already identified RMMs in different ways.

For audits performed under the PCAOB standards, those charged with governance for this activity are the audit committee or, if there is no audit committee, the board of directors.

### How may management bias affect the selection and application of accounting principles and policies? [ISA | 786.1800]

Examples of how management bias may affect how management selects and applies accounting principles and policies - e.g. to allow them to manipulate earnings - include:

- changing the accounting principle or policy for inventory pricing between FIFO (first in, first out) / weighted average cost;
- using an accounting principle or policy that is not in line with the relevant accounting framework - e.g. using a threshold for capitalization of fixed assets that has a material effect on the financial statements; and
- interpreting an accounting standard - e.g. what costs are recorded within a restructuring charge.

### What may indicate management bias in the selection and application of accounting principles and policies? [ISA | 786.1900]

Examples that suggest management was biased in selecting and applying accounting principles and policies include situations where:

- management selected and applied an accounting principle or policy that is inconsistent with industry practice;
- management voluntarily changes an accounting policy that had a material impact on profit and loss in the period and the change is not 'preferable' (i.e., it does not clearly provide reliable and more relevant information to users of the financial statements).

Examples that suggest management was biased in determining accounting estimates include situations where:

- management selected and applied a method or model to determine an accounting estimate that is inconsistent with historical practice - e.g., booking accounting estimates at the low end of a range when management historically booked to the mid-point;
- management recorded estimates that are predominately optimistic, when they were cautious in the preceding year;
- management changes the assumptions and methods used in an accounting estimate from period to period; and
- management's assumptions for fair value accounting estimates are inconsistent with observable assumptions in the marketplace.

### Do we perform additional evaluation of selection and application of accounting principles and policies to address a financial statement level fraud risk? [ISA | 786.11584]

Yes. We specifically consider the nature of the financial statement level fraud risk and what that tell us about how management may seek to manipulate earnings.

> For example, we may have identified a financial statement level fraud risk related to the fact an entity is planning to do an initial public offering (IPO). Given that broad fraud risk, management may seek to select and apply certain accounting policies to maximize earnings, achieve a certain enterprise valuation or maximise the ultimate share price in an IPO transaction.
>
> Similarly, we may have identified a financial statement level fraud risk related to the fact that an entity owes contingent consideration from a recent acquisition that is determined based on three-year earnings of the newly acquired subsidiary. In this instance, management may seek to select and apply accounting policies to minimise short-term earnings to reduce the contingent consideration payable - for example, by selecting and/or applying accounting policies that overstate the fair value of assets acquired and understate the fair value of liabilities assumed to reduce future earnings when they settle.

Once we have an understanding of how management may seek to manipulate earnings, we then evaluate the selection and application of accounting policies to determine if there are indicators that management is intentionally manipulating earnings in the selection and application of accounting policies. This may include:

- assessing newly selected policies to determine whether they are appropriate. This includes considering whether there are alternatives and whether management selected the accounting policy that we believe is most appropriate. If not, asking ourselves whether their selection is

indicative of management's efforts to manipulate earnings (i.e. is the financial impact of the inappropriate aligned with management's objectives to maximise or minimise earnings)?
- assessing changes in the selection or application of accounting policies This includes considering whether these changes are indicative of management's efforts to manipulate earnings (i.e. is the financial impact of the change aligned with management's objectives to maximise or minimise earnings)?
- If we identify indicators that management is intentionally manipulating earnings, then we determine the impacts on our audit, including whether we have identified fraudulent activity, the impact it has on our assertion level fraud risks and changes necessary in our response to the risk of management override.

# 1.1.5 Determine whether pervasive changes to audit procedures are necessary [ISA | 787]

## What do we do?

Determine whether it is necessary to make pervasive changes to the nature, timing or extent of our audit procedures to address RMMs

## Why do we do this?

In some cases, we may identify financial statement level and assertion levels and that are best addressed by making pervasive changes to our audit procedures. These changes form part of our overall response and can help us respond to these risks and obtain sufficient appropriate audit evidence.

## Execute the Audit

### What are pervasive changes to our audit procedures? [ISA | 787.1300]

Pervasive changes are broad modifications to our audit strategy that affect the nature, timing or extent of many of our planned audit procedures. These changes represent a form of overall response we can employ to adequately address risks of material misstatement.

### When might we make pervasive changes to our audit procedures? [ISA | 787.11585]

Pervasive changes can be made to address any risk of material misstatement, including both assertion-level RMMs and financial statement level risks. However, given the broad nature of the response, these changes are typically made to address financial statement level risks.

For example, if we identify deficiencies in the entity's control environment, we obtain more persuasive audit evidence from our substantive procedures, as opposed to relying on internal controls to reduce our substantive procedures.

### What are examples of pervasive changes to our audit procedures? [ISA | 787.1400]

The chart below sets outs examples of pervasive changes we may make to our audit procedure.

| Possible planned procedure in the absence of pervasive change: | Identified financial statement level risk: | Pervasive change: |
|---|---|---|
| Perform test of details, and conclude, as of an interim period, on the valuation of various assets which the entity carries at cost | Weakening economic conditions that negatively affect the value of many of the entity's assets | Alter the timing of our tests of details over the valuation of these assets so that we perform them at period-end |
| Plan to take a controls based approach over all areas of the audit | Pervasive weakness in the entity's risk assessment process | Don't take a controls based approach, and assess control risk at No Controls Reliance in all areas, increasing our level of substantive testing |
| Plan to take a controls based approach over fraud risks | Pervasive weaknesses related to tone at the top of the entity or lack of hotlines to identify and address improprieties or non-compliance with the code of conduct | Don't take a controls based approach, and assess control risk at No Controls Reliance for assertion-level RMMs due to fraud<br>Alter the nature of our tests of details over fraud risks to obtain more persuasive evidence or additional corroborative evidence |
| Assess the inherent risk of RMMs related to the valuation of various assets as Base or Elevated | Significant uncertainty about the long-term demand for an entity's products based on its expansion | Assess the inherent risk of these RMMs as Significant for each asset, and increase the extent of procedures we perform |

### Do we always make pervasive changes to our audit procedures? [ISA | 787.1600]

We always *think* about whether to make pervasive changes to our audit procedures; however, we may sometimes conclude that none are necessary - for example, if we identified no financial statement-level risks that would have a broad impact on how we conduct the audit.

# Examples

### How do we identify and respond to risks that results in pervasive changes to our audit procedures? [ISA | 787.1700]

**Fact pattern:**

An entity's VP of Human Resources left during the year and was replaced with an external hire. The new VP of HR changed the entity's hiring policies and practices. As a result, they no longer appropriately evaluate credentials or perform background checks when hiring for accounting and financial reporting roles. The entity hired a new Corporate Controller after the change in hiring policies was instituted.

Analysis:

The engagement team concludes that there is a deficiency in the control environment. Due to its pervasive nature, it is a financial statement-level risk.

The team decides to design and implement overall responses, such as:

- involving senior members of the engagement team in executing audit procedures;
- requiring more extensive supervision and review by the engagement partner; and
- considering whether to make pervasive changes to their planned audit procedures.

They consider the pervasive impact that the control environment deficiency has on their ability to rely on internal controls, particularly those in areas of the financial statements that involve the new Corporate Controller.

The team concludes that:

- during their walkthroughs, they will inquire of process and control operators whether they have noticed a change in the tone at the top about ICFR, changes to processes, etc.;
- they will alter their control testing procedures to obtain more persuasive evidence over controls involving or overseen by the Corporate Controller; and/or
- they will alter their substantive procedures to obtain more persuasive audit evidence in areas involving or overseen by the Corporate Controller.

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

## International Standards on Auditing: ISA 240.31

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

31. In accordance with ISA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.[11] (Ref: Para. A38-A41)

11 ISA 330, paragraph 6

## ISA Application and Other Explanatory Material: ISA 240.A38-A41

## *Audit Procedures* Responsive *to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level* (Ref: Para. 31)

A38. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
  - Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
  - The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement - for example, a misstatement involving improper revenue recognition - may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A39. 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.

A40. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A41. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Design and perform procedures to address each RMM [ISA | 587]

## What do we do?

Design and perform audit procedures whose nature, timing and extent address the risks of material misstatement for each assertion of each significant account and disclosure and in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory

## Why do we do this?

To meet our audit objectives, we reduce audit risk to an appropriately low level by obtaining persuasive - i.e. sufficient and appropriate - audit evidence.

To reduce audit risk, we design and perform audit procedures for each RMM for each significant account, disclosure and relevant assertions. When designing and performing these audit procedures, we can take a controls based approach or a substantive approach for each RMM.

If we are biased when we design and perform our audit procedures, then we may fail to obtain sufficient and appropriate audit evidence and draw the wrong conclusions on which we base our audit opinion.

## Execute the Audit

### What is our objective when performing a financial statement audit? [ISA | 587.1400]

Our audit objective is to provide reasonable assurance that the financial statements are free of material misstatement (whether due to error or fraud). We accomplish this audit objective by reducing audit risk to an appropriately low level.

## What is audit risk? [ISA | 587.1500]

Simply stated, audit risk is the possibility that we will reach the wrong overall conclusion in our audit - i.e. that we express an unqualified audit opinion when the financial statements are materially misstated.

### What are the components of audit risk? [ISA | 587.10999]

Audit risk has two primary components.

| | | |
|---|---|---|
| **Risk of material misstatement** | The risk that the financial statements are materially misstated | Exists independently of the audit |
| **Detection risk** | The risk that our audit procedures fail to detect that material misstatement | Influenced by what we do in the audit |

## How do we reduce audit risk to an appropriately low level? [ISA | 587.1600]

To reduce audit risk to an appropriately low level, we design and perform audit procedures to obtain persuasive evidence over each risk of material misstatement identified. We design and perform these procedures in a manner that is not biased towards obtaining corroborative audit evidence or towards excluding contradictory audit evidence.

We maintain professional skepticism when evaluating audit evidence with respect to the RMM, including when:

- considering information that may be used as audit evidence (corroborative or contradictory), and
- what procedures would be appropriate in the circumstances.

## What do we consider when designing our audit procedures? [ISA | 587.11161]

When we design our audit procedures, we consider:

- the type, likelihood, and magnitude of potential misstatements that may result from the identified risks (i.e. inherent risk);
- whether we intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures (i.e. control risk); and
- the persuasiveness of evidence we need, based on our risk assessment.

## What is persuasive evidence? [ISA | 587.1900]

Persuasive evidence is evidence that makes a more credible argument or strengthens our 'belief' in the results of our testing. To be persuasive, the evidence has to be sufficient (i.e. quantity) and appropriate (i.e. quality) audit evidence. Some types of evidence we gather are more persuasive than others. We may calibrate the level of audit evidence we plan to obtain by altering the nature, timing and/or extent of our audit procedures.

## How do we assess risk for assertion-level RMMs? [ISA | 587.2000]

Our assessment of the risk for assertion-level RMMs is a function of two separate components - inherent risk and control risk. We call this assessment combined assessed risk (CAR).

We assess CAR for each identified assertion-level RMM.


Our CAR assessment influences the substantive procedures we design and perform to reduce detection risk to the appropriate level, and therefore reduce audit risk.

### What is inherent risk? [ISA | 587.11000]

Inherent risk is the susceptibility of an assertion to a misstatement that may be material, before considering related control activities.

> For example, consider the inherent risk of having an accident while driving. We most likely assess the risk of city driving as higher than the risk of driving on the freeway or motorway. This is because city driving has many different hazards - e.g. lots of pedestrians and other cars - whereas a freeway may have fewer hazards - i.e. it's an open road with few other cars.
>
> When thinking about the inherent risk, we do not consider the potential controls in place, such as speed limits, road signs, and stop lights.

The same concept applies to auditing - certain accounts, disclosures and assertions are inherently riskier than others are. Inherent risk may be greater when transactions are complex, or in situations that include estimates with a high degree of uncertainty.

### What is control risk? [ISA | 587.11001]

Control risk is the risk that an entity's controls will fail to prevent or detect a material misstatement on a timely basis. Control risk is lower when the controls associated with a particular assertion are designed and operating effectively.

Essentially, control risk relates to how effective the controls are in reducing audit risk - in the same way that effective speed limits, road signs and stop lights can reduce the risk of having an accident while driving.

Similar to inherent risk, control risk exists independent of the audit. But unlike inherent risk, control risk is something that management can influence: the stronger an entity's controls over financial reporting, the lower control risk becomes.

However, while the strength of an entity's controls can have an impact on audit risk, we only factor that into our assessment of CAR when we obtain sufficient evidence over the design, implementation and operating effectiveness of the relevant control activities.

Due to the inherent limitations of internal control - e.g. human error or management override - some control risk will always exist.

### What is the CAR matrix? [ISA | 587.2100]

The CAR matrix provides our CAR assessment, based on our individual assessments of inherent risk and control risk for each assertion-level RMM.

| | Control risk (CR) | |
|---|---|---|
| Inherent risk (IR) | No Controls Reliance (N) | Controls Reliance (C) |
| Significant (S) | **SN** | **SC** |
| Elevated (E) | **EN** | **EC** |
| Base (B) | **BN** | **BC** |

### How does persuasive evidence relate to CAR? [ISA | 587.2200]

We gather more persuasive audit evidence for those RMMs that have a higher CAR (i.e. EN, EC, SN, SC).

We may calibrate the level of audit evidence we plan to obtain by altering the nature, timing and/or extent of our tests of controls or substantive procedures.

### What types of audit procedures can we design? [ISA | 587.2400]

In a financial statement audit, our procedures may include tests of controls - i.e. testing their operating effectiveness - and/or substantive procedures.

Effective controls allow us to alter the nature, timing and extent of substantive procedures. This allows us to obtain evidence that is less persuasive than we planned to obtain had we not tested controls and found them effective.

In some cases, we may decide that substantive procedures alone are the most appropriate audit response - for example, because:

- our risk assessment procedures did not identify relevant process control activities over the process risk points related to the RMM; or
- testing controls is inefficient.

In such cases, we may not rely on the operating effectiveness of controls to determine the nature, timing and extent of substantive procedures.

Tests of controls alone provide insufficient evidence to conclude on an RMM. Even when we plan to test controls, we still perform substantive procedures for each RMM.

The combination of substantive procedures and tests of controls, including the nature, timing and extent of those tests, may differ for each RMM.

# 1.1 Perform substantive procedures that respond to significant risks [ISA | 1266]

## What do we do?

IF we identify a significant risk, THEN perform substantive procedures that specifically respond to the assessed risk

## Why do we do this?

In situations where we have a significant risk, we design our substantive audit procedures so their nature, timing and extent properly address the risk of material misstatement (RMM).

## Execute the Audit

### What is a significant risk? [ISA | 1266.1400]

A significant risk is a risk of material misstatement (RMM) which is:

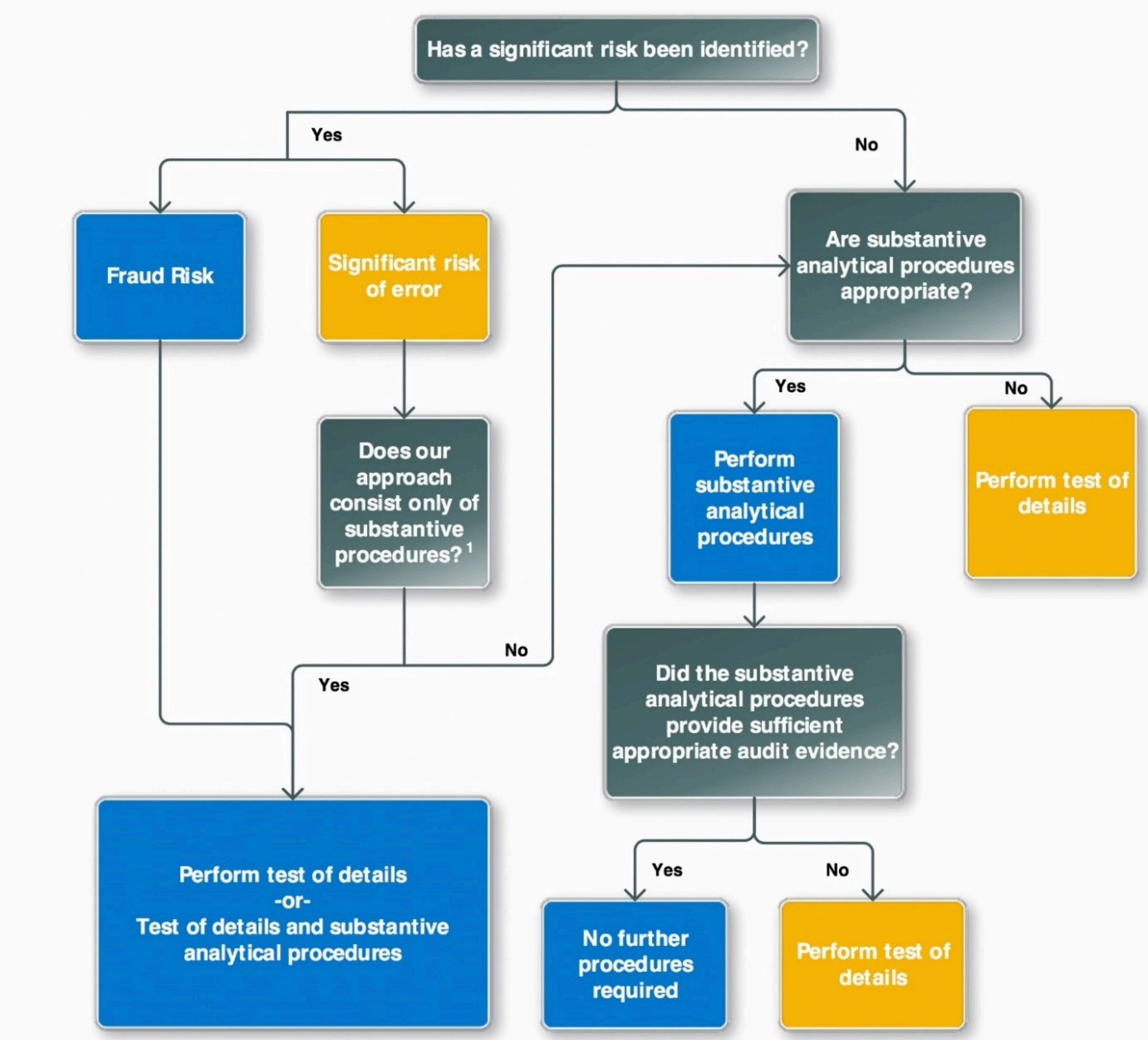
- close to the upper end of the continuum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
- fraud risks; or
- significant unusual transactions with related parties.

We document special audit considerations in response to significant risks.

### What substantive procedures do we perform to respond to a significant risk? [ISA | 1266.11989]

We select our procedures that would be responsive to the assessed risks. When the approach to a significant risk due to error consists only of substantive procedures (i.e., either we have not tested the operating effectiveness or such controls were not operating effectively), those procedures shall include tests of details. However, for significant risks of fraud (i.e., fraud risks), the substantive procedures we perform always include test of details, even when we have tested controls and determined they operate effectively.

**The following decision tree summarizes the substantive procedures we perform in response to identified risks:**




1. Our approach consists only of substantive procedures when we do not perform tests of operating effectiveness of controls or if we performed such tests but determine the controls are ineffective.

In addition, the nature, timing and extent of our substantive procedures differ from what we perform in the absence of a significant risk (see activity 'Design and perform substantive procedures to respond to the level of CAR').

## Why do we alter the nature, timing and extent of our procedures for a significant risk? [ISA | 1266.1600]

We alter the nature, timing and extent of our procedures because we obtain more persuasive evidence for a significant risk than for other risks.

## How do we alter our substantive procedures to respond to a significant risk? [ISA | 1266.1700]

To respond to a significant risk we may:

- design procedures that by their nature are more persuasive - e.g. use confirmation with a third party instead of inspection of documents, change our method of selecting items;
- change the nature of our procedures by designing and performing additional substantive procedures - e.g. perform both a substantive analytical procedure (SAP) and tests of details.

For example, management is under pressure to meet earnings expectations. A risk may exist that they respond to this pressure — for example, by inflating sales through:

- improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition; or
- invoicing sales before shipment and before control transfers.

Had no significant risk existed, we may have performed a test of details by inspecting invoices, bills of lading and proof of payment for a selection of sales transactions.

But having identified a significant risk, we choose to also design external confirmation procedures that confirm outstanding amounts and the details of the sales agreements with the customer - including dates, any rights of return and delivery terms. We also supplement these confirmations with inquiries of the entity's non-financial personnel about any changes in sales agreements and delivery terms.

Simply increasing the number (i.e., sample size) of sales transactions to inspect may be insufficient.

It may be helpful to ask ourselves what we are doing differently since we identified a significant risk. If the answer is nothing, then we may not have addressed the significant risk appropriately.

Can we only test the operating effectiveness of controls in response to a significant risk? [ISA | 1266.11790]

No. Testing the operating effectiveness of control activities as our *only* response to a significant risk is not appropriate. We also perform tests of details to address the significant risk.

However, we may choose to test the operating effectiveness of controls as part of our response to a significant risk.

# 1.2 Design and perform procedures to address each assertion-level RMM due to fraud [ISA | 789]

## What do we do?

Design and perform procedures to address risks of material misstatement due to fraud at the assertion level

## Why do we do this?

We design and perform procedures that are specifically responsive to our identified risks of material misstatement due to fraud (i.e. fraud risks) at the assertion level to gather sufficient appropriate audit evidence related to those risks. Given that fraud often involves attempts by the perpetrator to conceal the fraud, we design the nature, timing, and extent of the procedures we perform to respond to fraud risks to obtain more persuasive evidence.

## Execute the Audit

What are assertion-level fraud risks? [ISA | 789.1300]

Assertion-level fraud risks relate to:

- specific assertions for classes of transactions, account balances, or disclosures; and
- misstatements that can arise when the financial reporting framework (e.g. IFRS Standards, US GAAP), is not applied appropriately.

Two types of misstatements are relevant when we consider assertion-level fraud risks.

| Type | Description | How it may be accomplished |
|---|---|---|
| Fraudulent financial reporting | Intentional misstatements or omissions of amounts or disclosures designed to deceive financial statement users | • Manipulating, falsifying or altering accounting records or supporting documentation<br>• Misrepresenting or intentionally omitting events, transactions or other significant information from the financial statements<br>• Intentionally misapplying accounting principles (for SEC engagements, look to the requirements of the SEC for accounting principles applicable to the entity) |
| Misappropriation of assets | Theft of an entity's assets, causing the financial statements to be misstated | • Embezzling receipts<br>• Stealing assets<br>• Causing an entity to pay for goods or services that have not been received and may be accompanied by false or misleading records or documents, possibly created by circumventing controls |

## How do we design and perform procedures to respond to fraud risks? [ISA | 789.1400]

We design and perform procedures to respond to fraud risks as follows:

- Evaluate the design and implementation of the entity's controls over the applicable process risk points related to the fraud risks; and
- Perform substantive procedures, including tests of details.

We design the nature, timing, and extent of substantive procedures we perform to respond to fraud risks to obtain evidence that is more persuasive or obtain additional corroborative information. We may also determine to perform a combination of different procedures to respond to the fraud risk.

The table below sets out examples of how we may modify our planned audit procedures to address fraud risks.

| Change the.... | Examples |
|---|---|

| | |
|---|---|
| Nature of audit procedures | • Physically observe or inspect certain assets, or apply computer-assisted audit techniques to data contained in significant accounts or electronic transaction files.<br>• Use external confirmations to confirm details of the sales agreements - including date, any rights of return and delivery terms. Supplement such external confirmation procedures with inquiries of the entity's non-financial personnel regarding any changes in sales agreements and delivery terms. |
| Timing of audit procedures | • Perform audit procedures to be at, or closer to, either the period end or the points during the period in which fraudulent transactions are more likely to occur. We may decide that it's not effective to use audit procedures which roll forward audit conclusions from an interim date to the period end. |
| Extent of audit procedures | • Increase the extent of the population tested<br>• Perform analytical procedures with a higher level of precision.<br>• Apply computer-assisted audit techniques to select sample transactions from key electronic files, in order to identify transactions with specific characteristics, or test all of the items in an account. |

It is often helpful to ask ourselves what we are doing differently since we identified a fraud risk. If the answer is nothing, then we may not have addressed the fraud risk appropriately.

**Depending on the risk**, merely altering the extent of testing - e.g., increasing sample sizes - or altering the timing of testing may not be sufficient.

### Do we always take a controls based approach to respond to fraud risks? [ISA | 789.1600]

Not necessarily. We take a controls based approach either because of the type of audit we are performing, or because we believe it will be more efficient. We take a controls based approach as part of our response to fraud risks when:

- we perform an audit of ICFR - i.e., an integrated audit; or
- we cannot obtain sufficient evidence to respond to the fraud risk through substantive testing alone.

In many instances, we may determine to take a controls based approach to respond to fraud risks related to misappropriation, such as misappropriation of cash or inventory.

### What if we identify a deficiency in controls that are intended to address assessed fraud risks? [ISA | 789.11483]

When we identify deficiencies in controls that are intended to address assessed fraud risks, we take into account those deficiencies when designing our response to those fraud risks.

### What procedures might we perform to respond to fraud risks? [ISA | 789.1700]

No one procedure will be sufficient for all fraud risks because we design each procedure to respond to a specific fraud risk at a specific entity.

Our responses to our assessment of fraud risks vary depending on:

- the types or combinations of fraud risk factors or conditions identified; and
- the classes of transactions, account balances, disclosures and assertions they may affect.

### What are some general examples of substantive procedures we might perform to respond to fraud risks?

[ISA | 789.1800]

General examples of what we can do differently include:

- performing procedures at locations on an unannounced basis - for example:
  - observing inventory on unexpected dates or at unexpected locations
  - counting cash at a particular date on a surprise basis
- confirming contract terms with customers and suppliers both large and small
- confirming contract terms with customers and suppliers with whom the entity no longer does business
- altering the audit approach in the current period - for example:
  - contacting major customers and suppliers orally and sending written confirmations
  - sending confirmation requests to a specific party within an organization
  - seeking more or different information
- performing a detailed review of the entity's quarter-end or period-end adjusting entries, and investigating any that appear unusual in nature or amount
- investigating the possibility of related parties, and the sources of financial resources, behind significant and unusual transactions - particularly those occurring at or near the period end
- performing substantive analytical procedures using disaggregated data in addition to our test of details - for example, comparing gross profit or operating margins by location, line of business, or month to our own expectations
- performing additional inquiries with personnel in areas in which a fraud risk has been identified, and obtaining their insights about the risk and how controls address it (this is not sufficient audit evidence on its own)
- discussing with other auditors the extent of work needed to assess fraud risk at those components
- if a management's specialist's work on a financial statement item becomes significant, then performing additional procedures over some or all of their assumptions, methods or findings to determine whether they are reasonable (we may involve a KPMG specialist to do this)
- analyzing selected opening balances of previously audited financial statements, and assessing how the entity used hindsight to resolve issues involving accounting estimates and judgments, such as an allowance for sales returns
- performing computer-assisted audit techniques - e.g. using computer assisted audit techniques to identify unusual or unexpected transactions or anomalies
- testing the integrity of computer-produced records and transactions
- seeking additional audit evidence from sources outside of the entity.

### What are some examples of substantive procedures we might perform to respond to fraud risks related to revenue recognition? [ISA | 789.1900]

Revenue-specific examples of what we can do differently include:

- performing substantive analytical procedures over revenue using disaggregated data - e.g. performing a trend analysis on revenue reported by month and by product line or business segment during the current period against comparable prior periods. Computer-assisted audit techniques may also help identify unusual or unexpected revenue relationships or transactions
- confirming relevant contract terms and the absence of side agreements with customers, because these can often influence the accounting - 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
  - cancellation or refund provisions
- inquiring of the entity's sales and marketing personnel or in-house legal counsel about unusual terms or conditions associated with sales or shipments near the end of the period
- performing appropriate sales and inventory cut-off procedures, by being physically present at one or more locations at period end to observe goods being shipped or readied for shipment, or returns awaiting processing
- testing controls over the occurrence and recording of revenue transactions that are electronically initiated, processed and recorded.

### What are some examples of substantive procedures we might perform to respond to fraud risks related to inventory? [ISA | 789.2000]

Inventory-specific examples of what we can do differently include:

- examining the entity's inventory records to identify locations or items that warrant specific attention during or after the physical inventory count
- requesting that inventories be counted at the end of the reporting period or on a date closer to period end - this minimizes the risk of balances being manipulated between the date of the count and the end of the reporting period
- performing inventory counts unannounced
- performing inventory counts at all locations on the same date
- performing additional procedures while observing the count, such as examining the contents of boxed items and how the goods are labeled or stacked - e.g. hollow squares
- considering using a KPMG specialist if the inventory is valued on purity, grade or concentration - e.g. perfumes or specialty chemicals
- comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, and/or comparing the quantities counted against perpetual IT records
- using computer-assisted audit techniques to further test the aggregation of the physical inventory counts - e.g. sorting by tag number to test controls over tagging, or by serial number to test whether items were omitted or double-counted.

### What are examples of substantive procedures we might perform to respond to fraud risks related to estimates? [ISA | 789.2100]

Examples specific to management estimates of what we can do differently are:

- using a KPMG specialist to develop an independent estimate that we can compare to management's estimate; and
- extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans relevant to developing the estimate.

### What are examples of incremental procedures when a SUT is assessed with a fraud risk? [ISA | 789.11487]

Examples of incremental procedures to obtain more persuasive audit evidence related to a SUT assessed with fraud risk may be:

- confirming contract terms and agreements with third parties;
- confirming amendments to contract terms and agreements or side agreements with third parties;
- involving a specific team member to assess the authenticity of contracts and agreements;
- investigating the possibility of related parties involved in the transaction and the sources of financial resources supporting the transaction.

# Examples

### How might we design procedures in response to fraud risks? [ISA | 789.11489]

**Example 1**

*Fact pattern:*

During our risk assessment procedures, we identify the following fraud risk:

The use of side agreements could alter the terms and conditions of recorded sales transactions and may result in the revenue being overstated.

In designing audit procedures over revenue, we may plan to inspect a sample of invoices and compare them to the terms in the associated sales contract.

*Analysis:*

While this procedure may address the risk of error, it may not respond to the nature of the particular fraud risk. To address this risk, we may consider performing an additional procedure or altering the nature of our planned procedures - e.g., confirming the transaction terms directly with the customer.

Example 2

*Fact pattern:*

The same fact patter applies as for Example 1. However, this time we plan to confirm the transaction terms directly with the customer, to address the risk of fraud.

*Analysis:*

To specifically address the fraud risk, we may change the extent or timing of our planned procedures - e.g., by confirming more items than we originally planned, or performing the procedure at, or closer to, the end of the period.

Changing the timing of our procedures is particularly effective when we determine that there is a greater risk of a misstatement occurring at or near the end of the period.

We might also decide to modify the nature of our procedures by changing the confirmation form to ask the customer to specify the nature and terms of any side agreement.

# 1.2.1 Design and perform audit procedures related to fraudulent financial reporting [ISA | 790]

## What do we do?

Design and perform audit procedures that are responsive to assertion-level fraud risks related to fraudulent financial reporting

## Why do we do this?

We design and perform procedures that are specifically responsive to our identified risks of material misstatement (RMMs) due to fraud (i.e. fraud risks) related to fraudulent financial reporting at the assertion level to gather sufficient appropriate audit evidence related to those risks.

## Execute the Audit

### What audit procedures do we design and perform in response to assertion-level fraud risks related to fraudulent financial reporting? [ISA | 790.11808]

We design and perform audit procedures that are specifically responsive to risks of material misstatement (RMM) related to fraudulent financial reporting. We formulate different responses for different types of fraud risks. When we perform a financial statement audit, our response includes:

- evaluating the design and implementation of process control activities that address process risk points (PRPs) linked to the RMM related to fraudulent financial reporting; and
- designing and performing substantive audit procedures, including tests of details, that are specifically responsive to the RMM related to fraudulent financial reporting.

Depending on the specific fraud risk identified, we may determine to take a controls approach to respond to the fraud risks - e.g., when substantive procedures alone cannot sufficiently respond to the specific fraud risk. When we perform an audit of ICFR - i.e., an integrated audit - we take a controls approach to respond to the fraud risks.

#### What are examples of process control activities we may test to respond to assertion-level fraud risks related to fraudulent financial reporting? [ISA | 790.1300]

**The following table includes examples of process control activities we may test to respond to assertion-level fraud risks related to fraudulent financial reporting:**

| Fraud risk related to fraudulent financial reporting: | Example process control activities: |
|---|---|

| | |
|---|---|
| Revenue recognition - side agreements | • All employees of the sales department provide certifications of their knowledge of all side agreements entered outside of the company's normal reporting channels on an annual basis.<br>• The AR Aging is reviewed by the VP of Customer Accounting on a monthly basis for significant past due accounts. All accounts greater than 90 days outstanding are selected for further investigation.<br>• The controller inspects a listing of all credit memos issued to customers on a quarterly basis. All credit memos issued over $X are investigated. The listing is categorized by credit memos issued each individual quarter and then by year for the past three years. |
| Revenue recognition - channel stuffing | • The system does not allow a sales transaction that is recorded in a previous period to be reversed in a subsequent period. Sales can only be reversed in a subsequent period through a credit memo.<br>• All credit memos are reviewed and approved by the responsible party in accounting or finance prior to issuance.<br>• There is a 3-way match of customer information (including shipping quantity) in the system between purchase order, shipping documents and invoice. Any differences are flagged via an exception report and are investigated and resolved by accounting personnel in a timely manner.<br>• The controller reviews a listing of all credit memos issued by customer on a quarterly basis, including those subsequent to period end. The listing is categorized by credit memos issued each individual quarter and then by year for the past three years. |
| Revenue recognition - bill and hold transactions | • All contracts entered into with customers are reviewed by the Legal department. In addition, all customer contracts with bill and hold terms are approved and documented along with any subsequent changes, by finance or accounting personnel for the following criteria:<br>- There is a fixed purchase commitment in writing from the customer<br>- The risks of ownership pass to the buyer<br>- The customer has requested the transactions and has a legitimate business purpose for a bill and hold<br>- The entity does not retain any significant specific performance obligations, such as an obligation to assist in resale |

| | |
|---|---|
| | - There is a fixed delivery date that is reasonable and consistent with the customer's business purpose, and<br>- The entity has a location for storage of the inventory that is segregated from the entity's inventory used to fulfil other orders<br>• The IT system matches the quantity and items ordered to the schedule of delivery input into the system. Any differences are flagged in the system and investigated. Manual adjustments made are appropriately documented, reviewed, and approved by accounting personnel. Inventory for bill and hold customers is properly segregated and labelled as such in the warehouse and in the entity's IT system. |
| Revenue recognition - consignment sales | • Acknowledgement by all parties involved, of the terms and conditions of the consignment sale is maintained in writing and reviewed and approved by the legal department. In addition, personnel in the accounting or finance department review all consignment sales for criteria that may impact revenue recognition.<br>• The inventory manager reconciles consigned inventory usage to the general ledger on a monthly basis. All reconciliations are reviewed and approved by appropriate finance/accounting personnel.<br>• There is segregation of duties between individuals that perform customer confirmation / verification of consigned inventory usage and those in the accounts receivable / customer receivables department. |
| Inventory - inflating inventory quantities | • There is a 3-way match in the system between the entity's purchase order, shipping documents and receiving documents. Any differences are flagged via an exception report and are investigated and resolved by accounting personnel in a timely manner.<br>• The entity performs a full physical inventory verification on an annual basis, which is conducted by an independent third-party. For technical items, certifications are obtained from management's specialists. The inventory verification process includes verification of inventory held by third parties/off-site inventory. Independent third-party counters investigate and follow up on any test count differences.<br>• All manual adjustments to inventory booked as a result of the physical inventory verification are reviewed and approved by the controller. |

| | |
|---|---|
| | • All inventory movements between locations are logged into the IT system. On a semi-monthly basis, the inventory movements report is reviewed by accounting and any unusual or unexplained movements are followed up on.<br>• Inventory is verified by cycle counting and counts are conducted on various inventory components in accordance with defined schedule. The stock manager compares and reviews the results of the cycle counts with the system generated counts on hand and evidences his or her review by signing off on the comparison report. For any items that show discrepancies after the first count, a second count is performed by a different counter, and noted on the count sheets with a second signature. Minor discrepancies (less than $X in value) are referred to and are approved by an Inventory Manager. Major adjustments (over $X) are referred to the responsible manager for approval. |
| Inventory - inflating inventory value | • Management reviews a report to compare sales made in the past 12 months by product line to on-hand inventory balances. On-hand inventory balances in excess of 6-months of inventory sales are flagged for further investigation.<br>• The allowance for inventory obsolescence is reviewed by the Controller which includes a review of all additions and adjustments to the allowance. The Controller considers the inventory turnover, sales, and aging of inventory at a product line level in the evaluation of the allowance for inventory obsolescence.<br>• All inventory write-downs are approved per the authority matrix. |

What are examples of substantive procedures we may design and perform to respond to assertion-level fraud risks related to fraudulent financial reporting? [ISA | 790.1400]

**The following table includes examples of substantive procedures we may design and perform to respond to fraud risks related to fraudulent financial reporting:**

| Fraud risk related to fraudulent financial reporting: | Example substantive procedures to respond: |
|---|---|
| Revenue recognition | • Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting may be influenced by such terms or agreements and basis for rebates or the period to which they relate may be poorly documented. For example:<br>- acceptance criteria<br>- 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.

- When there is a moderate or high risk that there may be significant oral modifications or in jurisdictions where oral modifications may have legal effect, we may design the confirmation request to also inquire about the existence and details of modifications to agreements.
- Obtaining an independent confirmation of receivables using appropriate sampling techniques, rigorously investigating all differences. Altering the approach by contacting major customers or suppliers orally in addition to written confirmations or addressing requests to specific people in the organization.
- 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 cut-off 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.
- Comparing not only ratios relating to sales, but also in conjunction with ratios relating to purchases and liquidity, thereby linking revenue recognition to the level of activity and cash flow in the business.
- Other substantive procedures, including analyzing revenue data, including identification of transactions that meet specific criteria, and selecting such contracts for examination:

  - large transactions
  - transactions with specific customers or groups of customers or with related parties
  - transactions near the end of the reporting period
  - revenue transactions with vendors, or from new or old products
  - customer returns and allowances.

- Considering the use of CAATs to perform the procedures listed above. If appropriate, we may use specific team members with expertise in IT to extract the desired data and to assist in performing the relevant procedures.

| | |
|---|---|
| | • To supplement our tests of details, performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods or with revenue related to cash collections. Computer assisted audit techniques (CAATs) may be useful in identifying unusual or unexpected revenue relationships or transactions. |
| Inventory quantities | • Examining the entity's inventory records to identify locations or items that we may determine to warrants specific attention during or after the physical inventory count.<br>• Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date to prevent shifting of inventory from one location to another.<br>• 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.<br>• Performing additional procedures during the observation of the count, for example, more rigorously examining the:<br>- contents of boxed items<br>- manner in which the goods are stacked (for example, hollow squares) or labelled<br>- quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a KPMG specialist may be helpful in this regard.<br>- performing additional testing of count sheets, tags or other records, or<br>- retaining copies of count records to minimize the risk of subsequent alterations or inappropriate compilation.<br>• 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.<br>• Using CAATs to further test the compilation of the physical inventory counts, for example, sorting by:<br>- tag number to test tag controls, or<br>- item serial number to test the possibility of item omission or duplication. |
| Management estimates | • Using a KPMG specialist to develop an independent estimate for comparison to management's estimate. |

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

# 1.2.2 Design and perform procedures that are responsive to each RMM related to misappropriation of assets [ISA | 791]

## What do we do?

IF we are responding to a fraud risk related to misappropriation of assets, THEN design and perform procedures to specifically respond to the risk identified

## Why do we do this?

We design and perform procedures that are specifically responsive to our identified risks of material misstatement (RMMs) due to fraud (i.e. fraud risks) related to misappropriation of assets to gather sufficient appropriate audit evidence related to those risks.

## Execute the Audit

### What audit procedures do we design and perform in response to assertion-level fraud risks related to misappropriation of assets? [ISA | 791.11811]

We design and perform audit procedures that are specifically responsive to risks of material misstatement (RMMs) related to misappropriation of assets (misappropriation risks). We formulate different responses for different types of fraud risks. When we perform a financial statement audit, our response includes:

- evaluating the design and implementation of process control activities that specifically address process risk points (PRPs) linked to the misappropriation risks; and
- designing and performing substantive audit procedures, including tests of details, which are specifically responsive to the misappropriation risks.

Depending on the specific fraud risk identified, we may determine to take a controls approach to respond to the fraud risks - e.g., when substantive procedures alone cannot sufficiently respond to the specific fraud risk. When we perform an audit of ICFR - i.e., an integrated audit - we always take a controls approach to respond to the fraud risks.

#### What are some examples of process control activities we may test to respond to misappropriation risks? [ISA | 791.1300]

**The following table includes examples of process control activities we may test to respond to fraud risks related to misappropriation of assets:**

| Fraud risk related to misappropriation of assets: | Example process control activities: |
|---|---|
| Cash - fraudulent disbursements | • Reconciliation of all bank accounts on a timely basis<br>• Segregation of duties between individuals who reconcile bank accounts and individual responsible for cash disbursements<br>• Review of cancelled checks or activity, including transfers between bank accounts around year end, within bank statements<br>• Restricting logical access to computerized cash disbursement records<br>• Restricting physical access to negotiable assets, such as blank checks<br>• Review and approval of cash disbursements including checks and electronic wire transfers |
| Accounts receivable - embezzling receipts | • Segregation of duties between individuals who prepare invoices, receive payments, and maintain accounts receivable records<br>• Restricting logical access to computerized accounts receivable records<br>• Review and approval of credit memos and bad debt write-offs by an appropriate individual / member of management<br>• Review and approval of customer complaints related to billing by an appropriate individual / member of management<br>• Reconciliation of accounts receivable subledgers to general ledger account balances and investigation of unreconciled items |
| Purchasing and payroll - payments for goods and services not received | • Segregation of duties between purchasing, receiving, accounts payable, and disbursement functions<br>• Three way match between purchase orders, shipping documents, and receiving documents<br>• Restricting logical access to computerized vendor, accounts payable, and payroll records<br>• Review and approval of new vendors<br>• Periodic review of vendor records to identify matches with employee names, addresses, phone numbers or bank accounts<br>• Review and approval of new employees prior to adding them to payroll records<br>• Timely removal of terminated employees from payroll records<br>• Periodic review of payroll records to identify fictitious employees by an appropriate individual / member of management |
| Inventory - stealing physical assets | • Safeguarding controls over inventory susceptible to misappropriation |

| | |
|---|---|
| | • Segregation of duties between individuals responsible for inventory record keeping and individuals responsible for physical custody<br>• Restricting logical access to computerized inventory records<br>• Performing full physical inventory verification on an annual basis by an independent third party and obtaining certification for technical items from management's specialists<br>• Verification of inventory held by third parties/off-site inventory<br>• Review and approval of manual adjustments to inventory booked as a result of physical inventory verification<br>• Performing cycle counts on various inventory components in accordance with a defined schedule<br>• Review and approval of adjustments to inventory quantities as a result of cycle counts<br>• Review of reports related to inventory movements between locations to identify unusual or unexplained movements<br>• Restricting physical access to scrap inventory |

What are examples of substantive procedures we may perform to respond to misappropriation risks?

[ISA | 791.1400]

**The following table includes examples of substantive audit procedures we may perform to respond to fraud risks related to misappropriation of assets:**

| Fraud risks related to misappropriation of assets: | Example substantive procedures: |
|---|---|
| Accounts receivable - embezzling receipts | • 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.<br>• Analyzing recoveries of written-off accounts.<br>• Analyzing sales discounts and returns for unusual patterns or trends. |
| Cash / investments / inventory - stealing physical assets | • Counting cash or securities at or near year-end.<br>• Analyzing inventory shortages by location or product type.<br>• Comparing key inventory ratios to comparable ratios from others in the industry.<br>• Reviewing supporting documentation for reductions to the perpetual inventory records.<br>• Reviewing the propriety of large and unusual expenses.<br>• Reviewing the authorization and carrying value of senior management and related party loans.<br>• Reviewing the level and propriety of expense reports submitted by senior management. |

| | |
|---|---|
| Purchasing and payroll - payments for goods or services not received | • Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.<br>• Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.<br>• Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.<br>• Confirming specific terms of contracts with third parties.<br>• Obtaining evidence that contracts are being carried out in accordance with their terms. |

# 1.3 Consider anti-fraud control deficiencies when responding to fraud risks in financial statement audit [ISA | 1372]

## What do we do?

IF deficiencies in process control activities designed to prevent or detect fraud are identified, THEN take these deficiencies into account when developing our response to fraud risks in the financial statement audit.

## Why do we do this?

To the extent we identify deficiencies in process control activities that address fraud risks (anti-fraud controls), we take these deficiencies into account when we design our planned response to the related fraud risks in the financial statement audit because we are unable to rely on the effectiveness of these controls. Our inability to rely on these anti-fraud controls influences the level of audit evidence necessary from substantive procedures.

## Execute the Audit

### How do we take into account identified deficiencies in anti-fraud controls when we develop our response to fraud risks? [ISA | 1372.1300]

The existence of deficiencies in process control activities that are anti-fraud controls may cause us to obtain more persuasive audit evidence from substantive procedures.

This table shows how we take into account deficiencies in anti-fraud controls when we develop our response to the related fraud risks.

| Scenario | How do we take the deficiency into account when we develop our response to fraud risks? |
|---|---|

| | |
|---|---|
| We intend to apply a controls approach in the financial statement audit | The deficiency will usually change our initial assessment of control risk from 'Controls Reliance' to 'No Controls Reliance' and increase our initial assessment of CAR in the financial statement audit. This is true unless we are able to identify a compensating control that also addresses the same process risk point (PRP) and the compensating control is appropriately designed, implemented, and operating effectively.<br>For a higher CAR, we obtain more persuasive evidence from our substantive procedures, resulting in us modifying the nature, timing, and extent of our substantive procedures. |
| We do not intend to apply a controls approach in our financial statement audit | Even though control risk is not affected, it may still be necessary to modify the nature, timing, and extent of our substantive procedures.<br>In evaluating the deficiency, we may learn more about the risks of material misstatement affecting the entity, resulting in our performing additional or different substantive procedures to fully address these risks. |

# Examples

How do we take into account identified deficiencies in anti-fraud controls when we design our response to fraud risks? [ISA | 1372.1600]

**Fact pattern**

During the audit, an engagement team identified a control deficiency related to an anti-fraud control. This process control activity separates the duties of people who can create a journal entry from those who can post a journal entry.

**Analysis**

Based on this deficiency, the engagement team altered their substantive procedures to address the fraud risk that could occur from inappropriate segregation of duties. The team increased the extent of testing to substantively test 100% of the journal entries created and posted by the same individual. The team then obtained original supporting documentation related to each of those journal entries.

# 1.4 Perform procedures to address the identified fraud risk associated with the SUT [ISA | 831]

# What do we do?

Perform procedures to address the identified fraud risk associated with the significant unusual transactions.

# Why do we do this?

Similar to significant risks due to error, we perform specific procedures that directly respond to fraud risks.

Fraud risks are significant risks, so we obtain more persuasive evidence over them by altering the nature, timing and extent of our audit procedures. If we don't, we may reach the incorrect conclusion.

# Execute the Audit

How do we respond to an identified fraud risk? [ISA | 831.1300]

Refer to guidance related to our procedures to address an identified fraud risk .

What incremental procedures might we perform over a SUT with assessed fraud risk? [ISA | 831.1400]

Examples of procedures to obtain more persuasive audit evidence related to a SUT assessed with fraud risk may be:

- confirming contract terms and agreements with third parties;
- confirming amendments to contract terms and agreements or side agreements with third parties;
- involving another professional to assess the authenticity of contracts and agreements;
- investigating the possibility of related parties involved in the transaction and the sources of financial resources supporting the transaction.

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

# International Standards on Auditing: ISA 240.32-34

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

32. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

33. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(ii) Select journal entries and other adjustments made at the end of a reporting period; and

(iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A42-A45)

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. (Ref: Para. A46-A48)

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A49)

34. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (that is, where there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 33).

# ISA Application and Other Explanatory Material: ISA 240.A42-A49

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

### Journal Entries and Other Adjustments (Ref: Para. 33(a))

A42. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A43. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries[100] is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

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100 ISA 315 (Revised 2019), paragraph 26(a)(ii)

A44. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- *The identification and assessment of the risks of material misstatement due to fraud* - the presence of fraud risk factors and other information obtained during the auditor's identification and 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 controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated controls. Where information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
- *The characteristics of fraudulent journal entries or other adjustments* - inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial 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 nature and extent of controls as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A45. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 33(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 33(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

### Accounting Estimates (Ref: Para. 33(b))

A46. The preparation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and to monitor the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A47. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

A48. A retrospective review is also required by ISA 540 (Revised). That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's previous accounting estimates, audit evidence about the outcome, or where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this ISA may be carried out in conjunction with the review required by ISA 540 (Revised).

### Business Rationale for Significant Transactions (Ref: Para. 33(c))

A49. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

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

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Identify the risk of management override of controls as a fraud risk [ISA | 572]

## What do we do?

Identify the risk of management override of controls as a fraud risk

## Why do we do this?

Even though internal controls may appear to be well-designed and effective, controls that are otherwise effective may be overridden by management. Because management is in this unique position to perpetrate fraud, we identify a fraud risk related to management override of controls. We then design audit responses to address this risk.

## Execute the Audit

### How might management be able to override controls? [ISA | 572.1300]

Management may be able to override controls in several ways — including:

- creating, or instructing an employee to record, fictitious manual journal entries to circumvent the regular process for approving and recording journal entries
- applying bias when making estimates and judgments
- accounting for significant unusual transactions.

These are the common types of override we focus on as part of our audit.

### Do smaller entities have specific considerations related to management override? [ISA | 572.1400]

Smaller entities often have fewer employees, which can make segregation of duties impracticable. Management may be more able to override controls because the system of internal control is less structured. We take this into account when identifying RMMs due to fraud.

### Do we identify the risk of management override of controls as a fraud risk in every audit? [ISA | 572.1500]

Yes. The level of risk of management override of controls may vary from entity to entity, but the risk is present in all entities.

# 2 Design and perform procedures to address the risk of management override of controls [ISA | 792]

## What do we do?

Design and perform procedures to specifically address the risk of management override of controls

## Why do we do this?

Management override of controls could occur at any point in the entity's financial reporting and related business processes where an action of management could override other effective controls in the process. Management override of controls commonly involves recording of inappropriate journal entries or other adjustments, intentional misstatement and bias in the determination of accounting estimates, and entering into significant unusual transactions that lack a legitimate business purpose. Although the risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and we design and perform procedures that are specifically responsive to these risks as part of all audits.

# Execute the Audit

### What is the risk of management override of controls? [ISA | 792.1300]

Management override of controls is a fraud risk, and therefore a significant risk. Management are in a unique position to perpetrate fraud because they can manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways.

Management may be able to override controls in several ways - including:

- 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 systematic journal entries;
- applying bias when making accounting estimates and related judgments; and
- entering into significant unusual transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size, or nature.

Management override of controls could occur at any point in the entity's financial reporting and related business processes where an action of management could override other effective control activities in the process.

### Is the risk of management override of controls applicable to all audits? [ISA | 792.1400]

Yes. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities.

### How may an entity effectively respond to the risk of management override of controls? [ISA | 792.1500]

An entity may respond to the risk of management override of a control by implementing anti-fraud controls that address the risk of:

- fraudulent financial reporting
- misappropriation of assets by management.

These anti-fraud controls include:

- process control activities performed by non-management individuals - e.g. those charged with governance, including the audit committee, or an independent internal audit function that reports to those charged with governance; or
- process control activities that address the risk of collusion through appropriate segregation of duties.

### What other considerations apply to controls that address the risk of management override of controls? [ISA | 792.1600]

When we obtain an understanding of the entity's process, we specifically think about where and how in the process management has the ability to override controls. We identify the process risk points where the risk of management override exists and the process control activities that address them.

Internal controls may appear to be well-designed and effective, but management can still perpetrate fraud by overriding them. The ways management can override controls are specific to the process risk points identified.

#### What procedures do we perform to respond to the risk of material misstatement from management override of controls? [ISA | 792.1700]

At a minimum, we perform the following procedures to respond to the risk of management override of controls:

- Test the appropriateness of journal entries and other adjustments;
- Evaluate management bias in the preparation of accounting estimates; and
- Evaluate whether the business purpose (or lack thereof) for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud.

We also determine whether to perform other audit procedures in order to respond to the risk of management override of controls that are unique to the specific engagement.

When performing the above mentioned procedures to respond to the risk of management override of controls, we incorporate an element of unpredictability in the selection of audit procedures.

# 2.1 Test the appropriateness of journal entries and other adjustments [ISA | 793]

## What do we do?

Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements

## Why do we do this?

Evidence has shown that management override of controls frequently involves the recording of fraudulent journal entries and other adjustments, particularly those involving post-closing adjustments and other types of nonrecurring or nonstandard journal entries. We test journal entries and other adjustments in order to respond to the significant risk from management override of controls through the recording of inappropriate or unauthorized journal entries and other adjustments.

## Execute the Audit

#### What are journal entries? [ISA | 793.1300]

Journal entries are any entries made directly within the general ledger system that are used to record transactions, allocations, adjustments and corrections. They include:

- standard journal entries used to record recurring transactions and adjustments; and
- non-standard journal entries used to record non-recurring, unusual transactions, or adjustments.

### What are standard journal entries? [ISA | 793.13373]

Standard journal entries are journal entries used to record:

- recurring transactions - e.g., the day to day activities of the entity such as recurring sales, purchases, and cash disbursements; and
- recurring adjustments - e.g., adjustments related to accounting estimates that are made at each period-end such as changes in the estimate of uncollectible accounts receivable.

### What are automated journal entries? [ISA | 793.13374]

Automated journal entries are standard journal entries that are automatically initiated, authorized, recorded and processed in the general ledger. The use of automated journal entries can reduce the risk of management override of controls because automated journal entries are less likely to be susceptible to unauthorized or inappropriate intervention or manipulation.

### What are non-standard journal entries? [ISA | 793.13375]

Non-standard journal entries are journal entries used to record:

- non-recurring or unusual transactions - e.g., business combinations or disposals; and
- non-recurring adjustments - e.g., adjustments related to accounting estimates that are typically not made at each period-end such as the impairment of an asset.

The process and procedures used to record non-standard journal entries are typically manual journal entries.

### What are manual journal entries? [ISA | 793.13376]

Manual journal entries are journal entries that are initiated by an individual and manually entered into the general ledger system. The use of manual journal entries can increase the risk of management override of controls because manual journal entries are more likely to be susceptible to unauthorized or inappropriate intervention or manipulation.

### What are other adjustments? [ISA | 793.13378]

Other adjustments are adjustments made to the general ledger accounts outside of the general ledger system to determine the amounts presented on the face of the financial statements. Entities often use a spreadsheet to support other adjustments. Other times, entities may make other adjustments directly in the financial statements or disclosures themselves. Other adjustments are most often seen in period-end financial reporting through post-closing adjustments.

Similar to manual journal entries, the use of other adjustments can increase the risk of management override of controls because there is more opportunity for manual intervention in the process and procedures.

## What procedures do we perform to plan our response to the risk of management override of controls related to the recording of journal entries and other adjustments? [ISA | 793.1400]

To plan our response to the risk of management override of controls related to the recording of journal entries and other adjustments, we perform the following procedures:

(1) Obtain an understanding of the financial reporting process and evaluate the design and implementation of control activities over journal entries and other adjustments;
(2) Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity related to the processing of journal entries and other adjustments;

(3) Design our tests of journal entries and other adjustments, including:

3a. Consider certain factors when determining the nature, timing, and extent of testing of journal entries and other adjustments;

3b. Determine the period subject to test of journal entries and other adjustments;

3c. Identify the relevant population of journal entries and other adjustments and determine

- the nature of testing of journal entries and other adjustments, including

  - identifying the supporting documentation we will examine as part of our testing, and

  - determining whether we plan to test the operating effectiveness of control activities over journal entries and other adjustments, and

- the extent of testing of journal entries and other adjustments based on the number of journal entries and other adjustments that meet the high-risk criteria (i.e., the criteria we use to identify and select specific journal entries and other adjustments for testing).

## When do we plan our response to the risk of management override of controls related to the recording of journal entries and other adjustments? [ISA | 793.1500]

We initially plan our response to the risk of management override of controls related to the recording of journal entries and other adjustments during the planning phase of the audit. However, planning our response to the risk of management override of controls related to the recording of journal entries and other adjustments is an iterative process. We continuously re-evaluate whether our planned response is sufficient and appropriate throughout the audit - e.g., as we reconcile sub-ledgers to the ledgers, accounting ledgers from one system to another system, and accounting ledgers to the financial statements.

### What procedures do we perform to respond to the risk of management override of controls related to the recording of journal entries and other adjustments? [ISA | 793.13381]

We perform the following procedures to respond to the risk of management override of controls through the recording of journal entries and other adjustments:

(1) Perform tests of journal entries and other adjustments:

(a) Obtain the relevant population of journal entries and other adjustments by obtaining a system generated report or performing a direct extraction of journal entries from the entity's IT systems;

(b) Test the completeness of the population of journal entries and other adjustments by rolling forward account balances or using system query approach with effective general IT controls;

(c) Select high-risk journal entries and other adjustments by applying the high-risk criteria to the relevant population of journal entries and other adjustments; and

(d) Examine underlying support for journal entries and other adjustments identified and selected for testing.

Additionally, we roll-forward our inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity related to the processing of journal entries and other adjustments through the date on which the last journal entry or other adjustment is recorded.

By its nature, the selection of high-risk journal entries and other adjustments is an audit procedure that incorporates an element of unpredictability. However, when testing journal entries and other adjustments to respond to the risk of management override of controls, we may incorporate an additional element of unpredictability. For example, we may incorporate elements of unpredictability when determining the timing of testing of journal entries and other adjustments.

### When do we perform procedures to respond to the risk of management override of controls related to the recording of journal entries and other adjustments? [ISA | 793.1600]

We may choose to perform procedures that respond to the risk of management override of controls related to the recording of journal entries and other adjustments either at final or interim and final. When we plan on testing journal entries and other adjustments recorded throughout the reporting period, it is frequently more efficient and effective to perform these procedures at interim and final.

### Who do we involve in the testing of journal entries and other adjustments? [ISA | 793.1700]

Because we are responding to a fraud risk, we consider involving specific team members (e.g. forensics, IT Audit) and assigning more experienced engagement team members to perform or review the procedure.

Testing of journal entries and other adjustments is most effective when performed by engagement team members with the appropriate skills, training and familiarity with the entity's industry and financial reporting and business processes.

We do not 'outsource' our responsibilities related to the testing of journal entries and other adjustments when involving specific team members in the testing of journal entries and other adjustments. Rather, these specific team members are an integrated part of our audit engagement team and the audit engagement team remains responsible for supervising and reviewing the work performed by these specific team members.

#### How can specific team members with expertise in Forensics be helpful in the testing of journal entries and other adjustments? [ISA | 793.13382]

Specific team members with expertise in Forensics can, for example, assist in the evaluation of the design and implementation and testing of operating effectiveness of control activities related to journal entries and other adjustments and assist in the selection and testing of journal entries and other adjustments.

#### How can specific team members with expertise in IT be helpful in the testing of journal entries and other adjustments? [ISA | 793.13383]

IT Audit can be helpful in obtaining the population of journal entries and other adjustments, as well as performing procedures to test the completeness of the population and evaluating automated journal entries.

# 2.1.1 Consider performing other procedures to understand journal entries and other adjustments

[ISA | 799]

## What do we do?

Consider performing other procedures to understand journal entries and other adjustments such as using software audit tools to obtain an understanding of individual transactions that comprise an account balance

# Why do we do this?

Obtaining an understanding of the entity's financial reporting process and evaluating the design and implementation of control activities over journal entries and other adjustments provides us with knowledge needed to determine the criteria we use to identify and select journal entries for testing. In addition to these procedures, we may determine it is necessary to perform other procedures to understand the population of journal entries including the underlying transactions and adjustments that comprise certain account balances such as using software audit tools to summarize, sort, filter, or analyze journal entry data.

# Execute the Audit

## What other procedures might we perform to understand journal entries and other adjustments? [ISA | 799.1300]

In addition to obtaining an understanding of the entity's financial reporting process and evaluating the design and implementation of control activities over journal entries and other adjustments, we might determine it is necessary to perform other procedures to understand the population of journal entries and other adjustments recorded by the entity such as using software audit tools to analyze data related to journal entries:

- When relevant data is available in electronic format, the Journal Entry Analysis capability (JEA capability) may help us to understand the characteristic of journal entries booked by the entity and the sources of significant debits and credits to accounts - e.g., journal entries created by automated interfaces and manual journal entries, journal entries created by transaction source codes, and journal entries created by certain users or accounts.
- Other ready to use routines (for example KAAP-iJet) or end-user developed routines (for example using end user computing functionality in IDEA or Microsoft Excel) may provide similar functionality.
- When relevant data is not available in electronic format, we obtain our understanding through the performance of other 'manual' procedures - e.g. inquiry and observation, inspection of documentation.

For further information regarding use of software audit tools and/or end-user routines, see activity 'Plan and perform CAATs', where appropriate.

### What is the JEA capability? [ISA | 799.13499]

The JEA capability is a tool that automatically prepares pre-defined statistics over the imported journal entries and assists us in:

- Understanding the entity's journal entry population and highlighting patterns and trends;
- Allowing for screening of journal entries using pre-defined or entity-tailored risk criteria;
- Identifying and selecting individual journal entries for testing; and
- Documenting this analysis.

### What is KAAP-iJet? [ISA | 799.13500]

KAAP-iJet is a ready-to-use routine that uses Microsoft Excel Pivot Table functionality to display, read, analyze, summarize, and process journal entry data for the period selected for testing.

#### What is IDEA? [ISA | 799.13501]

IDEA (originally an acronym for Interactive Data Extraction and Analysis) is a software audit tool we use to display, read, analyze, summarize, and process data.

### When may we use the JEA capability? [ISA | 799.13503]

When relevant data is available in electronic format, we may use the JEA capability to obtain an understanding and to select journal entries and other adjustments for testing.

Relevant data for the use of the JEA capability refers to:

- General Ledger accounts, and
- Current period Journal Entries and related information — e.g. User, Posting Date, Entry type.

The analysis performed through the JEA capability does not include journal entries and other adjustments dated outside of the analysis period or posted outside the entity's general ledger system.

### How may we use JEA capability to understand the population of journal entries during the period? [ISA | 799.1310]

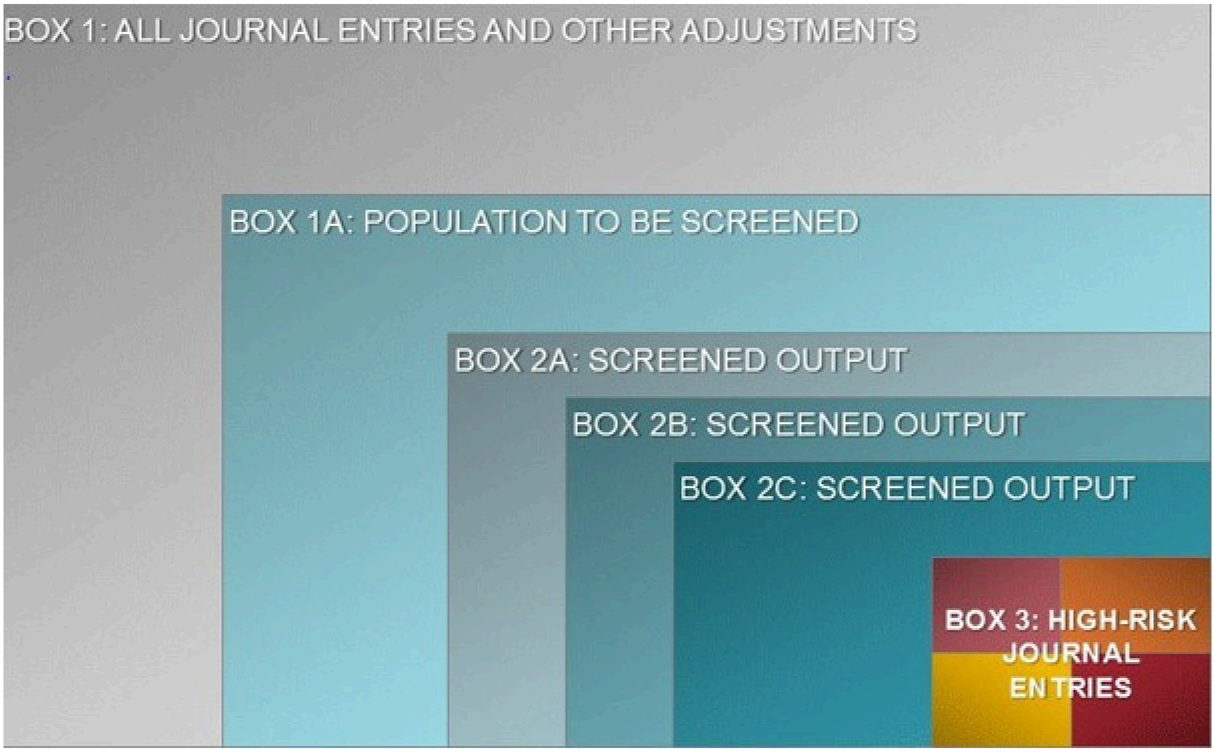
Using the pre-screen functionality within JEA capability allows us to obtain overall information about the journal entry population. The functionality within the JEA capability screens journal entries by focusing on certain attributes and facilitates an analysis of relevant characteristics in the population of journal entries. For example, we can identify manual versus automated journal entries, journal entries with missing descriptions for manual entries, journal entries with rounded line items, etc.

#### What does the screening of journal entries mean? [ISA | 799.13504]

Screening journal entries is a process where we analyze a population of journal entries and other adjustments to understand the characteristics of the population to identify high-risk criteria and to refine potential high-risk criteria identified as part of our other risk assessment procedures.

This analysis may be done through a combination of screening the population using KPMG supported electronic data analysis tools (such as JEA capability) and manually scanning the output of these tools.

Use of these electronic data analysis tools may require several iterations to produce output from which the high-risk criteria may be identified. This iterative approach is illustrated in the following diagram:




| Explanation | Example |
|---|---|
| Box 1 - Represents the entire population of all journal entries and other adjustments. | |
| Box 1a - Represents the population that we identify could contain high-risk journal entries and other adjustments (the relevant population). | Journal entries posted during the end of the reporting period. |
| Box 2 (a, b and c) - Represents layering. If using electronic data analysis tools, preliminary search criteria may be used that are generic and may result in screened output that includes journal entries that are not high-risk. The engagement team may review the screened output after | In screening the population of journal entries the engagement team identifies that there are:<br>• 10,000 journal entries ending 00,000<br>• 15,000 journal entries posted during a weekend, and<br>• 600 journal entries posted to "suspense account". |

| | |
|---|---|
| each iteration for entity-specific, high-risk combinations of characteristics in order to narrow down the criteria that will be used to identify high-risk journal entries. | Due to the team's understanding of the entity, and the fact that journal entries with these characteristics are expected to be common for the particular entity, none of these characteristics are considered to be high-risk criteria individually. However, we identify that there are 1 journal entries posted to the "suspense account" ending in 00,000 and posted on the last weekend of the year. This might be considered unusual. |
| Box 3 - Represents the high-risk journal entries remaining after screening | Entries posted on the weekend, with lines ending 00,000 and posted to the "suspense account" are considered as high risk. |

### What is our responsibility regarding the relevance and reliability of data used in applying the high-risk criteria to the relevant population? [ISA | 799.13505]

Our responsibility over the relevance and reliability of the data used in applying the high-risk criteria to the relevant population is based on the same requirements and guidance that we follow when we use data in other audit procedures. We determine the nature and extent of effort necessary to evaluate the relevance and reliability of the information used by thinking about how we intend to rely on information used in our audit (see activity 'Evaluate the relevance and reliability of information used as audit evidence' and 'Evaluate the reliability of the population of journal entries and other adjustments' for further information).

### What are the relevant data elements for information used in journal entry testing? [ISA | 799.13507]

When applying high-risk criteria to relevant population, we often rely on certain data elements in journal entry transaction files. We identify the relevant data elements (RDEs) for information used in journal entry testing based on our identified high-risk criteria. For example, manual and automated indicator, user name and creation date are the RDEs for the high-risk criteria 'manual entries created by CFO on weekends'. See the question 'What are 'relevant data elements' (RDEs)?' for further information.

### How may we use KAAP-iJet to understand the population of journal entries during the period? [ISA | 799.1320]

A report (referred to as the 'G19 report') is generated by KAAP-iJet presenting predetermined journal entries statistics and stratification of manual and automated journal entries that can help to understand how transactions are recorded in the system. We can create custom pivot tables using KAAP-iJet functionality to sort or filter the population of journal entries during the period according to specific criteria. For example, we can sort of filter manual and automated journal entries, journal entries by user, journal entries by amount and period, etc.

#### How may we use IDEA to understand the population of journal entries during the period? [ISA | 799.1600]

IDEA includes certain ready-to-use routines that may be used to understand the population of journal entries during the period by sorting or filtering it according to specific criteria. For example, we can sort or filter journal entries by user, by account number, by period and journal source, etc.

In addition to the ready-to-use routines listed above, other data analysis functionality within IDEA - e.g., data extractions, data categorization, data relations, and data visualizations - may be used to create custom reports that we can use to further analyze, summarize, and process journal entry data for the period. The IDEA Help file and the IDEA Tutorial (PDF document installed with IDEA) contain further instructions on how to use this additional functionality within IDEA.

#### What do we document when we obtain an understanding of the population of journal entries and determine the high-risk criteria? [ISA | 799.13508]

We document the procedures that were performed when we obtained an understanding of the population of journal entries and determined the high-risk criteria - i.e. whether software audit tools was used, steps taken to obtain the results, the analysis of the results and the relevant high-risk criteria determined.

# 2.1.2 Inquire about inappropriate or unusual activity relating to journal entries and other adjustments [ISA | 800]

## What do we do?

Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

## Why do we do this?

As part of our response to the fraud risk related to management override of controls, we inquire of individuals involved in the entity's financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments. The responses to these inquiries may identify specific journal entries or adjustments that we examine as part of our testing of journal entries and adjustments or potential weaknesses or deficiencies in the entity's internal controls (opportunities to perpetrate fraud) that we consider when determining the nature, timing, and extent of testing of journal entries and adjustments.

## Execute the Audit

## Who do we inquire of about inappropriate or unusual activity relating to the processing of journal entries and other adjustments? [ISA | 800.1300]

We inquire of both:

- individuals with responsibility for preparing, recording, and authorizing journal entries for risks related to management override through the recording of journal entries; and
- individuals involved in preparing the entity's financial statements and related supporting schedules for risks related to management override through the recording of other adjustments.

We also think about whether it is necessary to inquire of different individuals for different IT systems based on our understanding of the entity's financial reporting and related business processes as there may be different individuals involved in preparing, recording, and authorizing journal entries in an entity's transaction processing, general ledger, and consolidation IT systems.

### What procedures might we perform to evaluate the completeness of the listing of individuals we inquire of about inappropriate or unusual activity relating to the processing of journal entries and other adjustments? [ISA | 800.13451]

We may evaluate the completeness of the listing of individuals inquired of by comparing those individuals to the individuals included in the population of journal entries obtained for journal entry testing - e.g., create a summary of users who created or posted journal entries using the data summarization analysis in IDEA or a pivot table in Microsoft Excel and compare the summary to the listing of individuals previously inquired of.

## What do we inquire about inappropriate or unusual activity relating to the processing of journal entries and other adjustments? [ISA | 800.1400]

We inquire of these individuals about:

- whether they are aware of any inappropriate or unusual activity related to processing of journal entries;
- whether there were any journal entries or other adjustments recorded without adequate support or explanation;
- whether there were any instances of management override of controls through recording journal entries or other adjustments; and
- whether journal entries or other adjustments initiated by management are outside of the normal course of business.

The responses to these inquiries may help to identify:

- members of management who have the ability to circumvent the internal control process and override controls;
- specific accounts that have an increased susceptibility to management override;
- particular periods of time that provide the opportunity for management to override controls and to commit fraud; and
- individuals who are subject to incentives or pressures, opportunities and/or engage in rationalizations to commit fraud.

We use the knowledge obtained from these inquiries when we determine the nature, timing, and extent of our testing of journal entries and other adjustments.

### When do we inquire about inappropriate or unusual activity relating to the processing of journal entries and other adjustments? [ISA | 800.1500]

We inquire of individuals involved in the financial reporting process at multiple times during the course of the audit including:

- an initial inquiry as part of our risk assessment procedures; and
- a final inquiry near the end of the entity's financial reporting process.

Our initial inquiries help us to plan our response to the risk of management override of controls through the recording of journal entries and other adjustments.

We roll-forward our inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity related to the processing of journal entries and other adjustments through the date on which the last journal entry or other adjustment is recorded as inappropriate or unusual activity can occur right up until the point in time when the entity's financial statements are issued.

# Examples

### How might we evaluate the completeness of the listing of individuals we inquire of regarding inappropriate or unusual activity related to journal entries and other adjustments? [ISA | 800.8477]

**Fact pattern**

When performing a walkthrough of an entity's financial reporting process and evaluating the design and implementation of control activities over journal entries and other adjustments, the engagement team obtains an understanding of (i) the individuals who have access to create and post journal entries within the general ledger IT system and (ii) the individuals involved in the preparation of the financial statements and related disclosures. In planning the team's procedures to respond to the risk of management override of controls through the recording of journal entries and other adjustments, the team inquires of each of these individuals regarding inappropriate or unusual activity.

**Analysis**

The engagement team obtains the population of journal entries recorded in the entity's general ledger IT system as part of their testing of journal entries and other adjustments. The team summarizes the journal entries recorded in the entity's general ledger IT system by the 'USER_CREATED' data field (the data field corresponding to the user who created the journal entry in the general ledger IT system) using the data summarization analysis in IDEA or a pivot table in Microsoft Excel and compares the summary to the listing of individuals previously inquired of. The summary identifies two new user accounts that were granted access and permissions to create journal entries in the general ledger IT system subsequent to the point in time when the team evaluated the design and implementation of control activities related to journal entries and other adjustments during the planning phase of the audit. The team inquires of the individuals corresponding to the two new user accounts regarding inappropriate or unusual activity as part of their final testing of journal entries.

# 2.1.3 Consider certain factors when determining the high-risk criteria and timing of testing [ISA | 801]

# What do we do?

Consider certain factors when determining the high-risk criteria we use to identify and select journal entries and other adjustments for testing and the timing of testing

# Why do we do this?

We consider certain factors because those help us to determine the high-risk criteria to apply

# Execute the Audit

### What factors do we consider when we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing and the timing of testing? [ISA | 801.1300]

When we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing and the timing of testing, we consider the following factors:

- our assessment of risks of material misstatement due to fraud ;
- the effectiveness of controls over journal entries and other adjustments ;
- the entity's financial reporting process ;
- the characteristics of fraudulent journal entries and other adjustments ;
- the nature and complexity of accounts ; and
- journal entries and other adjustments processed outside the normal course of business .

### What if we don't identify any high-risk criteria related to journal entries and other adjustments? [ISA | 801.1400]

It would be very rare not to identify any high-risk criteria related to journal entries and other adjustments. In these rare instances, we document the rationale why no high-risk criteria related to journal entries and other adjustments were identified.

Even when we don't identify any high-risk criteria, we still identify and select journal entries and other adjustments made at the end of the reporting period for testing.

### Do we test journal entries and other adjustments made at the end of the reporting period? [ISA | 801.13450]

Yes. Our response to the fraud risk related to management override of controls through the recording of journal entries and other adjustments includes testing journal entries and other adjustments made at the end of the reporting period.

# 2.1.3.1 Consider our assessment of fraud risks [ISA | 802]

# What do we do?

Consider our assessment of fraud risks when determining the high-risk criteria we use to identify and select journal entries and other adjustments for testing

# Why do we do this?

Fraud risks identified can influence the criteria we use to identify and select high-risk journal entries and other adjustments (the 'high-risk criteria') by highlighting accounts and assertions that have a higher risk of material misstatement from management override of controls through the recording of journal entries and other adjustments.

# Execute the Audit

### How do we consider fraud risks when we identify and define the relevant population? [ISA | 802.1300]

When a fraud risk is applicable to journal entries recorded throughout the reporting period, we are more likely to conclude that it is necessary to test journal entries and other adjustments throughout the reporting period in addition to those recorded at the end of the reporting period.

| Fraud risk applicable to: | Testing of journal entries and other adjustments will include: |
|---|---|
| Journal entries and other adjustments recorded at the end of the reporting period | Journal entries and other adjustments recorded at the end of the reporting period<br>Note: Even when the fraud risk is only applicable to journal entries and other adjustments recorded at the end of the reporting period, we consider whether it is necessary to incorporate an element of unpredictability in the timing of our testing and include journal entries and other adjustments recorded throughout the reporting period. |
| Journal entries and other adjustments recorded at the end of the reporting period **AND** throughout the reporting period | Journal entries and other adjustments recorded at the end of the reporting period<br>Journal entries and other adjustments recorded throughout the reporting period |

We may incorporate the specific accounts and assertions associated with the fraud risks when we identify and define the relevant population of journal entries and other adjustments.

If we choose to apply the high-risk criteria to a subset of the population of journal entries and other adjustments - i.e., a population that is less than all journal entries and other adjustments recorded during the reporting period, we include these accounts when we identify and define the relevant population.

### How do we incorporate fraud risks when we determine the high-risk criteria we use to identify and select journal entries and other adjustments? [ISA | 802.1400]

Fraud risks can highlight specific classes of journal entries - for example, specific accounts, transactions or types of journal entries - that may be more susceptible to management override of controls or fraud, which can help us determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing.

> For example, if we identify a fraud risk associated with the capitalization of expenses into in order to understate operating expenses, we incorporate both accounts and assertions related to cost capitalization (debits to PP&E accounts) as well as accounts and assertions related to the understatement of expenses (credits to operating expenses) into the high-risk criteria we use to identify and select journal entries and other adjustments for testing.

> For example, if we identify a fraud risk associated with the existence of revenue, particularly through recording manual journal entries to revenue related accounts, we incorporate the accounts and assertions (credits to revenue related accounts) into the high-risk criteria we use to identify and select journal entries and other adjustments for testing.

# 2.1.3.2 Consider the effectiveness of control activities over journal entries and other adjustments [ISA | 803]

## What do we do?

Consider the effectiveness of controls over journal entries and other adjustments when determining the high-risk criteria we use to identify and select journal entries and other adjustments for testing

## Why do we do this?

Control activities over journal entries and other adjustments may be used to focus the high-risk criteria on certain types of journal entries and other adjustments with higher risk - e.g., manual journal entries - and alter the nature, timing, and extent of our testing of journal entries and other adjustments provided that we have tested the operating effectiveness of the control activities.

## Execute the Audit

What control activities over journal entries and other adjustments may be relevant when we determine the nature, timing, and extent of testing of journal entries and other adjustments? [ISA | 803.1300]

Relevant control activities can include:

- automated process control activities related to journal entry interfaces (including general IT controls that support the consistent operation of automated controls); and
- process control activities related to manual journal entries and other adjustments.

What are some examples of control activities related to journal entry interfaces? [ISA | 803.13521]

Examples of control activities over journal entry interfaces:

- automated process control activities (and related general IT controls) that ensure the completeness and accuracy of the information transferred as part of the interface; and
- automated process control activities (and related general IT controls) that prevent changes in relevant information after a journal entry has been posted, such as preventing management from changing journal entries created from automated interfaces.

### What are some examples of control activities related to manual journal entries and other adjustments? [ISA | 803.13522]

Examples of control activities over manual journal entries and other adjustments:

- access controls that prevent the CFO or CEO from initiating, processing, or authorizing journal entries within IT systems;
- review of all journal entries over a certain dollar amount or those initiated or approved by senior management by internal audit; or
- automated control activities that prevent changes in relevant information after a journal entry has been posted, such as preventing changing the identity of the user or account that created or posted a journal entry.

### What could be the impact of testing the operating effectiveness of control activities when we select manual journal entries and other adjustments for substantive testing? [ISA | 803.13523]

When we have tested the operating effectiveness of control activities over manual journal entries and other adjustments, we can consider the effectiveness of these controls when we determine the high-risk criteria for testing: e.g., we can modify the extent of journal entries selected as high-risk criteria based on the operating effectiveness of control activities.

> For example, we conclude that control activities over manual journal entries and other adjustments are operating effectively and have identified a single fraud risk related to revenue recognition - e.g., channel stuffing or bill and hold transactions. In these instances, the high-risk criteria we use to identify and select journal entries and other adjustments for testing may be more targeted and limited to certain revenue transactions.

### What could be the impact of testing the operating effectiveness of control activities when we determine whether to test journal entries and other adjustments throughout the period? [ISA | 803.1400]

We consider the effectiveness of control activities as follows:

| Control activities over journal entries and other adjustments recorded throughout the reporting period are: | Testing of journal entries and other adjustments recorded throughout the reporting period: |
|---|---|
| Tested and operating effectively | Less likely to test journal entries and other adjustments recorded throughout the reporting period<br>Note: Even when the fraud risk is only applicable to journal entries and other adjustments recorded at the end of the reporting period, we consider whether it is necessary to incorporate an element |

| | |
|---|---|
| | of unpredictability into the timing of our testing and include journal entries and other adjustments recorded throughout the reporting period. |
| Not tested or not operating effectively | More likely to test journal entries and other adjustments recorded throughout the reporting period |

What testing do we perform in order to exclude journal entries recorded through an automated interface from our high-risk criteria/population? [ISA | 803.8457]

When we determine that journal entries in the general ledger system of a particular source can only be recorded via an automated interface, we may choose to exclude this journal entry source from the high-risk criteria. In order to exclude them:

- we test the operating effectiveness of control activities over the automated interface and over the integrity of data / information within the general ledger system and conclude that these control activities were operating effectively throughout the reporting period; or
- we directly test the relevant data elements.

When we exclude journal entries from certain transaction codes from the high-risk criteria or the relevant population of journal entries, separate consideration is given to each separate interface / journal entry source.

Can we only test control activities over journal entries and other adjustments? [ISA | 803.1600]

No. We perform substantive procedures over journal entries and other adjustments regardless of the size of the entity being audited or the effectiveness of control activities. However, effective control activities can reduce the extent of journal entry testing. In these instances, we focus the nature and extent of our testing on accounts and assertions where there is a greater risk of management override of controls.

How might control activities over journal entries and other adjustments be different for a smaller entity? [ISA | 803.1700]

Smaller entities often have limited segregation of duties and less formalized controls over journal entries and other adjustments. These situations can create greater opportunities for management override of controls through the recording of journal entries and other adjustments.

When control activities over journal entries and other adjustments are ineffective, we modify the nature, timing, and extent of our testing of journal entries and other adjustments accordingly.

# 2.1.3.3 Consider the financial reporting process and the nature of evidence that can be examined

[ISA | 804]

## What do we do?

Consider our understanding of the entity's financial reporting process when determining the high-risk criteria we use to identify and select journal entries and other adjustments for testing and the nature of evidence that can be examined.

# Why do we do this?

We specifically consider the knowledge obtained from understanding of the entity's financial reporting process when we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing and identify the relevant population of journal entries and other adjustments. This knowledge helps us to identify certain accounts with a higher risk of fraudulent journal entries and other adjustments, characteristics of fraudulent journal entries and other adjustments, and characteristics of journal entries processed outside the normal course of business for the entity.

# Execute the Audit

### How do we consider the entity's financial reporting process when we determine the high-risk criteria and identify and define the relevant population? [ISA | 804.1300]

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 systems and controls.

We use the knowledge from our understanding of the entity's financial reporting process in order to:

| We use the knowledge obtained to: | Examples: |
|---|---|
| Identify the points within an entity's financial reporting process that are subject to manual intervention and management override of controls could occur - i.e., where and how journal entries and other adjustments can be recorded | Manual versus automated interfaces between IT systems, IT systems where manual journal entries can be recorded, and where information outside of IT systems used to support amounts presented and disclosed in the entity's financial statements can be manipulated |
| Identify accounts and disclosures which are more susceptible to material misstatement from management override of controls through the recording of journal entries and other adjustments | Accounts that are used to record journal entries and other adjustments related to estimates, late adjusting journal entries, or significant unusual transactions<br><br>Different types of journal entries and other adjustments that are typically recorded by the entity to an account as part of the financial reporting and related business processes - e.g., sources of journal entries and other adjustments for particular account balances |

| | |
|---|---|
| Identify the characteristics of fraudulent journal entries and other adjustments, including those associated with journal entries and other adjustments recorded outside the normal course of business | Individuals who are authorized to create and post journal entries and other adjustments as part of the entity's financial reporting and related business processes - e.g., individuals with access to create or approve journal entries and other adjustments or conflicting segregation<br><br>Characteristics of journal entries and other adjustments that are atypical of the entity's normal financial reporting and related business processes - e.g., journal entries that are created or posted on unusual dates or at unusual times |

We consider each of these items when we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing and identify and define the relevant population of journal entries and other adjustments.

#### Can we incorporate a specified threshold in our selection of journal entries to test? [ISA | 804.13579]

No, it is not appropriate to only identify journal entries above an arbitrary quantitative threshold (e.g. performance materiality or the audit misstatement posting threshold), as fraud can be perpetrated by recording numerous low-value entries. We use high-risk criteria for identifying and selecting specific journal entries and other adjustments for testing. These high-risk criteria are specific to the circumstances of the engagement based on our judgement.

#### How do we determine the nature of evidence we examine? [ISA | 804.1500]

We use our knowledge from understanding the entity's financial reporting process to help us determine the supporting documentation to examine as part of our testing. For example, when the entity uses IT systems as part of their 'financial reporting process, journal entries and other adjustments, including the related supporting documentation, may only exist in electronic form.

# 2.1.3.4 Consider the characteristics of fraudulent journal entries or other adjustments [ISA | 805]

## What do we do?

Consider the characteristics of fraudulent journal entries when determining the high-risk criteria we use to identify and select journal entries

## Why do we do this?

We specifically consider the characteristics of fraudulent journal entries and other adjustments when we determine the high-risk criteria used to identify and select journal entries and other adjustments for testing and identify the relevant population. Characteristics of fraudulent journal entries and other adjustments may include entries made to unrelated, unusual, or seldom-used accounts, made by individuals who typically do not make journal entries, recorded at the end of the period or as postclosing entries that have little or no explanation or description made either before or during the preparation of the financial statements that do not have account numbers, or containing round numbers or consistent ending numbers.

# Execute the Audit

### How do we determine the characteristics of fraudulent journal entries and other adjustments? [ISA | 805.1300]

We use our knowledge obtained from our understanding of the entity's financial reporting and related business processes, including the IT systems used in these processes, to determine the characteristics of journal entries and other adjustments which may be indicative of fraud. Characteristics of fraudulent journal entries and other adjustments may include:

| Characteristics | Examples |
|---|---|
| Journal entries and other adjustments made to unusual or seldom-used accounts | Journal entries and other adjustments posted to accounts used to record significant unusual transactions, accounting estimates, and post-closing adjustments<br>Journal entries and other adjustments posted to accounts that are no longer used by the entity<br>Journal entries and other adjustments posted to an account that has less than a certain number of journal entries posted to it during the period. |
| Journal entries and other adjustments created or posted by users and accounts who typically do not create or post journal entries | Journal entries and other adjustments created or posted by individuals who typically do not create or post journal entries,<br>Journal entries and other adjustments created or posted by individuals who have not been authorized or approved to create or post journal entries<br>Journal entries and other adjustments created or posted by individuals who may have incentives to commit fraud - e.g., incentive compensation arrangements linked to financial performance |

| | |
|---|---|
| Journal entries and other adjustments recorded at the end of the period or as postclosing entries that have little or no explanation or description | Journal entries that are recorded on unusual dates or at unusual times considering our understanding of the entity's financial reporting and related business processes |
| Journal entries and other adjustments made either before or during the preparation of financial statements that do not have account numbers | Journal entries that are non-standard or "top-side" entries |
| Journal entries and other adjustments containing round numbers or consistent ending numbers | Journal entries which end with round numbers or recorded for amounts slightly below an entity's specified thresholds for authorization, approval, or review |
| Journal entries and other adjustments that contain unusual combinations of debits and credits | Journal entries that are recorded to an unusual combination of accounts- e.g., journal entries that credit revenue with no associated debit to cash, A/R, or another revenue related account for the same amount |
| Journal entries and other adjustments containing unusual descriptions | Journal entries and other adjustments with descriptions such as "restatement", "reversal", "reclass", or "reclassification" |

### Which period do we apply the characteristics of fraudulent journal entries and other adjustments to? [ISA | 805.1400]

When the characteristics of fraudulent journal entries are applicable to journal entries and other adjustments recorded throughout the reporting period, we are more likely to conclude that it is necessary to test journal entries and other adjustments throughout the reporting period in addition to those recorded at the end of the reporting period.

| Characteristics of fraudulent journal entries applicable to: | Testing of journal entries and other adjustments will include: |
|---|---|
| Journal entries and other adjustments recorded at the end of the reporting period | Journal entries and other adjustments recorded at the end of the reporting period<br>Note: Even when the fraud risk is only applicable to journal entries and other adjustments recorded at the end of the reporting period, we consider whether it |

| | |
|---|---|
| | is necessary to incorporate an element of unpredictability in the timing of our testing and include journal entries and other adjustments recorded throughout the reporting period. |
| Journal entries and other adjustments recorded at the end of the reporting period **AND** throughout the reporting period | Journal entries and other adjustments recorded at the end of the reporting period<br>Journal entries and other adjustments recorded throughout the reporting period |

## How do we consider the characteristics of fraudulent journal entries and other adjustments when we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing? [ISA | 805.1500]

Examples of how we may incorporate the characteristics of fraudulent journal entries into the high-risk criteria we use to identify and select journal entries and other adjustments for testing include:

| Characteristic of fraudulent journal entries and other adjustments: | Example high-risk criteria: |
|---|---|
| Entries to unusual accounts | Debit or credit to an account that is no longer used by the entity - e.g., a credit to a revenue related account that is no longer used by the entity due to discontinuance of a product line or service |
| Entries to seldom-used accounts | Debit or credit to an account only used to record significant unusual transactions or nonstandard journal entries related to accounting estimates - e.g., credits to an account created in the current year to record a significant revenue agreement with a related party |
| Entries created or posted by individuals who typically do not create or post journal entries | Debit or credit to an account created or posted by an individual who is not typically involved in the related processes - e.g., a credit to an operating expense or SG&A expense account by members of senior management who are not involved in the procurement process or the recording of journal entries related to the procurement process |

| | |
|---|---|
| Entries recorded at the end of the period or as postclosing entries that have little or no explanation or description | Debit or credit to an account with no explanation or description - e.g., a debit or a credit to an account associated with a fraud risk with no explanation or description |
| Entries made either before or during the preparation of financial statements that do not have account numbers | Debit or credit to an account recorded top-side (an "other adjustment") - e.g., an adjustment to reclassify expenses outside of operating income |
| Entries containing round numbers or consistent ending numbers, possibly to fall below a threshold for review or approval | Debit or credit to an account slightly below thresholds for approval or review - e.g., credit to a revenue account slightly below the threshold for approval and review of the contract for unusual terms affecting revenue recognition<br>Debit or credit to an account for a round number - e.g., debits to property, plant, and equipment account for round numbers that end in 000 |
| Entries that contain unusual combinations of debits and credits | Credit to revenue with no associated debit to cash, AR, or another revenue account<br>Credit to an operating expense or SG&A expense account with a debit to an expense account outside of income from operations<br>Credit to an operating expense or SG&A expense account with an associated debit to an unusual account such as accumulated depreciation |

# 2.1.3.5 Consider the nature and complexity of accounts [ISA | 806]

## What do we do?

Consider the nature and complexity of accounts when determining the high-risk criteria we use to identify and select journal entries and other adjustments for testing

## Why do we do this?

We specifically consider accounts that:

- contain transactions that are complex or unusual in nature,
- contain significant estimates and/or period-end adjustments,
- have been prone to errors in the past,
- have not been reconciled in a timely basis or contain unreconciled differences,
- contain intercompany transactions, and/or
- are otherwise associated with an identified fraud risk

when we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing and identify the relevant population as these accounts are more likely to contain material misstatements from management override of controls through the recording of journal entries and other adjustments.

# Execute the Audit

### Are there certain accounts that are more likely to contain a material misstatement from management override of controls? [ISA | 806.1300]

Yes. Certain accounts are more likely to contain material misstatements from management override of controls through the recording of journal entries and other adjustments, including:

- Accounts that contain transactions that are complex or unusual in nature:

  When an entity uses certain accounts to record significant unusual transactions that are outside that are outside the normal course of business, we consider incorporating these specific accounts into the high-risk criteria as there is an increased risk of material misstatement from management override of controls associated with journal entries and other adjustments recorded to these accounts.

  Journal entries recorded to these accounts are also considered when we identify significant unusual transactions (SUTs) and understand the business purpose (or lack thereof) for each SUT as part of our response to the risk of management override of controls.

- Accounts that contain significant estimates and period-end adjustments:

  When an entity uses certain accounts to record significant estimates and period-end adjustments, we consider incorporating these specific accounts into the high-risk criteria as there is an increased risk of material misstatement from management override of controls associated with journal entries and other adjustments recorded to these accounts.

  Journal entries recorded to these accounts are considered when we identify accounting estimates that we review for management bias .

- Accounts that have been prone to misstatements in the past:

  When certain accounts have been prone to misstatement, particularly misstatements due to fraud, in the past, we consider incorporating these specific accounts into the high-risk criteria as there is an increased risk of material misstatement from management override of controls associated with journal entries and other adjustments recorded to these accounts.

- Accounts that have not been reconciled on a timely basis or that contain unreconciled differences:

When we identify certain accounts that have not been reconciled by the entity in a timely manner or that contain significant or unusual reconciling items, we consider incorporating these specific accounts into the high-risk criteria as there is an increased risk of material misstatement from management override of controls associated with journal entries and other adjustments recorded to these accounts.

- Accounts that contain intercompany transactions and transactions with unconsolidated related parties:

  When an entity uses certain accounts to record intercompany transactions, including transactions with unconsolidated related parties, and these transactions do not eliminate in consolidation, we consider incorporating these specific accounts into the high-risk criteria as there is an increased risk of material misstatement from management override of controls associated with journal entries and other adjustments recorded to these accounts.

  Journal entries recorded to these accounts are also considered when we identify significant unusual transactions (SUTs) and understand the business purpose (or lack thereof) for each SUT as part of our response to the risk of management override of controls.

- Accounts that are otherwise associated with an identified fraud risk:

  We incorporate accounts and assertions associated with an identified fraud risk into the high-risk criteria as there is an increased risk of material misstatement from management override of controls associated with journal entries and other adjustments recorded to these accounts.

  In addition to the above accounts, we also consider whether inappropriate journal entries and adjustments also might be made to other accounts.

## How do we consider the nature and complexity of accounts when we identify and define the relevant population of journal entries and other adjustments? [ISA | 806.1400]

When the accounts that are more likely to contain material misstatements from management override of controls through the recording of journal entries and other adjustments contain journal entries recorded throughout the reporting period, we are more likely to conclude that it is necessary to test journal entries and other adjustments throughout the reporting period in addition to those recorded at the end of the reporting period.

| Accounts that are more likely to contain material misstatements from management override of controls through the recording of journal entries and other adjustments contain: | Testing of journal entries and other adjustments will include: |
|---|---|
| Journal entries and other adjustments recorded at the end of the reporting period | Journal entries and other adjustments recorded at the end of the reporting period<br>Note: Even when the fraud risk is only applicable to journal entries and other adjustments recorded at the end of the reporting period, we consider whether it is necessary to incorporate an element of |

| | |
|---|---|
| | unpredictability in the timing of our testing and include journal entries and other adjustments recorded throughout the reporting period. |
| Journal entries and other adjustments recorded at the end of the reporting period **AND** throughout the reporting period | Journal entries and other adjustments recorded at the end of the reporting period<br>Journal entries and other adjustments recorded throughout the reporting period |

### How do we consider the nature and complexity of accounts when we determine the high-risk criteria we use to identify and select journal entries and other adjustments? [ISA | 806.1500]

Examples of how we may incorporate the nature and complexity of accounts into the high-risk criteria we use to identify and select journal entries and other adjustments for testing include:

| Nature and complexity of accounts: | Example of high-risk criteria: |
|---|---|
| Accounts that contain transactions that are complex or unusual in nature | Debits or credits to accounts that are used to record transactions with related parties<br>Debits or credits to accounts that are used to record significant transactions over a specified dollar amount |
| Accounts that contain significant estimates and period-end adjustments | Debits or credits to accounts that are used to record accruals or reserves |
| Accounts that have not been reconciled on a timely basis or contain unreconciled differences | Debits or credits to accounts with unusual or significant reconciling items |
| Accounts that contain intercompany transactions | Debits or credits to accounts that are used to record intercompany transactions |
| Accounts that are associated with an identified fraud risk | Debits or credits to accounts that are associated with an identified assertion-level fraud risk |

### What if we have tested all journal entries recorded to a particular account as part of other substantive procedures? [ISA | 806.1600]

When we have already tested all journal entries recorded to a particular account as part of other substantive procedures, we may exclude journal entries posted to that particular account from the high-risk criteria provided that we have performed the same procedures that we would have performed had they been selected as high-risk journal entries.

When we do not exclude journal entries posted to that particular account from the high-risk criteria, we may cross reference to the other substantive procedures performed for each of the high-risk journal entries selected for testing from that particular account.

# 2.1.3.6 Determine the components and locations to select journal entries from [ISA | 807]

## What do we do?

Determine the work to be performed on journal entries at components or locations

## Why do we do this?

We are responsible for assessing the risk of material misstatement related to management override of controls through the recording of journal entries and other adjustments and determining the scope of work to be performed over components and locations.

## Execute the Audit

Group Audit | How do we determine the components to select journal entries and other adjustments from in a group audit? [ISA | 807.1300]

Management override of controls is a fraud risk that we, as the lead group auditor, address at the group level. Part of our response to the risk of management override of controls are procedures directed at the recording of journal entries and other adjustments for the group financial statements at the group level.

We assess the risk of material misstatement from management override of controls through the recording of journal entries and consider the following when designing our response:

- Component auditors may assist us in designing and performing procedures to address the risk of management override of controls.
- It is presumed that we will perform procedures to address the risk of management override of controls at each of the components where we are performing audit procedures. However, we may determine that it is not necessary to perform procedures at some of those components after considering the size and nature of the component and other qualitative factors relating to that risk.
- We may identify other components where we will perform procedures to address the risk of management override of controls where we do not perform any other procedures as part of the group audit.

For each of these components where we determine that we will perform procedures, we may:

- determine the high-risk criteria to be applied by the component auditors and instruct the component auditors to perform group auditor designed procedures to respond to the risk of management override of controls through the recording of journal entries and other adjustment at their respective locations or components;

- instruct the component auditors to determine the high-risk criteria (or additional high-risk criteria) to identify and select journal entries and other adjustments at their respective component and evaluate the appropriateness of the high-risk criteria determined by the component auditor; or

In instances where we instruct component auditors to determine the high-risk criteria, we also take responsibility for obtaining an understanding of the financial reporting process and control activities over journal entries and other adjustments. We may obtain this understanding ourselves or through coordination with a component auditor. The component auditor determines whether the audit procedures designed and communicated by the group auditor are appropriate based upon their knowledge of the component and communicates the results of the procedures in the Clearance Memorandum.

Group Audit | Who is responsible for testing journal entries and other adjustments in a group audit? [ISA | 807.12322]

We, as the lead group auditor, are responsible for determining the response to the risk of management override of controls for the group financial statements at the group level.

For certain locations, we may choose to perform the work ourselves for each of the components where we determine that we will perform procedures.

How do we determine the locations to select journal entries and other adjustments from? [ISA | 807.12323]

In an audit with multiple locations that is not a group audit, we, as the lead auditor, determine the high risk criteria and identify the high risk journal entries ourselves. We may involve auditors at certain locations to assist us in testing the selected journal entries.

# 2.1.3.7 Consider journal entries and other adjustments processed outside the normal course of business [ISA | 808]

## What do we do?

Consider journal entries and other adjustments processed outside the normal course of business when determining the high-risk criteria we use to identify and select journal entries and other adjustments for testing.

## Why do we do this?

We consider entries processed outside the normal course of business, including non-standard journal entries and other adjustments, when we determine the high-risk criteria we use to identify and select journal entries and other adjustments for testing as these non-standard journal entries and other adjustments may not be subject to the same level of internal control and are often used to record intentional and inappropriate adjustments to accounts and disclosures.

# Execute the Audit

### What journal entries and other adjustments are considered to be processed outside the normal course of business? [ISA | 808.1300]

Journal entries recorded outside the normal course of business include non-standard journal entries and other adjustments, which include post-closing adjustments.

We also use knowledge obtained from our understanding of the entity's financial reporting and related business processes to identify certain dates and time periods where it would be unusual for a journal entry or other adjustment to be recorded.

For some entities, it may be unusual to record a journal entry after a certain time or on a weekend, while for other entities, this may be part of the normal financial reporting close process depending on the timing of the close.

> For example, consider an entity with a short financial reporting close calendar whereby most members of the financial reporting and consolidations department routinely work weekends in order to complete the close process on time. In these instances, journal entries recorded by these members of the financial reporting and consolidations department on weekends are likely not considered to be unusual.

#### What are non-standard journal entries? [ISA | 808.13375]

Non-standard journal entries are journal entries used to record:

- non-recurring or unusual transactions - e.g., business combinations or disposals; and
- non-recurring adjustments - e.g., adjustments related to accounting estimates that are typically not made at each period-end such as the impairment of an asset.

The process and procedures used to record non-standard journal entries are typically manual journal entries.

#### What are other adjustments? [ISA | 808.13378]

Other adjustments are adjustments made to the general ledger accounts outside of the general ledger system to determine the amounts presented on the face of the financial statements. Entities often use a spreadsheet to support other adjustments. Other times, entities may make other adjustments directly in the financial statements or disclosures themselves. Other adjustments are most often seen in period-end financial reporting through post-closing adjustments.

Similar to manual journal entries, the use of other adjustments can increase the risk of management override of controls because there is more opportunity for manual intervention in the process and procedures.

### How do we consider journal entries and other adjustments processed outside the normal course of business when we identify and define the relevant population of journal entries? [ISA | 808.1400]

We always test journal entries and other adjustments recorded at the end of the reporting period as part of our testing of journal entries and other adjustments. This does not necessarily mean that we examine all journal entries created or posted at the end of the reporting period.

To the extent journal entries and other adjustments recorded at the end of the financial reporting period meet the high-risk criteria, we examine support for these journal entries and other adjustments identified and selected as part of our response to the risk of management override of controls.

In addition, we examine all material journal entries and other adjustments made as part of the period-end financial reporting process in order to address the risk of error.

## How do we consider journal entries and other adjustments processed outside the normal course of business when we determine the high-risk criteria? [ISA | 808.1500]

We incorporate the characteristics associated with nonstandard journal entries, post-closing and other adjustments into the high-risk criteria we use to identify and select journal entries and other adjustments for testing.

Examples of how we may incorporate these characteristics include:

| Characteristic of non-standard journal entries and other adjustments: | Example of high-risk criteria: |
|---|---|
| Entries with certain transaction source codes used to record manual journal entries | Debits or credits to accounts associated with a fraud risk from certain transaction source codes |
| Entries to accounts associated with non-standard journal entries | Debits or credits to accounts that are used to record significant transactions over a specified dollar amount<br><br>Debits or credits to accounts that are used to record non-recurring accruals or reserves |
| Entries recorded within certain IT systems | Debits or credits to accounts associated with a fraud risk within the consolidation IT system |

We also consider incorporating certain dates and times that are considered to be outside the normal course of business into the criteria we use to identify high-risk journal entries and other adjustments for testing.

Examples of how we may incorporate these characteristics include:

| Characteristic of journal entries and other adjustments outside the normal course of business: | Example of high-risk criteria: |
|---|---|
| Entries created or posted on unusual dates or at unusual times | Debits or credits to accounts created or posted on unusual dates - e.g., holidays or weekends |

| | |
|---|---|
| | Debits or credits to accounts created or posted at unusual times - e.g., after 9pm or before 7am |

# 2.1.4 Determine the period subject to our testing [ISA | 809]

## What do we do?

Determine the period subject to our testing of journal entries and other adjustments - i.e. journal entries and other adjustments made at the end of the reporting period or journal entries and other adjustments made at the end of the reporting period and journal entries made throughout the period.

## Why do we do this?

In order to determine the timing of our testing - i.e., whether we plan to test journal entries and other adjustments throughout the period in addition to those made at period-end - we consider whether the high-risk criteria we use to identify and select journal entries and other adjustments also apply to journal entries and other adjustments throughout the period. Because fraudulent journal entries and other adjustments are often made at the end of an entity's financial reporting period in order to manage earnings, we focus our testing of journal entries and other adjustments recorded at the end of the reporting period. However, because material misstatements in financial statements due to fraud can occur throughout the period, we also consider whether it is necessary to test journal entries throughout the period under audit by determining whether the high-risk criteria would apply to these entries.

## Execute the Audit

### How do we determine the period that is subject to our testing of journal entries and other adjustments? [ISA | 809.1300]

Because fraudulent journal entries and other adjustments are often made at the end of the reporting period, we identify and select journal entries and other adjustments made at the end of the reporting period for testing. This does not necessarily mean that we examine all journal entries created or posted at the end of the reporting period. Rather, the relevant population of journal entries and other adjustments includes journal entries and other adjustments made at the end of the reporting period.

Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, we also consider whether it is necessary to test journal entries and other adjustments throughout the period. This is a risk-based decision.

### Do we test journal entries and other adjustments made at the end of the reporting period? [ISA | 809.1400]

Yes. Our response to the fraud risk related to management override of controls through the recording of journal entries and other adjustments includes testing journal entries and other adjustments made at the end of the reporting period.

### How do we determine whether we want to test journal entries and other adjustments throughout the period? [ISA | 809.1500]

We consider the following when we determine whether we intend to test journal entries and other adjustments throughout the period:

- the results to inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

> For example, the results of these inquiries may identify inappropriate or unusual activity that occurred prior to the end of the reporting period or identify opportunities for management override of controls that could occur throughout the reporting period. In these instances, we more likely test journal entries recorded throughout the reporting period.

- our understanding of the entity's financial reporting process and control activities over journal entries and other adjustments and whether the high-risk criteria we use to identify and select journal entries and other adjustments for testing applies to journal entries and other adjustments made throughout the period - i.e., not just to journal entries and other adjustments made at the end of the reporting period.

When the criteria for high-risk journal entries would apply or be relevant to journal entries and other adjustments made throughout the period, we also identify and select journal entries made throughout the period for testing.

### When may it be appropriate not to test journal entries throughout the period? [ISA | 809.1600]

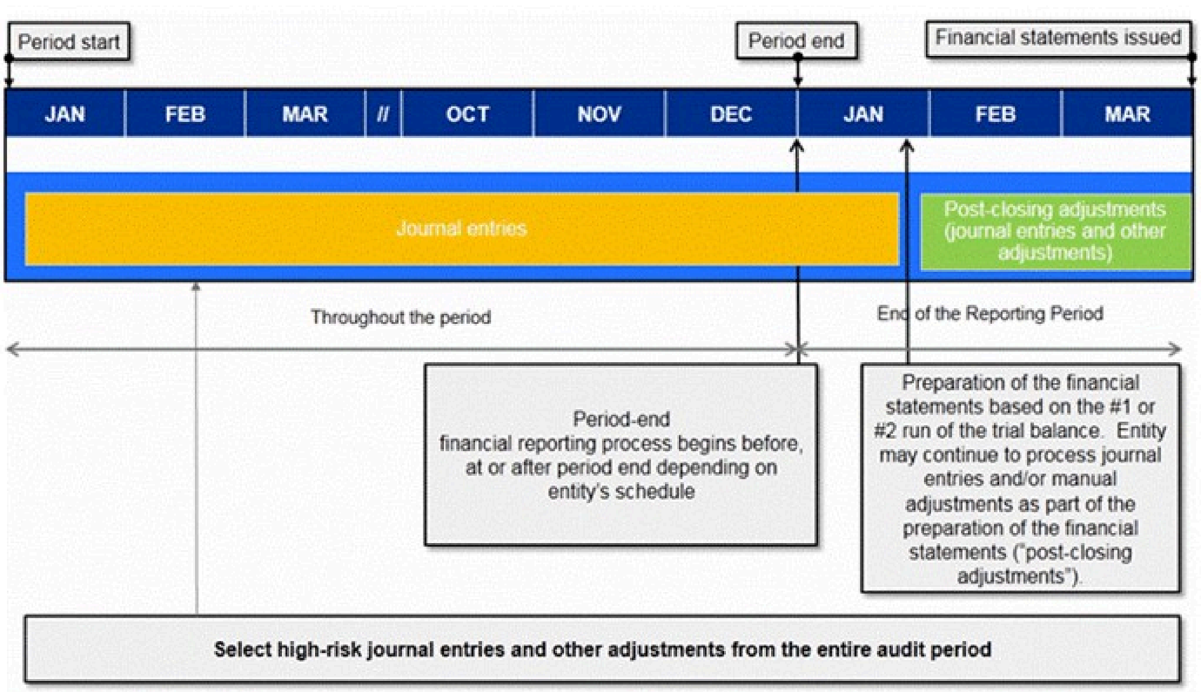
There may be circumstances in which we determine that the criteria for high-risk journal entries would not apply to journal entries and other adjustments made throughout the period.

Examples of these circumstances could include:

- journal entries recorded throughout the period consist primarily of recurring transactions recorded as part of the normal operations of the entity, are created and posted using automated interfaces, and we have tested the operating effectiveness of the process control activities over the automated interfaces and when they are automated, the general IT controls that support their consistent operation.
- manual journal entries are re-recorded at the end of each reporting period - e.g., manual journal entries recorded as part of the month-end closing process for estimates, manual accruals, and post-close adjustments are automatically reversed on the 1st day of the following period, and there are no non-standard journal entries recorded throughout the period.
- journal entries are only prepared in connection with the preparation of the annual financial statements.
- all account balances and transactions are confirmed with third parties at period end, e.g. an investment fund that has outsourced administration, investment management and custodial services to service organizations.
- the determined high-risk criteria do not apply to journal entries posted throughout the period; however, we carefully consider this conclusion, as high risk criteria often apply to journal entries that could be posted at any time throughout the year.

### What are the different types of journal entries and other adjustments recorded as part of the financial reporting and related business processes? [ISA | 809.1700]

Journal entries and other adjustments are made up of various sub-populations, including journal entries recorded throughout the reporting period, journal entries recorded at the end of the reporting period, and other adjustments made during the preparation of the financial statements as depicted in the following diagram:




The separate sub-populations within the entire population of journal entries and other adjustments comprise:

| Sub-population | Time period | Includes |
|---|---|---|
| Journal entries made throughout the period | This starts at the beginning of the financial period and runs to the date when the end of the reporting period starts | Journal entries only |
| Journal entries made at the end of the reporting period | This starts when the period end financial reporting process begins and ends when the financial statement closing process begins. | Journal entries only |
| Post-closing adjustments made during the financial | This is a subset of the end of the reporting period | Journal entries and other adjustments (generally other |

| | | |
|---|---|---|
| statement closing process (part of the end of the reporting period) | which starts when the financial data is transferred from the general ledger to prepare the financial statements (for example, into a spreadsheet or the draft financial statements) and ends when the financial statements are issued. | adjustments made outside of the general ledger) |

Each of the different sub-populations is likely to have different risk characteristics that affect the nature, timing, and extent of our testing of journal entries and other adjustments.

### What types of journal entries and other adjustments are recorded at the end of the reporting period? [ISA | 809.1800]

Journal entries and other adjustments recorded at the end of the reporting period include both:

- journal entries recorded subsequent to the beginning of the period-end financial reporting process in the general ledger IT systems (non-standard journal entries) and other post-closing journal entries recorded as part of the entity's financial reporting process in the entity's consolidation IT systems (consolidation or adjusting journal entries); and

  There is typically higher risk of management override of controls arising from these journal entries as these are typically recorded using manual journal entries within the entity's general ledger or consolidation IT systems. However, an entity may have automated processes and process control activities to authorize, approve, and review manual journal entries.

- other adjustments made during the financial statement close process between the amounts reported in the entity's IT systems (e.g., general ledger and consolidation IT systems) and the amounts reported in the entity's financial statements.

  Other adjustments are typically not recorded in an entity's information systems, but rather represent manual adjustments that may not be subject to the same control activities as journal entries recorded in transaction processing, general ledger, and consolidation IT systems. As a result, there is often the highest risk of management override of controls arising from other adjustments.

### What types of journal entries are recorded throughout the period? [ISA | 809.1900]

Journal entries recorded throughout the period may include standard journal entries recorded within transaction processing IT systems and standard and non-standard journal entries recorded within general ledger IT systems.Depending on entity specific facts and circumstances, there may be lower risk of management override of controls arising from journal entries recorded throughout the period.

> For example, when:
>
> - there is no ability to record manual journal entries within an entity's transaction processing IT systems; and

- automated interfaces and related control activities over the transfer of data and information from the entity's transaction processing IT system to the entity's general ledger IT system (both process control activities over the interface itself and general IT controls that support their effective operation when they are automated controls) are designed, implemented, and operating effectively

there is likely to be lower risk of management override of controls through the recording of journal entries throughout the period.

How might we incorporate elements of unpredictability when we determine the timing of testing of journal entries and other adjustments? [ISA | 809.2000]

Even when we determine it is not necessary to test journal entries throughout the reporting period, we may incorporate an element of unpredictability in our testing of journal entries and other adjustments by selecting additional journal entries and other adjustments recorded throughout the reporting period in addition to those at the end of the reporting period.

When we incorporate an element of unpredictability by performing audit procedures over accounts that would not otherwise be tested, we document not only the procedure's results but also why we performed them - i.e. to incorporate unpredictability. If we don't, an experienced auditor with no previous connection with the engagement may think that we believe there is a risk of management override of controls related to journal entries and other adjustments recorded throughout the period.

# 2.1.5 Identify and select journal entries and other adjustments for testing [ISA | 810]

## What do we do?

Identify and select journal entries and other adjustments for testing

## Why do we do this?

Once we have designed procedures to address the risk of material misstatement (RMM) related to management override of controls through the recording of journal entries and other adjustments and determined the nature, timing, and extent of testing, we determine the completeness of the population of journal entries and other adjustments, apply the high risk criteria to the relevant population, and examine support for each of the high risk journal entries selected for testing.

## Execute the Audit

How do we determine the extent of our testing of journal entries and other adjustments? [ISA | 810.1300]

The extent of our testing is determined based on the number of journal entries and other adjustments that meet the high-risk criteria we use to identify and select specific journal entries and other adjustments for testing.

What do we do to identify and select journal entries and other adjustments for testing? [ISA | 810.1400]

We perform the following procedures to identify and select journal entries and other adjustments for testing:

(1) Determine the completeness of the population(s) of journal entries and other adjustments.
   (a) Identify the relevant population of journal entries and other adjustments. When the relevant population is less than the entire population of journal entries and other adjustments, we document the rationale.
   (b) Obtain the relevant population of journal entries and other adjustments in a format that can be used to effectively and efficiently identify and select journal entries and other adjustments for testing and contains the necessary fields based on the high-risk criteria.
   (c) Perform procedures to test the completeness of the relevant population.
(2) Apply the high-risk criteria to the relevant population to select journal entries and other adjustments for testing.
(3) Examine support for all high-risk journal entries and other adjustments identified.

What if no journal entries and other adjustments meet the high-risk criteria identified? [ISA | 810.159432]

In an instance when no journal entries and other adjustments are identified after applying the high-risk criteria, we reassess the high-risk criteria and still identify and select journal entries and other adjustments made at the end of the reporting period for testing.

When do we identify and select journal entries and other adjustments for testing? [ISA | 810.1500]

The timing of our testing of journal entries and other adjustments will be dependent upon the timing of an entity's financial reporting process and whether we plan to test journal entries and other adjustments throughout the reporting period in addition to those recorded at the end of the reporting period.

For entities that typically record a significant number of journal entries and other adjustments as part of the period-end financial reporting process, our testing of journal entries and other adjustments is likely to occur later and will extend right up until the date of the auditor's report.

# 2.1.5.1 Determine the completeness of the population of journal entries and other adjustments

[ISA | 811]

## What do we do?

Determine the completeness of the population of journal entries and other adjustments

## Why do we do this?

We determine the completeness of the relevant population of journal entries and other adjustments prior to applying the high-risk criteria in order to determine that our identification and selection of journal entries and other adjustments is complete.

## Execute the Audit

### What do we do to determine the completeness of the population of journal entries and other adjustments? [ISA | 811.1300]

We determine the completeness of the population of journal entries and other adjustments by performing the following procedures:

(1) Identify the relevant population of journal entries and other adjustments .

As part of this step, we determine the entity's information systems where journal entries can be recorded, the locations or entities that will be included in the population, and whether the population of journal entries and other adjustments will include all journal entries recorded during the period or be limited to certain entries (e.g., entries recorded to certain accounts or from certain source types).

When the relevant population does not include all journal entries and other adjustments for the entire period, we document our rationale.

(2) Obtain the relevant population of journal entries and other adjustments .

Once we have identified the relevant population of journal entries and other adjustments, we determine the method we will use to obtain the population of journal entries and other adjustments from the entity's information systems and the data and information that needs to be included in the relevant population.

(3) Test the completeness of the population of journal entries and other adjustments .

Once the population has been obtained, we perform procedures to test the completeness of the population of journal entries and other adjustments obtained from the entity's information systems using an appropriate method.

### When do we determine the completeness of the population of journal entries and other adjustments? [ISA | 811.1400]

Planning our response to the risk of management override of controls related to the recording of journal entries and other adjustments includes identifying the relevant population of journal entries and other adjustments. In most instances, it is most efficient and effective to identify the relevant population of journal entries and other adjustments early in the audit - i.e., during the planning phase of the audit.

When we plan to test journal entries and other adjustments at multiple dates throughout the reporting period - e.g., at an interim testing date and then roll-forward our testing through the date on which the last journal entry or other adjustment is recorded - we obtain the relevant population of journal entries and other adjustments at each testing date and test the completeness of the relevant population using an appropriate method.

# 2.1.5.1.1 Identify the relevant population of journal entries and other adjustments [ISA | 812]

## What do we do?

Identify the relevant population of journal entries and other adjustments

# Why do we do this?

Our response to the fraud risk related to management override of controls through the recording of journal entries and other adjustments may be insufficient if we do not correctly identify and define the relevant population. If certain entries and adjustments are inadvertently excluded, we will not be able to identify and select these entries or adjustments for testing as part of our response.

# Execute the Audit

### What is the relevant population of journal entries and other adjustments? [ISA | 812.1300]

The relevant population is the population of journal entries and other adjustments in the identified period that could contain high-risk journal entries and other adjustments.

While the relevant population can be limited to the population that could contain high-risk journal entries and other adjustments, it is likely to be more efficient and effective to identify and define the relevant population to include all journal entries and other adjustments. In these instances, the relevant population is the entire population from the beginning of the year to the end of the year including all journal entries posted through the general ledger and other adjustments posted in preparation of the financial statements.

In rare circumstances where it is not possible to obtain the entire population, the relevant population may be limited to the population that could contain high-risk journal entries and other adjustments - e.g., when the high-risk criteria is limited to certain accounts - the relevant population can be limited to journal entries and other adjustments to these accounts. However, we document the rationale why we are confident that the excluded population does not include any journal entries that meet the higher risk criteria.

### How do we identify and define the relevant population of journal entries and other adjustments? [ISA | 812.1400]

We identify and define the relevant population of journal entries by considering:

- the period subject to our testing of journal entries and other adjustments - i.e., whether we plan to test journal entries and other adjustments at the end of the reporting period or journal entries and other adjustments at the end of and throughout the reporting period; and
- the high-risk criteria that we use to identify and select high-risk journal entries and other adjustments for testing; and
- whether we plan to perform a dual purpose test. When we plan to perform a dual purpose test, refer to the question 'What if we plan to perform a dual purpose test of journal entries and other adjustments' to determine the relevant population.

### How does the high-risk criteria impact the identification and definition of the relevant population of journal entries and other adjustments? [ISA | 812.1600]

We consider the high-risk criteria and include all journal entries and other adjustments that the high-risk criteria would apply to in the relevant population.The identification and definition of the relevant population affects the methods we may use to test the completeness of the relevant population. We can identify and define the relevant population based on characteristics other than accounts: e.g., limiting the relevant population to journal entries recorded to particular transaction source codes associated with manual journal entries when we have tested process control activities over the automated interfaces and related general IT controls that support their consistent operation. In these instances, it is not possible to use a roll-forward of account balances to test the completeness of the population. If we plan to use the roll-forward method to test the completeness of journal entries, it is not recommended to identify and define the relevant population based on characteristics other than accounts.

What if we plan to perform a dual purpose test of journal entries and other adjustments? [ISA | 812.1700]

When we plan to perform a dual purpose test over journal entries and other adjustments, we keep in mind that selecting and testing high-risk criteria entries naturally biases our selection to entries that have certain pre-defined criteria. However, when we are testing process control activities that are designed to operate over all journal entries or all journal entries of a certain type - e.g., manual entries - we select a sample of instances from the entire population of entries in a way that every instance has a chance of selection. Unless the process control activity we are testing is only applied to the entries that meet our high-risk criteria, it may not be possible to effectively design a dual purpose test. This is because the entries that do not meet the high-risk criteria within the entire population of entries subject to the process control activity would have no chance of being selected.

# 2.1.5.1.2 Obtain the relevant population of journal entries and other adjustments [ISA | 813]

## What do we do?

Obtain the relevant population of journal entries and other adjustments and document our rationale when the relevant population is less than the entire population

## Why do we do this?

When obtaining the relevant population of journal entries and other adjustments, we consider the necessary format of the data and the fields that must be included in the data based on the criteria we will use to identify high-risk journal entries and other adjustments for testing.

## Execute the Audit

How may we obtain the relevant population of journal entries? [ISA | 813.1300]

We may obtain the relevant population of journal entries by using different methods, for example:

| Method | Description |
|---|---|
| Obtain a system generated report from the entity's information system containing the journal entries recorded to the ledger during the period | Under this method, we obtain the relevant population of journal entries by obtaining a system generated report from the entity's IT systems. |

| | |
|---|---|
| Perform a direct extraction from the entity's information system containing the journal entries recorded to the ledger during the period | Under this method, specific team members with expertise in IT or in Forensics, central teams, or others with appropriate skills and knowledge may assist us in directly extracting the population from the relevant databases that include journal entries. |

There may be other methods to obtain the relevant population of journal entries based on the IT systems used by the entity and the engagement specific circumstances.

Due to size restrictions that may be encountered, including restrictions associated with the transfer medium (e.g. email or flash drive size limitations), the file format, or the processing capabilities of the client's general ledger system, this listing may need to be created in smaller files and appended into one file within IDEA®.

### Do we obtain the relevant population of journal entries in a particular format? [ISA | 813.1400]

Due to the challenges of manually analyzing high volumes of journal entries and testing the completeness of the population of these entries, it is often most efficient and effective to obtain the journal entry population in an electronic format.

When the population of journal entries and other adjustments cannot be obtained in an electronic format, we can only apply the criteria for high-risk journal entries and other adjustments to the population manually, which is likely to be less efficient and may be prone to human errors.

### What data and information are necessary to include in the population of journal entries and other adjustments? [ISA | 813.1500]

The data and information that should be included in the population of journal entries and other adjustments will depend on the high-risk criteria that we will use to identify and select journal entries and other adjustments for testing and the attributes we plan to test.

At a minimum, the journal entry data will include data fields for the account number, journal entry number, and amount.

Other fields that may be necessary in order to identify and select journal entries and other adjustments that meet the high-risk criteria include but are not limited to:

| Routine | Additional data and information to be included in the relevant population: |
|---|---|
| Entries made to unrelated, unusual, or seldom-used accounts - e.g., accounts associated with a fraud risk, accounts used to record complex and/or unusual transactions, accounts used to record significant estimates and period-end adjustments, accounts that | Account description |

| | |
|---|---|
| have not been reconciled, or accounts used to record intercompany transactions | |
| Entries from certain transaction source codes associated with manual journal entries - e.g., certain transaction source codes related to manual journal entries | Transaction source code |
| Entries created or posted by certain individuals - e.g., by certain individuals or individuals who typically do not make journal entries | User / account of individual that created the journal entry<br>User / account of individual that posted the journal entry |
| Entries that have little or no explanation or description | Journal entry description |
| Entries that have a description containing certain words or phrases - e.g., entries that have descriptions containing phrases such as "adjustment" or "correction" | Journal entry description |
| Entries made at the end of the reporting period - e.g., entries created or posted on dates considered to be at the end of the reporting period | Created / posted date |
| Entries recorded on unusual dates or times | Created / posted date<br>Created / posted time |

### When do we obtain the relevant population of journal entries? [ISA | 813.1600]

Our timing of obtaining the relevant population of journal entries will depend on our anticipated timing of testing of journal entries. When possible, we seek to accelerate our testing of journal entries recorded throughout the period under audit by performing testing at an interim date and rolling forward our testing through the end of the period.

We obtain the relevant population of journal entries that will be used to identify and select journal entries after all journal entries have been recorded by the entity for the period. When additional journal entries are recorded after we have obtained the population of journal entries, we include these additional journal entries in the relevant population.

We may determine it is most efficient and effective to establish a regular process with an entity's accounting or IT department to extract, validate, and transfer journal entry data using a standard format.

#### How do we obtain the relevant population of other adjustments? [ISA | 813.1700]

We obtain the relevant population of other adjustments recorded during the preparation of the financial statements by reconciling the financial statements to the underlying accounting records - for example, the general ledger.

Through performing this reconciliation, we can identify where adjustments have been recorded outside of the general ledger or consolidation systems.

#### What is our responsibility regarding the relevance and reliability of data used in applying the high-risk criteria to the relevant population? [ISA | 813.13505]

Our responsibility over the relevance and reliability of the data used in applying the high-risk criteria to the relevant population is based on the same requirements and guidance that we follow when we use data in other audit procedures. We determine the nature and extent of effort necessary to evaluate the relevance and reliability of the information used by thinking about how we intend to rely on information used in our audit (see activity 'Evaluate the relevance and reliability of information used as audit evidence' and 'Evaluate the reliability of the population of journal entries and other adjustments' for further information).

#### What are the relevant data elements for information used in journal entry testing? [ISA | 813.13507]

When applying high-risk criteria to relevant population, we often rely on certain data elements in journal entry transaction files. We identify the relevant data elements (RDEs) for information used in journal entry testing based on our identified high-risk criteria. For example, manual and automated indicator, user name and creation date are the RDEs for the high-risk criteria 'manual entries created by CFO on weekends'. See the question 'What are 'relevant data elements' (RDEs)?' for further information.

# 2.1.5.1.3 Test the completeness of the population of journal entries and other adjustments [ISA | 814]

## What do we do?

Test the completeness of the population of journal entries and other adjustments

## Why do we do this?

Once we have identified and obtained the relevant population of journal entries that will be subject to testing, we perform procedures to test the completeness of the relevant population prior to applying the high-risk criteria to the relevant population. Testing the completeness of the relevant population helps us to evidence that the relevant population is complete and we have identified and selected all journal entries and other adjustments that meet the high-risk criteria.

## Execute the Audit

#### How do we test the completeness of the population of journal entries? [ISA | 814.1300]

We test the completeness of the population of journal entries and other adjustments using one of the following approaches:

- roll-forward of account balances; or
- system query with effective general IT controls and other controls.

### How do we test completeness of the relevant population of journal entries using a roll-forward of account balances? [ISA | 814.1400]

To test the completeness of the population of journal entries using a roll-forward of account balances, we:

- obtain a trial balance by account number for the prior period end and the end of the current period subject to audit;
- reconcile the prior year trial balance to the financial statements audited in the prior period and the current year trial balance to the financial statements audited in the current period;
- determine that the number of accounts listed in the electronic file reconciles with the number of accounts in the trial balance by account number at the end of the current period subject to audit;
- select one of the following two options to roll-forward account balances:

| | |
|---|---|
| Roll-forward of all accounts | Roll-forward all accounts to evaluate the completeness of the entire population. |
| Roll-forward of specific accounts | Roll-forward the specific accounts affected by the high-risk criteria and consider incorporating an element of unpredictability. |

When selecting one of these options, we consider whether the option we select is appropriate based on the high-risk criteria we use to identify and select journal entries and other adjustments further described below.

- sum the amounts of journal entries by account number from the electronic file of journal entries using a software audit tool such as IDEA or Excel;
- reconcile the sum of the amounts of journal entries by account number for income statement accounts included in the relevant population (either all accounts or specific accounts depending on the option selected above) to the amount per the trial balance for the current period; and
- reconcile the sum of the amounts of journal entries by account number for balance sheet accounts other than retained earnings included in the relevant population (either all accounts or specific accounts depending on the option selected above) to the change between the amount per the trial balance for the current period and the amount per the trial balance for the prior period - i.e., roll-forward balance sheet accounts included in the relevant population.

#### When do we use a roll-forward of all accounts to test the completeness of the relevant population of journal entries? [ISA | 814.13459]

Whenever it is possible to obtain the entire population of journal entries in an efficient manner, we roll-forward all accounts, because a roll-forward of all accounts provides us with the most persuasive audit evidence regarding the completeness of the population.

### When do we use a roll- forward of specific accounts to test the completeness of the relevant population of journal entries? [ISA | 814.13460]

When it is not possible to obtain the entire population of journal entries and other adjustments in an efficient manner, a roll-forward of specific accounts may be used.

A roll-forward of specific accounts is appropriate when the high-risk criteria we use to identify and select journal entries and other adjustments for testing

- are expected to be limited to certain accounts,
- we do not expect to identify exceptions, and
- the entity is not aware of the accounts that we are testing for completeness.

When the high-risk criteria we use to identify and select journal entries and other adjustments for testing are not limited to certain accounts - e.g., when the high-risk criteria include all journal entries created on certain dates or by specific users - we do not use a roll-forward of specific accounts to test the completeness of the relevant population of journal entries.

When a roll-forward of specific accounts is used, we roll-forward all accounts affected by the high-risk criteria and also consider incorporating an element of unpredictability in our selection.

In these instances, we document the rationale for selecting the specific accounts we roll-forward and why we believe it is not necessary to roll-forward the remaining accounts.

### How do we test completeness of the relevant population of journal entries if we intend to test journal entries made at the end of the reporting period only? [ISA | 814.13461]

If we intend to test journal entries made at the end of the reporting period only (i.e. we don't test journal entries throughout the period), we perform the same completeness test as we do when we test journal entries throughout the period and journal entries and other adjustments made at the end of the reporting period: we use the roll-forward method or the system query.

After the test of completeness, we apply the high-risk criteria to the journal entries made at the end of the reporting period.

## How do we test completeness of the relevant population of journal entries using a system query? [ISA | 814.1500]

In circumstances where we obtained the total population of journal entries and other adjustments by running a query against the entity's IT systems and we have tested the operating effectiveness of control activities over the IT systems, integrated application systems, database management systems and interfaces through to the general ledger, we may choose to assess the completeness of the population in conjunction with the testing of general IT controls and other control activities to address the integrity of the data and information sourced from the IT system.

To test the completeness of the relevant population of journal entries and other adjustments using a system query, we:

- observe entity personnel execute a system query to obtain the relevant population of journal entries and other adjustments.
- test the reliability of the system query by considering the following:
  - whether the underlying database(s) represent a complete population of relevant journal entries;

Obtaining an understanding of the entity's approach to determining the completeness of the information will assist in developing an effective audit approach to obtain audit evidence about the completeness of the information.

- whether the nature of the query appropriately captures all journal entries for the relevant period(s);
- whether the automated control activities relevant to the system query are tested and effective;
- whether the interface control activities relevant to the system query are tested and effective; and
- whether the general IT controls necessary to support the automated control activities and interface control activities and the integrity of data and information from the IT system from which the information is extracted are tested and effective.

Do we still perform a roll-forward of account balances when we test completeness using a system query approach? [ISA | 814.13462]

It depends. In some instances, we may determine it is necessary to perform a roll-forward of account balances even when we test the completeness of the relevant population using a system query approach. This may be necessary when we perform a system query approach for the first time and wish to validate that we have properly identified the underlying database(s) containing journal entries and whether the nature of the query appropriately captures all journal entries. In other instances where we have validated these items in prior periods and are unaware of changes that could affect the accuracy and completeness of the system query in the current period, we may determine it is unnecessary to perform additional procedures.

How do we test the completeness of the population of other adjustments? [ISA | 814.1600]

We test the completeness of the population of other adjustments recorded during the preparation of the financial statements by reconciling the financial statements to the underlying accounting records - for example, the general ledger.

Through performing this reconciliation, we can identify where adjustments have been recorded outside of the general ledger or consolidation systems.

# 2.1.5.2 Apply the high-risk criteria to the relevant population [ISA | 815]

## What do we do?

Apply the high-risk criteria to the relevant population of journal entries and other adjustments in order to select high-risk journal entries and other adjustments to be tested

## Why do we do this?

Once we have determined the high-risk criteria and determined the completeness of the population of journal entries and other adjustments, we apply the high-risk criteria to the relevant population in order to identify and select the journal entries and other adjustments within the relevant population that meet the high-risk criteria.

# Execute the Audit

### How do we apply the high-risk criteria to the relevant population of journal entries? [ISA | 815.1300]

We apply the criteria for high-risk journal entries to the relevant population using one of the following methods:

| Method | Description |
|---|---|
| Ready-to-use routines | When we have obtained the relevant population in electronic format, we may use the Journal Entry Analysis capability (JEA capability) to apply the high-risk criteria to the relevant population of journal entries to select specific entries for testing.<br>Other ready to use routines (for example KAAP-iJet or IDEA) may provide similar functionality. |
| End-user routines | When we have obtained the relevant population in electronic format, we may also be able to apply the high-risk criteria using end-user computing functionality, such as sorting or filtering, available in software audit tools such as IDEA or Microsoft Excel. |
| Manual application | When we are unable to obtain the relevant population in an electronic format, we apply the high-risk criteria manually by obtaining and inspecting each journal entry in the relevant population and determining whether the journal entry meets the high-risk criteria. |

For further information regarding use of software audit tools and/or end-user routines, see activity 'Plan and perform CAATs'.

### How do we apply the high-risk criteria to the relevant population of other adjustments? [ISA | 815.1400]

Due to the nature of other adjustments (adjustments made outside of accounting ledgers), we manually apply the high-risk criteria to identify the adjustments that meet the high-risk criteria.

#### Are the JEA capability, KAAP-iJet and IDEA globally approved software audit tools to apply the criteria for high-risk journal entries and other adjustments? [ISA | 815.13472]

Yes. The JEA capability, KAAP-iJet and IDEA are software audit tools (SATs) that have been globally approved for use in audits. When we use a SAT, we determine whether it is included in the KPMG member firm SAT list in order to consider how we support reliance on that tool. For further information, see activity 'Plan and perform CAATs'.

### How may we use JEA capability to apply the high-risk criteria to the relevant population of journal entries? [ISA | 815.1600]

Pre-defined journal entry (JE) Reports are generated by the JEA capability presenting predetermined journal entries statistics and characteristics. For example, manual and automated journal entries, journal entries by user, by account number, by period and journal source, etc.

We can create custom pivot tables to combines these pre-defined JE Reports to identify the journal entries that meet the high-risk criteria that we have determined as relevant.

### How may we use KAAP-iJet to apply the high-risk criteria to the relevant population of journal entries? [ISA | 815.1700]

A report (referred to as the 'G19 report') is generated by KAAP-iJet presenting predetermined journal entries statistics and characteristics. For example, manual and automated journal entries, journal entries by user, journal entries by amount and period, etc.

Using KAAP-iJet functionality, we can create custom pivot tables to combine those statistics and characteristics to identify the journal entries that meet the specific high-risk criteria that we have determined as relevant.

### How may we use ready-to-use routines within IDEA to apply the high-risk criteria to the relevant population of journal entries? [ISA | 815.1750]

IDEA includes certain ready-to-use routines that may be used to apply certain high-risk criteria to the relevant population of journal entries. For example, we can sort or filter journal entries by user, by account number, by period and journal source, etc.

> For example, for the selection characteristics related to the CEO, CFO and Commercial Charter Sales Manager posting entries involving revenue accounts in the last month of the period, we can use IDEA ready-to-use routines to select journal entries and other adjustments:
>
> - Posted to revenue accounts;
> - Posted by any of the three selected individuals; and
> - Posted on dates within the last month of the period.

### How may we use end-user routines to apply the high-risk criteria to the relevant population of journal entries? [ISA | 815.1900]

We may be able to use IDEA or Excel to develop end-user routines to apply the high-risk criteria to the relevant population. For example, we may use end-user computing functionality within IDEA - e.g., data summarization, data extraction, and/or data joins - or Excel - e.g., sorting, filtering, pivot tables, and/or formulas - to apply the high-risk criteria to the relevant population.

#### How do we document the use of end-user routines to apply the high-risk criteria to the relevant population of journal entries? [ISA | 815.13476]

When we develop and use end-user routines, we are responsible for evaluating the appropriateness of the design and test the consistent operation of the individual routines to the extent considered necessary in the circumstances. We document the end-user routines used in a sufficient level of detail such that an experienced auditor can understand whether these were appropriately designed and produced the intended output - i.e., identified and selected all of the journal entries in the relevant population that met the high-risk criteria.

#### What is our responsibility regarding the relevance and reliability of data used in applying the high-risk criteria to the relevant population? [ISA | 815.13505]

Our responsibility over the relevance and reliability of the data used in applying the high-risk criteria to the relevant population is based on the same requirements and guidance that we follow when we use data in other audit procedures. We determine the nature and extent of effort necessary to evaluate the relevance and reliability of the information used by thinking about how we intend to rely on information used in our audit (see activity 'Evaluate the relevance and reliability of information used as audit evidence' and 'Evaluate the reliability of the population of journal entries and other adjustments' for further information).

#### What are the relevant data elements for information used in journal entry testing? [ISA | 815.13507]

When applying high-risk criteria to relevant population, we often rely on certain data elements in journal entry transaction files. We identify the relevant data elements (RDEs) for information used in journal entry testing based on our identified high-risk criteria. For example, manual and automated indicator, user name and creation date are the RDEs for the high-risk criteria 'manual entries created by CFO on weekends'. See the question 'What are 'relevant data elements' (RDEs)?' for further information.

# 2.1.5.3 Examine support for all journal entries and other adjustments identified and selected [ISA | 816]

## What do we do?

Examine support for all journal entries and other adjustments that are identified and selected for evidence of possible material misstatement

## Why do we do this?

We perform procedures to test each of the journal entries and other adjustments selected to determine whether there is evidence of misstatement, particularly related to possible management override of controls.

## Execute the Audit

#### What is meant by the nature of our testing of journal entries and other adjustments? [ISA | 816.1300]

The nature of our testing refers to the type of procedures we perform for each journal entry and other adjustment selected for testing.

#### Can we incorporate a specified threshold in our selection of journal entries to test? [ISA | 816.13579]

No, it is not appropriate to only identify journal entries above an arbitrary quantitative threshold (e.g. performance materiality or the audit misstatement posting threshold), as fraud can be perpetrated by recording numerous low-value entries. We use high-risk criteria for identifying and selecting specific journal entries and other adjustments for testing. These high-risk criteria are specific to the circumstances of the engagement based on our judgement.

## What substantive procedures do we perform to test journal entries and other adjustments identified and selected for testing? [ISA | 816.1400]

As our testing of journal entries and other adjustments is part of our response to management override of controls (a fraud risk), the nature of our testing procedures includes examining appropriate supporting documentation. When examining the supporting documentation, we:

- determine whether the journal entry or other adjustment reflects the underlying events or transactions;
- determine whether the journal entry or other adjustment has been recorded in the correct accounting period at appropriate amounts;
- determine whether the journal entry or other adjustment has been recorded to the correct general ledger account (or has been included in the appropriate financial statement captions); and
- assess whether the journal entry or other adjustment is indicative of management override of controls.

### Do we examine support for all journal entries and other adjustments that meet the high-risk criteria? [ISA | 816.13516]

Yes. We examine support for all journal entries and other adjustments that meet the high-risk criteria. It is inappropriate to examine support for a sample of the journal entries and other adjustments that meet the high-risk criteria.

### What if the journal entry identified and selected for testing is a recurring entry? [ISA | 816.13517]

When the journal entry is a recurring journal entry or adjustment, we may compare the journal entry to the prior period and assess whether the entry recorded in the current period remains appropriate.

## What if an exception is identified as part of our testing of journal entries and other adjustments? [ISA | 816.1600]

When exceptions are identified as part of our testing of journal entries and other adjustments, we determine:

- whether the exceptions are indicative of fraud due to management override of controls;
- whether the exception represents an audit misstatement in excess of our audit misstatement posting threshold that should be included in our summary of audit misstatements; and
- whether the exception is indicative of a control deficiency in the entity's control activities over journal entries and other adjustments and the related impact on our assessment of combined assessed risk related to an identified risk of material misstatement.

### What if an exception identified as part of our testing of journal entries and other adjustments is indicative of fraud due to management override of controls? [ISA | 816.13518]

When the exception is indicative of fraud due to management override of controls, we perform additional procedures to respond to the identified or suspected fraud including:

- obtain an understanding of the nature of the identified or suspected fraud and the circumstances in which it occurred; and
- when we conclude, based on the information obtained, that fraud is likely to have occurred, we also evaluate the materiality of the identified or suspected fraud on the financial statements as well as other aspects of the audit.

Refer to the activity 'Evaluate whether misstatements are the result of fraud and the implications' for further information.

What if an exception identified as part of our testing of journal entries and other adjustments represents an audit misstatement? [ISA | 816.13519]

When the exception represents an audit misstatement, we determine the amount of the identified misstatement based on the amount recorded per the journal entry and the amount per the supporting documentation. Please refer to activity 'Accumulate, communicate and evaluate misstatements' for more guidance about accumulating and evaluating misstatements.

What if an exception identified as part of our testing of journal entries and other adjustments is indicative of a control deficiency? [ISA | 816.13520]

When the exception is indicative of a control deficiency - e.g., when an exception indicates that a control activity over journal entries and other adjustments is missing, a process control activity is not designed at an appropriate level of precision to prevent or detect a material misstatement to the financial statements, or a control activity has not been performed in accordance with its design or by an individual with an appropriate level of authority or competence, we identify and evaluate the severity of the deficiency.

For example, when examining support for journal entries identified and selected for testing and performing a control test, we identify a deviation whereby a journal entry was not reviewed and approved by an appropriate individual consistent with the entity's policies and procedures. As the deviation is indicative of a control deficiency, we perform further procedures to identify the related control deficiency and evaluate the severity of the deficiency. We determine that certain individuals were granted access and permissions to review journal entries in the entity's general ledger IT system that were not commensurate with the entity's policies and procedures or their job responsibilities. We identify a deficiency related to both the general IT control related to the provisioning of access and the related automated process control activities, including the automated process control activity related to access to create journal entries, affected by the general IT control deficiency, and evaluate the severity of the deficiencies.

# 2.2 Evaluate management bias in the preparation of accounting estimates [ISA | 4463]

## What do we do?

Evaluate management bias in the preparation of accounting estimates.

## Why do we do this?

Financial statements often contain accounting estimates that impact a number of elements of the financial statements (e.g. assets, liabilities or disclosures). Estimates introduce the potential for management bias (both intentional and unintentional) because:

- estimates are an approximation and generally have a degree of uncertainty associated with them,

- estimates can involve complex processes and methods; and
- management's judgment is involved in their preparation.

The more subjectivity there is in an estimate, the greater the potential for management bias. Given this potential, we specifically evaluate management bias related to accounting estimates.

# Execute the Audit

## How do we evaluate management bias in accounting estimates at various points of the audit? [ISA | 4463.1300]

We evaluate bias in the preparation of accounting estimates in the following ways:

| When? | Procedures | How? |
|---|---|---|
| During our risk assessment | Perform and evaluate a retrospective review of accounting estimates | • comparing the prior period's estimates to actual results, if any, individually and in aggregate. |
| During the audit while we perform the substantive procedures over the estimates. | Evaluate management bias in accounting estimates 'individually' | • evaluating whether the estimate was prepared in a cautious or optimistic manner, and<br>• evaluating whether management is trying to achieve an expected or desired outcome (e.g. increase income, loss, or other key financial statement metrics). |
| During our concluding procedures, while we evaluate the results of the audit. | Evaluate management bias in accounting estimates 'in aggregate'<br><br>Evaluate management bias in the effect of changes in estimates from the prior period to the current period | • evaluating whether many or all of the estimates were recorded toward the same end of the range (i.e. they were all prepared in a cautious manner or they were all prepared in an optimistic manner),<br>• evaluating whether the estimates in the financial statements are grouped |

| | | |
|---|---|---|
| | | at one end of the range of reasonable estimates in the prior period and are grouped at the other end of the range of reasonable estimates in the current period (i.e. they were all prepared in a cautious manner in the prior period and in an optimistic manner in the current period, or vice versa), and<br>• evaluating whether management is trying to achieve an expected or desired outcome (e.g. increase income, loss, or other key financial statement metrics). |

### What do we do if we identify management bias in accounting estimates? [ISA | 4463.15831]

If we identify indicators of bias and/or actual bias in management's judgments when we evaluate the accounting estimates individually, in aggregate or with respect to the effect of changes from the prior period to the current period, we:

- Evaluate whether the bias is material to the financial statements and/or is the result of fraud ;
- Evaluate whether our risk assessments and the related audit responses remain appropriate .

# 2.2.1 Perform and evaluate a retrospective review of accounting estimates [ISA | 1115]

## What do we do?

Perform a retrospective review of accounting estimates with a reasonable possibility of a risk of material misstatement in the current year or where there was a risk of material misstatement in the prior year. Evaluate the results of our retrospective review to identify and assess the risks of material misstatement in the current period, including fraud risks, identify indicators of possible management bias and address the risk of management override of controls.

## Why do we do this?

Our retrospective review serves multiple purposes, including assisting us in identifying and assessing the risks of material misstatement in the current period, assessing the risk of management override of controls and other possible fraud risks and assessing the susceptibility of the estimate to indicators of possible management bias.

# Execute the Audit

## What is a retrospective review of an accounting estimate? [ISA | 1115.1300]

A retrospective review is the comparison of the entity's prior year estimate to the outcome of an estimate or is a review of the re-estimation of the prior year accounting estimate.

### What is the 'outcome' of an estimate? [ISA | 1115.15174]

The 'outcome' of an estimate represents the transfer or realization of the asset or liability in the current year that was estimated in the prior year.

> For example, prior year bonus or legal accruals that have been paid in the current year allow us to compare the amount paid or the 'outcome' to the prior year accrual or 'estimate'.

### What is meant by 're-estimation' of the previous accounting estimate? [ISA | 1115.15175]

Estimates that do not yet have an outcome in the current period or won't ever have an outcome are re-estimated in the current year.

> For example, actuarial assumptions in pension costs do not have an outcome in the current year, so our retrospective review is focused on the subsequent re-estimation of those amounts for purposes of the current year financial statements.

### Are there instances where we review both the 'outcome' and the subsequent 're-estimation of the estimate'? [ISA | 1115.15176]

Yes. There could be instances where reviewing both the 'outcome' and the subsequent 're-estimation' is appropriate.

> For example, an entity uses an income-based approach to estimate the fair value of a reporting unit as part of its quantitative goodwill impairment assessment. In determining the fair value of the reporting unit in the prior year (20X1), certain assumptions and data were used to prepare the projected financial information contained in the valuation model. One assumption included forecasted revenue growth rates for the years 20X2 through 20X6.
>
> When we perform our retrospective review in the following year (20X2), the actual revenue amounts for 20X2 may be compared with the prior year's forecasted growth rates for 20X2 to obtain information about the effectiveness of management's estimation process.
>
> Additionally, the subsequent re-estimation growth rates for years 20X3-20X6, and the reasons for any changes, may also provide information about the effectiveness of management's estimation process and may help us identify and assess RMMs in the current period.

## Do we perform a retrospective review for all accounting estimates? [ISA | 1115.15177]

No. We perform a retrospective review only for those accounting estimates for which we have identified a reasonable possibility of an RMM associated with the selection of the methods, assumptions, or data and/or an RMM associated with the application of the methods, assumptions, and data in the current year or for which we identified an RMM in the prior year.

This includes:

- Accounting estimates for which we identified an RMM in the prior year but none in the current year; and/or
- Accounting estimates for which we identified a reasonable possibility of an RMM in the current year.

#### If I meet the conditions to perform a retrospective review, is there ever a situation where it is appropriate NOT to perform a retrospective review? [ISA | 1115.15178]

Yes. When an accounting estimate is new or does not have an outcome (i.e., settled through subsequent transfer or realization) or subsequent re-estimation, it may not be possible to perform a retrospective review.

> For example, an entity granted stock-based compensation in the prior year in the form of options to its employees, which required an estimate of fair value on the grant date. However, the fair value is only used to determine the expense to recognize over the life of the grant in future periods and is not re-estimated unless there is a change in the award. Because the value of the options is fixed on the grant date and there is no re-estimation or indication of fair value upon settlement, we do not perform a retrospective review.

### When do we perform our retrospective review? [ISA | 1115.15179]

We perform our retrospective review as part of our risk assessment procedures as we use the results to help identify and assess RMMs.

### Enhanced | What is management's responsibility to perform a retrospective review? [ISA | 1115.15479]

Management is responsible for monitoring the reasonableness of its accounting estimates on an on-going basis. Management's process will likely vary depending on the degree of complexity, subjectivity and estimation uncertainty related to an estimate and may include performing a retrospective review related to the estimate as whole or focused on the elements of an estimate.

#### Enhanced | What if management does not perform a retrospective review? [ISA | 1115.15480]

When management does not prepare a retrospective review, we evaluate the implications on our audit - primarily whether it impacts our assessment of inherent risk or our ability to rely on the entity's controls.

In situations where certain assumptions or data could be reasonably determined without using hindsight, the lack of a retrospective review may have no implications on our audit related to those assumption or data. Conversely, in situations where we would expect an assumption or data to be adjusted based on the historical experience of the entity, the lack of a retrospective review may have more significant implications on our ability to rely on controls or our assessment of inherent risk related to the assumption or data.

Similarly, in situations where the entity's model(s) are not complex or dependent on updates being made in the future, the lack of a retrospective review may have no implications on our audit. However, other models call for the design and calibration to be periodically evaluated and a lack of a retrospective review may have more significant implications on our ability to rely on controls or our assessment of inherent risk related to the model.

### Core and Less Complex | What is management's responsibility to perform a retrospective review? [ISA | 1115.15281]

Management is responsible for monitoring the reasonableness of its accounting estimates on an on-going basis. Management's process will likely vary depending on the degree of complexity, subjectivity and estimation uncertainty related to an estimate and may include performing a retrospective review related to the estimate as whole or focused on the elements of an estimate.

#### Core and Less Complex | What if management does not perform a retrospective review? [ISA | 1115.15282]

When management does not prepare a retrospective review, we evaluate the implications on our audit - primarily whether it impacts our assessment of inherent risk or our ability to rely on the entity's controls.

In situations where certain assumptions or data could be reasonably determined without using hindsight, the lack of a retrospective review may have no implications on our audit related to those assumption or data. Conversely, in situations where we would expect an assumption or data to be adjusted based on the historical experience of the entity, the lack of a retrospective review may have more significant implications on our ability to rely on controls or our assessment of inherent risk related to the assumption or data.

Similarly, in situations where the entity's model(s) are not complex or dependent on updates being made in the future, the lack of a retrospective review may have no implications on our audit. However, other models call for the design and calibration to be periodically evaluated and a lack of a retrospective review may have more significant implications on our ability to rely on controls or our assessment of inherent risk related to the model.

### Can we use the retrospective review prepared by management? [ISA | 1115.15180]

There may be situations where we are able to leverage management's retrospective review as part of our risk assessment procedures. When management prepares a retrospective review, we obtain an understanding of how management performs the retrospective review and responds to its results. This may inform us as to the nature, timing and extent of our approach towards performing our own retrospective review.

However, leveraging something that management has already done does not mean we simply take what management has done and insert it into our file. It means that we may gain insight into how to perform a retrospective review based on what management does for their own purposes. Ultimately, we take responsibility for whatever is in our file and whether it satisfies the objective of the auditing standards.

#### Do we evaluate the information used in management's retrospective review? [ISA | 1115.15181]

When we leverage management's retrospective review as part of our risk assessment procedures, we evaluate the relevance of information and whether the information is sufficiently reliable for the purpose of the risk assessment procedure by following the guidance in 'How do we evaluate the reliability of information used in our risk assessment procedures?'.

### How do we determine the nature and extent of our retrospective review? [ISA | 1115.15182]

The nature and extent of the review can vary, but is influenced by the characteristics of the estimate and the assessed risks related an estimate in the prior year and current year. Characteristics we think about that can influence the nature and extent of our retrospective review include:

| Characteristics | How this matter may impact the nature and extent of our retrospective review |
|---|---|
| **Assessment of risk in the prior period and current period** | *Prior period assessment:*<br><br>For estimates where inherent risk associated with the selection of one or more individual methods, assumptions, or data, or the application of the methods, assumptions, and data, was assessed as 'elevated' or 'significant' in the prior period, our review may be more extensive. For example, we may focus our review on both the estimate as a whole and the individual elements of the estimate that gave rise to the increased risk.<br><br>On the other hand, for estimates where inherent risk was assessed as base associated with the selection or the application of the elements, analytical procedures may be sufficient.<br><br>*Current period assessment:*<br><br>Our other risk assessment procedures or previous knowledge of an accounting estimate may provide insights into the level of expected risk in the current period. For example, we may know there are three relevant assumptions that give rise to an increased level of risk based on our other risk assessment procedures, so we may focus more attention in our retrospective review on these individual elements of the estimate.<br><br>Our retrospective review may not be as robust for an estimate that does not give rise to an RMM. However, there may be "close calls" where in order to determine whether there is an RMM associated with the selection of the methods, assumptions, or data or the application of the methods, assumptions and data for an estimate, a more granular understanding of the elements is necessary. In those cases, our retrospective review may focus on the relevant assumptions and judgments that management made in developing an estimate. |

| | |
|---|---|
| | Our current period assessment could change the nature and extent of our retrospective review as we learn more information. |
| **Changes from the prior period** | When the recorded estimate, or the circumstances surrounding an estimate, have changed from the prior year this may be an indicator to perform a more extensive retrospective review. Our review may apply additional focus on the reasons for the change and the related circumstances to understand the impact on the individual elements of an estimate.<br><br>For example, when there has been a significant decrease in the reserve for uncollectible receivables this may be an indicator to perform more extensive procedures to understand whether this decrease causes us to have an increased level of risk associated with the selection and/or the application of the elements. |
| **Period of time over which the estimate is resolved** | Depending on how the estimate is resolved and the length of time it is resolved over, our review may be performed by looking at several periods, a shorter period (such as half-yearly or quarterly) or a longer period (over several years).<br><br>For example, we may perform a retrospective review each quarter on a rolling basis for an account that contains legal accruals related to multiple cases that are each recognized and settled over various periods of time. In this instance, comparing settlement amounts back to the previously estimated accruals on a case-by-case basis each quarter can provide audit evidence over management's ability to estimate over a period of time greater than one year. |
| **Assessed fraud risk** | When we have assessed there to be a fraud risk - either pervasively related to the development of management's estimates or related to significant changes to assumptions in recurring estimates - we may apply additional focus on the elements of the estimate that gives rise to the fraud risk. Retrospective review can highlight areas where management bias may exist. |

### What information might we learn from our retrospective review? [ISA | 1115.15183]

The table below sets out the types of matters we may learn about through our retrospective review and how it may influence our audit approach.

| Matter | Examples of relevant information that we may gather |
|---|---|
| **Information regarding the effectiveness of management's estimation process which provides audit evidence about the likely effectiveness of management's current process** | • The on-going relevance and accuracy of the model<br>• Whether the model remains suitable for its intended use<br>• How the model is changed or adjusted on a timely basis for changes in market or other conditions<br>• Whether adjustments are made to the output of the model and whether the criteria applied is consistent with the prior period<br>• The basis for management's selection of assumptions<br>• The nature and source of the data<br>• How management evaluates whether data is appropriate<br>• The consistency of data used with data in the previous periods |
| **Reasons for changes in prior estimates that may require disclosure in the current period financial statements** | Financial reporting frameworks may require the disclosure of estimation uncertainty, subjective assumptions, or the reasons for changes in estimated amounts. |
| **Information regarding the complexity or estimation uncertainty pertaining to the accounting estimate** | **Complexity:**<br>• Where the financial reporting framework requires a measurement basis that results in a more complex model<br>• When complicated adjustments are made to the output of the model<br>• When management uses a lag period between when the method/model is calculated and when an estimate is recorded<br>• The use of forward-looking assumptions, within multiple interrelationships between them<br>• Assumptions that involve unobservable data or adjustments to observable data<br>• When the process to derive the data is complicated, including maintaining the integrity of the data<br>• When there is a high volume of data and multiple sources of data<br>**Estimation uncertainty:**<br>• Where the financial reporting framework requires the use of a method or assumptions that have a high level of estimation uncertainty<br>• Assumptions that are sensitive to variation |

| | |
|---|---|
| | • Assumptions that involve unobservable data or adjustments to observable data<br>• Assumptions that rely on the entity's intent or ability to carry out specific courses of action |
| **Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias** | Sources of subjectivity that may be subject to management bias include, for example:<br>• Where the financial reporting framework does not specify the valuation approach, concepts, or techniques and factors to use in the estimation method<br>• When subjective adjustments are made to the output of the model<br>• When management uses a lag period between when the method/model is calculated and when an estimate is recorded<br>• The availability of alternative assumptions or data sources<br>• Assumptions that are sensitive to variation<br>• The use of forward-looking assumptions, within multiple interrelationships between them<br>• Assumptions that involve unobservable data or adjustments to observable data |

## How do we use the results of our retrospective review? [ISA | 1115.15184]

We use the information that we learned from our retrospective review to:

- identify and assess the risks of material misstatement in the current period, including fraud risks; and
- address the risk of management override of controls.

Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates - i.e. management override of controls through intentional management bias.

### How do we use the information we obtain from our retrospective review to identify and assess the risks of material misstatement in the current period? [ISA | 1115.15185]

We use the information from our retrospective review to understand how the inherent risk factors - i.e. the estimation uncertainty, complexity, and subjectivity (including susceptibility to management bias) - impact the different elements of the estimate. We use that understanding, along with the other information that we have gathered from our risk assessment procedures, to help us identify RMMs and assess the inherent risk associated with the individual methods, assumptions, and/or data. Ultimately, this will help us determine the nature, timing, and extent of our current year audit procedures.

### How do we use the information from our retrospective review to address the risk of management override of controls and other fraud risks? [ISA | 1115.15186]

Information from our retrospective review may help us identify indicators of possible management bias with respect to management's selection of the methods, assumptions and/or data. For example the methods, assumptions and/or data selected by management may all be toward the same end of the range (i.e. prepared in a cautious manner or all prepared in an optimistic manner), resulting in a specific effect to the estimate and / or financial statements (i.e. understating / overstating estimate, increasing income, loss or other key financial statement metric).

This review is not intended to call into question our professional judgments made in the prior year that were based on information available at the time.

When we identify possible bias on the part of management, we evaluate whether the circumstances producing such bias represent a fraud risk.

#### What is 'management bias' and how does it affect our audit of accounting estimates? [ISA | 1115.15187]

Management bias can be thought of as a lack of neutrality by management in preparing an accounting estimate. We evaluate management bias as we think about management's selection of the various elements of an estimate, for each of the estimates as a whole and in the aggregate for all accounting estimates made.

Management bias can be unintentional or it can be intentional (fraud).

Understanding the likely sources of management bias is part of risk assessment and can be one of the factors that drives our audit response to accounting estimates and influences our assessment of risks of material misstatement.

Examples of information we may learn from our retrospective review that may be indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or method for making it, where management has made a subjective assessment that there has been a change in circumstances;
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions;
- Using relevant assumptions that yield a point estimate outside a reasonable range; and
- Selection of a point estimate within a reasonable range that may indicate a pattern of optimism or pessimism.

#### What if the bias is intentional? [ISA | 1115.15188]

When we identify intentional bias, we consider the possible implications of fraud and the impact on our audit approach. We re-evaluate our risk assessment conclusions and determine whether there are fraud risks we did not previously identify.

See the chapter on Fraud (ISA 240, AU-C 240, AS 2401) for a full list of activities that we perform when we identify intentional management bias.

#### What do we include in our audit documentation if we identify indicators of management bias? [ISA | 1115.15189]

When we identify bias, we:

- document the indicators of management bias
- document the implications for the audit

### Are differences identified as a result of our retrospective review considered to be misstatements? [ISA | 1115.15190]

A difference between the outcome of an accounting estimate in the current period and the amount recognized in the prior period financial statements does not necessarily represent a misstatement. Rather, it could be the result of estimation uncertainty.

US GAAP | If the difference is considered a misstatement, what are the implications to our audit? [ISA | 1115.15191]

We evaluate prior year misstatements identified in the current period following the guidance in activity 'Evaluate misstatements detected in the current period that relate to prior periods'.

We also consider the implications on our control conclusions in activity 'Conclude on our assessment of control risk'.

In addition to identifying the difference as a misstatement, we may revise our current year assessment of inherent risk or control risk.

# 2.2.2 Evaluate management bias in accounting estimates 'individually' [ISA | 4464]

## What do we do?

Evaluate whether the judgments and decisions made by management in the making of an accounting estimate, which is individually reasonable, indicate a possible management bias.

## Why do we do this?

Accounting estimates that we conclude are individually reasonable can still be affected by management bias that result in a material effect to the financial statements.

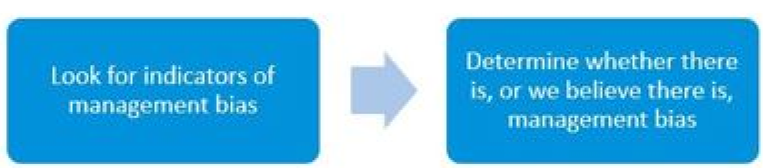
## Execute the Audit

When might management bias exist in an accounting estimate that is individually reasonable? [ISA | 4464.15821]

Management bias may exist in an accounting estimate that is individually reasonable when a range of reasonable estimates exists.

When there are alternatives that may be considered acceptable or reasonable, management's judgments and decisions in the preparation of the accounting estimate may be biased.

How do we determine whether there is management bias in an accounting estimate? [ISA | 4464.1400]




The fact that there is an indicator of management bias does not necessarily mean that there was management bias in the preparation of an accounting estimate. An indicator that shows that there may be management bias may be alleviated by another indicator that shows there is no management bias.

There are different types of indicators. Some indicators may point out the fact that there may be management bias and some others may point out the contrary.

We collectively consider all types of indicators and other information we may have about the preparation of the estimate to determine whether there is management bias.

The use of judgment and professional skepticism is key in determining whether there is, or we believe there is, management bias.

### When do we look for indicators of management bias in an accounting estimate? [ISA | 4464.1600]

We look for indicators of management bias in an accounting estimate while we perform audit procedures over the estimate.

Examples of the audit procedures that we perform over the estimates that could help us identify indicators of management bias are:

- Evaluation of whether the method used is appropriate.
- Determination of the reasons for a change in the method from prior period and the appropriateness of the change.
- Evaluation of whether:
  - the data used is internally consistent with its use by the entity in other estimates tested
  - the source of the data used has changed from the prior period and, if so, whether the change is appropriate.
- Evaluation of whether:
  - the entity has a reasonable basis for the significant assumptions used and, when applicable, for its selection of assumptions from a range of potential assumptions
  - the significant assumptions are consistent with 1) relevant industry, regulatory, and other external factors, including economic conditions, 2) existing market information, 3) historical or recent experience, taking into account changes in conditions and events affecting the entity and 4) other significant assumptions used by the entity.
- Evaluation of management's sensitivity analysis for critical accounting estimates.

### What indicators of management bias may we identify in an accounting estimate and what do we do to identify them? [ISA | 4464.1700]

Indicators of management bias in the method, data and significant assumptions chosen by management to prepare the estimate - i.e. management chose alternatives that do not appear to be the most appropriate. These are indicators at the element level.

Indicator at the estimate level – management prepared the estimate as a whole in a cautious or optimistic manner.

The indicators of management bias are usually present in the areas of the estimate where management has to use judgment (e.g. selecting specific methods, data and assumptions).

These indicators point out the fact that there may be management bias.

See sub-question 'What do we do to identify indicators of management bias at the element level and at the estimate level? ' for further information on these indicators and how we identify them.

> Management's responses when we investigate why management:
>
> — chose the methods, data and assumptions used
>
> — prepared the estimate in a cautious or optimistic manner - e.g. why many or all elements are cautious or optimistic making the estimate as a whole cautious or optimistic.

This type of indicator may further point out that there may be management bias or may point out the contrary.

If we identify indicators of management bias in the methods, data and assumptions used, it does not automatically mean that there is management bias. Investigating why management made its decisions may provide further information.

We may begin our investigation by inquiring of management. Based on management's responses, further audit procedures may be necessary to corroborate management's explanations or obtain further evidence.

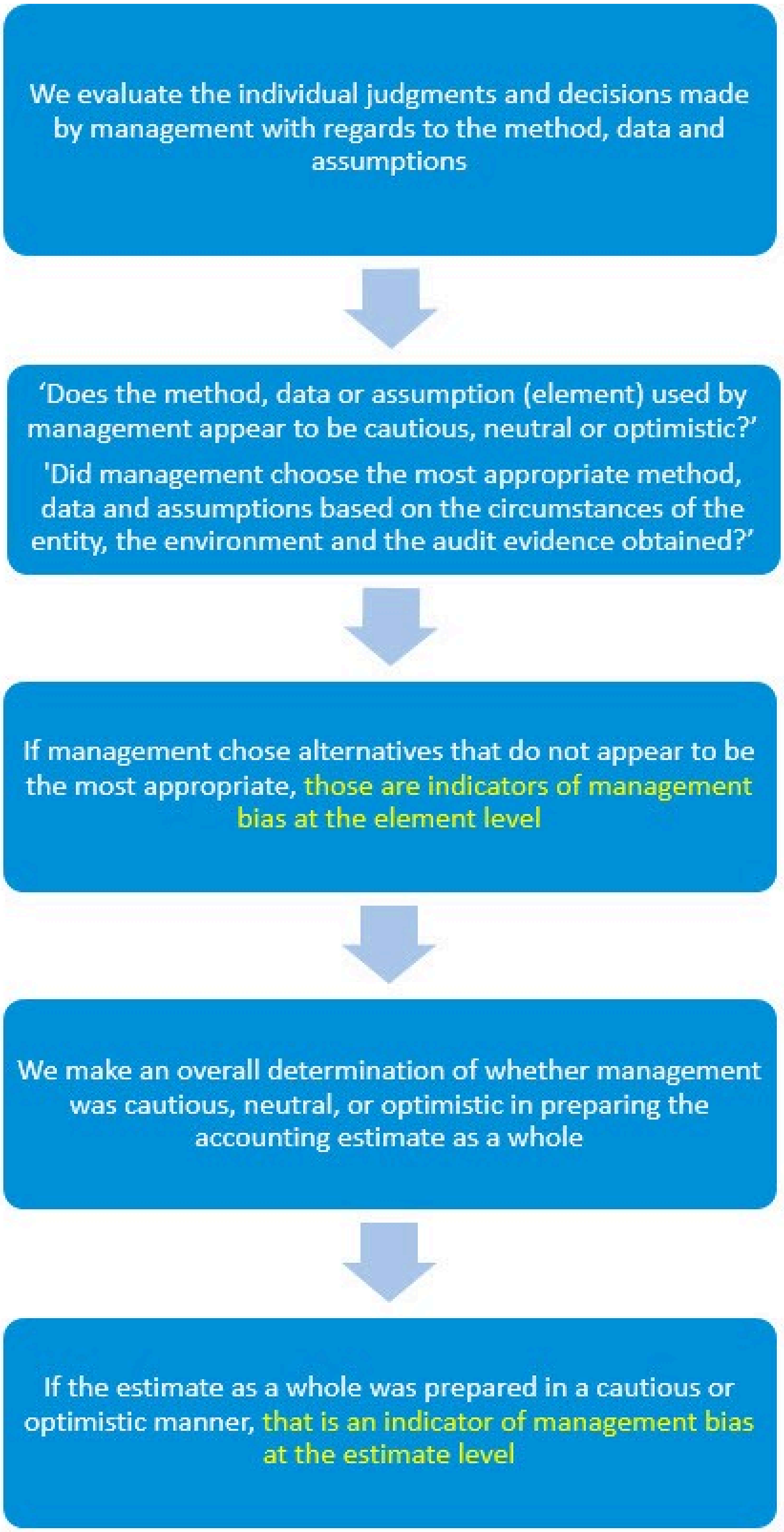
The reasonableness, or lack of reasonableness, in management's responses, considering everything we know about the entity, provides another indicator.

> Answer to the question:
>
> 'Does the estimate appear to be prepared in a way that results in a specific benefit to management or the entity - e.g. it may affect bonuses, analyst expectations or debt covenants?'

Asking ourselves this question provides another indicator.

This type of indicator may further point out that there may be management bias or may point out the contrary.

### What do we do to identify indicators of management bias at the element level and at the estimate level? [ISA | 4464.15824]




To evaluate the judgments and decisions made by management in preparing the accounting estimate, it is useful to ask ourselves:

- 'Does the method, data or assumption (element) used by management appear to be cautious, neutral or optimistic?' or 'Are the elements at the higher or lower end of the range of reasonable elements?'; and
- 'Did management choose the most appropriate method, data and assumptions based on the circumstances of the entity, the environment and the audit evidence obtained?'

If management chose alternatives that do not appear to be the most appropriate, those are indicators of management bias at the element level.

Examples of indicators of management bias in methods, data and assumptions include:

- use of a method that yields a more favorable result over other methods
- changes in an accounting estimate, or the method for making it, and management has made a subjective assessment that there has been a change in circumstances
- use of an entity's own assumptions for fair value accounting estimates and those assumptions are inconsistent with observable marketplace assumptions
- selection or construction of significant assumptions that yield a point estimate favorable for management objectives (e.g. all the assumptions are 'leaning' the same way)
- use of assumptions that are inconsistent with industry and current economic conditions.

If there is an indicator of management bias in the method, assumptions or data, such fact probably makes the estimate cautious or optimistic.

| | Estimate that is a liability | Estimate that is an asset |
|---|---|---|
| **Cautious estimate** | The estimate is in the higher end of the range of reasonable estimated amounts. | The estimate is in the lower end of the range of reasonable estimated amounts. |
| **Optimistic estimate** | The estimate is in the lower end of the range of reasonable estimated amounts. | The estimate is in the higher end of the range of reasonable estimated amounts. |

Once we have this information for each indicator of bias, we make an overall determination of whether, based on our judgment, we believe management was cautious, neutral, or optimistic in preparing the accounting estimate as a whole.

We make this overall determination by considering:

- the total amount of methods, data and assumptions used in the preparation of the estimate;
- the total amount of methods, data and assumptions used that indicate management bias;
- whether the indicators of bias make the estimate cautious or optimistic and their relative significance in the calculation of the amount of the estimate.

If we determine that the estimate as a whole was prepared in a cautious or optimistic manner, instead of in a neutral manner, this is an indicator of management bias at the estimate level.

This information, together with other indicators, will help us determine whether there is, or we believe there is, management bias. The fact that management prepared an accounting estimate in a cautious or optimistic manner does not necessarily mean there is bias. There may be other indicators that point out the contrary.

# Example

How does an engagement team evaluate management bias in an estimate? [ISA | 4464.1900]

**Fact pattern**

Entity ABC is a manufacturing company 'with stable operations and revenues over the past six years. However, the economy has recently declined.

Historically, the entity has determined the allowance for doubtful accounts using its own historical collection ratios over the past three years.

When the engagement team performs audit procedures, they notice that the entity did not adjust its method and/or the collectability assumptions to take into account the declining economic conditions when determining the allowance for doubtful accounts. Consequently, the allowance remained stable, even though the engagement team expected it to increase during the current period because of the recent economic downturn.

**Analysis**

The engagement team inquires of management about this. Management acknowledges the economic downturn but do not believe it will affect the entity's customers. However, there is no rationale or justification for their explanation.

Since there is no valid reason for management to exclude this from their collectability assumptions, it could indicate that management is trying to avoid increasing the allowance. As such, the engagement team concludes that there is an indicator of possible management bias in the preparation of the allowance for doubtful accounts.

# 2.2.3 Evaluate management bias in accounting estimates 'in aggregate' [ISA | 4465]

# What do we do?

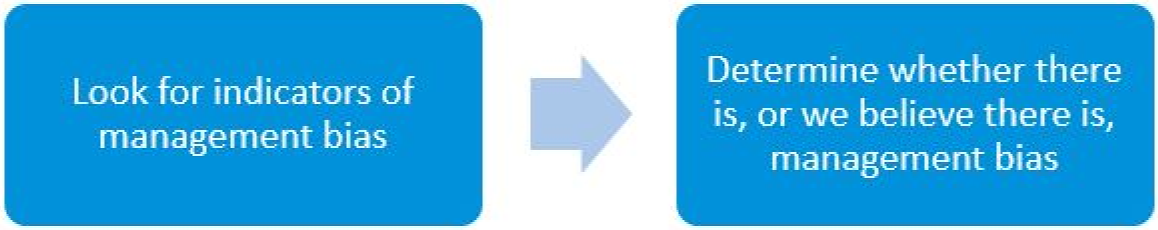
**IF** accounting estimates are individually reasonable but recorded towards the same end of the range,
**THEN** evaluate whether it indicates potential management bias.

# Why do we do this?

We evaluate management bias in accounting estimates 'in aggregate' to help us identify indications of management bias that we might miss by only evaluating estimates individually. Sometimes, management bias may be more evident through the evaluation of the cumulative effect in the financial statements of multiple estimates.

# Execute the Audit

### How do we determine whether there is management bias in the accounting estimates in aggregate? [ISA | 4465.1400]




The fact that there is an indicator of management bias does not necessarily mean that there was management bias in the preparation of the accounting estimates. An indicator that shows that there may be management bias may be alleviated by another indicator that shows there is no management bias.

There are different types of indicators. Some indicators may point out the fact that there may be management bias and some others may point out the contrary.

We collectively consider all types of indicators and other information we may have about the preparation of the estimates to determine whether there is management bias.

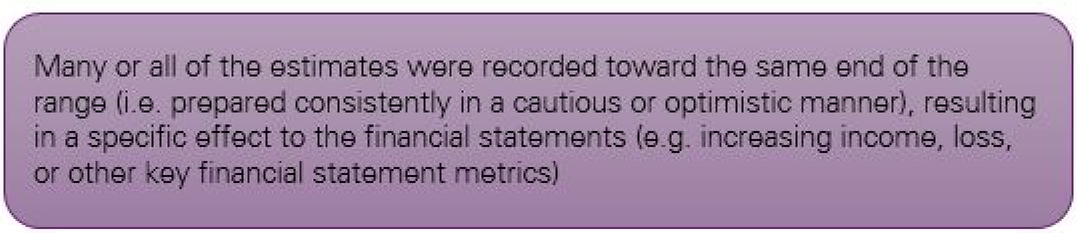
The use of judgment and professional skepticism is key in determining whether there is, or we believe there is, management bias.

### When do we look for indicators of management bias in the accounting estimates in aggregate? [ISA | 4465.1500]

We look for indicators of management bias in the accounting estimates in aggregate towards the end of the audit when we have already performed audit procedures on all estimates and evaluated management bias on all estimates individually.

### What indicators of management bias in the accounting estimates in aggregate may we identify and what do we do to identify them? [ISA | 4465.1600]

The main indicator of management bias in the accounting estimates in aggregate is:

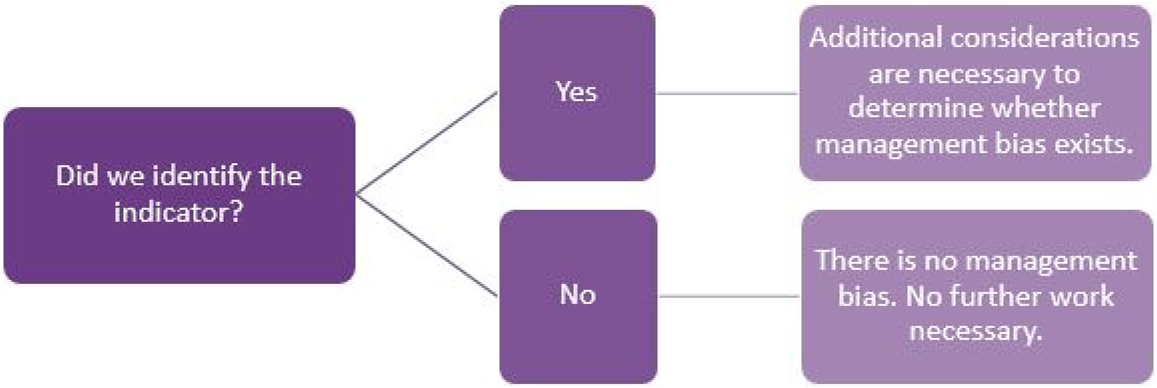



When we evaluated whether there was management bias in the accounting estimates individually, we determined whether the estimates were prepared in a cautious, neutral or optimistic manner.

This information will now help us determine whether many or all of the estimates were recorded toward the same end of the range (i.e. prepared consistently in a cautious or optimistic manner), resulting in a specific effect to the financial statements (e.g. increasing income, loss, or other key financial statement metrics).

When this indicator does not exist, it means that there is no management bias in the accounting estimates in aggregate and no further work is necessary in this respect.

If we identify this indicator of management bias, it does not automatically mean that there is management bias. We evaluate further indicators to determine whether there is, or we believe there is, management bias.




### What are the other indicators that could help us determine whether there is management bias in the accounting estimates in aggregate? [ISA | 4465.15891]

> Management's responses when we investigate the reasons for which management prepared the estimates that way

This type of indicator may further point out that there may be management bias or may point out the contrary.

If we determine that many or all of the estimates were recorded toward the same end of the range (i.e. prepared consistently in a cautious or optimistic manner), it does not automatically mean that there is management bias. Investigating why management prepared the estimates that way may provide further information.

We may begin our investigation by inquiring of management. Based on management's responses, further audit procedures may be necessary to corroborate management's explanations or obtain further evidence.

The reasonableness, or lack of reasonableness, in management's responses, considering everything we know about the entity, provides another indicator.

> Answer to the question:
>
> 'Is the effect caused by those estimates recorded toward the same end of the range favorable to management or the entity - e.g. they may affect bonuses, analyst expectations or debt covenants?'

Asking ourselves these questions provides another indicator.

This type of indicator may further point out that there may be management bias or may point out the contrary.

The fact that many or all of the estimates were recorded toward the same end of the range (i.e. prepared consistently in a cautious or optimistic manner) does not necessarily mean that there is management bias if there is no clear benefit to management or the entity.

## Example

# 2.2.4 Evaluate management bias in the effect of changes in estimates from the prior period to the current period [ISA | 4466]

## What do we do?

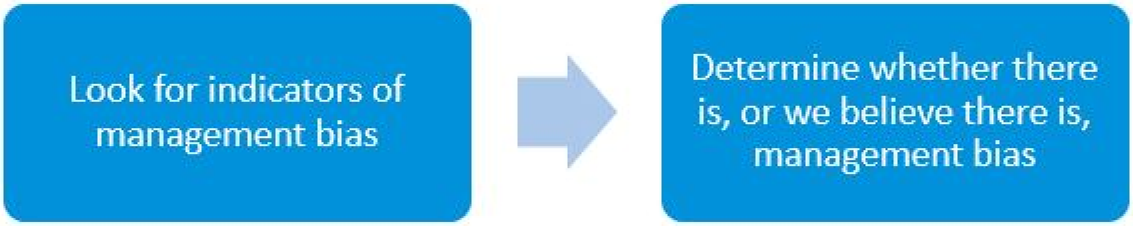
**IF** the recorded estimates are grouped at one end of the range in the prior year and are grouped at the other end of the range in the current year, **THEN** evaluate whether management is using swings in estimates to achieve a desired outcome.

## Why do we do this?

Management bias may not be evident to us when we only focus on accounting estimates in the current period, because management bias can also arise from the cumulative effect of changes in accounting estimates from period to period.

## Execute the Audit

How do we determine whether there is management bias in the effect of changes in accounting estimates from one period to the next? [ISA | 4466.15808]




The fact that there is an indicator of management bias does not necessarily mean that there was management bias in the preparation of accounting estimates. An indicator that shows that there may be management bias may be alleviated by another indicator that shows there is no management bias.

There are different types of indicators. Some indicators may point out the fact that there may be management bias and some others may point out the contrary.

We collectively consider all types of indicators and other information we may have about the preparation of the estimates to determine whether there is management bias.

The use of judgment and professional skepticism is key in determining whether there is, or we believe there is, management bias.

### When do we look for indicators of management bias in the effect of changes in accounting estimates from one period to the next? [ISA | 4466.15809]

We look for indicators of management bias in the effect of changes in accounting estimates from one period to the next towards the end of the audit when we have already performed audit procedures on all estimates and evaluated management bias on all estimates individually and in aggregate.

### What indicators of management bias may we identify in the changes in accounting estimates from one period to the next and what do we do to identify them? [ISA | 4466.15810]

The main indicator of management bias in the changes in accounting estimates from one period to the next is:

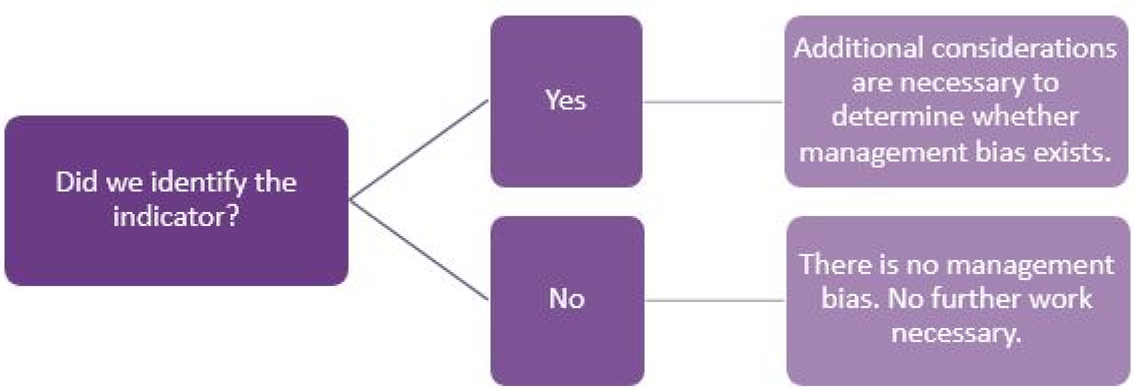
> Many or all of the estimates were recorded toward one end of the range in the prior period and the other end of the range in the current period (i.e. they are prepared in a cautious manner in the prior period and in an optimistic manner in the current period, or vice versa)

When we evaluated whether there was management bias in the accounting estimates individually, we determined whether the estimate was prepared in a cautious, neutral or optimistic manner.

This information, together with the equivalent information from the prior period, will now help us determine whether many or all of the estimates were recorded toward one end of the range in the prior period and the other end of the range in the current period (i.e. they are prepared in a cautious manner in the prior period and in an optimistic manner in the current period or vice versa).

When this indicator does not exist, it means that there is no management bias in the changes in accounting estimates from one period to the next and no further work is necessary in this respect.

If we identify this indicator of management bias, it does not automatically mean that there is management bias. We evaluate further indicators to determine whether there is, or we believe there is, management bias.



#### What are the other indicators that could help us determine whether there is management bias in the changes in accounting estimates from one period to the next? [ISA | 4466.15811]

Management's responses when we investigate the reasons for which management prepared the estimates that way

This type of indicator may further point out that there may be management bias or may point out the contrary.

If we determine many or all of the estimates were recorded toward one end of the range in the prior period and the other end of the range in the current period (i.e. they are prepared in a cautious manner in the prior period and in an optimistic manner in the current period, or vice versa), it does not automatically mean that there is management bias. Investigating why management prepared the estimates that way may provide further information.

We may begin our investigation by inquiring of management. Based on management's responses, further audit procedures may be necessary to corroborate management's explanations or obtain further evidence.

The reasonableness, or lack of reasonableness, in management's responses, considering everything we know about the entity, provides another indicator.

Answer to the question:

'Is the effect caused by those estimates recorded toward the same end of the range in the prior period and the other end in the current period favorable to management or the entity - e.g. they may affect bonuses, analyst expectations or debt covenants?'

Asking ourselves this question provides another indicator.

This type of indicator may further point out that there may be management bias or may point out the contrary.

## Example

# 2.2.5 Evaluate whether our risk assessments and the related audit responses remain appropriate [ISA | 4469]

## What do we do?

**IF** we identify indicators of bias or actual bias in management's judgments, **THEN** evaluate whether our risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

# Why do we do this?

If we identify indicators of bias or actual bias, there could be a risk of other biases, other issues in the financial statements or additional risks that we did not identify when we were planning the audit. This is particularly relevant when considering our fraud risk assessments, as the bias may be intentional and represent fraud.

# Execute the Audit

How do we re-evaluate our risk assessments? [ISA | 4469.1300]

When we identify indicators of bias or actual bias, we re-evaluate our risk assessments. This includes not only the specific area (e.g. a specific account or disclosure) where the bias exists, but also other areas where similar biases could exist.

> For example, if we identify management bias in the warranty estimate, we re-evaluate our risk assessments not only for the warranty estimate, but also in other estimates and areas prone to bias.

See this activity for additional information about revising our risk assessment: 'Continue to assess RMMs, and revise audit approach as necessary '.

What is a common indicator of a higher risk of management bias in other areas of the financial statements?

The fact that management is aggressive with the selection and application of accounting principles/ policies is an indicator that the risk of management bias in other areas may be higher.

# 2.2.6 Evaluate whether the bias is material to the financial statements and/or is the result of fraud [ISA | 4468]

# What do we do?

**IF** we identify - or we believe that there is - management bias, **THEN** evaluate whether the effect of management bias is material to the financial statements as a whole AND evaluate whether the bias is the result of fraud.

# Why do we do this?

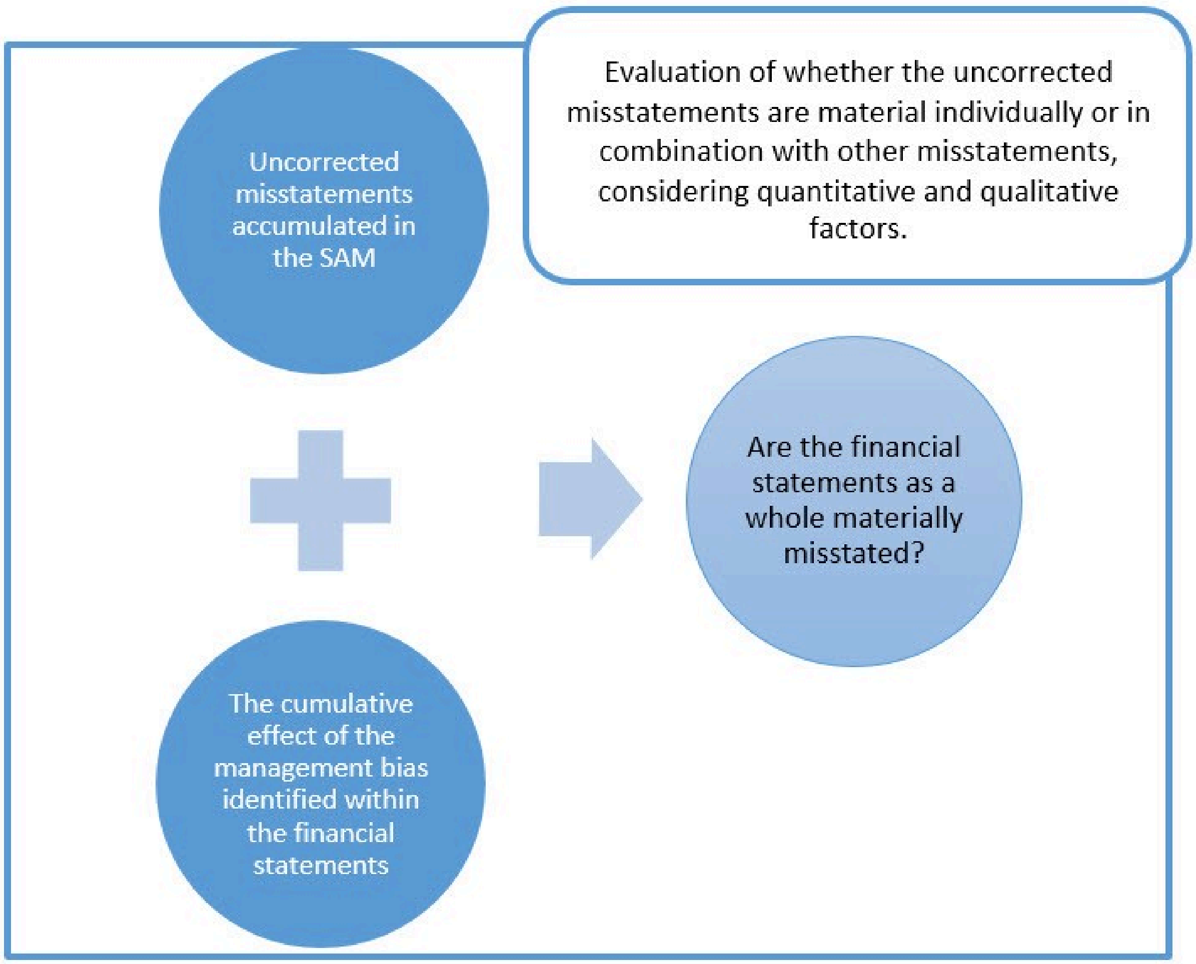
If we identify management bias, the effect of that bias may cause the financial statements to be materially misstated. In addition, if the bias represents fraud, there are additional implications for the audit.

# Execute the Audit

## How do we evaluate whether the effect of management bias is material to the financial statements as a whole and whether it is the result of fraud? [ISA | 4468.1400]

To evaluate whether the effect of the bias is material to the financial statements as a whole, we consider the uncorrected misstatements accumulated, including the cumulative effect of the management bias identified within the financial statements.

This evaluation can be different depending on whether the amount of the misstatement can be more easily determined. When we are unable to determine the amount of the misstatement generated from management bias, we estimate the cumulative effect of management bias identified in the financial statements.




To evaluate whether the bias is the result of fraud, we look for indicators of fraud. Activity '[Evaluate whether misstatements are the result of fraud and the implications ]' includes useful information that may also apply to a situation in which the amount of the misstatement is not known.

This consideration becomes more relevant when there are many misstatements that are close to being material to the financial statements as a whole and when adding the effect of the bias in our evaluation, we realize that in combination with the other misstatements, it makes the financial statements materially misstated.

See activity 'Evaluate whether uncorrected misstatements are material and the implications ' for additional information on our evaluation of whether the uncorrected misstatements are material individually or in combination with other misstatements, considering quantitative and qualitative factors.

What amount does management record if they decide to correct the misstatement? [ISA | 4468.1600]

Management may choose to correct misstatements that result from bias that we identified. However, if bias exists in accounting estimates, additional analysis may be necessary for management to determine the appropriate amount to record and support their adjustment (see activity 'Evaluate management's examination of an account or disclosure in response to misstatements detected by us ' for further information about what we do when management further examines an account or disclosure in response to misstatements detected by us).

It is not appropriate for management to use our work papers or analysis as support for their estimates or adjustments recorded.

# 2.3 Evaluate whether the business purpose for SUTs (or lack thereof) is indicative of fraud [ISA | 823]

## What do we do?

Evaluate whether the business purpose for significant unusual transactions indicates that the transactions (SUTs) may have been entered into to engage in fraud.

## Why do we do this?

During our audit, we have certain responsibilities relating to fraud. Given their nature, SUTs can provide opportunities for entities to engage in financial reporting fraud and many financial reporting frauds have been perpetrated or concealed by using unusual transactions that are outside the normal course of business.

SUTs also tend to have risks that are higher on the inherent risk continuum, causing us to place greater focus on them in the audit. This is because there may be:

- greater management intervention to specify the accounting treatment;
- greater manual intervention for data collection and processing;
- complex calculations or accounting principles;
- the nature of non-routine transactions, which may make it difficult for the entity to implement effective processes to account for the transactions; and/or
- related-party transactions.

As part of our procedures, we specifically focus on SUTs, including evaluating whether the business rationale for certain significant transactions indicate that they may have been entered into to engage in fraudulent financial reporting.

## Execute the Audit

What is a significant unusual transaction (SUT)? [ISA | 823.14472]

A SUT is a significant transaction that is outside the normal course of business for the entity or that otherwise appears to be unusual due to its timing, size, or nature.

#### What factors do we think about in determining whether a transaction is 'significant'?

We think about the following are factors when we determine whether a transaction is 'significant':

- The quantitative impact to the financial statements. Transactions that have an impact greater than materiality are significant.
- The nature of the transaction. When the nature of the transaction is such that it could have an impact on the decision making of a reasonable investor, the transaction is considered significant, regardless of its quantitative impact.

#### What does 'normal course of business for the entity' mean?

Transactions in the normal course of business are those that occur on a recurring basis at an entity. When an entity already has a process and controls in place and/or that type of transaction has occurred in the past, it is an indicator that the transaction is likely to be in the normal course of business for the entity.

#### What factors do we think about in determining whether a transaction is 'unusual'?

Several factors can impact whether a transaction is unusual, including:

- The timing of the transaction. Even if a transaction is determined to be within the normal course of business for the entity, a transaction entered into at a different timing than normal may be considered unusual - for example, transactions recorded right at period-end.
- The size of the transaction. Even if a transaction is determined to be within the normal course of business for the entity, a transaction that is of a size that is above the normal size of such transactions, may be considered unusual - for example, a particular sales order that is several times bigger than the average customer order.
- The nature of the transaction. Even if a transaction is determined to be within the normal course of business for the entity, a transaction that is different from the normal transactions of that type may be considered unusual - for example, a transactions that include or are indirectly influenced by a related party, are more complex or where certain significant terms and conditions have been altered.

### What are some examples of SUTs? [ISA | 823.1400]

Examples of SUTs may include the following items:

- complex equity transactions, such as corporate restructurings or acquisitions;
- transactions with offshore entities in jurisdictions with less rigorous corporate governance structures, laws, or regulations;
- the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged;
- sales transactions with unusually large discounts or returns or at unusual times, amounts or terms;
- transactions with circular arrangement (e.g., sales with a commitment to repurchase); and
- transactions under contracts whose terms are changed prior to expiry.

### Are all SUTs associated with a significant risk? [ISA | 823.1500]

Not necessarily. However, we treat any significant related party transactions that are outside the entity's normal course of business as giving rise to significant risks.

The general characteristics of SUTs are indicators that risks of material misstatement are higher along the inherent risk continuum - for example, complexity and the non-routine nature of SUTs. For this reason, one of the factors we evaluate in assessing inherent risk includes whether the risk of material misstatement relates to a SUT. Although SUTs won't giving rise to significant risks in all instances, we will assess those risks as either significant or elevated in many circumstances.

Refer to further guidance in activity Identify significant risks .

### Enhanced | What procedures do we perform over significant unusual transactions? [ISA | 823.14367]

We perform the following procedures to respond to the risks associated with SUTs, including the potential fraud risk related to management override of controls:

- Identify SUTs taking into account information obtained throughout the audit
- Obtain an understanding of controls that address SUTs
- Obtain an understanding of any SUTs identified, including the business purpose (or lack thereof) of each SUT
    - Read the underlying documentation
    - Determine whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures
    - Evaluate the financial capability of the other parties involved in the significant unusual transaction
    - Take into account potential misstatements from a SUT
    - Perform other procedures as necessary depending on identified and assessed RMMs
- Evaluate whether the business purpose of SUTs (or lack thereof) are indicative of fraud
- Perform procedures to address the identified fraud risk associated with the SUT
- Evaluate whether SUTs have been properly accounted for and disclosed in the financial statements

### Core and Less Complex | What procedures do we perform over significant unusual transactions? [ISA | 823.14369]

We perform the following procedures to respond to the risks associated with SUTs, including the potential fraud risk related to management override of controls:

- Identify SUTs taking into account information obtained throughout the audit
- Obtain an understanding of controls that address SUTs
- Obtain an understanding of any SUTs identified, including the business purpose (or lack thereof) of each SUT
    - Read the underlying documentation
    - Determine whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures
    - Evaluate the financial capability of the other parties involved in the significant unusual transaction
    - Take into account potential misstatements from a SUT
    - Perform other procedures as necessary depending on identified and assessed RMMs

- Evaluate whether the business purpose of SUTs (or lack thereof) are indicative of fraud
- Perform procedures to address the identified fraud risk associated with the SUT
- Evaluate whether SUTs have been properly accounted for and disclosed in the financial statements

# 2.3.1 Identify SUTs [ISA | 824]

## What do we do?

Identify significant unusual transactions (SUTs) using information obtained from risk assessment procedures, other procedures performed during the audit (e.g., reading of minutes and performing journal entry testing), and procedures performed over related parties.

## Why do we do this?

SUTs will not always be apparent and easily identifiable. For this reason, we take into account information obtained throughout the audit to help us identify SUTs.

## Execute the Audit

### What information is taken into account to identify SUTs? [ISA | 824.1300]

We take into account information obtained from:

- risk assessment procedures performed - for example, inquiries and our understanding of the processes used to identify, authorize, approve, account for and disclose significant unusual transactions and internal controls;
- our evaluation of whether an entity has properly identified its related parties and relationships and transactions with related parties, specifically whether we have identified information that indicates that related parties or relationships or transactions with related parties previously undisclosed to us exists; and
- other procedures performed during the audit - for example, reading minutes of the board of directors meetings and performing journal entry testing.

### Enhanced | Do we evaluate an entity's controls over the identification of SUTs? [ISA | 824.1400]

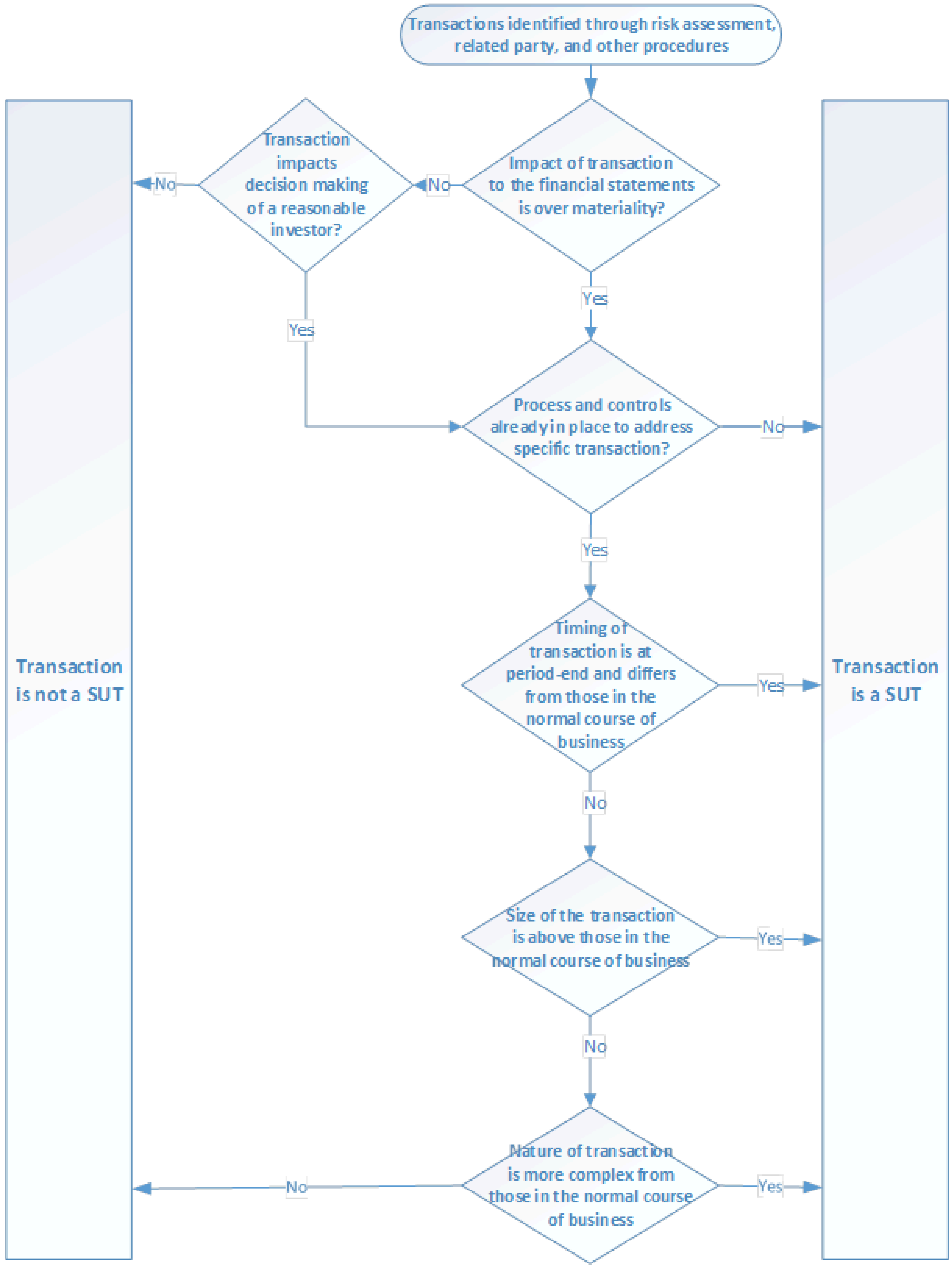
Yes, we evaluate the design and implementation of an entity's control over the identification of SUTs. Refer to further guidance on our evaluation of these controls in activity 'Understand relevant controls that address SUTs '.

### Enhanced | What if management does not have a process in place to identify SUTs? [ISA | 824.1500]

To the extent management does not have a reasonable process for identifying SUTs, we may have a pervasive financial statement level risk that we assess and respond to.

### How do we determine whether a transaction is a SUT? [ISA | 824.1600]

The following flowchart illustrates the decisions that we go through when determining whether a transaction is a




SUT:

# Examples

### How do we determine whether a transaction is in the normal course of business for the entity? [ISA | 824.14380]

**Fact Pattern**

The engagement team audits a listed technology entity that sells electronic goods directly to consumers through a well-established process and controls. The entity had two larger revenue transactions leading up to its year-end, which contributed significantly to the entity meeting analyst revenue expectations:

- Transaction A - The entity recorded a sale to a consumer in the last minute of the last day of the year.
- Transaction B - The entity entered into a new agreement with a reseller, shipped goods to this reseller and revenue recognized from this shipment on the last day of the year.

**Analysis**

The engagement team determines both transactions A and B to be 'significant' because they directly contribute to the entity meeting analyst expectations.

For transaction A, the entity already has a process in place for the specific type of transaction (i.e., direct consumer sales) and has entered into such transactions previously, so the engagement team determine that the transaction is in the normal course of business for the entity. However, the transaction may still be considered a SUT if it is unusual due to the timing, size or nature. For example, if the entity's period always ends on a Sunday and they rarely make sales on a Sunday, it may be a SUT due to its timing. Or if it is unusually large, it may be a SUT due to its size.

For transaction B, this is first instance of a sale to a reseller and there is no established process or controls for those types of sales. As a result, the engagement team considers the transaction to be outside the normal course of business for the entity and a SUT.

### How do we determine whether a transaction is unusual for the entity? [ISA | 824.14381]

**Fact Pattern**

The engagement team audits an entity that has a core strategy of growing through acquisitions and periodically enters into transactions to acquire other companies. The entity has a well-established process and controls for making acquisitions.

The entity acquired the following companies at the beginning of the year:

- Acquisition X - a material impact to its financial statements, however the impact is not above any of the acquisitions that were completed in previous years. The complexity of the transaction is also no different than those acquisitions in previous years.
- Acquisition Y - a material impact to its financial statements that is significantly above any of the acquisitions that were completed in previous years. The complexity of the transaction is no different than those acquisitions in previous years.
- Acquisition Z - a material impact to its financial statements, however the impact is not above any of the acquisitions that were completed in previous years. The entity has recorded negative goodwill for this acquisition and there appears to be an increased level of complexity for this transaction compared to those in previous years.

**Analysis**

Acquisitions X, Y, and Z are all material to the entity's financial statements, making them significant transactions. Because the entity frequently acquires other companies and has a process and controls in place, the engagement team determine Acquisitions X, Y, and Z are part of the normal course of business for this entity.

In order to determine whether Acquisitions X, Y, and Z are SUTs, the engagement team assesses whether these transactions are unusual due to its timing, size, and nature of the acquisitions as follows:

- Acquisitions X: Because the timing, size, and nature of this acquisition is not out of the ordinary for the entity, this transaction is not a SUT.
- Acquisitions Y: Because the size of the acquisition is significantly greater than previous acquisitions, this transaction is unusual and deemed to be a SUT.
- Acquisitions Z: Because the nature of the acquisition is more complex than previous acquisitions, this transaction is unusual and deemed to be a SUT.

# 2.3.2 Understand the business purpose (or the lack thereof) for each SUT [ISA | 825]

## What do we do?

Design and perform procedures to obtain an understanding of the business purpose (or lack thereof) of each significant unusual transaction that we have identified.

## Why do we do this?

We obtain an understanding of the business purpose of a SUT to determine whether the transaction could have been entered into to engage in fraud. Because fraud is an intentional act that may result in a material misstatement in the financial statements, we evaluate indicators of inconsistency in the business purpose between what management asserts and our understanding.

## Execute the Audit

### What procedures do we perform to obtain an understanding of the business purpose of the SUT? [ISA | 825.1300]

To obtain an understanding of the business purpose of SUTs we:

- Read underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or lack thereof) of the transaction ;
- Determine whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures ;
- Evaluate the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- Perform other procedures as necessary depending on the identified and assessed risks of material misstatement .

#### When do we obtain an understanding of the business purpose of the SUT? [ISA | 825.1400]

We obtain an understanding of the business purpose of any identified SUTs during planning and risk assessment. If we identify SUTs later in the audit, we obtain an understanding of the business purpose of the SUT as soon as such transactions are identified. Our understanding of the business purpose of the SUT can affect our assessment of the risks of material misstatement related to the SUT and the nature and extent of the procedures we plan to perform.

# 2.3.2.1 Read underlying documentation [ISA | 826]

## What do we do?

Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

## Why do we do this?

Reading the underlying documentation related to a significant unusual transaction (SUT) helps us to identify possible inconsistencies between the terms and other information about the transaction with the explanations from inquiries and other audit evidence regarding the business purpose (or lack thereof) of the transaction.

## Execute the Audit

#### What types of underlying documentation related to a SUT may exist? [ISA | 826.1300]

Underlying documentation may include a variety of items, such as:

- contracts and agreements (and any amendments to the original contracts and agreements),
- presentations or documents prepared by management for the board of directors related to the transaction, and
- presentations or documents summarizing the steps to complete a particular transaction.

#### Can we read draft documents related to a SUT? [ISA | 826.1400]

We may first read draft contracts and agreements related to a significant unusual transaction prior to receiving final executed copies. However, we also obtain and read the final executed copies of the contracts and agreements to determine whether there have been any changes to the terms of the contracts and agreements made subsequent to the draft provided.

#### Who should read the underlying documentation related to a SUT? [ISA | 826.1500]

As SUTs are often complex in nature and may have been entered into to engage in fraud, we assign personnel with an appropriate level of knowledge, skill, ability, and experience to perform procedures in response to significant unusual transactions and increase the level of supervision and review.

Given the complexity and importance of these times, it may be necessary for more experienced team members - e.g., engagement manager and/or partner - to read the underlying documentation related to a SUT.

# 2.3.2.2 Determine whether the transaction has been authorized and approved [ISA | 827]

## What do we do?

Determine whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures.

## Why do we do this?

When a significant unusual transaction (SUT) has not been authorized and approved in accordance with the entity's established policies and procedures, it can be an indicator that it may lack a legitimate business purpose and/or may have been entered into to engage in fraud.

## Execute the Audit

### Enhanced | How do we determine the entity's established policies and procedures for authorizing and approving SUTs? [ISA | 827.1300]

We obtain an understanding of and evaluate the design and implementation of controls that management has established to identify, authorize and approve, and account for and disclose SUTs as part of our procedures performed to identify and assess risks of material misstatement.

We use our knowledge obtained from these procedures when determining whether a SUT has been authorized and approved in accordance with the entity's established policies and procedures and what evidence of this authorization/approval exists.

#### What are authorization controls? [ISA | 827.14410]

Authorization involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not.

#### What are approval controls? [ISA | 827.14411]

Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorization was granted.

#### What are examples of process control activities the entity may have to authorize and approve SUTs? [ISA | 827.14412]

Examples of process control activities the entity may have to authorize and approve significant unusual transactions include:

- approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders; and
- monitoring controls to ensure such transactions and arrangements have been appropriately authorized and approved in accordance with the entity's established policies and procedures for authorization and approval.

### Core and Less Complex | How do we determine the entity's established policies and procedures for authorizing and approving SUTs? [ISA | 827.14413]

We obtain an understanding of and evaluate the design and implementation of controls that management has established to authorize and approve SUTs as part of our procedures performed to identify and assess risks of material misstatement.

We use our knowledge obtained from these procedures when determining whether a SUT has been authorized and approved in accordance with the entity's established policies and procedures and what evidence of this authorization/approval exists.

#### What are authorization controls? [ISA | 827.1401]

Authorization involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not.

#### What are approval controls? [ISA | 827.1402]

Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorization was granted.

#### What are some examples of process control activities an entity may have to authorize and approve SUTs? [ISA | 827.1403]

Examples of process control activities the entity may use to authorize and approve significant unusual transactions include:

- approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders; and
- monitoring controls to ensure such transactions and arrangements have been appropriately authorized and approved in accordance with the entity's established policies and procedures for authorization and approval.

### Do we evaluate the design and implementation of process control activities over the authorization and approval of SUTs? [ISA | 827.14414]

Not necessarily. When the entity has not entered into any SUTs during the year, we don't evaluate the design and implementation of process control activities over the authorization and approval of SUTs. This is because there are no current year operations of the process control activity to evaluate.

### How do we determine whether a SUT has been authorized and approved in accordance with the entity's established policies and procedures? [ISA | 827.1500]

We inspect documentation supporting the authorization and approval of the SUT. Such documentation may include final executed contracts and agreements, evidence of approval by board of directors and other required approvals, included in related meeting minutes.

# 2.3.2.3 Evaluate the financial capability of the other parties [ISA | 828]

# What do we do?

Evaluate the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any

# Why do we do this?

When a significant unusual transaction (SUT) has been entered into with other parties who are not capable of meeting or fulfilling their respective obligations, this can be an indicator that the SUT lacks a legitimate business purpose and may have been entered into in order to engage in fraud.

# Execute the Audit

### How do we evaluate the financial capability of other parties involved in a SUT? [ISA | 828.1300]

We obtain and inspect evidence regarding the financial capability of the other parties.

> Examples of evidence we may obtain and inspect include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications (e.g., credit agency ratings) and income tax returns of the other party, to the extent available.

### How does the financial capability of other parties affect the recognition and measurement of a transaction? [ISA | 828.1400]

The initial recognition and subsequent measurement of an accounting transaction is often dependent upon the financial capability of other parties involved in a transaction.

> Examples of the initial recognition and subsequent measurement of an accounting transaction dependent upon financial capability of other parties include:
>
> - Revenue recognition. Assessing whether an entity will collect substantially all of the consideration to which it will be entitled in exchange for goods and services that are transferred to customers.
> - Lease classification. A lease that would otherwise meet the tests to be classified either as a sales-type lease, direct finance lease or a leveraged lease but that does not meet the "collectability of the minimum lease payments is reasonably predictable" criterion is classified as an operating lease by the lessor.

# 2.3.2.4 Perform other procedures as necessary, depending on identified and assessed RMMs [ISA | 829]

# What do we do?

Perform other procedures as necessary, depending on the identified and assessed risks of material misstatement.

## Why do we do this?

When we identify significant unusual transactions (SUTs) entered into by the entity, we identify and assess risks of material misstatement (RMM) related to the SUT. Our assessment is based on our understanding of the transaction entered into, including the business rationale (or lack thereof), as well as the accounting standards applicable to the transaction. We then design and perform procedures whose nature, timing, and extent are responsive to each RMM so that there is a clear link between our procedures and our risk assessment.

## Execute the Audit

### What other procedures might we perform over a SUT to obtain an understanding of the business purpose? [ISA | 829.1600]

Our other procedures may consist of substantive procedures or a combination of tests of operating effectiveness of controls and substantive procedures. In some cases, it may be helpful to involve specific team members or specialists to obtain an understanding of the business purpose of complex SUTs.

# 2.3.3 Evaluate whether the business purpose of SUTs (or lack thereof) are indicative of fraud [ISA | 830]

## What do we do?

Evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

## Why do we do this?

We evaluate any indicators of inconsistency in the business purpose between what is asserted by management and our understanding obtained from other procedures performed needs to be evaluated because fraud is an intentional act that could result in a material misstatement to the financial statements.

## Execute the Audit

### What are indicators that a SUT may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets? [ISA | 830.1300]

We evaluate the following indicators:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the entity, or any related party of the entity;

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that entity), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the entity to achieve certain financial targets;
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and
- Management has not discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

We may also think about indicators such as whether the transaction:

- has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
- is processed in an unusual manner.

The existence of one or any combination of the listed indicators may result in a fraud risk being identified for the SUT.

### What are unconsolidated related parties and variable interest entities?

An unconsolidated related party is a company that is owned by a parent entity, but whose individual financial statements are not included in the consolidated or combined financial statements of the parent entity/investor. Instead, an unconsolidated related party appears in the consolidated financial statements of the parent entity/investor as an investment.

A variable interest entity (VIE) refers to a legal business structure in which an investor has a controlling interest despite not having a majority of voting rights. Or it may refer to an accounting structure involving equity investors that do not have sufficient resources to support the ongoing operating needs of the business. In most cases, the VIE is used to protect the business from creditors or legal action.

# Examples

### How do we evaluate the business purpose of a SUT? [ISA | 830.1500]

**Scenario 1**

**Fact pattern**

A public entity enters into an agreement with one of its shareholders (i.e., a related party) to form a joint venture (JV). The entity contributes a significant foreign subsidiary to the JV and the transaction is determined to be a SUT. The entity has communicated to its audit committee and us that the business purpose of the transaction was to de-risk the entity from the expected deterioration in the operational results of the foreign subsidiary and that they do not believe the JV qualifies for consolidation, based on the structure of the agreement.

**Analysis**

- The transaction includes a combination of indicators that it may have been entered into to engage in fraudulent financial reporting, such as:
- The form of the transaction is overly complex;
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction enables the entity to achieve certain financial targets;
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and
- Management has not discussed the nature of and presented the accounting treatment for the transaction to the audit committee or another committee of the board of directors or the entire board.

Based on the presence of these indicators, we identify a fraud risk relating to the RMM associated with the deconsolidation of the JV.

**Scenario 2**

**Fact pattern**

A private entity obtains significant funding from its issuance of debt with features that allow for conversion to equity shares when certain circumstances or events occur. This transaction is determined to be a SUT. The entity has communicated to its audit committee and us that the business purpose of the transaction was to obtain equity financing and that they do not believe the financing round will result in a liability classification. The entity's debt-to-equity ratio would not meet the financial covenant on its existing debt if this financing round results in a liability classification.

**Analysis**

The transaction includes a combination of indicators that it may have been entered into to engage in fraudulent financial reporting, such as:

- The form of the transaction is overly complex;
- The transaction enables the entity to achieve certain financial targets;
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and
- Management has not discussed the nature of and presented the accounting treatment for the transaction to the audit committee or another committee of the board of directors or the entire board.

Based on the presence of these indicators, we identify a fraud risk relating to the RMM associated with the liability versus equity classification of the convertible debt.

**Scenario 3**

**Fact pattern**

A public software entity enters into a revenue contract on the last day of the period, which is determined to be a SUT. The contract is the largest contract ever entered into by the entity and the majority of the revenue from the contract is recognized on the last day of the year. The revenue recognized from this contract enables the entity to narrowly meet analyst revenue expectations for the period. The entity has communicated to its audit committee and us that the business purpose of the transaction was to deliver its software to customers and that other than the size of the contract, it was not overly complex compared to any of their other revenue contracts.

**Analysis**

The transaction includes indicators that it may have been entered into to engage in fraudulent financial reporting, such as:

- The transaction enables the entity to achieve certain financial targets;
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and
- Management has not discussed the nature of and presented the accounting treatment for the transaction to the audit committee or another committee of the board of directors or the entire board.

Based on the presence of these indicators, we identify a fraud risk relating to the RMMs associated with the timing and amount of revenue recognized from this contract.

# 2.3.4 Evaluate whether SUTs have been properly accounted for and disclosed [ISA | 832]

## What do we do?

Evaluate whether significant unusual transactions have been properly accounted for and disclosed in the financial statements.

## Why do we do this?

Significant unusual transactions (SUT) may relate to transactions that are particularly challenging to account for or lead to specific disclosures that are essential for fair presentation. As a result, we specifically evaluate whether a SUT has been properly accounted for and disclosed in the financial statements in accordance with the applicable financial reporting framework.

## Execute the Audit

### How do we evaluate whether a significant unusual transaction has been properly accounted for? [ISA | 832.1300]

If the SUT is assessed as a significant risk, we first evaluate the design and implementation of the entity's process control activities over the accounting for SUTs.

We then consider whether:

- the accounting principles selected and applied to the significant unusual transaction have general acceptance;
- the accounting principles selected and applied to the significant unusual transaction are appropriate in the circumstances;
- the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and

- the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits (i.e., materiality).

For SUTs that are complex, we may engage specific team members or specialists to assist us in the performance of any or all of the above procedures.

#### What if a SUT has not been properly accounted for? [ISA | 832.14379]

When a SUT is not properly accounted for, we identify a misstatement. Refer to activity 'Evaluate whether uncorrected misstatements are material and the implications' for further guidance.

#### How do we evaluate whether a SUT has been properly disclosed in the financial statements? [ISA | 832.1600]

If the SUT is assessed as a significant risk, we first evaluate the design and implementation of the entity's process control activities over the disclosure of SUTs.

We then evaluate whether a SUT is disclosed in the financial statements in conformity with the applicable financial reporting framework. Refer to activity 'Evaluate whether the financial statements are presented fairly' for further guidance.

#### What if a SUT is not properly disclosed in the financial statements? [ISA | 832.1800]

SUT is not properly disclosed when there is omission of disclosures or presentation of inaccurate or incomplete disclosures. Refer to activity 'Evaluate whether uncorrected misstatements are material and the implications' for further guidance.

# 2.4 Determine whether to perform other procedures to address management override of controls [ISA | 833]

## What do we do?

Determine whether it is necessary to perform other audit procedures to address the risk of management override of controls.

## Why do we do this?

After performing procedures to respond to the risk of management override of controls, including testing journal entries, reviewing accounting estimates for management bias, and evaluating the business purpose of significant unusual transactions (SUTs), and performing other procedures to respond to assertion-level fraud risks identified, we take a step back and determine whether it is necessary to perform other procedures to respond to the risk of management override of controls. When other risks related to management override of controls are identified, we revisit our risk assessment and revise our planned approach to address these changes.

## Execute the Audit

### What are some examples of other ways in which management may override controls? [ISA | 833.1300]

Other ways in which management may override controls include:

- omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period;
- omitting, obscuring or misstating disclosures required by the applicable financial reporting framework, or disclosures that are necessary to achieve fair presentation; and
- concealing facts that could affect the amounts recorded in the financial statements.

### How do we determine whether it is necessary to perform other procedures to address the risk of management override of controls? [ISA | 833.1400]

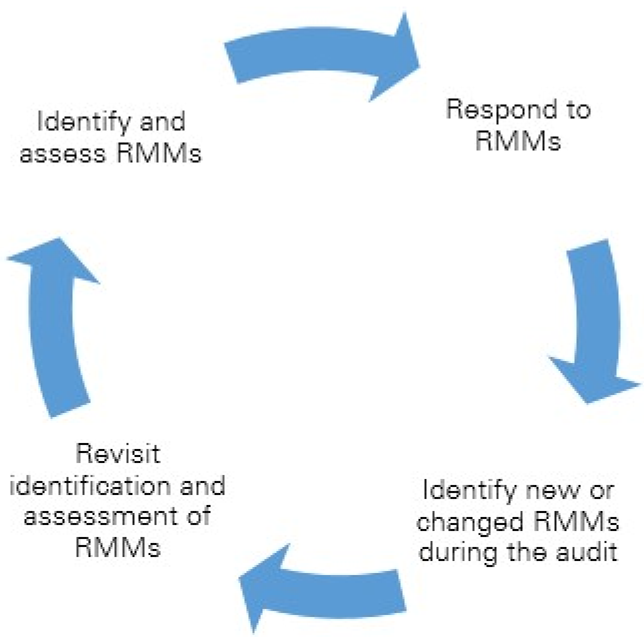
The audit is a continual process, during which we may, and often will, identify new RMMs or revise our assessment of RMMs.

At this point, we step back and evaluate whether there are other risks related to management override of controls that have not been addressed by:

- testing of journal entries and other adjustments,
- reviewing accounting estimates for management bias,
- evaluating the business purpose for significant unusual transactions (SUTs), and
- performing other procedures performed in response to assertion-level fraud risks - e.g., procedures performed to respond to fraud risks related to entering into side agreements that affect the timing of revenue recognition.

### What if we identify other risks of management override of controls? [ISA | 833.1500]

In this case, we revisit our risk assessment and revise our planned approach to address these changes.




# Evaluation of Audit Evidence

# International Standards on Auditing: ISA 240.35-38

## Evaluation of Audit Evidence (Ref: Para. A49)

35. The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity, indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A51)

36. If the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A52)

37. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A53)

38. If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A54)

# ISA Application and Other Explanatory Material: ISA 240.A50-A54

## **Evaluation of Audit Evidence** (Ref: Para. 35-38)

A50. ISA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.[21] This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

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21 ISA 330, paragraph 25

### *Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion* (Ref: Para. 35)

A51. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

### *Consideration of Identified Misstatements* (Ref: Para. 36-38)

A52. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A53. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A54. ISA 450[22] and ISA 700 (Revised)[23] establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

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22 ISA 450, *Evaluation of Misstatements Identified during the Audit*

23 ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Evaluate whether the final analytical procedures indicate new RMMs [ISA | 4430]

## What do we do?

Evaluate whether unusual or unexpected items indicate previously unidentified risks of material misstatement, in particular fraud risks, AND perform additional procedures as necessary.

## Why do we do this?

While performing our final analytical procedures, we evaluate whether unusual or unexpected items indicate previously unidentified risks of material misstatement, including fraud risks, to determine that we have not missed anything.

## Execute the Audit

#### How might unusual or unexpected items impact risk assessment? [ISA | 4430.1300]

The identification of unusual or unexpected transactions, events, amounts, or relationships may cause changes to initial assessment of risks of material misstatement as well as fraud risks.

#### How do we know whether an unusual or unexpected item indicates a fraud risk? [ISA | 4430.1400]

Whether an unusual or unexpected item indicates a fraud risk depends on the relevant facts and circumstances, including the nature of the account(s) involved.

> For example, certain unusual or unexpected items could indicate a fraud risk if the account(s) and disclosure(s) involved are those that management has incentives or pressures to manipulate.

Unusual relationships involving period-end revenue or income can be particularly relevant, as they often indicate that there may be a fraud risk.

The table below sets out examples of unusual or unexpected relationships and the fraud risks they may indicate.

| Possible types of unusual or unexpected relationships we may identify | Possible fraud risks |
|---|---|
| Uncharacteristically large amounts of revenue being reported in the last few weeks of the reporting period | • a risk that fictitious revenue transactions are recorded at or near the end of the period |
| Unusual relationship between net income and cash flows from operations | • a risk that fictitious revenue transactions are recorded during the period<br>• a risk that management made inappropriate entries to accrual or liability accounts to manipulate net income during the period |
| Inconsistent changes in inventory, accounts payable, sales and cost of sales from the prior period to the current period | • a risk of employee theft of inventory items during the period (i.e. misappropriation of assets)<br>• a risk that fictitious revenue transactions are recorded during the period |
| Unusual discrepancies between the entity's profitability and industry trends | • a risk that fictitious revenue transactions are recorded during the period |
| Unusual discrepancies between the entity's bad debt write-offs and industry data | • a risk of employee theft of cash receipts during the period (i.e. misappropriation of assets)<br>• a risk that fictitious revenue transactions are recorded during the period |
| Unexpected or unexplained relationships between sales volume as determined from the accounting records and | • a risk that fictitious revenue transactions are recorded during the period<br>• a risk that fictitious items are listed in inventory |

| | |
|---|---|
| production statistics maintained by operations personnel | |

### What do we include in our documentation regarding the new fraud risks and our responses? [ISA | 4430.15833]

We include in our documentation:

- the analytical relationships or other conditions that caused us to identify a new RMM or fraud risk and to believe that additional audit procedures or other responses were necessary; and
- the audit procedures or other responses we concluded were appropriate to address the new risks or other conditions.

# Examples

### How does an engagement team determine that there is a new fraud risk? [ISA | 4430.1500]

Scenario 1:

**Fact pattern**

An engagement team is performing a December year-end audit. During the month of September, the entity sold subsidiary B, which represented approximately half of the entity's consolidated operations. In performing final analytical procedures, the team expects payroll expense to decrease by approximately 10-15% in the current period (approximately one half the payroll expense from the last quarter of the year) taking into account the sale of subsidiary B. However, they identify a 2% increase in payroll expense from the prior year instead. This difference represents an unexpected amount that they did not previously identify.

**Analysis**

When the engagement team inquires of management about this unexpected relationship, their responses are imprecise and/or lack a sufficient level of detail - e.g. management cites 'timing differences' and 'normal changes in salaries that occurred during the period'. In response, the engagement team performs additional procedures to address the unexpected item and discovers that management recorded an unsupported amount in the payroll expense account during the last week of the reporting period.

Based on the circumstances, the engagement team determines that there is an additional fraud risk - e.g. finance personnel may be using payroll accounts to misappropriate cash. In response, the engagement team designs and performs additional procedures to address this new fraud risk.

Scenario 2:

**Fact pattern**

When performing final analytical procedures over revenue at a manufacturing entity, an engagement team observes that there is an unusual increase in revenue during the last two months of the period. When the engagement team inquires of management, they respond that the increase in revenue is the result of 'increased production'.

The engagement team determines that management's response is not precise enough to help them understand the nature of the increase. Additionally, based on the revenue recognition model, production does not drive revenue recognition, which also makes management's explanation implausible.

**Analysis**

These facts are an indicator of a fraud risk associated with revenue that the engagement team may not have previously identified. If they determine that a fraud risk exists, they design and perform additional procedures to address this newly identified risk.

# 2 Evaluate whether misstatements are the result of fraud and the implications [ISA | 4457]

## What do we do?

Evaluate whether the identified misstatements are or are likely to be the result of fraud AND if so, perform specific procedures to evaluate the implications.

## Why do we do this?

Once we have determined that we have a sufficient understanding of the nature of an individual misstatement and the reason for which it occurred, we are in a better position to evaluate whether the identified misstatements are or are likely to be the result of fraud. When the misstatement is the result of fraud, the implications to our audit could be extensive.

## Execute the Audit

### What makes a misstatement fraudulent? [ISA | 4457.1300]

Misstatements in the financial statements can arise from either error or fraud. The distinguishing factor between the two is whether the underlying action is intentional or unintentional. Fraud is an intentional act.

### Over what misstatements do we perform our evaluation of whether a misstatement indicates fraud? [ISA | 4457.1400]

Our evaluation of whether the misstatements indicate fraud is performed over all misstatements identified regardless of whether they are:

- not clearly trivial (i.e. accumulated in the SAM) or clearly trivial;
- related to a prior period or the current period; and
- misstatements in accounts or disclosures. Fraud could be committed not only in accounts but also by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be fairly presented.

### Do we perform our evaluation over misstatements individually or in aggregate? [ISA | 4457.1500]

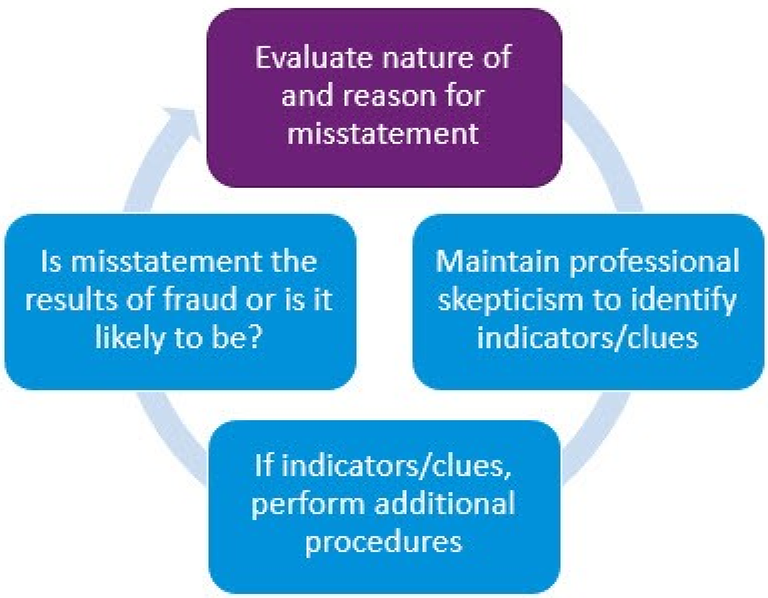
Both. In addition to evaluating whether the misstatements indicate fraud individually, we evaluate whether the misstatements indicate fraud in aggregate. Even though we consider all misstatements, even the ones that are clearly trivial, we do not accumulate misstatements that are clearly trivial in the SAM or anywhere else.

For example, identifying a number of misstatements - whether they are clearly trivial or not - within accounts in which we previously identified a fraud risk may indicate fraud.

### How do we evaluate whether the identified misstatements are or are likely to be the result of fraud? [ISA | 4457.1600]

We evaluate whether the identified misstatements are or are likely to be the result of fraud when we are evaluating the nature of and reason for the misstatements. See activity 'Evaluate the nature of and reasons for the misstatements ' for information on this evaluation.

However, determining whether a misstatement is or is likely to be the result of fraud is not easy, so we follow the following process:




Once we have determined that we have a sufficient understanding of the nature of an individual misstatement and the reason for which it occurred, we are in a better position to evaluate whether the identified misstatements are or are likely to be the result of fraud.

#### Why may this evaluation be a challenging task and how do we try to overcome the challenge?

Evaluating whether the misstatements are or are likely to be the result of fraud may be a challenging task because management's intention may be difficult to determine.

In addition, the determination of whether fraud has occurred is a legal determination, which we, as auditors, are not qualified to make. We may never know for sure whether fraud has occurred, but at least we might have some indication that fraud is likely to have occurred.

That is why we exercise professional skepticism and remain alert for possible indications or clues that a misstatement may be the result of fraud.

Examples of possible indicators or clues are:

- missing documentation,
- the existence of fraud risk factors in the area in which we identified the misstatement,
- unsupported or unauthorized balances or transactions,
- inconsistent, vague, or implausible responses from management or employees,
- missing inventory or physical assets of significant magnitude,
- undue time pressures imposed by management to resolve the issues, and/or
- unusual delays by management in providing requested information.

The existence of these indicators and others, may tell us something about the possibility that the misstatement identified may be the result of fraud.

### What do we do when there are indicators or clues that a misstatement may be the result of fraud?

When there are indicators or clues that a misstatement may be the result of fraud, we perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred.

If there are 'tip off laws', we take care not to tip management off while we perform the relevant procedures.

Examples of the procedures we may perform are:

- inquiring of management and employees (not suspected of perpetrating the fraud);
- inspecting additional documentation about the matter;
- performing additional procedures on the account or related accounts;
- involving KPMG specialists - e.g. Forensics in the Audit team; and/or
- inquiring of other departments in the entity outside of accounting (e.g. legal department).

All those procedures have a common goal, which is to understand the nature of the misstatement and the circumstances in which it occurred - i.e. the reason for the misstatement.

Example: Procedures performed when we determine that a misstatement might indicate fraud

**Fact pattern**

As part of the audit of the financial statements of PDL, we receive an accounts receivable confirmation back from a customer that indicates an exception. Although the entity's records show that an invoice to the customer was unpaid as of period end, the customer indicates that the invoice had already been paid.

**Analysis**

After investigating the incident further and considering the susceptibility of cash receipts to fraud - the entity receives checks on site -, we consider that the misstatement could indicate possible theft or misappropriation of assets.

As a result of discovering an indication that the misstatement might be intentional, we perform additional procedures to determine whether fraud has occurred or is likely to have occurred. These procedures include:

- informing client management, senior to the level of personnel involved in the exception, and asking them to investigate the matter further;
- inspecting additional records from the bank to obtain information about the customer payment;
- increasing the extent of our confirmation procedures and/or performing additional procedures over balances that are unpaid as of period end, which may help us to find out whether there are other invoices in the same situation; and
- involving forensics team members, depending on the situation and results of our additional procedures.

### How do we evaluate the audit implications when we believe that a misstatement is or is likely to be the result of fraud? [ISA | 4457.1700]

When we believe that a misstatement is or is likely to be the result of fraud, there are additional procedures that we perform to evaluate the audit implications:

- We consider the fraudulent nature of the misstatement when evaluating the materiality of uncorrected misstatements and the related audit responses.
- We perform additional procedures if the effect on the financial statements could be material or cannot be readily determined.
- We evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit, particularly the reliability of management representations.
- We re-evaluate our assessment of fraud risk and its effect on a) the nature, timing and extent of procedures and b) the effectiveness of controls.
- We evaluate whether the circumstances indicate possible collusion and, if so, its effect on the reliability of evidence obtained.
- We determine our responsibilities under fraud and illegal acts related standards and regulations.

While performing these procedures, we exercise professional skepticism.

The table includes additional information about these procedures:

| Procedure | Additional information |
|---|---|
| We consider the fraudulent nature of the misstatement when evaluating the materiality of uncorrected misstatements and the related audit responses | Fraud is one of the qualitative factors that we take into account when evaluating whether a misstatement is material to the financial statements. Thus, we often consider misstatements resulting from fraud to be material, even when they are relatively small amounts, especially if management or senior management is involved. |

| | |
|---|---|
| If the effect on the financial statements could be material or cannot be readily determined, we perform additional procedures | When we believe that a misstatement is or is likely to be the result of fraud, sometimes we are able to determine how significant it is to the financial statements without difficulty. However, there are other times when the effect on the financial statements is not clear. In those situations, we perform additional procedures to better determine the full effect on the financial statements and the auditor's report.<br><br>For example:<br>• inquiring of management and employees;<br>• inspecting additional documentation about the matter;<br>• performing additional procedures on the account or related accounts;<br>• involving KPMG specialists - Forensics in the Audit team; and/or<br>• inquiring of other departments in the entity outside of accounting - e.g. legal department.<br><br>See Example below in this activity. |
| We evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit, particularly the reliability of management representations | A misstatement that is or is likely to be the result of fraud may suggest that there are more pervasive issues, such as concerns with management's integrity. This is especially true when higher-level management is involved. Instances of fraud that involve higher-level management are more significant as there is a higher probability that the fraudulent activity may be more pervasive - i.e. not concentrated in just one area.<br><br>Fraud of this nature may call into question the reliability of audit evidence previously obtained because we may have doubts about the completeness and truthfulness of representations made to us and about the genuineness of accounting records and documentation.<br><br>If there are questions about the integrity of management, including concerns that the fraudulent activity may be more pervasive or involve higher-level management, we may:<br>• re-examine the audit evidence we previously obtained and determine whether it is still relevant and reliable;<br>• disclaim an opinion on the financial statements; and/or<br>• re-evaluate our client-continuance decisions and possibly withdraw from the engagement. |
| We re-evaluate our assessment of fraud risk and | Fraud is unlikely to be isolated. If a fraudulent activity occurred, it may indicate that there are others. There may also be other individuals in the entity that can rationalize the commitment of fraud. |

| | |
|---|---|
| its effect on a) the nature, timing and extent of procedures and b) the effectiveness of controls | When we perform our risk assessments at the beginning of the audit, we take into consideration all the information we have available at that moment. However, as we perform the audit and discover additional information, such as the fact that fraud has occurred or is likely to have occurred, adjustments to our fraud risk assessments may be necessary.<br><br>Therefore, determining that a misstatement is or is likely to be the result of fraud may also cause us to reconsider whether our original fraud risk assessments are still appropriate. This is especially true when we identify fraud in an area in which we had not previously identified a fraud risk.<br><br>Our re-evaluation of our fraud risk assessments may bring to light a new fraud risk or additional fraud risk factors that we had not previously identified or considered. When we identify additional fraud risks, we may decide to modify the nature, timing and extent of our substantive procedures to address the new risk.<br><br>For example, we may determine that:<br>• there is a financial statement level fraud risk, for which we might implement additional overall responses - e.g. incorporating an element of unpredictability, selecting items for testing that have lower amounts or are otherwise outside customary selection parameters, and/or increasing the persuasiveness of audit evidence obtained from our substantive procedures across the board;<br>• there is a higher possibility of management override of controls, especially when we have concerns about management's integrity; or<br>• there are fraud risk factors that we may not have previously identified, such as opportunity to commit fraud and an attitude/ rationalization for fraud. If this is the case, we consider whether these new fraud risk factors indicate the existence of new fraud risks, for which it may be necessary to modify our procedures.<br><br>In addition, a misstatement is usually evidence of one or more control deficiencies. If the misstatement is or might be the result of fraud, there may be a breakdown of internal controls that allowed the fraudulent activity to occur. Therefore, fraud may bring into question our assessment of the effectiveness of controls, which may affect our control risk assessments. |
| We evaluate whether the circumstances | Fraud may be the result of collusion involving employees, management and/or external parties. An entity's internal controls usually include certain mechanisms, such as segregation of duties, to deter individuals |

| | |
|---|---|
| indicate possible collusion and, if so, its effect on the reliability of evidence obtained | from committing fraud. However, it is possible that two or more employees, notwithstanding the segregation of duties for example, decide to work together to circumvent the entity's internal controls to commit the fraudulent activity.<br><br>Fraud that is the result of collusion may call into question the reliability of audit evidence previously obtained. In those situations, we may have doubts about the completeness and truthfulness of representations made to us and about the genuineness of accounting records and documentation. This depends on the nature of the collusion and how widespread it may be.<br><br>If we are concerned about the reliability of audit evidence, our audit responses will vary depending on who is involved in the collusion - either management, employees or external parties.<br><br>For example, we may:<br>• re-examine the audit evidence we previously obtained and determine whether it is still relevant and reliable;<br>• disclaim an opinion on the financial statements; and/or<br>• re-evaluate our client-continuance decisions and possibly withdraw from the engagement. |
| We determine our responsibilities under fraud and illegal acts related standards and regulations | If fraud or another illegal act has occurred or is likely to have occurred, we have additional responsibilities under the auditing standards and other laws and regulations.<br><br>If we become aware of possible illegal acts, we perform the procedures, as applicable, specified in activities:<br>• Ascertain whether non-compliance with laws and regulations, including illegal acts, has occurred<br>• Perform additional procedures if satisfactory information is not provided<br>• Evaluate the possible effect of actual or suspected non-compliance, including illegal acts<br>• US teams \| Perform additional steps related to the entity's response<br>• Non-US teams \| Evaluate the entity's response to the non-compliance, including illegal acts<br>• US teams \| Perform additional procedures regarding governmental enforcement investigations<br>• Communicate the actual, or suspected, instance of non-compliance, including an illegal act<br>• Consider the effect on the auditor's report when non-compliance, including an illegal act, has or is likely to have occurred |

- PCAOB & AICPA | Perform procedures when the modified audit report is not accepted
- Perform procedures when unable to determine whether non-compliance, including an illegal act, has occurred .

If we become aware of fraud, we perform the procedures, as applicable, specified in activities:

- Perform additional procedures when we identify or suspect a fraud
- Communicate fraud related matters .

Example: Additional procedures performed when we believe a misstatement is or is likely to be the result of fraud but we do not know how material its effect to the financial statements is

**Fact pattern**

During our audit of the financial statements of LDP, we learn that there was an incident at one of the entity's plants and the plant manager was terminated. When we inquire about the incident, we learn that the plant manager hired a friend to perform some construction work in the plant and purchased equipment from this friend over the past three years. Even though the invoices were paid (the payments were authorized by the plant manager), most of the improvements in the plant were not performed and the majority of the equipment was not delivered.

**Analysis**

This incident reveals a misstatement (property, plant and equipment that is recorded but does not exist) resulting from fraud, and the possible circumvention of controls over asset acquisitions. However, management and we do not know the actual effect of the fraud and how significant it is to the financial statements.

As a result, we perform additional audit procedures to determine the effect of the fraudulent activity on the financial statements. These procedures include:

- requesting management to perform a full investigation of the incident, including physically inspecting all the recorded property plant and equipment at the plant;
- performing observation procedures at the plant to determine whether the property plant and equipment exists;
- inspecting other vendors' invoices that were authorized or paid by the plant manager to determine whether fraud has been perpetrated through other vendors; and/or
- involving forensics team members.

# 3 Evaluate conditions related to the assessment of fraud risks [ISA | 4470]

## What do we do?

Evaluate conditions related to the assessment of fraud risks.

## Why do we do this?

Identifying and assessing risks is a continuous activity that occurs throughout every phase of the audit.


# Execute the Audit

How do we evaluate conditions related to the assessment of fraud risks? [ISA | 4470.15832]

We evaluate conditions related to the assessment of fraud risks by performing the following activities:

- Evaluate whether the accumulated results of audit procedures affect our fraud risks ; and
- Determine whether there have been appropriate fraud risk communications with engagement team .

# 3.1 Evaluate whether the accumulated results of audit procedures affect our fraud risks [ISA | 4471]

## What do we do?

Evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the fraud risks and whether it is necessary to modify our audit procedures to address those risks.

## Why do we do this?

Toward the end of the audit, we have a final opportunity to ask ourselves whether we have identified and appropriately addressed all the fraud risks in the audit. The evidence and other information that we have gathered throughout our audit - for example, while testing controls or performing substantive procedures - can affect and better inform our initial risk assessments. This might lead us to identify new fraud risks or modify previously identified fraud risks.

# Execute the Audit

## How do we evaluate the accumulated results of auditing procedures and other observations? [ISA | 4471.1300]

Toward the end of the audit, we:

- take a step back and evaluate *in aggregate:*
  - the audit evidence obtained through performing all of our audit procedures;
  - the results of our concluding procedures; and
  - specific matters that we might have identified during the audit.
- determine whether such evaluation provides further insights about previously identified fraud risks or leads to the identification of new fraud risks.

If our evaluation of the accumulated results of auditing procedures and specific matters affects our assessment of fraud risks made throughout the audit, we evaluate whether it is necessary to modify our audit procedures to respond to those risks.

See this activity for additional information about revising our risk assessment: "Continue to assess RMMs, and revise audit approach as necessary".

## What are the specific matters that we might have identified during the audit that might affect our fraud risk assessments? [ISA | 4471.1400]

We may identify specific matters that can affect our fraud risk assessments, which include:

| Matters | More specifically.... |
|---|---|
| Discrepancies in the accounting records | (1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.<br>(2) Unsupported or unauthorized balances or transactions.<br>(3) Last-minute adjustments that significantly affect financial results.<br>(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties.<br>(5) Tips or complaints to us about alleged fraud. |
| Conflicting or missing evidence | (1) Missing documents.<br>(2) Documents that appear to have been altered.<br>(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.<br>(4) Significant unexplained items in reconciliations.<br>(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures. |

| | |
|---|---|
| | (6) Unusual discrepancies between the entity's records and confirmation responses.<br><br>(7) Missing inventory or physical assets of significant magnitude.<br><br>(8) Unavailable or missing electronic evidence that is inconsistent with the entity's record retention practices or policies.<br><br>(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current year system changes and deployments.<br><br>(10) Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g. receivables growing faster than revenues.<br><br>(11) Large numbers of credit entries and other adjustments made to accounts receivable records.<br><br>(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.<br><br>(13) Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the entity with the bank statement.<br><br>(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated. |
| Problematic or unusual relationships between us and management | (1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:<br><br>– Unwillingness to facilitate access to key electronic files for testing through the use of computer-assisted audit techniques.<br><br>– Denial of access to key information technology operations staff and facilities, including security, operations, and systems development.<br><br>(2) Undue time pressures imposed by management to resolve complex or contentious issues.<br><br>(3) Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with our critical assessment of audit evidence or in the resolution of potential disagreements with management.<br><br>(4) Unusual delays by management in providing requested information.<br><br>(5) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete, transparent, and understandable. |

| | |
|---|---|
| | (6) Management's unwillingness to address identified deficiencies in internal control on a timely basis. |
| Other matters | (1) Unwillingness by management to permit us to meet privately with the those charged with governance.<br>(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.<br>(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances.<br>(4) Tolerance of violations of the entity's code of conduct |

The list of matters is helpful not only during our concluding procedures but also throughout the audit.

### How do we evaluate the specific matters that may affect our assessment of fraud risks? [ISA | 4471.7461]

To help make sure that we do not lose sight of the specific matters that may affect our assessment of fraud risks, we ask ourselves throughout the audit: 'Have we identified any of the specific matters that may affect our assessments of fraud risks?'

Toward the end of the audit, we also consider the list of matters one more time and determine whether any of these items, or any other matter that can affect our fraud risk assessments, exists.

If we identify one or more matters, we consider what it means to our assessment of fraud risk and our audit procedures. We often involve more senior engagement team members to help us determine the potential effects on the audit.

These specific matters may also help facilitate communication within the engagement team as to whether any matters that may affect our assessment of fraud risks have been identified during the audit. See activity 'Determine whether there have been appropriate fraud risk communications with engagement team'.

# Example

### How does an engagement team identify a new fraud risk and respond to it? [ISA | 4471.1700]

**Fact pattern**

The engagement team evaluates the misstatements identified during the audit of entity LMN and notices several misstatements that unfavorably affect elements of the financial statements that are used to determine compliance with the entity's debt covenants. If the entity fails to meet a debt covenant, the entity may be forced to repay their debt obligations.

If management corrected the misstatements, the entity would be close to failing a debt covenant to maintain positive working capital.

**Analysis**

Based on the circumstances, the engagement team determines that there is increased pressure (i.e. a fraud risk factor) to meet certain financial covenants, which leads them to identify and assess a new fraud risk that they had not previously identified.

Depending on the fraud risk identified, they may perform additional procedures or modify the nature, timing and extent of their procedures related to the significant accounts that affect working capital. Particularly those areas that are more judgmental (e.g. estimates) as those are easier for management to manipulate. For example, they may alter their procedures to obtain external evidence related to litigation contingencies and payroll related accruals.

# 3.2 Determine whether there have been appropriate fraud risk communications with engagement team [ISA | 4472]

## What do we do?

Determine whether there have been appropriate communication with the engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

## Why do we do this?

Although we hold a formal engagement team discussion about potential fraud risks during our risk assessment procedures (see activity 'Discuss the potential for material misstatement due to fraud ' for information on this subject), communication continues throughout the audit (see activity 'Communicate significant matters among team members throughout the audit ' for information on this subject). This is especially true when conditions change. Effective communication of the risks throughout the audit is one of the ways we can a) keep all engagement team members connected and focused on the same set of risks and b) improve their ability to identify potential issues when performing the work.

The end of the audit provides a time for us to determine whether the communications about information or conditions that indicate fraud risks have been taking place throughout the audit.

## Execute the Audit

### Who determines whether there has been appropriate communication with the other engagement team members throughout the audit about information or conditions that indicate fraud risks? [ISA | 4472.15892]

The engagement partner determines whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

### Enhanced | When do we determine whether there has been appropriate communication with the other engagement team members throughout the audit about information or conditions that indicate fraud risks? [ISA | 4472.15893]

Toward the end of the audit, we determine whether there has been appropriate communication with the other engagement team members throughout the audit about information or conditions that indicate fraud risks.

In practice, we may accomplish this during our RAQA meeting.

Our RAQA meeting can serve several purposes, including providing an opportunity for the engagement partner to:

- summarize and communicate to the engagement team (including specific team members and employed KPMG specialists) all the information or conditions we have identified that indicate fraud risks;
- engage in a two-way dialogue with all engagement team members to determine whether anyone has identified other information or conditions that indicate fraud risks, which were not previously discussed or communicated; and
- highlight and discuss changes that have occurred since our planning and risk assessment procedures and their potential effect on fraud risks.

See activity 'Hold a RAQA meeting and document the details ' for further information on the RAQA meeting.

Core and Less Complex | When do we determine whether there has been appropriate communication with the other engagement team members throughout the audit about information or conditions that indicate fraud risks? [ISA | 4472.1500]

Toward the end of the audit, we determine whether there has been appropriate communication with the other engagement team members throughout the audit about information or conditions that indicate fraud risks.

In practice, we may accomplish this during our RAQA meeting, when the engagement partner considers it necessary to hold one (see activity 'Hold a RAQA meeting and document the details, if applicable ' for further information).

Our RAQA meeting can serve several purposes, including providing an opportunity for the engagement partner to:

- summarize and communicate to the engagement team (including specific team members and employed KPMG specialists) all the information or conditions we have identified that indicate fraud risks;
- engage in a two-way dialogue with all engagement team members to determine whether anyone has identified other information or conditions that indicate fraud risks, which were not previously discussed or communicated; and
- highlight and discuss changes that have occurred since our planning and risk assessment procedures and their potential effect on fraud risks.

# Auditor Unable to Continue the Engagement

## International Standards on Auditing: ISA 240.39

### Auditor Unable to Continue the Engagement

39. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A55-A58)

# ISA Application and Other Explanatory Material: ISA 240.A55-A58

## **Auditor Unable to Continue the Engagement** (Ref: Para. 39)

A55. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

- The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements;
- 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
- The auditor has significant concern about the competence or integrity of management or those charged with governance.

A56. 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.

A57. 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 may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.[24]

24 The IESBA *Code of Ethics for Professional Accountants* provides guidance on communications with an auditor replacing the existing auditor.

### *Considerations Specific to Public Sector Entities*

A58. In many cases in the public sector, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate or public interest considerations.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Perform additional procedures when we identify or suspect a fraud [ISA | 834]

## What do we do?

IF we identify or suspect a fraud, THEN perform additional procedures.

## Why do we do this?

When we identify or suspect fraud as part of the audit, we perform additional procedures to evaluate the effect of the identified or suspected fraud on the financial statements and our audit and understand the entity's response to the identified or suspected fraud. When exceptional circumstances bring into question our ability to continue performing the audit, we consult with the appropriate parties in order to assist in deciding whether to withdraw from the engagement and determining the appropriate course of action. Consulting with the appropriate parties helps us to comply with the applicable laws, statutes, and regulations as well as our duties and responsibilities under professional standards and other contractual arrangements in these instances.

## Execute the Audit

### What additional procedures do we perform when we identify or suspect fraud? [ISA | 834.13466]

When we identify or suspect fraud as part of the audit, we evaluate the:

- effect of the identified or suspected fraud on the financial statements and our audit (see activity 'Evaluate the possible effect of actual or suspected non-compliance, including illegal acts ' for additional information); and
- entity's response and document the identified or suspected non-compliance, including illegal acts (see activity 'Evaluate the entity's response to the non-compliance, including illegal acts ' for additional information).

### What if we identify exceptional circumstances that may bring into question our ability to continue performing the audit? [ISA | 834.1400]

When we identify exceptional circumstances that may bring into question our ability to continue performing the audit we:

- determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for us to report to the parties who made the audit appointment or, in some cases, to regulatory authorities
- consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation.

#### What are examples of exceptional circumstances that may bring into question our ability to continue performing the audit?

Examples of exceptional circumstances that may bring into question our ability to continue performing the audit include:

- management does not take, or those charged with governance do not cause management to take, the appropriate action regarding identified or suspected fraud that we consider necessary in the circumstances, even when the identified or suspected fraud is not material to the financial statements; or
- we identify and assess a significant risk of material and pervasive fraud due to deficiencies in the entity's control environment or concerns about the competence or integrity of management or those charged with governance as a result of identified or suspected fraud; or
- we are unable to rely on representations of management or those charged with governance due to concerns about the competence or integrity of management or those charged with governance as a result of identified or suspected fraud.

#### When is it appropriate to withdraw from the engagement?

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 may affect our conclusion include:

- whether withdrawal is possible under applicable law or regulation
- the implications of the involvement of a member of management or of those charged with governance and
- the effects of continuing association with the entity.

When we identify exceptional circumstances that may bring into question our ability to continue performing the audit, we consult with the appropriate parties to assist in deciding whether to withdraw and determining the appropriate course of action.

#### What do we do when we withdraw from the engagement? [ISA | 834.13469]

When we have decided to withdraw from the engagement, we:

- 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
- determine whether there is a professional or legal requirement to report to the parties who made the audit appointment or, in some cases, to regulatory authorities, our withdrawal from the engagement and the reasons for the withdrawal.

# Written Representations

## International Standards on Auditing: ISA 240.40

### Written Representations

40. The auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have 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;

(c) They have disclosed to the auditor their 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) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A59-A60)

# ISA Application and Other Explanatory Material: ISA 240.A59-A60

## **Written Representations** (Ref: Para. 40)

A59. ISA 580[25] establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

25 ISA 580, *Written Representations*

A60. 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 obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

(a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Obtain written representations for all financial statement periods [ISA | 3851]

## What do we do?

Obtain written representations from management for all financial statement periods covered by the auditor's report

# Why do we do this?

While management representations do not provide sufficient appropriate audit evidence on their own, they complement the evidence we obtain from other auditing procedures. Specifically, they serve as a written record of management's acknowledgement that they have fulfilled their responsibilities, their understanding and evaluation of audit differences and their honesty and cooperation with us during the audit. Accordingly, failure of management to provide written representations requested by the auditor can have serious implications on the audit and on our report.

# Execute the Audit

### Which financial statement period(s) do management's written representations relate to? [ISA | 3851.1300]

The written representations relate to all financial statement periods covered in the audit report, including prior periods that are presented in the financial statements.

#### Why do we obtain management's written representations about prior periods that have already been reported?

Management reaffirms to us that the written representations from previous period(s) remain appropriate before we sign our audit opinion in the current year, as our audit opinion relates to all periods presented in the financial statements. If a restatement has been made to correct a material misstatement in the prior period that affects the comparative financial statements, then we draft a specific representation for management to review and also reaffirm.

#### What written representations do we obtain from management if we are issuing more than one audit report?

We obtain representations from management for all audit reports issued, either in one representation letter, listing the applicable set of financial statements, or in separate representation letters for each set of financial statements.

### Who prepares the management representation letter? [ISA | 3851.1600]

We prepare the MRL template and provide it to management for their review and signature.

### How do we prepare the management representation letter? [ISA | 3851.15774]

We first select the appropriate KPMG example MLR template https://alex.kpmg.com/AROWeb/document/lfc/GSC_INTL_AUDDOC_DOCSEAUDIT_TOC/toc/GSC_INTL_AUDDOC_DOCSEAUDIT_TOC?tocref=GSC_INTL_AUDDOC_DOCSEAUDIT_TOC, depending on the applicable auditing standards, financial reporting framework used by the entity and legal and regulatory framework in which the entity operates.

We then determine any additional representations to include in the MLR template. Attachment 1 provides additional representations that we may include, depending on the other circumstances that are applicable to the entity. At a minimum, we include all required representations from the auditing standards, which are included in the KPMG example MLR template.

In some circumstances, we use nationally-tailored versions of the base representation letter and/or listing of additional representations.

Once we have compiled all applicable representations into the MRL template, we provide it to management.

### How do we determine which additional representations, beyond those which are required, are appropriate in the circumstances of our audit? [ISA | 3851.1800]

We select additional representations based on the specific facts and circumstances of the audit and the entity we audit. This can include additional representations to address a variety of topics, such as:

- specific circumstances related to the engagement and basis of presentation of the financial statements (e.g. US GAAP, IFRS);
- specific types of transactions, balances and disclosures present at the entity;
- the nonexistence of transactions/balances/disclosures or circumstances that commonly exist for entities or entities within a particular industry;
- management's intent (e.g., intention to reinvest undistributed earnings of a foreign subsidiary) or plans (e.g., going concern);
- oral representations made to us by management, explicitly or implicitly, during the course of our audit (e.g., disclosure of unique sales terms);
- information presented with the audited financial statements that is not contemplated by the base letter (e.g., supplemental information, adjustments to a prior period that are audited by us as the successor auditor);
- specialized circumstances or disclosures (e.g., restatement, restructuring); and
- management's selection and application of accounting policies, for example non-GAAP policies.

### When might it be appropriate for management to modify the representations we have requested from them? [ISA | 3851.2100]

We expect that management will not make any major revisions to the letter template we provide. We review the signed letter that is provided back to us to allow us to make sure we agree with final version, including any revisions management may have made or proposed.

In some cases, management may modify a representation to further describe and represent relevant facts and circumstances, but not to change or limit its meaning or contradict the auditing standards.

Base representations (i.e. required representations), are not to be removed or modified by management unless it adds an "except for" clause to highlight a matter already disclosed in the financial statements and/or disclosed to the auditor. If management modifies the base representations, refer to activity 'Consider the effect if management refuses to provide representations ' to determine what to do.

**Examples of representations modified by management:**

| | Default Language: | Example Modified Language: |
|---|---|---|
| **Scenario 1** : *An event subsequent to the balance sheet has been disclosed in financial statements* | To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements. | To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require |

| | | |
|---|---|---|
| | | adjustment to or disclosure in the aforementioned financial statements. |
| **Scenario 2:** *Management plans to dispose of a specific business segment* | The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities. | The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1 meeting of the board of directors. |
| **Scenario 3:** *Management has received a communication of an allegation of fraud or suspected fraud* | We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, analysts, regulators, short sellers, or others. | Except for the allegation discussed in the minutes of the December 7, 20X1 meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others. |

If we think management may have questions as to the meaning of certain terminology used in the MRL template, we may consider providing those definitions to management or requesting that they include the definitions in the MRL response to confirm their understanding.

## How does the management representation letter address materiality? [ISA | 3851.2200]

Management representations may be limited to matters that are considered individually or in the aggregate to be material to the financial statements. In order for management to exclude "immaterial" items from its representations, we first come to a common understanding with management as to what is material. Materiality may be different for different representations, similar to the concept of having different materiality considerations for specific areas of the audit.

A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms.

### Does the concept of materiality apply to all management representations?

No. Materiality does not apply to:

- representations not directly related to financial statement amounts;
- any representations regarding the possible effects of fraud on other aspects of the audit; or
- items that involve an omission or misstatement of accounting information that, based on the circumstance, would change or influence the judgment of a reasonable person relying on the financial statements if the omission or misstatement were adjusted.

The following table sets out some examples of representations in which materiality would not be applicable.

| | Representation |
|---|---|
| **Example 1** | We confirm that we are responsible for the fair presentation in the [consolidated] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles [or other applicable accounting framework]. |
| **Example 2** | We have made available to you all -<br>(a) Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.<br>(b) Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. |
| **Example 3** | There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices. |
| **Example 4** | We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud. |

### Do we attach any information to the management representation letter? [ISA | 3851.15776]

Yes. We attach a summary of uncorrected misstatements, which includes the nature, amount, and effect of the uncorrected misstatements, excluding those misstatements that are clearly trivial. We also include a listing of omissions of amounts or disclosures in the financial statements.

We use the KPMG template, Summary of Audit Misstatements (SAM) - uncorrected misstatements section for the summary of uncorrected misstatements unless law, regulation or custom specifies a different format.

While not required, we also may choose to attach a summary of corrected misstatements.

How is the management representation letter adjusted when management disagrees with an uncorrected misstatement? [ISA | 3851.15778]

If management does not agree with a misstatement we have included on the SAM - uncorrected misstatements section attached to the MRL, they may modify the representation about uncorrected audit misstatements as follows:

*We do not agree that items ... and ... constitute misstatements because [description of reasons].*

# Communications to Management and with Those Charged with Governance, Reporting Fraud to an Appropriate Authority Outside the Entity

## International Standards on Auditing: ISA 240.41-44

### Communications to Management and with Those Charged with Governance

41. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters, unless prohibited by law or regulation, on a timely basis with the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A61-A62)

42. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

(a) management;

(b) employees who have significant roles in internal control; or

(c) others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters with those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions with those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. Such communications with those charged with governance are required unless the communication is prohibited by law or regulation. (Ref: Para. A61, A63-A65)

43. The auditor shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A61, A66)

### Reporting Fraud to an Appropriate Authority Outside the Entity

44. If the auditor has identified or suspects a fraud, the auditor shall determine whether law, regulation or relevant ethical requirements: (Ref: Para. A67-A69)

(a) Require the auditor to report to an appropriate authority outside the entity.

(b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

# ISA Application and Other Explanatory Material: ISA 240.A61-A69

## Communications to Management and with Those Charged with Governance (Ref: Para. 41-43)

A61.In some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with management and those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report the fraud to an appropriate authority pursuant to anti-money laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.

### *Communication to Management* (Ref: Para. 41)

A62. 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.

### *Communication with Those Charged with Governance* (Ref: Para. 42)

A63. The auditor's communication with those charged with governance may be made orally or in writing. ISA 260 (Revised) identifies factors the auditor considers in determining whether to communicate orally or in writing.[26] 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 on a timely basis and may consider it necessary to also report such matters in writing.

26 ISA 260 (Revised), paragraph A38

A64. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A65. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

### Other Matters Related to Fraud (Ref: Para. 43)

A66. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

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

## **Reporting Fraud to an Appropriate Authority outside the Entity** (Ref: Para. 44)

A67. ISA 250 (Revised)[27] provides further guidance with respect to the auditor's determination of whether reporting identified or suspected non-compliance with laws or regulations to an appropriate authority outside the entity is required or appropriate in the circumstances, including consideration of the auditor's duty of confidentiality.

27 ISA 250 (Revised), Consideration of Laws and Regulations in an Audit of Financial Statements, paragraphs A28-A34

A68. The determination required by paragraph 44 may involve complex considerations and professional judgments. Accordingly, the auditor may consider consulting internally (e.g., within the firm or a network firm) or on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The auditor may also consider obtaining legal advice to understand the auditor's options and the professional or legal implications of taking any particular course of action.

### *Considerations Specific to Public Sector Entities*

A69. In the public sector, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related law, regulation or other authority.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Communicate fraud related matters [ISA | 835]

## What do we do?

Communicate fraud related matters to the appropriate parties

# Why do we do this?

We communicate fraud related matters so entity, including those charged with governance, can investigate the matter and take corrective actions when necessary.

# Execute the Audit

### How do we communicate fraud related matters? [ISA | 835.11691]

We:

- communicate identified or suspected fraud to the appropriate level of management;
- determine whether it is necessary to communicate fraud to those charged with governance;
- communicate fraud involving those charged with governance to the next higher level of authority and consult when necessary;
- communicate other matters related to fraud to management and those charged with governance;
- determine whether we have a responsibility to report fraud to parties outside the entity;
- identify whether certain fraud related matters represent significant deficiencies or material weaknesses

### What fraud related matters do we communicate? [ISA | 835.1300]

We communicate the following fraud related matters:

- Identified actual fraud or information that indicates that a fraud may exist (i.e., suspected fraud).
- Fraud risks identified by us as part of our risk assessment procedures, including the risk related to management override of controls.
- Any other matters related to fraud, that we believe are relevant to the responsibilities of management and those charged with governance of the entity. These matters may include fraud risks with continuing implications for internal controls and deficiencies in internal controls that address fraud risks.

# 1.1 Communicate identified or suspected fraud to the appropriate level of management [ISA | 836]

# What do we do?

IF we determine there is evidence that fraud may exist, THEN communicate the matter to the appropriate level of management

# Why do we do this?

We communicate identified and suspected fraud to management so they can appropriately respond - for example, by investigating the matter and taking corrective actions when necessary.

# Execute the Audit

### How do we communicate fraud to management? [ISA | 836.11692]

We communicate with management either orally or in writing, depending on the circumstances, unless specifically stated.

Even if we communicate in writing, having a dialogue with management is a key part of effective two-way communications.

#### What information do we include in our communication of identified or suspected fraud? [ISA | 836.11693]

Our communications related to fraud include (i) a description of the fraud, (ii) the circumstances surrounding the fraud, and (iii) the effect of the fraud on the financial statements. Our communications may also include a description of the possible consequences of the fraud and the recommended course of action to be followed, when appropriate.

#### What factors do we think about to determine the form of the communication? [ISA | 836.11694]

We think about the following factors in determining the appropriate form of our communications:

- how significant the matter is;
- whether the matter will be included in the auditor's report;
- whether the matter has been satisfactorily resolved;
- whether management has previously communicated the matter;
- whether the nature of the matter is complex;
- our experience with the past effectiveness of oral and written communications; and
- whether, in our professional judgment, oral communication is inadequate based on the circumstances.

In the case of audits of smaller entities, we may communicate with management in a less structured manner than in the case of larger entities.

### What is the appropriate level of management to communicate identified or suspected fraud? [ISA | 836.1300]

Ordinarily, the appropriate level of management is at least one level above the person(s) who appear to be involved with the identified or suspected fraud.

We also take into account factors such as the likelihood of collusion and the nature and magnitude of the suspected fraud. If we believe there is a likelihood of collusion or the nature and magnitude of the fraud may be pervasive and involve other members of management, we may determine it is necessary to communicate the matter directly to those charged with governance.

Entities may designate certain members of management, such as a Chief Compliance Officer, who are responsible for the prevention and detection of fraud at an entity and the communication of actual or suspected fraud to those charged with governance of the entity. When we have no reason to believe these individuals are involved in the actual or suspected fraud, we may communicate actual or suspected fraud to these individuals.

### When do we communicate identified or suspected fraud to management? [ISA | 836.1400]

When there are no laws or regulations that limit our ability to communicate, we communicate the matter to management in a timely manner (i.e., as soon as practicable) regardless of the significance of the matter.

It certain situations, there may be laws or regulations that limit our ability to communicate actual or suspected fraud. In some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with management. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity. For example, when we are required to report the fraud to an appropriate authority pursuant to anti-money laundering legislation.

In these circumstances, the issues may be complex and we may consider it appropriate to obtain legal advice.

## What if identified or suspected fraud causes or could cause a material misstatement to the financial statements? [ISA | 836.1600]

When identified fraud causes a material misstatement or there is a reasonable possibility it could cause a material misstatement to the entity's financial statements, we communicate the matter to management.

### How do we determine whether identified or suspected fraud causes or could cause a material misstatement to the financial statements? [ISA | 836.11696]

We think about both the quantitative and the qualitative impact of materiality when evaluating the impact of the identified or suspected fraud on the financial statements.

### What are some quantitative indicators that fraud causes a material misstatement to the financial statements? [ISA | 836.11698]

Quantitative indicators that identified or suspected fraud causes a material misstatement to the financial statements include:

- the quantitative impact of the fraud on the entity's financial statements is greater than materiality;
- contingent monetary effects, such as fines, penalties, and damages or loss contingencies resulting from the identified or suspected fraud are greater than materiality; and

### What are some qualitative indicators that fraud causes a material misstatement to the financial statements? [ISA | 836.11699]

Qualitative indicators that identified or suspected fraud causes a material misstatement to the financial statements:

- the nature of the identified or suspected fraud could cause actual or potential significant harm might be caused to investors, creditors, employees or the general public (i.e. matters of public interest); and
- the nature of the identified or suspected fraud could have significant effects on the reputation of the entity, management, or those charged with governance.
- the nature of the identified or suspected fraud could have a significant impact to the entity's ability to be in compliance with its financial debt covenants

## When is an identified or suspected fraud matter considered to be insignificant? [ISA | 836.11701]

Certain instances of actual or suspected fraud may be considered insignificant such as cash or product/merchandise defalcations of an immaterial value by non-management personnel, where the entity has properly addressed such matters in the ordinary course of business. Such items are considered to be clearly inconsequential to the audit.

## What if we have doubts about the integrity or honesty of management? [ISA | 836.11702]

When we have doubts about the integrity or honesty of management, we may consult with legal counsel, such as OGC, to assist in determining the appropriate course of action.

#### Group Audit | What is different in communicating fraud to management in the context of a group audit? [ISA | 836.1700]

Actual or suspected fraud may be identified directly by the group auditor, or brought to its attention by a component auditor. In this regard, component auditors communicate to the group auditor significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud. When the group auditor identifies actual or suspected fraud that impacts the component, such communication is also made to the component auditor.

The group auditor communicates these matters to the appropriate level of group management.

# 1.2 Determine whether it is necessary to communicate fraud to those charged with governance [ISA | 837]

## What do we do?

IF we have identified or suspect a fraud, THEN determine whether it is necessary to communicate the matter to those charged with governance of the entity.

## Why do we do this?

We communicate identified and suspected fraud to the appropriate level of management in order to inform those with the primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. When identified or suspected fraud involves management, employees who have significant roles in internal control, or results in a material misstatement to the financial statements, we also communicate these matters to those charged with governance of the entity. Those charged with governance of an entity may also wish to be informed of actual and suspected fraud even when such matters are considered to be clearly inconsequential.

## Execute the Audit

#### When do we communicate identified or suspected fraud to those charged with governance? [ISA | 837.11703]

We communicate identified or suspected fraud to those charged with governance of the entity when:

- the identified or suspected fraud involves management;
- the identified or suspected fraud involves employees who have significant roles in internal control over financial reporting; or
- the identified or suspected fraud results in, or is expected to result in, a material misstatement in the financial statements.

What do we do when the identified or suspected fraud involves management?

When the identified or suspected fraud involves management, we communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. We do this unless the communication is prohibited by law or regulation.

## How do we communicate fraud to those charged with governance? [ISA | 837.11705]

We communicate with those charged with governance either orally or in writing, depending on the circumstances, unless specifically stated.

Even if we communicate in writing, having a dialogue with those charged with governance is a key factor in effective two-way communications.

Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, we may consider it necessary to report such matters in writing.

### What information do we include in our communication of identified or suspected fraud?

Our communications related to fraud include (i) a description of the fraud, (ii) the circumstances surrounding the fraud, and (iii) the effect of the fraud on the financial statements. Our communications may also include a description of the possible consequences of the fraud and the recommended course of action to be followed, when appropriate.

### What factors do we think about to determine the form of the communication?

We think about the following factors in determining the form of our communications:

- how significant the matter is;
- whether the matter will be included in the auditor's report;
- whether the matter has been satisfactorily resolved;
- the expectations and desires of those charged with governance, including arrangements made for periodic meetings or communications with us;
- the amount of ongoing contact and dialogue we have with those charged with governance;
- whether there have been significant turnover within those charged with governance;
- whether the nature of the matter is complex;
- our experience with the past effectiveness of oral and written communications with those charged with governance; and
- whether, in our professional judgment, oral communication is inadequate based on the circumstances.

In the case of audits of smaller entities, we may communicate with those charged with governance in a less structured manner than in the case of larger entities.

### Under what circumstances do we communicate fraud in writing to those charged with governance?

We communicate identified or suspected fraud / non-compliance with laws and regulations / illegal acts in writing to those charged with governance when:

- the fraud, has a material effect on the financial statements;
- management has not taken, and those charged with governance has not caused management to take, timely and appropriate remedial action in response to the fraud; and

- the failure to take remedial action is reasonably expected to warrant a departure from a standard auditors' report(s), when issued, or warrant withdrawal from the engagement.

What if we have doubts about the integrity or honesty of those charged with governance? [ISA | 837.11715]

When we have doubts about the integrity or honesty of those charged with governance, we may consult with legal counsel, such as OGC, to assist in determining the appropriate course of action.

# 1.3 Communicate fraud involving those charged with governance to the next higher level of authority and consult when necessary [ISA | 838]

## What do we do?

IF we suspect that those charged with governance are involved in fraud THEN communicate the matter to the next higher level of authority at the entity, if it exists and consult as necessary

## Why do we do this?

Communicating identified or suspected fraud to the next higher level of authority allows the entity to take appropriate actions in response to the identified or suspected fraud, including determining the steps necessary to investigate the matter and taking any necessary corrective actions in response to the matter.

Consulting with the appropriate parties when we are unsure as to whom to report identified or suspected fraud to or believe the communication may not be acted upon enables us to comply with the applicable laws, statutes, and regulations as well as our duties and responsibilities under professional standards and other contractual arrangements in these instances.

## Execute the Audit

Who do we communicate to when identified or suspected fraud involves those charged with governance? [ISA | 838.1400]

We communicate fraud involving those charged with governance of the entity to the next higher level of authority (if one exists). For example, when we identify fraud involving those charged with governance, we may determine that the next higher level of authority are members of the entity's audit committee or board of directors that are not suspected to be involved in the fraud.

Who do we consult with when there is no higher level of authority to communicate fraud to, we believe that the communication may not be acted upon or we are unsure as to the person to whom to report? [ISA | 838.1500]

The following table summarizes the parties we consult with based upon the KPMG member firm performing the audit and the characteristics of the client and the engagement.

| When the audit is performed by: | In accordance with the following | Involving: | Consult with: |
|---|---|---|---|

| | **auditing standards:** | | |
|---|---|---|---|
| U.S. firm | PCAOB | All clients and engagements | RPPP;<br>DPP; and<br>OGC |
| | U.S. GAAS / ISA / other auditing standards | Audits of Global accounts<br>Audits where the U.S. firm is participating, and the U.S. firm is not group auditor/lead auditor | RPPP;<br>DPP; and<br>OGC |
| | | All other clients and engagements | BUPPP - audit;<br>DPP; and<br>OGC |
| Non-U.S. firms | PCAOB / U.S. GAAS / ISA / other auditing standards | All clients and engagements | Risk Management Partner<br>Note: The Risk Management Partner is responsible for consulting with the member firm's general counsel and / or external counsel as stated under Policy 14.2.7 of the Global Quality & Risk Management Manual. Local member firms may have consultation with additional parties based on local risk management |

| | | | |
|---|---|---|---|
| | | | policies and procedures. |

### How do we document our consultation? [ISA | 838.8931]

We perform activity 'Details of the matters consulted on and the conclusions reached' to document our consultations.

# 1.4 Communicate other matters related to fraud to management and those charged with governance

[ISA | 840]

## What do we do?

Communicate other matters related to fraud that are relevant to the responsibilities of those charged with governance, including other fraud risks, if any, identified

## Why do we do this?

We communicate other fraud related matters that are relevant to the responsibilities of management and those charged with governance of the entity, including fraud risks that we identify, matters related to the entity's internal control over financial reporting, and other significant matters identified as part of our consideration of fraud during the audit. We communicate these matters as part of complying with the auditing standards and to inform those with the primary responsibility for the prevention and detection of fraud of any matters.

## Execute the Audit

### What other fraud related matters do we communicate? [ISA | 840.1300]

Other fraud related matters we communicate to management and those charged with governance include:

- other fraud risks identified as part of our risk assessment to those charged with governance, including fraud risks related to management override of controls; and
- other matters related to fraud that are, in our judgment, relevant to the responsibilities of management and those charged with governance.

Some communications may be prohibited by law or regulation.

#### What do we communicate to those charged with governance about other fraud risks identified as part of our risk assessment? [ISA | 840.11735]

We communicate fraud risks identified as part of our risk assessment.

#### What do we communicate about management override of controls to those charged with governance? [ISA | 840.11736]

We communicate the risk of management override of controls related to fraudulent journal entries and other adjustments, management bias related to accounting estimates, and significant unusual transactions that may have been entered into by the entity to engage in fraudulent financial reporting or conceal misappropriation of assets.

We also communicate other risks of management override of controls identified as part of our risk assessment.

### What other matters related to fraud may be relevant to the responsibilities of management and those charged with governance? [ISA | 840.1400]

Other matters related to fraud to be communicated to management and those charged with governance of the entity include, for example:

| Matters related to: | Communicated to: | Examples of matters: |
|---|---|---|
| Internal control over financial reporting | Management (for all control deficiencies) / those charged with governance (when the control deficiency is a significant deficiency or material weakness) | • the absence of programs or controls to address fraud risks that are significant deficiencies or material weaknesses (control activities);<br>• 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 (monitoring activities);<br>• a failure by management to appropriately address identified significant deficiencies or material weaknesses in internal control, or to appropriately respond to an identified fraud (control environment and monitoring activities);<br>• our evaluation of the entity's control environment, including concerns regarding the |

| | | |
|---|---|---|
| | | competence and integrity of management (control environment); and<br>• concerns about the adequacy and completeness of the authorization of significant unusual transactions (control activities) |
| Management bias in the selection and application of accounting principles and policies | Those charged with governance | • actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies and principles 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 |

## When do we communicate other fraud related matters? [ISA | 840.1500]

The timing of the communication will depend on the matter being communicated.

We communicate other fraud risks identified as part of our risk assessment procedures during the planning phase of our audit. Additionally, we communicate any revisions to fraud risks identified during the year in a timely manner, but no later than the date of the auditor's report.

We communicate matters related to internal control over financial reporting and matters related to management bias in the selection and application of accounting principles and policies as they arise or when they are identified. Communication of these matters occur in a timely manner, but no later than the date of the auditor's report.

## How do we communicate other fraud related matters? [ISA | 840.1600]

Templates for letters used to communicate other fraud related matters can be found on Alex https://alex.kpmg.com/AROWeb/document/top/Intl_AuditCommitteeToolkit.

# 1.5 Identify whether certain fraud related matters represent significant deficiencies or material weaknesses [ISA | 841]

## What do we do?

Identify whether certain fraud related matters represent significant deficiencies. Communicate all deficiencies we identify to management and deficiencies that represent significant deficiencies to both management and those charged with governance.

## Why do we do this?

Fraud risks represent significant risks at the entity.

## Execute the Audit

### When can control deficiencies related to fraud risks arise? [ISA | 841.1400]

Control deficiencies related to fraud risks can arise at various times throughout the audit such as:

| When: | Type(s) of deficiency we identify: |
| --- | --- |
| We identify fraud risks that have continuing control implications as part of our risk assessment process. Continuing control implications means when a deficiency in an anti-fraud control is not remediated in a timely manner. | Deficiency in the entity's risk assessment process or could be an indicator of a more severe deficiency assessment |
| We identify fraud risks that were not identified or considered by the entity as part of their fraud risk assessment process. | Deficiency in the entity's fraud risk assessment process |
| We determine that the design and/or implementation of certain process control activities is not appropriate given the identified fraud risk. | Deficiency in the design and/or implementation of the control |
| We test the operating effectiveness of process control activities that are intended to address fraud risks as part of our response to the fraud risk and the control is not operating as designed. | Deficiency in the operating effectiveness |

| | |
|---|---|
| We identify control deficiencies related to misstatements identified as part of the audit. | One or a combination of any of the above. |

### What do we do if we identify continuing control implications during our risk assessment process? [ISA | 841.13297]

When we identify a continuing control deficiency during our risk assessment process, we evaluate the severity of the deficiency to determine whether it represents a significant deficiency.

## How do we identify control deficiencies related to an entity's fraud risk assessment process? [ISA | 841.13318]

We may identify deficiencies in the entity's fraud risk assessment process when we understand and evaluate the entity's risk assessment process , including how the entity considers fraud when assessing risks (Element 8).

We may also identify control deficiencies related to an entity's fraud risk assessment process when we understand the results of the entity's risk assessment process.

### What if we identify a deficiency when obtaining an understanding of the fraud risk assessment process? [ISA | 841.13319]

When we identify a deficiency when obtaining an understanding of the risk assessment process, we:

- identify and evaluate the severity of the deficiency in the entity's fraud risk assessment process (part of the risk assessment component of ICFR); and
- determine whether there are related deficiencies in the entity's process control activities (part of the control activities component of ICFR) based on whether the deficiency in the entity's fraud risk assessment process resulted in additional fraud risks that were not identified and considered by the entity.

### What if we identify additional fraud risks that were not identified and considered by the entity? [ISA | 841.13320]

When we identify additional fraud risks that were not identified or considered by the entity as part of their fraud risk assessment process, we:

- determine whether these differences represent a deficiency in the entity's risk assessment process (part of the risk assessment component of ICFR) and evaluate the severity of the deficiency when a deficiency is identified.
- identify and evaluate the severity of the related deficiency in the entity's process control activities (part of the control activities component of ICFR) as a result of the failure to identify the fraud risk as part of their risk assessment process.

## What is a design deficiency related to anti-fraud process control activities? [ISA | 841.13313]

A design deficiency related to an anti-fraud process control activity exists when a process control activity necessary to address a process risk point (PRP) related to a fraud risk is missing or the design of the control is insufficient to address a PRP at an appropriate level of precision to effectively prevent or detect fraud that could result in material misstatements in the financial statements. Often, the design deficiency relates to a breakdown in the Risk Assessment component of internal control over financial reporting (ICFR).

#### What is an operating effectiveness deficiency related to an anti-fraud process control activity? [ISA | 841.13314]

An operating effectiveness deficiency related to an anti-fraud process control activity exists when a process control activity necessary to address a PRP related to a fraud risk is effectively designed, but the control activity was not performed as designed or by a person that possesses the necessary authority and competence to perform the control activity effectively. When we identify a deficiency in the operating effectiveness of a control, we ask ourselves if management's monitoring function detected the deficiency as well, and if not, why not?

#### How do we evaluate the severity of control deficiencies? [ISA | 841.13315]

We perform the activity "Identify and evaluate control deficiencies".

#### Do we communicate control deficiencies related to the entity's fraud risk assessment process to management? [ISA | 841.13316]

Yes. We communicate the deficiencies we have identified, including those related to the entity's fraud risk assessment process, to management.

#### Do we communicate control deficiencies related to the entity's fraud risk assessment process to those charged with governance? [ISA | 841.13317]

When the severity of a deficiency we have identified, including those related to the entity's fraud risk assessment process, is determined to result in a significant deficiency (for all audits) or a material weakness (for PCAOB and U.S. GAAS audits), we communicate the deficiency to those charged with governance of the entity.

# 1.6 Determine whether we have a responsibility to report fraud to parties outside the entity [ISA | 843]

## What do we do?

IF we identify or suspect a fraud, THEN determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity

## Why do we do this?

We determine whether or not we have a responsibility to report identified or suspected fraud to parties outside of the entity, in order to comply with laws and regulations, professional standards, and contractual arrangements.

## Execute the Audit

#### What do we do to report fraud to parties outside the entity? [ISA | 843.11738]

When we report fraud to parties outside the entity we:

- Consult with the appropriate parties when considering disclosure of fraud to parties outside the entity

- Disclose identified or suspected fraud to relevant external parties

### How do we determine whether we have a responsibility to report identified or suspected fraud to parties outside of the entity? [ISA | 843.1300]

Our professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected fraud to a party outside of the entity.

In certain circumstances, our professional duty to maintain the confidentiality of client information may be overridden by statute, regulation, courts of law, professional standards, specific requirements of audits of entities that receive government financial assistance, or waived by agreement. In some circumstances, we have a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some circumstances we have a duty to report identified or suspected fraud to authorities in those cases where management and those charged with governance fail to take corrective action.

For example, when we perform an audit in accordance with Government Auditing Standards, we report identified or suspected fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, or abuse directly to parties outside the audited entity in the following two circumstances:

(a) When management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, we first communicate the failure to report such information to those charged with governance. If the entity still does not report this information to the specified external parties in a timely manner after our communication with those charged with governance, then we report the information directly to the specified external parties.
(b) When entity management fails to take timely and appropriate steps to respond to identified or suspected fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, or abuse that (i) is likely to have a material effect on the financial statements and (ii) involves funding received directly or indirectly from a government agency, we first report management's failure to take timely and appropriate steps to those charged with governance. If the entity still does not take timely and appropriate steps in a timely manner after our communication with those charged with governance, then we report the entity's failure to take timely and appropriate steps directly to the funding agency.

For example, when we perform an audit of an issuer in accordance with PCAOB auditing standards, we communicate identified or suspected fraud the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to identified or suspected fraud that has been detected or have otherwise comes to our attention during the audit, unless the illegal act is clearly inconsequential in order to comply with Section 10A of the Securities Exchange Act of 1934. If we conclude that the identified or suspected fraud:

(a) has a material effect on the financial statements of the issuer;
(b) senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the identified or suspected fraud; and

(c) the failure to take remedial action is reasonably expected to warrant departure from a standard auditors' report, when made, or warrant resignation from the audit engagement;

we, in a timely manner, directly report this conclusion to the board of directors.

An issuer whose board of directors receives a report from us informs the Securities Exchange Commission (SEC) by notice not later than 1 business day after the receipt of such report and furnishes us with a copy of the notice furnished to the SEC. If we do not receive a copy of the notice before the expiration of the 1-business-day period, we furnish to the SEC a copy of our report.

#### When do we consider whether we have a responsibility to report identified or suspected fraud to parties outside of the entity? [ISA | 843.1400]

We consider whether we have a responsibility to communicate identified or suspected fraud to other parties when any identified or suspected fraud has been identified or brought to our attention as part of the audit. We do this regardless of whether the matter is considered clearly inconsequential.

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

#### Who is involved in determining whether we have a responsibility to report identified or suspected fraud to parties outside of the entity? [ISA | 843.1500]

When we determine whether we have a responsibility to report identified or suspected fraud to parties outside of the entity often involves interpretation of laws and regulations and terms contained within contractual agreements, we often involve individuals such as the Office of General Counsel or the Risk Management Partner. These individuals help us to determine the appropriate course of action and ascertain the steps necessary in considering the public interest aspects of identified or suspected fraud.

# 1.6.1 Consult with the appropriate parties when considering disclosure of fraud to parties outside the entity [ISA | 844]

## What do we do?

Consult with the appropriate parties when we are considering disclosure of identified or suspected fraud to parties outside the entity

## Why do we do this?

Consulting with the appropriate parties when we are considering disclosure of fraud to parties outside the entity enables us to comply with the applicable laws, statutes, and regulations as well as our duties and responsibilities under professional standards and other contractual arrangements in these instances.

# Execute the Audit

## Who do we consult with when considering communication or disclosure of fraud to parties outside the entity? [ISA | 844.1300]

We consult with the appropriate parties prior to communicating or disclosing fraud to parties outside of the entity. The parties we consult with will depend upon the location of the audit and the characteristics of the client and engagement.

The following table summarizes the parties we consult with based upon the KPMG member performing the audit and the characteristics of the client and the engagement.

| When the audit is performed by: | In accordance with the following auditing standards: | Involving: | Consult with: |
|---|---|---|---|
| U.S. firm | PCAOB | All clients and engagements | RPPP;<br>DPP; and<br>OGC |
| | U.S. GAAS / ISA / other auditing standards | Audits of Global accounts<br>Group audits where the group auditor is not the U.S. firm | RPPP;<br>DPP; and<br>OGC |
| | | All other clients and engagements | BUPPP - audit;<br>DPP; and<br>OGC |
| Non-U.S. firms | All auditing standards | All clients and engagements | Risk Management Partner<br>Note: The Risk Management Partner is responsible for consulting with the member firm's general counsel and / or external counsel as required under Policy 14.2.7 of the Global Quality |

| | | | |
|---|---|---|---|
| | | | & Risk Management Manual. Local member firms may require consultation with additional parties based on local risk management policies and procedures. |

How do we document our consultation? [ISA | 844.8931]

We perform activity 'Details of the matters consulted on and the conclusions reached' to document our consultations.

# 1.6.2 Disclose identified or suspected fraud to relevant external parties [ISA | 845]

## What do we do?

After consulting with the appropriate parties, disclose the existence of possible fraud to relevant external parties when our legal responsibility overrides our responsibility to maintain client confidentiality

## Why do we do this?

If we determine we have a responsibility to communicate identified or suspected fraud to other parties outside of the entity after consulting, we communicate the matter to relevant other parties in order to comply with relevant laws and regulations, professional standards, and contractual arrangements. The form and timing of our communication will likely depend on the statute, laws, regulations, professional standards, or contractual arrangements requiring such communication.

## Execute the Audit

How do we communicate identified or suspected fraud to a party outside the entity? [ISA | 845.1300]

The nature and content of communications to parties outside of the entity will generally be dictated by the laws or regulations or contractual arrangements that require the communication. As a result, we work closely with our local risk management group. The nature of the communication refers to the form of the communication being made (e.g., written or oral), whereas the content refers to the information that is included within the communication.

Our communication of fraud may be written or oral when the laws or regulations that require us to communicate do not specify.

SEC Registrant | How do we communicate Section 10A matters to the SEC?

We submit a notice to the SEC under Section 10A of the Securities Exchange Act via a PDF document through e-mail to a dedicated electronic mailbox at 10Aletters@sec.gov. The staff will accept the date of the e-mail as the notification date. If the notice is sent by e-mail, a paper copy is sent promptly by mail.

#### What information do we include in our communication of identified or suspected fraud to a party outside the entity? [ISA | 845.1400]

When determining the content to be included within the communication, we act in good faith and exercise caution when making statements and assertions.

We also consider whether it is appropriate to inform the client, including management and those charged with governance of the entity, regarding our intentions to disclose the matter to other parties outside of the entity.

#### When do we communicate identified or suspected fraud to a party outside the entity? [ISA | 845.1500]

The timing of communications to parties outside of the entity will generally be dictated by the laws or regulations that require the communication. Some laws or regulations will stipulate a period within which such communications are to be made.

Regardless of whether the laws or regulations or contractual arrangements stipulate a period within which communications are to be made, we communicate to outside parties in a timely manner after consulting with the appropriate parties.

##### What if we become aware of fraud that constitutes an imminent breach of law or regulation?

In exceptional circumstances, we may become aware of identified or suspected fraud that we have reason to believe constitutes an imminent breach of a law or regulation that causes substantial harm to investors, creditors, employees or the general public. We may determine it is necessary to immediately disclose the matter to an appropriate authority in order to prevent or mitigate the consequences of such imminent breaches of laws and regulations.

##### SEC Registrant | When do we communicate Section 10A matters to the SEC?

A client that receives our report under Section 10A of the Securities Exchange Act notifies the SEC within one business day after its receipt and to send a copy of that notice to us. If we do not receive a copy of that notice within the one-day period, whether or not we resign, we furnish our report to the SEC within one business day after the failure of the client to give its required notice.

# Documentation

## International Standards on Auditing: ISA 240.45-48

### Documentation

45. The auditor shall include the following in the audit documentation[12] of the identification and the assessment of the risks of material misstatement required by ISA 315 (Revised 2019):[13]

(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;

(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level; and

(c) Identified controls in the control activities component that address assessed risks of material misstatement due to fraud.

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12 ISA 230, *Audit Documentation,* paragraphs 8 - 11, and paragraph A6

13 ISA 315 (Revised 2019), paragraph 38

46. The auditor shall include the following in the audit documentation of the auditor's responses to the assessed risks of material misstatement required by ISA 330:[14]

(a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and

(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

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14 ISA 330, paragraph 28

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

48. If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall include in the audit documentation the reasons for that conclusion.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Discuss the potential for material misstatement due to fraud [ISA | 554]

## What do we do?

Discuss the potential for material misstatement due to fraud.

## Why do we do this?

A material misstatement due to fraud could be present, regardless of our past experience with the entity and regardless of our belief about management's honesty and integrity.

Questioning what we think we know, particularly in an open discussion, may highlight risks of fraud that we would not otherwise have considered. In addition, brainstorming encourages us to share views and may generate new ideas about fraud risk.

# Execute the Audit

### When do we discuss the potential for material misstatement due to fraud? [ISA | 554.1300]

Our discussion about fraud doesn't have to take place as part of the risk assessment and planning discussion (RAPD). We may discuss RMMs due to error separately from fraud risks. However, it's usually more convenient to hold the two discussions together — especially as all of the relevant members are already participating.

Also, a fraud risk may relate to the same account or disclosure as a risk due to error. So, given how the risks may interrelate, discussing the risks at the same time may be more effective.

If we decide to discuss fraud separately from the RAPD, we conduct our discussion in a very similar manner - i.e., with similar attendees and documentation. Regardless of how or when this happens, we hold a robust discussion about the potential for material misstatement due to fraud.

### How do we prepare for and participate in the fraud discussion? [ISA | 554.1400]

To make the discussion more effective, it may be useful to inspect items that help us to brainstorm — including:

- our past audit experience with the entity
- current-period information obtained during planning
- experience on other audits
- KPMG guidance and training
- the entity's internal fraud risk assessment
- the entity's board minutes
- the entity's earnings calls and press releases.

These can help identify matters and events that are relevant to considering risks of fraud.

### What ideas do we exchange about the possible occurrence of fraud? [ISA | 554.1500]

When we discuss the potential for material misstatement due to fraud, it's helpful to start with understanding the three categories of fraud risk factors (i.e., 1. Incentive / Pressure, 2. Attitude or Rationalization, 3. Opportunity), which forms the fraud triangle (refer to activity on identifying fraud risk factors for further discussion on the fraud risk factors and illustration of the fraud triangle). Then brainstorming how and where we believe the entity's financial statements (including individual statements and disclosures) may be susceptible to fraud. We specifically exchange ideas about:

- how and where management could perpetrate and conceal fraudulent financial reporting;
- how the entity's assets could be misappropriated;
- the susceptibility of the financial statements to material misstatement through related party transactions;
- how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;
- how the financial statements could be manipulated through management bias in accounting estimates in significant accounts and disclosures;

- what incentives, pressures or opportunities are present to enable fraud;
- whether management could rationalize committing fraud;
- circumstances that might indicate earnings management or manipulation of other financial measures; and
- practices that management might follow to manage earnings or manipulate other financial measures.

### How do we exchange ideas about the possible occurrence of fraud? [ISA | 554.1600]

The exchange of ideas works in combination with thinking about fraud risk factors and fraud risks. Our discussions are intended to be an iterative process among team members in which we exchange ideas and information.

These discussions go beyond simply inspecting a list of fraud risks from the prior period and confirming which of them still apply to the current period. We do include considerations from prior periods, but we use a fresh lens to identify and assess:

- new circumstances that might indicate the potential for fraud; and
- when fraud risks may have changed.

All participants bring their thoughts to the table and discuss the fraud risks that may exist for the current period audit.

> Suppose that an audit manager on the engagement team knows that the entity is implementing a new payroll system during the fourth quarter of its fiscal year.
>
> They also know, from past audits, that the entity has previously given inappropriate access to users during system implementations, and didn't promptly revoke that access after implementation.
>
> Therefore, the engagement team may discuss the potential for a fraud risk in the current period over inappropriate access to the new payroll system implemented. This information may help the team discuss fraud risks in the current period that weren't fraud risks in the prior period.

### What do we emphasize to all engagement team members during our fraud discussions? [ISA | 554.1700]

During our discussion of fraud risk, we stress to all engagement team members that throughout the audit we:

- maintain a questioning mind and exercise professional skepticism in gathering and evaluating evidence;
- remain alert for information or other conditions that might affect our assessment of fraud risks — e.g. contradictory or inconsistent evidence; and
- consider any contradictory or inconsistent information we identify by:
  - probing the issues;
  - obtaining additional evidence, as necessary; and
  - consulting with other team members and others in the firm — including specialists and/or specific team members, if appropriate.

#### Why do we consider contradictory or inconsistent information? [ISA | 554.11533]

Contradictory or inconsistent information identified during the audit may suggest other fraud risks that we haven't yet identified or, possibly, actual instances of fraud.

If we gather evidence that is inconsistent or seems to contradict our initial conclusions, we do not want to — nor is it appropriate for us to — brush it off or stop there.

To reach a conclusion about the matter, we probe, obtain additional evidence and involve others.

It is helpful to remind engagement team members of the matters that might affect our assessment of fraud risks.

### Why do we set aside prior beliefs about management's honesty and integrity and maintain a questioning mind? [ISA | 554.1800]

Sometimes, we can develop a high degree of trust or confidence in management, which can have negative consequences. For example, we do not just accept management representations at face value but corroborate them and seek both confirming and disconfirming evidence.

Our goal is to approach our fraud discussion with the mindset that a material misstatement due to fraud could be present, regardless of our past experience with the entity and our belief about management's honesty and integrity.

In practice, this means that:

- we assume that management are neither honest nor dishonest; and
- we don't trust management blindly, or without gathering and objectively evaluating evidence, where appropriate.

We act with professional skepticism.

This questioning frame of mind allows us to carefully and objectively consider areas where there is potential for material misstatement due to fraud.

### What do we focus on when discussing the risk of material misstatement from related party relationships and transactions? [ISA | 554.1900]

Our RAPD may include the following matters in relation to related party relationships and transactions.

- The nature and extent of the entity's relationships and transactions with related parties — using, for example, our record of identified related parties, which we update after each audit.
- An emphasis on maintaining professional skepticism throughout the audit about the potential for material misstatement from related party relationships and transactions.
- Entity-specific circumstances that may indicate related party relationships or transactions that management has not identified or disclosed to us — for example:
  - a complex organizational structure;
  - use of special-purpose entities for off-balance sheet transactions; or
  - an inadequate information system.
- Records or documents that may indicate related party relationships or transactions.
- The importance that management and those charged with governance attach to:
  - identifying, appropriately accounting for, and disclosing related party relationships and transactions (if the entity is subject to related party accounting and disclosure requirements); and

- the related risk of management override of relevant controls.

### Why do we discuss related party relationships and related party transactions? [ISA | 554.2000]

Transactions with related parties are common, but they may give rise to fraud risks. This is because related parties are not independent of each other. For example:

- special-purpose entities controlled by management might be used for earnings management; or
- transactions could be arranged between the entity and the business partner of a key member of management, to misappropriate the entity's assets.

### Why do we discuss the risk of management override, and what do we discuss? [ISA | 554.2100]

We discuss risk of management override because:

- fraud can be perpetrated through override of management's controls; and
- this risk is present in all entities.

We put aside beliefs we have had in prior periods and discuss thoroughly where we believe the risk of management override may occur in the current period.

Entities operate in a dynamic environment, so significant changes may have occurred from prior periods, especially significant changes in the entity — e.g. new revenue streams, new management, or new pressures or incentives — that may change or elevate the risks of management override that existed in prior periods.

### Why do we discuss our potential audit responses to fraud? [ISA | 554.2200]

Discussing our potential audit responses to fraud — including the nature, timing and extent of procedures — can help us better identify and assess fraud risks.

This discussion will also help us begin to formulate our audit plan, including detailed audit procedures to address these fraud risks.

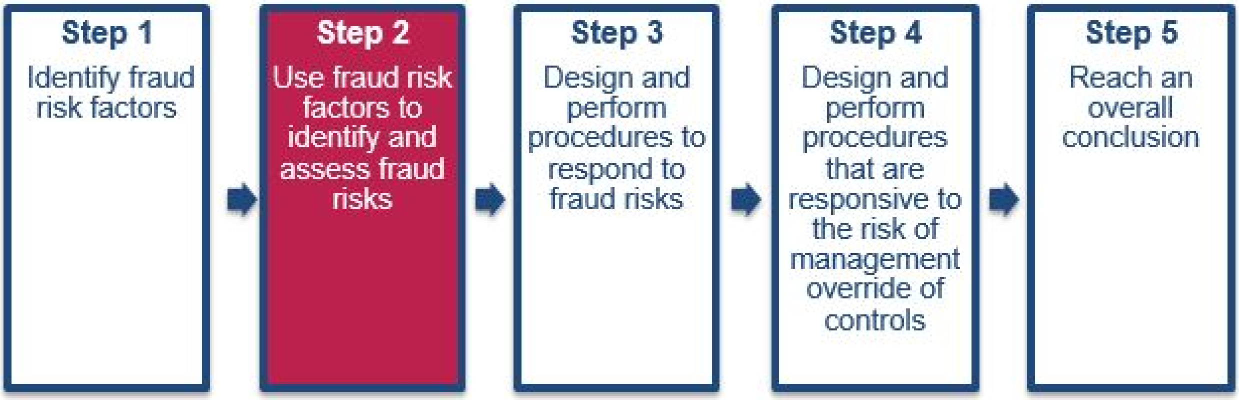
# 2 Use fraud risk factors to identify and assess fraud risks [ISA | 570]

## What do we do?

Take the fraud risk factors identified into account when identifying and assessing fraud risks

## Why do we do this?

Now that we have identified the fraud risk factors that are relevant to the entity, we next evaluate these factors to identify the fraud risks relevant to our audit. This affects our audit response, so we give it careful consideration. However, identifying fraud risk factors does not necessarily mean that fraud exists or will eventually occur.




# Execute the Audit

### How do we identify fraud risks? [ISA | 570.1300]

We apply professional judgment to our experience and knowledge of the entity as we evaluate whether the identified fraud risk factors, individually or in combination, indicate that a fraud risk is present.

As part of this evaluation, we ask ourselves:

**How could fraud be perpetrated given the fraud risk factors?**

When we answer this question, we consider the types of misstatements that could arise. This helps us better identify and define the fraud risk.

Our analysis includes thinking about those accounts that could be misstated or manipulated. We also consider how an individual could perpetrate or conceal fraud by presenting incomplete or inaccurate disclosures, or by omitting necessary disclosures.

Remember: fraud is not always the result of a grand plan or conspiracy, and can often be difficult to spot. For example, management may commit fraud by rationalizing an overly aggressive accounting position in a judgmental accounting area, as opposed to doing something that clearly violates an accounting rule. Or, management could commit fraud by simply creating a temporary misstatement that they expect to correct later when operational results improve.

### When do we identify fraud risks? [ISA | 570.11467]

The risk assessment is ongoing throughout the audit, following the initial assessment.

### How does this activity relate to the RMs we identified earlier in the audit? [ISA | 570.1400]

When we identify risks of misstatement (RMs) , we consider all of the information that might indicate a risk. This includes risks related to both error and fraud.

We may have already identified and assessed an RMM that represents a fraud risk during our risk assessment procedures. Evaluating the fraud risk factors could:

- confirm our assessment; or

- lead us to identify a fraud risk that we had not yet identified.

## Are we looking to identify all fraud risks? [ISA | 570.1500]

We don't necessarily seek to identify every instance of fraud across the entity. Our aim is to focus on and identify those risks with a reasonable possibility that the financial statement effect could be material.

This includes thinking about both quantitative and qualitative factors. For example, misstatements resulting from fraud may be considered material, even when they are less than the materiality we established for the audit, because of qualitative factors.

## Will every fraud risk factor we identify result in a fraud risk? [ISA | 570.1600]

No. Identifying fraud risk factors does not necessarily mean that fraud exists or will eventually occur. However, these factors are often present when fraud exists.

### How might a fraud risk factor not result in a fraud risk? [ISA | 570.11468]

Consider a small entity with limited controls and segregation of duties. The *opportunity* for fraud may exist — however, the engagement team may conclude that no fraud risk exists if:

- there is no incentive — e.g. the business is small, without pressures, and has one primary owner; and
- management's attitude does not foster fraud — e.g. there is an ethical business culture.

### How might only one or two fraud risk factors contribute to fraud risk? [ISA | 570.11469]

Assume the same facts as in the previous example. However, this time the engagement team have identified a single fraud risk factor that most executive management salaries are exclusively tied to earnings. If certain earnings targets are not met, management receive an extremely low salary.

Here, the team might conclude that despite management's ethical attitude and a strong control environment, the incentive is so great that it, alone, indicates the presence of a fraud risk - especially when the earnings targets are aggressive.

## What types of misstatements are relevant to our consideration of fraud risks? [ISA | 570.1700]

Two basic types of misstatements are relevant when we consider fraud risks.

| Type | Description | How it's accomplished |
| --- | --- | --- |
| **Fraudulent financial reporting** | Intentional misstatements or omissions of amounts or disclosures designed to deceive financial statement users | • Manipulating, falsifying or altering accounting records or supporting documentation<br>• Misrepresenting or intentionally omitting events, transactions or other significant information from the financial statements<br>• Intentionally misapplying accounting policies or principles |

| | | |
|---|---|---|
| **Misappropriation of assets** | Theft of an entity's assets, causing the financial statements to be misstated | • Embezzling receipts<br>• Stealing assets<br>• Causing an entity to pay for goods or services that have not been received and may be accompanied by false or misleading records or documents, possibly created by circumventing controls |

## What do we consider when identifying and describing fraud risks? [ISA | 570.1800]

The table below sets out principles we may consider when identifying and describing fraud risks.

| Basic principle | Discussion |
|---|---|
| **Document the link between fraud risk factors and identified fraud risks** | Fraud risk factors help us identify fraud risks, so we evidence how each fraud risk factor is associated with an identified fraud risk(s).<br>This includes providing a rationale for fraud risk factors that didn't lead us to identify a fraud risk. Evidencing this thought process helps us demonstrate that our risk assessment process was thorough, and how we applied professional skepticism in the audit. |
| **Be specific in defining each fraud risk** | As with any risk, we define fraud risks in a manner that is not overly broad or too narrow. Our description aims to capture the nature of the fraud risk and make it easy to see the types of potential misstatements that could arise from it. Specifying the nature of the fraud risk helps us design audit procedures that respond to it.<br>And thinking about the components of a particular significant account or disclosure may help us to better define the fraud risk. We specify whether the fraud risk relates to the entire significant account/disclosure or a certain subset of transactions within the account.<br>A fraud risk may not always apply to the entire entity. In those cases, we also specify the locations or business units where the fraud risk is present and relevant to the audit. |
| **Link fraud risks to the specific accounts, disclosures, and assertions affected** | When we link the risk to the specific accounts, disclosures and assertions that it could affect, we are able to provide a clear link to our audit response. |

| | |
|---|---|
| | In the unusual case that we cannot associate a fraud risk with a specific set of account(s)/disclosure(s), and assertions, we may have identified an overly broad fraud risk. |
| **Don't just stop at one** | We don't necessarily stop once we have identified one fraud risk. We consider *all* of the fraud risk factors and whether they suggest that other fraud risks may also be present. |

#### What do we do for those fraud risk factors that don't result in a fraud risk? [ISA | 570.11470]

A fraud risk factor doesn't always lead to a fraud risk. In these instances, we document our rationale as to why that was the case.

Evidencing this thought process helps us demonstrate that our risk assessment process was thorough, and how we applied professional skepticism in the audit.

#### When might a fraud risk be overly broad or too narrow? [ISA | 570.11471]

The table below sets out some examples of fraud risks that are overly broad or too narrow, alongside appropriately defined fraud risks.

| Example of overly broad or too narrow fraud risk | Example of appropriately specific fraud risk |
|---|---|
| Risk of fraud over revenue recognition due to rebuttable presumption (Overly broad) | Using side agreements to sell Product A could alter the terms and conditions of recorded sales transactions and may result in a risk of overstatement of revenue recognized |
| Risk of overstating net income by understating expenses related to manufacturing employee incentive compensation (Too narrow) | Understating the accrual for annual employee incentive costs for all eligible employees may result in a risk of overstatement of net income |

#### How might portions of an account or class of transactions help us identify a fraud risk? [ISA | 570.11472]

**Fact pattern:**

A manufacturing entity sells only one product and recognizes revenue on all sales transactions when ownership and legal title have transferred.

It records all revenue transactions in a single significant account (revenue). However, there are different shipping terms for different transactions within the account — e.g. FOB shipping versus FOB delivery.

**Analysis:**

Here, we may determine that different transaction types within the significant account are subject to slightly different risks.

We may identify a fraud risk factor related to management's incentive to manipulate revenue cut-off — i.e. the period in which it recognizes revenue. However, considering the risks for each type of transaction may lead us to identify a fraud risk over period-end revenue recognition, but only for FOB delivery transactions.

This is a narrower risk, resulting from the increased opportunity for management to manipulate the timing of revenue recognition for those specific transactions.

### How do we consider the risk of omitted, incomplete or inaccurate disclosures? [ISA | 570.1900]

As we evaluate fraud risk factors, we remember that an entity can perpetrate or conceal fraud by presenting incomplete or inaccurate disclosures, or by omitting necessary disclosures.

It can often be more challenging to identify disclosures that are misstated than amounts recorded in the financial statements. This is because the wording or presentation of a disclosure can often be subjective or prepared in more than one way. So, it can sometimes be easier for management to commit and conceal fraud by manipulating or omitting disclosures.

As part of our risk assessment procedures, we develop expectations about the disclosures necessary for the entity's financial statements to be presented fairly to conform with the applicable financial reporting framework. Our expectations can be particularly helpful when we consider the possible fraud risks. This is especially true of those disclosures that are more subjective or provide increased opportunities to perpetrate fraud.

When we assess the risk of omissions of, or incomplete or inaccurate, disclosures, we are particularly concerned with the risks that:

- disclosures may intentionally contain insufficient information, or omit relevant facts — e.g. they fail to disclose a significant claim against the entity;
- disclosures may be intentionally inaccurate — e.g. segment data is altered to hide the fact that a prominent segment incurred a significant loss; and
- the entity may deliberately disclose too much to distract the reader from what the entity wants to obscure — e.g. many trivial and less important details make it hard to understand the amount of a particular claim, and the potential risk to the entity.

### What are common types of fraud risks that we may consider? [ISA | 570.2000]

A common area of fraud risk is revenue recognition. In fact, we presume a fraud risk related to improper revenue recognition.

Other common fraud risks include:

- manipulating cost of goods sold or other expenses, which may be understated/deferred to later periods to achieve current earnings targets
- inappropriately capitalizing costs to present higher net income
- intentionally not recognizing expenses/liabilities by not consolidating an entity that meets the accounting criteria to be consolidated
- intentionally recognizing assets in the wrong period or when they have not met all the recognition criteria from the accounting framework
- using inappropriate assumptions in estimates to intentionally understate costs/liabilities
- intentionally not recognizing impairment losses on impaired assets.

# Examples

## How might fraud risk factors contribute to fraud risk? [ISA | 570.2100]

**Scenario 1 | Pressure to meet analyst expectations**

**Fact pattern:**

An entity is preparing its period-end financial statements. Several analysts have documented that its business is booming.

Over the last few periods, the entity has experienced a slowdown, but is still under significant pressure to meet analysts' expectations. It derives its revenue from construction contracts that include variable consideration.

Estimating this variable consideration involves judgments and subjectivity from management. Based on past experience, we know that management have a history of taking more aggressive positions when determining these estimates.

**Analysis:**

When the engagement team analyze this set of facts and circumstances, they may identify these risk factors:

| Category | Identified risk factor |
|---|---|
| Incentive or pressure | The recent slowdown, combined with the strong analyst focus, could create an incentive for management to manipulate earnings |
| Opportunity | The estimated variable consideration, which is based on subjective estimates, provides an opportunity for the entity to manipulate the estimates/judgments and materially affect earnings |
| Attitude or rationalization | Management's past attitude of aggressive forecasting and estimating sets the stage for potential rationalization of manipulating revenue |

The team may therefore conclude that a fraud risk exists over the Valuation/Allocation assertions of estimated variable consideration, since the inputs into the variable consideration calculation depend on management estimates.

**Scenario 2 | Additional financing needed for a business expansion**

**Fact pattern:**

The entity has a fully-drawn, revolving credit facility with a community bank. The amount that the entity may borrow under the facility — i.e. the borrowing base — is based on the net inventory balance recorded at December 31.

Through their risk assessment procedures, the engagement team learn that the entity plans to expand its business, financed through additional borrowings under the revolving facility. Management therefore need a large enough inventory balance at December 31 to enable them to increase the borrowing base of the facility, and to allow for additional borrowing. Management have often stated that their expansion plans will provide a huge benefit to shareholders.

**Analysis:**

When the engagement team analyze this set of facts and circumstances, they may identify the following risk factors.

| Category | Identified risk factor |
|---|---|
| Incentive or pressure | The entity is relying on an increase in the borrowing base of the credit facility for additional financing, which is critical for its expansion plans. Therefore, the entity has an incentive to overstate its inventory balance. |
| Opportunity | The inventory balance is based on several variables, including:<br>• the physical inventory on hand;<br>• the recorded price/value of the inventory items; and<br>• the amount of the inventory reserve (which offsets the gross value of inventory).<br>There is therefore an opportunity to manipulate and misstate the inventory balance by intentionally adjusting the results of the inventory count, altering the inventory pricing, or manipulating the inventory reserve (which is based on judgment). |
| Attitude/rationalization | Management may try to rationalize their actions by saying that the funding is necessary for expansion, which is in the shareholders' best interest. |

The team may therefore conclude that fraud risks exist related to the Existence and Valuation assertions of inventory recorded as of the period end.

# 3 Design and implement overall responses [ISA | 782]

## What do we do?

Design and implement overall responses to address the risks of material misstatement

## Why do we do this?

Overall responses lay the foundation for the rest of our audit procedures. They also act together with our assertion-level responses to help us obtain sufficient appropriate audit evidence. Overall responses affect how the overall audit is conducted and performed. Whereas, assertion-level responses relate to the nature, timing and extent of the procedures we perform over each assertion-level RMM.

If we fail to design and implement an appropriate overall response to the audit, our assertion-level responses are unlikely to meet our audit objective.

## Execute the Audit

### What are overall responses? [ISA | 782.1300]

We may design and implement two different types of overall responses.

| Type of response | Responses |
|---|---|
| **General overall responses** | • Assigning significant engagement responsibilities appropriately<br>• Providing appropriate supervision<br>• Selecting audit procedures with elements of unpredictability<br>• Evaluating the entity's selection and application of significant accounting policies or principles |
| **Other overall responses** - e.g. how we respond to identified pervasive financial statement-level risks | • Making pervasive or general changes to the nature, timing and extent of our audit procedures |

### When do we design and implement overall responses? [ISA | 782.11520]

We always perform the following overall responses to respond to the assessed risks of material misstatement on every audit, regardless of whether we have identified an entity specific financial statement level risk or not:

- Making appropriate assignments of significant engagement responsibilities. The knowledge, skill, and ability of engagement team members with significant engagement responsibilities is to be commensurate with the assessed risks of material misstatement.

- Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.
- Incorporating elements of unpredictability in the selection of audit procedures to be performed. As part of our response to the assessed risks of material misstatement, including the assessed fraud risks, we incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year.
- Evaluating the entity's selection and application of significant accounting policies or principles. We evaluate whether the entity's selection and application of significant accounting policies or principles, particularly those related to subjective measurements and complex transactions, are indicative of bias that could lead to material misstatement of the financial statements.

Overall responses can also help us address risks of material misstatement at the financial statement level and **assertion-level**.

#### Can a specific overall response address multiple financial statement level risks?

Yes.

### What effect might the control environment have on our overall responses? [ISA | 782.11521]

An effective control environment may allow us to have more confidence in both internal controls and the reliability of audit evidence generated within the entity.

This can affect our assessment of RMMs and how we respond to them. For example, we may be able to perform some audit procedures at an interim date rather than at the period end.

Deficiencies in the control environment, however, have the opposite effect. For example, we may respond to an ineffective control environment by:

- conducting more audit procedures as of the period end rather than at an interim date;
- obtaining more extensive audit evidence from substantive procedures; and/or
- including more locations in the scope of our audit.

Such considerations, therefore, have a significant bearing on our general approach - for example, whether we take:

- a substantive approach - i.e. placing an emphasis on substantive procedures; or
- a combined approach - i.e. using tests of controls as well as substantive procedures.

### How are overall responses different from assertion-level responses? [ISA | 782.1500]

Overall responses affect how we conduct the audit broadly. Assertion-level responses are more specific than overall responses, as they focus on tests of controls and substantive procedures designed to address assertion-level RMMs.

### Why do we apply both overall and assertion-level responses? [ISA | 782.1600]

To illustrate why we apply both overall and assertion-level responses to appropriately respond to risks, consider this non-financial example.

> In our daily lives, we often perform activities whose success depends on a combination of both overall and specific approaches. Consider gardening, for example. We take some actions that are

intended to affect only certain plants, such as pruning, relocating a plant to get more or less sun, or watering selectively.

However, we also act in ways that are intended to affect the entire garden. We might change the soil, apply fertilizer or adjust the overall watering schedule. Ultimately, the combination of both types of activity is what helps us maintain a healthy garden.

# 4 Design and perform procedures to address each assertion-level RMM due to fraud [ISA | 789]

## What do we do?

Design and perform procedures to address risks of material misstatement due to fraud at the assertion level

## Why do we do this?

We design and perform procedures that are specifically responsive to our identified risks of material misstatement due to fraud (i.e. fraud risks) at the assertion level to gather sufficient appropriate audit evidence related to those risks. Given that fraud often involves attempts by the perpetrator to conceal the fraud, we design the nature, timing, and extent of the procedures we perform to respond to fraud risks to obtain more persuasive evidence.

## Execute the Audit

### What are assertion-level fraud risks? [ISA | 789.1300]

Assertion-level fraud risks relate to:

- specific assertions for classes of transactions, account balances, or disclosures; and
- misstatements that can arise when the financial reporting framework (e.g. IFRS Standards, US GAAP), is not applied appropriately.

Two types of misstatements are relevant when we consider assertion-level fraud risks.

| Type | Description | How it may be accomplished |
| --- | --- | --- |
| Fraudulent financial reporting | Intentional misstatements or omissions of amounts or disclosures designed to deceive financial statement users | • Manipulating, falsifying or altering accounting records or supporting documentation<br>• Misrepresenting or intentionally omitting events, transactions or other significant information from the financial statements<br>• Intentionally misapplying accounting principles (for SEC engagements, look to the requirements of the SEC for |

| | | |
|---|---|---|
| | | accounting principles applicable to the entity) |
| Misappropriation of assets | Theft of an entity's assets, causing the financial statements to be misstated | • Embezzling receipts<br>• Stealing assets<br>• Causing an entity to pay for goods or services that have not been received and may be accompanied by false or misleading records or documents, possibly created by circumventing controls |

### How do we design and perform procedures to respond to fraud risks? [ISA | 789.1400]

We design and perform procedures to respond to fraud risks as follows:

- Evaluate the design and implementation of the entity's controls over the applicable process risk points related to the fraud risks; and
- Perform substantive procedures, including tests of details.

We design the nature, timing, and extent of substantive procedures we perform to respond to fraud risks to obtain evidence that is more persuasive or obtain additional corroborative information. We may also determine to perform a combination of different procedures to respond to the fraud risk.

The table below sets out examples of how we may modify our planned audit procedures to address fraud risks.

| Change the.... | Examples |
|---|---|
| Nature of audit procedures | • Physically observe or inspect certain assets, or apply computer-assisted audit techniques to data contained in significant accounts or electronic transaction files.<br>• Use external confirmations to confirm details of the sales agreements - including date, any rights of return and delivery terms. Supplement such external confirmation procedures with inquiries of the entity's non-financial personnel regarding any changes in sales agreements and delivery terms. |
| Timing of audit procedures | • Perform audit procedures to be at, or closer to, either the period end or the points during the period in which fraudulent transactions are more likely to occur. We may decide that it's not effective to use audit procedures which roll forward audit conclusions from an interim date to the period end. |
| Extent of audit procedures | • Increase the extent of the population tested<br>• Perform analytical procedures with a higher level of precision. |

| | |
|---|---|
| | • Apply computer-assisted audit techniques to select sample transactions from key electronic files, in order to identify transactions with specific characteristics, or test all of the items in an account. |

It is often helpful to ask ourselves what we are doing differently since we identified a fraud risk. If the answer is nothing, then we may not have addressed the fraud risk appropriately.

**Depending on the risk**, merely altering the extent of testing - e.g., increasing sample sizes - or altering the timing of testing may not be sufficient.

### Do we always take a controls based approach to respond to fraud risks? [ISA | 789.1600]

Not necessarily. We take a controls based approach either because of the type of audit we are performing, or because we believe it will be more efficient. We take a controls based approach as part of our response to fraud risks when:

- we perform an audit of ICFR - i.e., an integrated audit; or
- we cannot obtain sufficient evidence to respond to the fraud risk through substantive testing alone.

In many instances, we may determine to take a controls based approach to respond to fraud risks related to misappropriation, such as misappropriation of cash or inventory.

### What if we identify a deficiency in controls that are intended to address assessed fraud risks? [ISA | 789.11483]

When we identify deficiencies in controls that are intended to address assessed fraud risks, we take into account those deficiencies when designing our response to those fraud risks.

### What procedures might we perform to respond to fraud risks? [ISA | 789.1700]

No one procedure will be sufficient for all fraud risks because we design each procedure to respond to a specific fraud risk at a specific entity.

Our responses to our assessment of fraud risks vary depending on:

- the types or combinations of fraud risk factors or conditions identified; and
- the classes of transactions, account balances, disclosures and assertions they may affect.

### What are some general examples of substantive procedures we might perform to respond to fraud risks? [ISA | 789.1800]

General examples of what we can do differently include:

- performing procedures at locations on an unannounced basis - for example:
  - observing inventory on unexpected dates or at unexpected locations
  - counting cash at a particular date on a surprise basis
- confirming contract terms with customers and suppliers both large and small
- confirming contract terms with customers and suppliers with whom the entity no longer does business
- altering the audit approach in the current period - for example:

  - contacting major customers and suppliers orally and sending written confirmations
  - sending confirmation requests to a specific party within an organization
  - seeking more or different information

- performing a detailed review of the entity's quarter-end or period-end adjusting entries, and investigating any that appear unusual in nature or amount
- investigating the possibility of related parties, and the sources of financial resources, behind significant and unusual transactions - particularly those occurring at or near the period end
- performing substantive analytical procedures using disaggregated data in addition to our test of details - for example, comparing gross profit or operating margins by location, line of business, or month to our own expectations
- performing additional inquiries with personnel in areas in which a fraud risk has been identified, and obtaining their insights about the risk and how controls address it (this is not sufficient audit evidence on its own)
- discussing with other auditors the extent of work needed to assess fraud risk at those components
- if a management's specialist's work on a financial statement item becomes significant, then performing additional procedures over some or all of their assumptions, methods or findings to determine whether they are reasonable (we may involve a KPMG specialist to do this)
- analyzing selected opening balances of previously audited financial statements, and assessing how the entity used hindsight to resolve issues involving accounting estimates and judgments, such as an allowance for sales returns
- performing computer-assisted audit techniques - e.g. using computer assisted audit techniques to identify unusual or unexpected transactions or anomalies
- testing the integrity of computer-produced records and transactions
- seeking additional audit evidence from sources outside of the entity.

### What are some examples of substantive procedures we might perform to respond to fraud risks related to revenue recognition? [ISA | 789.1900]

Revenue-specific examples of what we can do differently include:

- performing substantive analytical procedures over revenue using disaggregated data - e.g. performing a trend analysis on revenue reported by month and by product line or business segment during the current period against comparable prior periods. Computer-assisted audit techniques may also help identify unusual or unexpected revenue relationships or transactions
- confirming relevant contract terms and the absence of side agreements with customers, because these can often influence the accounting - 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
  - cancellation or refund provisions

- inquiring of the entity's sales and marketing personnel or in-house legal counsel about unusual terms or conditions associated with sales or shipments near the end of the period

- performing appropriate sales and inventory cut-off procedures, by being physically present at one or more locations at period end to observe goods being shipped or readied for shipment, or returns awaiting processing
- testing controls over the occurrence and recording of revenue transactions that are electronically initiated, processed and recorded.

### What are some examples of substantive procedures we might perform to respond to fraud risks related to inventory? [ISA | 789.2000]

Inventory-specific examples of what we can do differently include:

- examining the entity's inventory records to identify locations or items that warrant specific attention during or after the physical inventory count
- requesting that inventories be counted at the end of the reporting period or on a date closer to period end - this minimizes the risk of balances being manipulated between the date of the count and the end of the reporting period
- performing inventory counts unannounced
- performing inventory counts at all locations on the same date
- performing additional procedures while observing the count, such as examining the contents of boxed items and how the goods are labeled or stacked - e.g. hollow squares
- considering using a KPMG specialist if the inventory is valued on purity, grade or concentration - e.g. perfumes or specialty chemicals
- comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, and/or comparing the quantities counted against perpetual IT records
- using computer-assisted audit techniques to further test the aggregation of the physical inventory counts - e.g. sorting by tag number to test controls over tagging, or by serial number to test whether items were omitted or double-counted.

### What are examples of substantive procedures we might perform to respond to fraud risks related to estimates? [ISA | 789.2100]

Examples specific to management estimates of what we can do differently are:

- using a KPMG specialist to develop an independent estimate that we can compare to management's estimate; and
- extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans relevant to developing the estimate.

### What are examples of incremental procedures when a SUT is assessed with a fraud risk? [ISA | 789.11487]

Examples of incremental procedures to obtain more persuasive audit evidence related to a SUT assessed with fraud risk may be:

- confirming contract terms and agreements with third parties;
- confirming amendments to contract terms and agreements or side agreements with third parties;
- involving a specific team member to assess the authenticity of contracts and agreements;
- investigating the possibility of related parties involved in the transaction and the sources of financial resources supporting the transaction.

# Examples

How might we design procedures in response to fraud risks? [ISA | 789.11489]

**Example 1**

*Fact pattern:*

During our risk assessment procedures, we identify the following fraud risk:

The use of side agreements could alter the terms and conditions of recorded sales transactions and may result in the revenue being overstated.

In designing audit procedures over revenue, we may plan to inspect a sample of invoices and compare them to the terms in the associated sales contract.

*Analysis:*

While this procedure may address the risk of error, it may not respond to the nature of the particular fraud risk. To address this risk, we may consider performing an additional procedure or altering the nature of our planned procedures - e.g., confirming the transaction terms directly with the customer.

Example 2

*Fact pattern:*

The same fact patter applies as for Example 1. However, this time we plan to confirm the transaction terms directly with the customer, to address the risk of fraud.

*Analysis:*

To specifically address the fraud risk, we may change the extent or timing of our planned procedures - e.g., by confirming more items than we originally planned, or performing the procedure at, or closer to, the end of the period.

Changing the timing of our procedures is particularly effective when we determine that there is a greater risk of a misstatement occurring at or near the end of the period.

We might also decide to modify the nature of our procedures by changing the confirmation form to ask the customer to specify the nature and terms of any side agreement.

# 5 Design and perform procedures to address the risk of management override of controls [ISA | 792]

## What do we do?

Design and perform procedures to specifically address the risk of management override of controls

## Why do we do this?

Management override of controls could occur at any point in the entity's financial reporting and related business processes where an action of management could override other effective controls in the process. Management override of controls commonly involves recording of inappropriate journal entries or other adjustments, intentional misstatement and bias in the determination of accounting estimates, and entering into significant unusual transactions that lack a legitimate business purpose. Although the risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and we design and perform procedures that are specifically responsive to these risks as part of all audits.

# Execute the Audit

### What is the risk of management override of controls? [ISA | 792.1300]

Management override of controls is a fraud risk, and therefore a significant risk. Management are in a unique position to perpetrate fraud because they can manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways.

Management may be able to override controls in several ways - including:

- 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 systematic journal entries;
- applying bias when making accounting estimates and related judgments; and
- entering into significant unusual transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size, or nature.

Management override of controls could occur at any point in the entity's financial reporting and related business processes where an action of management could override other effective control activities in the process.

### Is the risk of management override of controls applicable to all audits? [ISA | 792.1400]

Yes. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities.

### How may an entity effectively respond to the risk of management override of controls? [ISA | 792.1500]

An entity may respond to the risk of management override of a control by implementing anti-fraud controls that address the risk of:

- fraudulent financial reporting
- misappropriation of assets by management.

These anti-fraud controls include:

- process control activities performed by non-management individuals - e.g. those charged with governance, including the audit committee, or an independent internal audit function that reports to those charged with governance; or
- process control activities that address the risk of collusion through appropriate segregation of duties.

### What other considerations apply to controls that address the risk of management override of controls? [ISA | 792.1600]

When we obtain an understanding of the entity's process, we specifically think about where and how in the process management has the ability to override controls. We identify the process risk points where the risk of management override exists and the process control activities that address them.

Internal controls may appear to be well-designed and effective, but management can still perpetrate fraud by overriding them. The ways management can override controls are specific to the process risk points identified.

### What procedures do we perform to respond to the risk of material misstatement from management override of controls? [ISA | 792.1700]

At a minimum, we perform the following procedures to respond to the risk of management override of controls:

- Test the appropriateness of journal entries and other adjustments;
- Evaluate management bias in the preparation of accounting estimates; and
- Evaluate whether the business purpose (or lack thereof) for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud.

We also determine whether to perform other audit procedures in order to respond to the risk of management override of controls that are unique to the specific engagement.

When performing the above mentioned procedures to respond to the risk of management override of controls, we incorporate an element of unpredictability in the selection of audit procedures.

# 6 Communicate fraud related matters [ISA | 835]

## What do we do?

Communicate fraud related matters to the appropriate parties

## Why do we do this?

We communicate fraud related matters so entity, including those charged with governance, can investigate the matter and take corrective actions when necessary.

## Execute the Audit

### How do we communicate fraud related matters? [ISA | 835.11691]

We:

- communicate identified or suspected fraud to the appropriate level of management;
- determine whether it is necessary to communicate fraud to those charged with governance;
- communicate fraud involving those charged with governance to the next higher level of authority and consult when necessary;
- communicate other matters related to fraud to management and those charged with governance;
- determine whether we have a responsibility to report fraud to parties outside the entity;
- identify whether certain fraud related matters represent significant deficiencies or material weaknesses

### What fraud related matters do we communicate? [ISA | 835.1300]

We communicate the following fraud related matters:

- Identified actual fraud or information that indicates that a fraud may exist (i.e., suspected fraud).
- Fraud risks identified by us as part of our risk assessment procedures, including the risk related to management override of controls.
- Any other matters related to fraud, that we believe are relevant to the responsibilities of management and those charged with governance of the entity. These matters may include fraud risks with continuing implications for internal controls and deficiencies in internal controls that address fraud risks.

# 7 Presume that there is a fraud risk involving improper revenue recognition [ISA | 571]

## What do we do?

Presume that there is a fraud risk involving improper revenue recognition, and evaluate which types of revenue, revenue transactions or assertions may give rise to such risks.

## Why do we do this?

In many industries, revenue is a key metric and an area of focus for investors and financial statement users, as it directly affects earnings and other key metrics. Therefore, an entity often has a greater incentive or pressure to manipulate revenue.

## Execute the Audit

### What does it mean to presume there is a fraud risk involving improper revenue recognition? [ISA | 571.1300]

Initially, we expect there to be a fraud risk involving improper revenue recognition.

However, we may rebut the presumed fraud risk involving improper revenue recognition — but only after we've carefully evaluated the specific facts and circumstances. For example:

- facts and circumstances may indicate limited incentives, rationalizations, and/or opportunities to fraudulently adjust revenue recognition; or
- there may be only a single type of simple revenue transaction.

We may, therefore, conclude that there is no fraud risk related to revenue recognition.

If we do rebut the presumed fraud risk involving improper revenue recognition, we evidence our conclusions — including the specific facts and circumstances that led us to overcome the presumed fraud risk.

### How do we identify and define fraud risks involving improper revenue recognition? [ISA | 571.1400]

The standards presume we will identify a fraud risk related to revenue recognition; however, we don't just identify a general fraud risk that broadly covers improper revenue recognition. Like when we identify and define other fraud risks, we define revenue fraud risks specifically, and in a manner that is not overly broad or too narrow.

To achieve this, we evaluate which specific revenue transactions may give rise to a fraud risk. As with other fraud risks, this includes using what we learned during risk assessment and thinking about the specific fraud risk factors relevant to improper revenue recognition.

If we identify only a general risk of improper revenue recognition without trying to assess *how* revenue could be intentionally misstated, then we may have difficulty developing meaningful responses to the identified fraud risks.

### What do we consider in identifying fraud risks involving improper revenue recognition? [ISA | 571.1500]

Identifying fraud risks involving revenue recognition is very similar to identifying and defining any other fraud risk. We consider the fraud risk factors that could be relevant to manipulating revenue recognition, and each type of revenue or specific revenue transactions.

But remember: fraud may not only occur by overstating revenue — e.g. recognizing revenue early or recording fictitious revenue. It can also occur by understating or deferring revenue.

For example, if an entity has already exceeded expectations in the current period, but is concerned that the next period's revenue may be lower, it may try to shift revenue from the current period to next period. This would result in an understatement of current period revenue.

### What are some examples of common fraud techniques? [ISA | 571.1600]

Some examples of more common fraud techniques involving improper revenue recognition include:

- sham sales
- recording transactions even though the sales involved unresolved contingencies
- 'round-tripping' — i.e. selling an asset to another entity with an agreement to buy it back at the same price
- recording loans as sales
- improperly recording sales from bill and hold transactions that do not meet the criteria for revenue recognition
- recording revenue before all the terms of the sales are complete
- improper sales cut-off
- improperly accelerating the estimated percentage of completion method for projects in process
- shipping goods that a customer did not order
- shipping defective products and recording revenue at full, rather than discounted, prices
- recording revenue for consignment shipments, or shipments of goods for customers to consider on a trial basis.

Thinking about these techniques for each of the entity's revenue streams can help us identify opportunities or incentives for management to use them.

# Examples

### What is an example of rebutting the presumed fraud risk involving improper revenue recognition? [ISA | 571.1700]

**Fact pattern:**

RST Investments' sole source of revenue is from a manufacturing facility leased to a single entity over seven years. The lease payments are fixed for the duration of the lease so that the lease revenues are the same from year to year, and match directly to the lease agreement.

**Analysis:**

Given the lack of complexity and ability to manipulate revenue, we may consider rebutting the presumption of fraud risk over revenue recognition.

# 8 Understand relevant control activities that address significant risks [ISA | 576]

## What do we do?

IF we determine that a significant risk, including a fraud risk, exists, THEN obtain an understanding of the relevant control activities that are intended to address the risks, by evaluating the design and implementation of those controls

## Why do we do this?

As part of our risk assessment procedures, we obtain an understanding of a process to help us identify risks of material misstatement (RMMs). When we have a significant risk, including a fraud risk, we go even further, and evaluate the design and implementation of relevant control activities. This helps us better understand the risk, and informs our overall assessment of significant risks and how best to respond to them.

## Execute the Audit

### How do we identify relevant control activities that address a significant risk? [ISA | 576.1400]

We identify relevant control activities that address a significant risk by:

- understanding ICFR, including the entity's processes and CERAMIC;
- identifying all the process risk points related to the significant risk;
- identifying and obtaining an understanding of the control activities that address the relevant process risk points and risks arising from IT.

Not all control activities related to a significant risk may be relevant. Relevant control activities are those that address the PRP/RAFITs related to an RMM.

### How do we identify controls that address fraud risks? [ISA | 576.1500]

All fraud risks are significant risks, so we identify relevant control activities that address fraud risks in the same manner as all other significant risks.

We describe process control activities that address process risk points related to a fraud risk as anti-fraud controls. There are specific considerations about the nature, timing and extent of audit procedures we design and perform to test anti-fraud controls.

A process control activity is an anti-fraud control when:

- we have identified a fraud risk at the assertion level or financial statement level; and

- that process control activity directly mitigates the identified fraud risk, either individually or when combined with other controls.

#### Can anti-fraud controls also address a risk of error? [ISA | 576.11815]

Yes. Some process control activities are designed to address the risk of fraud (anti-fraud controls) and the risk of error simultaneously.

An example of this might relate to an estimate that:

- has a high degree of judgment (risk of error); and
- creates an opportunity for management to intentionally manipulate assumptions to achieve a desired result (risk of fraud).

Management may implement process control activities that address risks related to determining the key assumptions, and evaluating the potential for management bias in selecting those assumptions. If so, the identified control may respond to the fraud risk and the risk of error for the estimate.

### What if control activities are not designed and implemented for significant risks? [ISA | 576.2000]

Failure of the design or implementation of control activities addressing a significant risk is a deficiency in internal control and may indicate a significant deficiency. We evaluate deficiencies like this, and communicate them, as appropriate — even if we're performing a financial statement audit in which we do not intend to test the operating effectiveness of such control activities.

# Examples

### How may anti-fraud controls be designed to address the risk of management override for an accounting estimate? [ISA | 576.11816]

**Fact pattern:**

An entity prepares a cash flow forecast to support its going concern assessment. The Financial Controller prepares the forecast and the CFO reviews it.

During the engagement team's fraud planning meeting — i.e. the RAPD — they identified incentives, opportunities and rationalizations that caused them to identify a fraud risk associated with the going concern disclosures. The team determined it may be easy for the CFO to tweak the revenue or expenses in the forecast, so that the entity's cash appeared sufficient for the relevant assessment period required by the financial reporting framework.

The entity has introduced a process control activity that is an anti-fraud control to address the risk of management override, whereby the board — i.e. those charged with governance — review the components of the going concern assessment. The board receive an analysis of each estimate used in the forecast, including:

- the range of reasonableness of each estimate;
- how that range was determined;
- how the range compares to prior periods; and
- where within the range management's estimate fell in this period compared to prior periods.

The board also receive an analysis of how the estimates as a whole affected earnings.

**Analysis**:

In this case, the review of each estimate by those charged with governance is an anti-fraud control designed to mitigate the risk of management bias in the estimates.

Bias may be evident in management's changes to:

- how the range of reasonable results is determined;
- where within that range their estimate falls (at the lower end, in the middle, or at the higher end); and
- how the relative placement of the point estimate changed period over period.

As this example illustrates, process control activities that are anti-fraud controls addressing the risk of management override in estimates can involve the board or audit committee. In many cases, estimates are reviewed by senior management — but that's where the risk of fraud due to management override lies. Involving the board in the review of certain assumptions can be an effective way for an entity to introduce anti-fraud controls.

# Appendix 1 - Examples of Fraud Risk Factors

## International Standards on Auditing: ISA 240.Appendix 1

## Appendix 1 Examples of Fraud Risk Factors

(Ref: Para. A26)

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.

Fraud risk factors may relate to incentives or pressures, or opportunities, that arise from conditions that create susceptibility to misstatement before consideration of controls (i.e., the inherent risk). Such factors are inherent risk factors, insofar as they affect inherent risk, and may be due to management bias. Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (for example, complexity or uncertainty may create opportunities that result in susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in the entity's internal control that create such opportunities. Fraud risk factors related to attitudes or rationalizations may arise, in particular, from limitations or deficiencies in the entity's control environment.

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

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

*Incentives/Pressures*

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

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

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

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive - including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

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

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

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

*Opportunities*

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

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.

Deficiencies in internal control as a result of the following:

- Inadequate process to monitor the entity's system of internal control, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

*Attitudes/Rationalizations*

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- 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.

- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
    - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

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

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

*Incentives/Pressures*

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

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

*Opportunities*

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

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

Inadequate controls over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

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

*Attitudes/Rationalizations*

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for controls over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

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1 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.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Identify fraud risk factors [ISA | 569]

## What do we do?

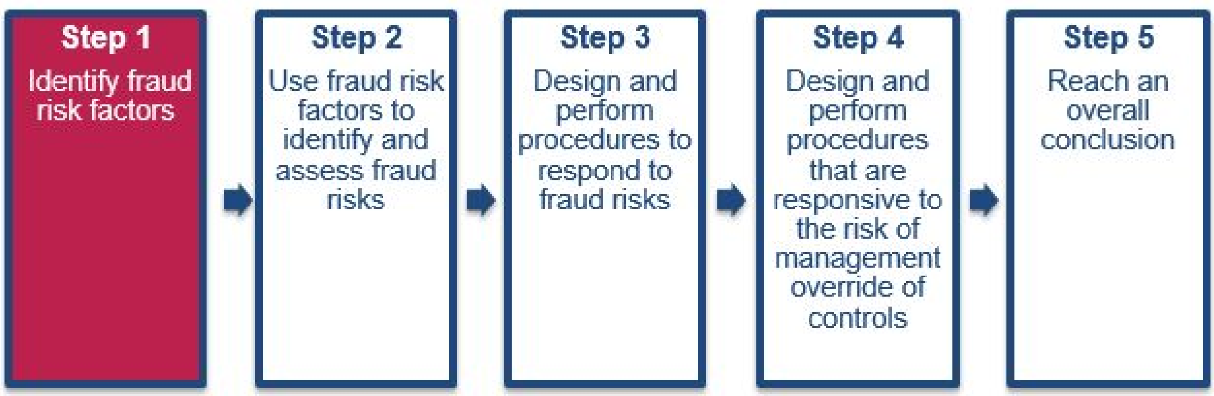
Evaluate whether the information obtained from the risk assessment procedures indicates that one or more fraud risk factors are present.

# Why do we do this?

As auditors, we have a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Therefore, our audits focus on risks not only related to error, but also to fraud.

Fraud may be difficult for us to detect because it is intentional and can be concealed by management. Evaluating circumstances that might lead to a fraud helps us better identity the fraud risks we will address in our audit.

The first step in our five-step process for identifying and responding to fraud risks is to identify fraud risk factors.




# Execute the Audit

## What are fraud risk factors? [ISA | 569.11964]

Fraud risk factors can cover a broad range of events and conditions. They are specific events and conditions we observe or identify that promote or foster an environment where fraud could occur.

Understanding these factors helps us consider where fraud risks may exist that call for a specific audit response.

Identifying fraud risk factors does not necessarily mean that fraud exists or will eventually occur. But these factors are often present in circumstances in which fraud exists.

| Category of fraud risk factor | Description | Example |
|---|---|---|
| Incentive or pressure | Why someone might commit fraud | An employee may be in financial distress (internal incentive), or management may be under extreme pressure to meet financial targets (external incentive). These situations can be a catalyst for committing the fraud, and could be internal or external to the entity or the person committing the fraud. |

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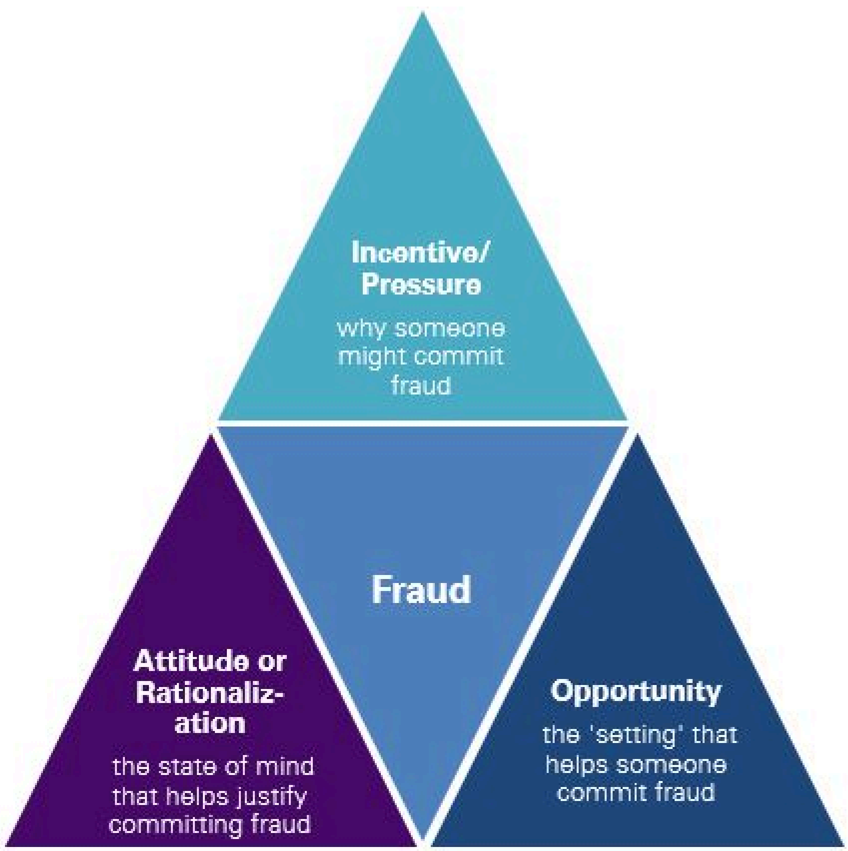
| Opportunity | The 'setting' that helps someone commit fraud | Deficiencies in CERAMIC or poorly designed control activities can make it easier for an individual to carry out fraud. |
| Attitude or rationalization | The state of mind that helps justify committing fraud | Management's attitude that the entity will meet its targets at all costs, or a justification claiming that the fraud doesn't really harm anybody. |

These three categories of fraud risk factors form the fraud triangle.




### What are the examples of fraud risk factors related to fraudulent financial reporting? [ISA | 569.7462]

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

| Conditions for fraud | Types of fraud risk factors | Examples of fraud risk factors |
|---|---|---|

| | | |
|---|---|---|
| **Incentives / pressures** | Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by): | High degree of competition or market saturation, accompanied by declining markets |
| | | High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates |
| | | Significant declines in customer demand and increasing business failures in either the industry or overall economy |
| | | Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent |
| | | Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth |
| | | Rapid growth or unusual profitability especially compared to that of other companies in the same industry |
| | | New accounting, statutory, or regulatory requirements |
| | Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following: | Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages |
| | | Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures |
| | | Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements |

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| | | Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards |
| | | A need to achieve financial targets required in bond covenants |
| | | Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both |
| | | Significant transactions with no economic justification, intended to meet short-term earnings goals |
| | | For listed entities: demonstrated history of closely meeting earnings estimates, unusually high price/ earnings ratios for its industry, or unexplained trend or pattern in short positions in the entity's stock |
| | 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<br>(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) |
| | | Personal guarantees of debts of the entity |
| | | Large individual sales of the entity's shares by senior management (e.g., insider trading) |
| | | Significant related party loans without a clear business purpose |

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| | 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 | Management's past performance indicates they are rarely able to meet goals and are consistently managing by crisis |
| **Opportunities** | The nature of the industry, the entity's significance/ influence in its local and regional economy/ government, 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 or geographic region 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 |
| | | Overly complex banking arrangements given the nature and size of operations, including significant bank accounts or subsidiary or branch operations in |

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| | | tax-haven jurisdictions for which there appears to be no clear business justification |
| | | Contractual arrangements lacking a business purpose |
| | | The entity engages in bill and hold or other non-standard transactions |
| | | Significant, unusual, or highly complex investments, including equity method investees, joint ventures and variable interest entities, especially those that pose difficult 'substance over form' questions |
| | The monitoring of management is not effective as a result of the following: | Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls |
| | | Oversight by those charged with governance over the financial reporting process and internal control is not effective |
| | | The exertion of dominant influence by or over a related party |
| | | Failure by those charged with governance and key members of the finance function to act as a control in the event that senior management seeks to override established controls or take overly aggressive financial reporting positions, including an inadequate response to significant matters reported in the discussion on financial reporting quality |
| | | The internal audit function is not independent of, or is inappropriately influenced by, management (for example, management determines the scope of the function's work and they are directed to not focus on high risk areas) |
| | There is a complex or unstable organizational structure, as | Difficulty in determining the organization or individuals that have controlling interest in the entity |

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| | evidenced by the following: | Overly complex organizational structure involving unusual legal entities or managerial lines of authority |
| | | High turnover of senior management, internal auditors, legal counsel, those charged with governance, or individuals with significant roles in the financial reporting process |
| | | Senior management or individuals with significant roles in the financial reporting process are from another region or country and may lack knowledge of the local language and the company's business practices |
| | Internal control components are deficient as a result of the following: | Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required) |
| | | High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective |
| | | Accounting and information systems that are not effective, including situations involving significant deficiencies (or material weaknesses) in internal control |
| | | Weak controls over budget preparation and development and compliance with law or regulation |
| | | A history of significant adjustments or passed audit adjustments |
| | | Failure to implement controls to prevent, detect or deter fraud in areas which have been previously reported to those charged with governance |
| | | Inadequate or no policies relating to the prevention of non-compliance with laws and regulations, including illegal acts |

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| | Cultural norms in the business and regulatory environments provide opportunities for management to override controls or intentionally misstate the financial statements | Criticizing or questioning a figure of authority is contrary to the local culture |
| | | Whistle blowing channels and protections may be less developed |
| **Attitudes / rationalizations** | Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective | Evidence of significant ethical shortfalls and appropriate personnel actions have not been taken |
| | 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 | |

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| | those charged with governance alleging fraud or non-compliance with laws and regulations, including illegal acts | |
| | Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend | |
| | The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts | |
| | Management failing to remedy known significant deficiencies (or material weaknesses) in internal control on a timely basis | |
| | An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons | |
| | Low morale among senior management | An evaluation of management indicates low or moderate quality management |

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| | or lack of skills and experience | |
| | 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 | Failure to take appropriate action in response to significant restatements (for example, dismissal of key individuals involved or the installing of appropriate controls) |
| | | There is an indication that a restatement may have been due to a possible intentional manipulation. |
| | The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: | Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters |
| | | Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditors' report(s) |
| | | 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. |
| | Management has a history of earnings | Indication that management has provided unreasonable, unreliable or inaccurate estimates or |

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| | management or inaccurate estimates | other representations, or management has been less than forthright |
| | | There are concerns of apparent earnings management. |
| | There are issues regarding integrity of individuals who have significant influence over financial reporting or are expected to sign the representation letter | |
| | There is an indication that management has sought to unduly influence the reporting of audit findings to those charged with governance. | |

Although these fraud risk factors cover a broad range of situations, they are only examples and, accordingly, we may identify additional or different fraud 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.

What are the examples of fraud risk factors related to misappropriation of assets? [ISA | 569.7463]

The following are examples of fraud risk factors relating to misstatements arising from misappropriation of assets:

| Conditions for fraud | Types of fraud risk factors | Examples of fraud risk factors |
|---|---|---|
| **Incentives / pressures** | Personal financial obligations may create pressure on management or employees with access to cash or other | |

| | | |
|---|---|---|
| | assets susceptible to theft to misappropriate those assets | |
| | Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: | Known or anticipated future employee layoffs |
| | | Recent or anticipated changes to employee compensation or benefit plans |
| | | Promotions, compensation, or other rewards inconsistent with expectations. |
| **Opportunities** | Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following: | Large amounts of cash on hand or processed |
| | | Inventory items that are small in size, of high value, or in high demand |
| | | Easily convertible assets, such as bearer bonds, diamonds, or computer chips |
| | | Fixed assets which are small in size, marketable, or lacking observable identification of ownership. |
| | Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following: | Inadequate segregation of duties or independent checks |
| | | Inadequate oversight of senior management expenditures, such as travel and other re-imbursements |
| | | Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations |
| | | Inadequate job applicant screening of employees with access to assets |

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| | | Inadequate record keeping with respect to assets (e.g., fixed assets register) |
| | | 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 (e.g., comparison of inventory records to inventory counts) |
| | | 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 (e.g., blank checks left signed when on vacation) | |

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

Although these fraud risk factors cover a broad range of situations, they are only examples and, accordingly, we may identify additional or different fraud 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.

## How do we identify fraud risk factors? [ISA | 569.1400]

We identify fraud risk factors by evaluating the information gathered from all of our risk assessment procedures — including the fraud discussion held during our Risk Assessment and Planning Discussion. We think about whether any of this information indicates:

- an incentive or pressure to perpetrate fraud;
- an opportunity to carry out fraud; or
- an attitude or rationalization that justifies fraud.

Some factors may be easier to identify than others. However, maintaining our professional skepticism helps us critically and objectively evaluate the information we have gathered. We don't let past experience with the entity, or our beliefs about management's honesty and integrity, affect our ability to recognize potential fraud risk factors or fraud risks.

### Enhanced | What information do we consider? [ISA | 569.11460]

We obtain a variety of information from our risk assessment procedures that may be relevant when identifying fraud risk factors. We specifically consider whether the understanding of the entity's financial relationships and transactions with executive officers we obtained during risk assessment indicates the presence of fraud risk factors.

Types of information that may be particularly helpful include:

- external or internal factors impacting the entity's financial stability or profitability
- information we may have learned about management, such as compensation arrangements and turnover
- our understanding over CERAMIC
- unusual or unexplained changes in the behavior or lifestyle of management or employees
- related party relationships — in particular, those that are complex, outside the normal course of business, or that involve management or those charged with governance
- allegations of fraud
- accounting policies — in particular, those that are subject to judgment or can be manipulated.

### Core and Less Complex | What information do we consider? [ISA | 569.160096]

We obtain a variety of information from our risk assessment procedures that may be relevant when identifying fraud risk factors.

Types of information that may be particularly helpful include:

- external or internal factors impacting the entity's financial stability or profitability
- information we may have learned about management, such as compensation arrangements and turnover
- our understanding over CERAMIC
- unusual or unexplained changes in the behavior or lifestyle of management or employees
- related party relationships — in particular, those that are complex, outside the normal course of business, or that involve management or those charged with governance
- allegations of fraud
- accounting policies — in particular, those that are subject to judgment or can be manipulated

### How might the nature of the entity affect this assessment? [ISA | 569.11461]

The size, complexity and ownership characteristics of the entity greatly influence our consideration of fraud risk factors. For example, at a large entity we might see factors that constrain improper conduct by management, such as:

- effective oversight by those charged with governance
- an effective internal audit function
- the existence and enforcement of a written code of conduct.

When we consider fraud risk factors at a business segment operating level, we may gain different insights to those we obtain at an entity-wide level.

### How does our understanding of CERAMIC help us identify fraud risk factors? [ISA | 569.11462]

Understanding CERAMIC can give us insight into the entity's assessment of risks, including fraud risks, as well as management's overall attitude about maintaining internal controls. This includes management's judgments about the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. This information may highlight potential fraud risk factors at the entity. For example, management may conclude that it is not cost effective to implement and maintain a particular control to address a potential fraud risk (e.g., segregation of duties), increasing the opportunity for individuals at the entity to carry out fraud.

### What do we consider in describing the fraud risk factors? [ISA | 569.1500]

When we describe fraud risk factors relevant to the audit, we clearly articulate the event or condition causing:

- the incentive/pressure;
- the attitude/rationalization;
- the opportunity; and
- the potential outcome or fraud that could result.

Properly describing the fraud risk factors allows us to make a clear connection to the fraud risks we identify.

### What resources can help us identify possible fraud risk factors? [ISA | 569.1600]

The auditing standards provide a number of example fraud risk factors — e.g. AS 2401.85, ISA 240 Appendix 1 and AU-C 240 Appendix A (see questions 'What are the examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting?' and 'What are the examples of fraud risk factors relating to misstatements arising from misappropriation of assets?'). We think about these examples as we identify fraud risk factors.

Other interpretive guidance from standard setters may contain helpful guidance on assessing fraud risk factors and fraud risks — e.g. PCAOB Staff Audit Practice Alert (SAPA) No. 8 on entities that operate in emerging markets, and SAPA No. 9 on challenging economic conditions.

#### Group Audit | What sources of information can help us assess RMMs due to fraud in a group audit? [ISA | 569.11463]

The following sources of information may be helpful when we, as the group auditor, identify risk factors and assess fraud risks for the group financial statements:

- group management's assessment of the fraud risks
- group management's process for identifying and responding to the fraud risks in the group
- whether there are particular components for which a fraud risk is likely
- how those charged with governance of the group monitor group management's processes for identifying and responding to the fraud risks in the group, and the controls group management has established to mitigate these risks
- responses of our inquiries whether those charged with governance of the group, group or component management or others within the group have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.

### What specific procedures apply when considering whether specified fraud risk factors are present? [ISA | 569.7464]

We complete the 'Fraud Risk Factors - Required Work Paper' to document the consideration of whether specified fraud risk factors derived from the auditing standards are present. We also consider whether there are any fraud risk factors that may be present in addition to the examples in the work paper.

For audits performed using the KPMG Clara workflow - Standard or the KPMG Clara workflow - Small Entity, the fraud risk factors are considered in the relevant workflow and the 'Fraud Risk Factors - Required Work Paper' is not completed.

### Enhanced | Can a KPMG member firm develop an equivalent work paper(s)? [ISA | 569.7465]

Yes. The 'Fraud Risk Factors - Required Work Paper' is used unless a KPMG member firm has an equivalent work paper(s) (i.e. one that addresses the purpose of this work paper and, at a minimum, includes all the items in this work paper), or has requirements that address the purpose and documentation of the items included in this work paper directly in the KPMG Clara workflow screens.

# Example

### How might information gathered from our risk assessment procedures indicate potential fraud risk factors? [ISA | 569.1700]

The table below sets out examples of conditions or events that we may identify as part of our risk assessment procedures, and the factors we consider to determine whether they may result in entity-specific fraud risk factors.

| Condition or event present at the entity | Potential fraud risk factors |
|---|---|
| Gross revenue, a key metric followed by external analysts covering the entity, has decreased for two consecutive periods due to growth in competitors' market share. | This may indicate pressure on the entity's management to fraudulently overstate gross revenue - due to concern that decreasing revenue may result in a lower analyst rating. |
| Management project that the entity will significantly exceed external analysts' revenue expectations for the current fiscal year. | This may indicate an incentive to defer revenue to the next fiscal year. |
| A significant portion of management's compensation includes incentive bonuses dependent on achieving certain predetermined income targets. The entity is projecting that it will narrowly miss this target. | This may create an incentive to fraudulently overstate income to be eligible for a bonus in the current period. |
| An entity sells to customers worldwide and recognizes revenue at the time of delivery.<br>The entity records revenue when the products are shipped, and manually reverses any revenue transactions not yet delivered at the end of each reporting period. | The manual process to reverse sales of products not yet delivered may indicate an opportunity to manipulate revenue by fraudulently failing to reverse all transactions not yet delivered. |

| | |
|---|---|
| An entity's inventory comprises a low number of high-value specialized products, which cannot be easily moved. The entity has adequate controls over segregation of duties and safeguarding of assets. | This may indicate that there are no entity-specific fraud risk factors associated with misappropriation of inventory. |
| The entity has foreign subsidiaries that operate in jurisdictions where corruption is more widespread and accepted. | The ethical environment in the foreign jurisdiction may foster an attitude among the subsidiary's employees that fraud is acceptable or a normal part of doing business. |

# Appendix 2 - Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

## International Standards on Auditing: ISA 240.Appendix 2

## Appendix 2 Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

(Ref: Para. A41)

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

**Consideration at the Assertion Level**

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

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.

- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- 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 assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk material of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

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

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

*Revenue Recognition*

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor

obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

*Inventory Quantities*

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

*Management Estimates*

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

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

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the 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.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Design and perform procedures to address each assertion-level RMM due to fraud [ISA | 789]

## What do we do?

Design and perform procedures to address risks of material misstatement due to fraud at the assertion level

## Why do we do this?

We design and perform procedures that are specifically responsive to our identified risks of material misstatement due to fraud (i.e. fraud risks) at the assertion level to gather sufficient appropriate audit evidence related to those risks. Given that fraud often involves attempts by the perpetrator to conceal the fraud, we design the nature, timing, and extent of the procedures we perform to respond to fraud risks to obtain more persuasive evidence.

## Execute the Audit

### What are assertion-level fraud risks? [ISA | 789.1300]

Assertion-level fraud risks relate to:

- specific assertions for classes of transactions, account balances, or disclosures; and

- misstatements that can arise when the financial reporting framework (e.g. IFRS Standards, US GAAP), is not applied appropriately.

Two types of misstatements are relevant when we consider assertion-level fraud risks.

| Type | Description | How it may be accomplished |
|---|---|---|
| Fraudulent financial reporting | Intentional misstatements or omissions of amounts or disclosures designed to deceive financial statement users | • Manipulating, falsifying or altering accounting records or supporting documentation<br>• Misrepresenting or intentionally omitting events, transactions or other significant information from the financial statements<br>• Intentionally misapplying accounting principles (for SEC engagements, look to the requirements of the SEC for accounting principles applicable to the entity) |
| Misappropriation of assets | Theft of an entity's assets, causing the financial statements to be misstated | • Embezzling receipts<br>• Stealing assets<br>• Causing an entity to pay for goods or services that have not been received and may be accompanied by false or misleading records or documents, possibly created by circumventing controls |

## How do we design and perform procedures to respond to fraud risks? [ISA | 789.1400]

We design and perform procedures to respond to fraud risks as follows:

- Evaluate the design and implementation of the entity's controls over the applicable process risk points related to the fraud risks; and
- Perform substantive procedures, including tests of details.

We design the nature, timing, and extent of substantive procedures we perform to respond to fraud risks to obtain evidence that is more persuasive or obtain additional corroborative information. We may also determine to perform a combination of different procedures to respond to the fraud risk.

The table below sets out examples of how we may modify our planned audit procedures to address fraud risks.

| Change the.... | Examples |
|---|---|

| | |
|---|---|
| Nature of audit procedures | • Physically observe or inspect certain assets, or apply computer-assisted audit techniques to data contained in significant accounts or electronic transaction files.<br>• Use external confirmations to confirm details of the sales agreements - including date, any rights of return and delivery terms. Supplement such external confirmation procedures with inquiries of the entity's non-financial personnel regarding any changes in sales agreements and delivery terms. |
| Timing of audit procedures | • Perform audit procedures to be at, or closer to, either the period end or the points during the period in which fraudulent transactions are more likely to occur. We may decide that it's not effective to use audit procedures which roll forward audit conclusions from an interim date to the period end. |
| Extent of audit procedures | • Increase the extent of the population tested<br>• Perform analytical procedures with a higher level of precision.<br>• Apply computer-assisted audit techniques to select sample transactions from key electronic files, in order to identify transactions with specific characteristics, or test all of the items in an account. |

It is often helpful to ask ourselves what we are doing differently since we identified a fraud risk. If the answer is nothing, then we may not have addressed the fraud risk appropriately.

**Depending on the risk**, merely altering the extent of testing - e.g., increasing sample sizes - or altering the timing of testing may not be sufficient.

### Do we always take a controls based approach to respond to fraud risks? [ISA | 789.1600]

Not necessarily. We take a controls based approach either because of the type of audit we are performing, or because we believe it will be more efficient. We take a controls based approach as part of our response to fraud risks when:

- we perform an audit of ICFR - i.e., an integrated audit; or
- we cannot obtain sufficient evidence to respond to the fraud risk through substantive testing alone.

In many instances, we may determine to take a controls based approach to respond to fraud risks related to misappropriation, such as misappropriation of cash or inventory.

### What if we identify a deficiency in controls that are intended to address assessed fraud risks? [ISA | 789.11483]

When we identify deficiencies in controls that are intended to address assessed fraud risks, we take into account those deficiencies when designing our response to those fraud risks.

### What procedures might we perform to respond to fraud risks? [ISA | 789.1700]

No one procedure will be sufficient for all fraud risks because we design each procedure to respond to a specific fraud risk at a specific entity.

Our responses to our assessment of fraud risks vary depending on:

- the types or combinations of fraud risk factors or conditions identified; and
- the classes of transactions, account balances, disclosures and assertions they may affect.

## What are some general examples of substantive procedures we might perform to respond to fraud risks?

[ISA | 789.1800]

General examples of what we can do differently include:

- performing procedures at locations on an unannounced basis - for example:
  - observing inventory on unexpected dates or at unexpected locations
  - counting cash at a particular date on a surprise basis
- confirming contract terms with customers and suppliers both large and small
- confirming contract terms with customers and suppliers with whom the entity no longer does business
- altering the audit approach in the current period - for example:
  - contacting major customers and suppliers orally and sending written confirmations
  - sending confirmation requests to a specific party within an organization
  - seeking more or different information
- performing a detailed review of the entity's quarter-end or period-end adjusting entries, and investigating any that appear unusual in nature or amount
- investigating the possibility of related parties, and the sources of financial resources, behind significant and unusual transactions - particularly those occurring at or near the period end
- performing substantive analytical procedures using disaggregated data in addition to our test of details - for example, comparing gross profit or operating margins by location, line of business, or month to our own expectations
- performing additional inquiries with personnel in areas in which a fraud risk has been identified, and obtaining their insights about the risk and how controls address it (this is not sufficient audit evidence on its own)
- discussing with other auditors the extent of work needed to assess fraud risk at those components
- if a management's specialist's work on a financial statement item becomes significant, then performing additional procedures over some or all of their assumptions, methods or findings to determine whether they are reasonable (we may involve a KPMG specialist to do this)
- analyzing selected opening balances of previously audited financial statements, and assessing how the entity used hindsight to resolve issues involving accounting estimates and judgments, such as an allowance for sales returns
- performing computer-assisted audit techniques - e.g. using computer assisted audit techniques to identify unusual or unexpected transactions or anomalies
- testing the integrity of computer-produced records and transactions
- seeking additional audit evidence from sources outside of the entity.

### What are some examples of substantive procedures we might perform to respond to fraud risks related to revenue recognition? [ISA | 789.1900]

Revenue-specific examples of what we can do differently include:

- performing substantive analytical procedures over revenue using disaggregated data - e.g. performing a trend analysis on revenue reported by month and by product line or business segment during the current period against comparable prior periods. Computer-assisted audit techniques may also help identify unusual or unexpected revenue relationships or transactions
- confirming relevant contract terms and the absence of side agreements with customers, because these can often influence the accounting - 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
  - cancellation or refund provisions
- inquiring of the entity's sales and marketing personnel or in-house legal counsel about unusual terms or conditions associated with sales or shipments near the end of the period
- performing appropriate sales and inventory cut-off procedures, by being physically present at one or more locations at period end to observe goods being shipped or readied for shipment, or returns awaiting processing
- testing controls over the occurrence and recording of revenue transactions that are electronically initiated, processed and recorded.

### What are some examples of substantive procedures we might perform to respond to fraud risks related to inventory? [ISA | 789.2000]

Inventory-specific examples of what we can do differently include:

- examining the entity's inventory records to identify locations or items that warrant specific attention during or after the physical inventory count
- requesting that inventories be counted at the end of the reporting period or on a date closer to period end - this minimizes the risk of balances being manipulated between the date of the count and the end of the reporting period
- performing inventory counts unannounced
- performing inventory counts at all locations on the same date
- performing additional procedures while observing the count, such as examining the contents of boxed items and how the goods are labeled or stacked - e.g. hollow squares
- considering using a KPMG specialist if the inventory is valued on purity, grade or concentration - e.g. perfumes or specialty chemicals
- comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, and/or comparing the quantities counted against perpetual IT records
- using computer-assisted audit techniques to further test the aggregation of the physical inventory counts - e.g. sorting by tag number to test controls over tagging, or by serial number to test whether items were omitted or double-counted.

### What are examples of substantive procedures we might perform to respond to fraud risks related to estimates? [ISA | 789.2100]

Examples specific to management estimates of what we can do differently are:

- using a KPMG specialist to develop an independent estimate that we can compare to management's estimate; and
- extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans relevant to developing the estimate.

### What are examples of incremental procedures when a SUT is assessed with a fraud risk? [ISA | 789.11487]

Examples of incremental procedures to obtain more persuasive audit evidence related to a SUT assessed with fraud risk may be:

- confirming contract terms and agreements with third parties;
- confirming amendments to contract terms and agreements or side agreements with third parties;
- involving a specific team member to assess the authenticity of contracts and agreements;
- investigating the possibility of related parties involved in the transaction and the sources of financial resources supporting the transaction.

# Examples

### How might we design procedures in response to fraud risks? [ISA | 789.11489]

**Example 1**

*Fact pattern:*

During our risk assessment procedures, we identify the following fraud risk:

The use of side agreements could alter the terms and conditions of recorded sales transactions and may result in the revenue being overstated.

In designing audit procedures over revenue, we may plan to inspect a sample of invoices and compare them to the terms in the associated sales contract.

*Analysis:*

While this procedure may address the risk of error, it may not respond to the nature of the particular fraud risk. To address this risk, we may consider performing an additional procedure or altering the nature of our planned procedures - e.g., confirming the transaction terms directly with the customer.

Example 2

*Fact pattern:*

The same fact patter applies as for Example 1. However, this time we plan to confirm the transaction terms directly with the customer, to address the risk of fraud.

*Analysis:*

To specifically address the fraud risk, we may change the extent or timing of our planned procedures - e.g., by confirming more items than we originally planned, or performing the procedure at, or closer to, the end of the period.

Changing the timing of our procedures is particularly effective when we determine that there is a greater risk of a misstatement occurring at or near the end of the period.

We might also decide to modify the nature of our procedures by changing the confirmation form to ask the customer to specify the nature and terms of any side agreement.

# Appendix 3 - Examples of Circumstances that Indicate the Possibility of Fraud

## International Standards on Auditing: ISA 240.Appendix 3

## Appendix 3 Examples of Circumstances that Indicate the Possibility of Fraud

(Ref: Para. A50)

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:

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

Conflicting or missing evidence, including:

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

- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

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

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

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's code of conduct.

# How do we comply with the Standards? [ISA | KAEGHDWC]

# 1 Evaluate whether the accumulated results of audit procedures affect our fraud risks [ISA | 4471]

## What do we do?

Evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the fraud risks and whether it is necessary to modify our audit procedures to address those risks.

## Why do we do this?

Toward the end of the audit, we have a final opportunity to ask ourselves whether we have identified and appropriately addressed all the fraud risks in the audit. The evidence and other information that we have gathered throughout our audit - for example, while testing controls or performing substantive procedures - can affect and better inform our initial risk assessments. This might lead us to identify new fraud risks or modify previously identified fraud risks.

# Execute the Audit

### How do we evaluate the accumulated results of auditing procedures and other observations? [ISA | 4471.1300]

Toward the end of the audit, we:

- take a step back and evaluate *in aggregate:*
  - the audit evidence obtained through performing all of our audit procedures;
  - the results of our concluding procedures; and
  - specific matters that we might have identified during the audit.
- determine whether such evaluation provides further insights about previously identified fraud risks or leads to the identification of new fraud risks.

If our evaluation of the accumulated results of auditing procedures and specific matters affects our assessment of fraud risks made throughout the audit, we evaluate whether it is necessary to modify our audit procedures to respond to those risks.

See this activity for additional information about revising our risk assessment: "Continue to assess RMMs, and revise audit approach as necessary".

### What are the specific matters that we might have identified during the audit that might affect our fraud risk assessments? [ISA | 4471.1400]

We may identify specific matters that can affect our fraud risk assessments, which include:

| Matters | More specifically.... |
|---|---|
| Discrepancies in the accounting records | (1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.<br>(2) Unsupported or unauthorized balances or transactions.<br>(3) Last-minute adjustments that significantly affect financial results.<br>(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties.<br>(5) Tips or complaints to us about alleged fraud. |
| Conflicting or missing evidence | (1) Missing documents.<br>(2) Documents that appear to have been altered. |

| | |
|---|---|
| | (3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.<br>(4) Significant unexplained items in reconciliations.<br>(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.<br>(6) Unusual discrepancies between the entity's records and confirmation responses.<br>(7) Missing inventory or physical assets of significant magnitude.<br>(8) Unavailable or missing electronic evidence that is inconsistent with the entity's record retention practices or policies.<br>(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current year system changes and deployments.<br>(10) Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g. receivables growing faster than revenues.<br>(11) Large numbers of credit entries and other adjustments made to accounts receivable records.<br>(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.<br>(13) Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the entity with the bank statement.<br>(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated. |
| Problematic or unusual relationships between us and management | (1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:<br>– Unwillingness to facilitate access to key electronic files for testing through the use of computer-assisted audit techniques.<br>– Denial of access to key information technology operations staff and facilities, including security, operations, and systems development.<br>(2) Undue time pressures imposed by management to resolve complex or contentious issues.<br>(3) Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with our critical assessment of audit evidence or in the resolution of potential disagreements with management. |

| | |
|---|---|
| | (4) Unusual delays by management in providing requested information.<br>(5) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete, transparent, and understandable.<br>(6) Management's unwillingness to address identified deficiencies in internal control on a timely basis. |
| Other matters | (1) Unwillingness by management to permit us to meet privately with the those charged with governance.<br>(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.<br>(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances.<br>(4) Tolerance of violations of the entity's code of conduct |

The list of matters is helpful not only during our concluding procedures but also throughout the audit.

### How do we evaluate the specific matters that may affect our assessment of fraud risks? [ISA | 4471.7461]

To help make sure that we do not lose sight of the specific matters that may affect our assessment of fraud risks, we ask ourselves throughout the audit: 'Have we identified any of the specific matters that may affect our assessments of fraud risks?'

Toward the end of the audit, we also consider the list of matters one more time and determine whether any of these items, or any other matter that can affect our fraud risk assessments, exists.

If we identify one or more matters, we consider what it means to our assessment of fraud risk and our audit procedures. We often involve more senior engagement team members to help us determine the potential effects on the audit.

These specific matters may also help facilitate communication within the engagement team as to whether any matters that may affect our assessment of fraud risks have been identified during the audit. See activity 'Determine whether there have been appropriate fraud risk communications with engagement team'.

# Example

### How does an engagement team identify a new fraud risk and respond to it? [ISA | 4471.1700]

**Fact pattern**

The engagement team evaluates the misstatements identified during the audit of entity LMN and notices several misstatements that unfavorably affect elements of the financial statements that are used to determine compliance with the entity's debt covenants. If the entity fails to meet a debt covenant, the entity may be forced to repay their debt obligations.

If management corrected the misstatements, the entity would be close to failing a debt covenant to maintain positive working capital.

**Analysis**

Based on the circumstances, the engagement team determines that there is increased pressure (i.e. a fraud risk factor) to meet certain financial covenants, which leads them to identify and assess a new fraud risk that they had not previously identified.

Depending on the fraud risk identified, they may perform additional procedures or modify the nature, timing and extent of their procedures related to the significant accounts that affect working capital. Particularly those areas that are more judgmental (e.g. estimates) as those are easier for management to manipulate. For example, they may alter their procedures to obtain external evidence related to litigation contingencies and payroll related accruals.

# 2 Apply professional skepticism [ISA | 788]

# What do we do?

Apply professional skepticism in gathering and evaluating audit evidence.

# Why do we do this?

Professional skepticism plays a key role in the audit and is integral to our skill set. Our due professional care requires that we exercise professional skepticism throughout the audit. Exercising professional skepticism can be particularly relevant when considering our fraud risk assessment or response to identified fraud risks because fraud often involves sophisticated and carefully organized schemes designed to conceal it.

# Execute the Audit

### What is professional skepticism? [ISA | 788.1300]

Professional skepticism involves having a questioning mind that critically assesses audit evidence. It includes watching out for conditions or evidence that may indicate a possible misstatement due to error or fraud.

### What are examples of instances where we may apply a heightened degree of professional skepticism? [ISA | 788.7958]

Examples of potential red flags relevant to our understanding of the entity and its environment

- A lack of clarity regarding the identity of the counterparties and the nature of their relationship to the reporting entity;
- Reliance on a small number of business partners for significant volumes of revenues or profits;
- Transactions or arrangements that lack a clear business purpose or economic substance;
- Significant operations or business activities conducted through, or assets held in, offshore jurisdictions or jurisdictions with limited regulation/transparency;
- Complex or high volumes of related party transactions;
- Financial relationships/key performance indicators (KPIs) that are inconsistent with the entity's peers or our expectations, such as: – A significant and persistent or unusual gap between profitability and operating cashflows;

- The entity holds more interest-bearing debt than appears to be necessary given its holdings of liquid financial asset; or
- The entity has significantly increased its debt to finance assets that may be challenging to obtain audit evidence with respect to the existence assertion, such as material goods in transit, loans receivable, prepayments or assets under construction
- Excessively complex contractual arrangements;
- Media coverage or analyst reports which raise concerns, such as questions about the appropriateness of the entity's business or accounting practices;
- Commentary in the entity's Other Information, e.g. MD&A, which may highlight concerns about an entity's performance and future plans; and
- The existence of significant short positions held in the entity's shares.

If any of the above are identified, we understand the facts and circumstances, including consideration of the source of the information and its reliability, in determining whether there is an impact on our identification and assessment of the RMMs.

Examples of potential red flags relevant to other aspects of the audit

- Are there unusual delays in providing requested information?
- Is documentation only available as copies or electronically transmitted documents when documents in original form are expected to exist?
- Is electronic evidence missing or unavailable, and is this inconsistent with the entity's record retention practices or policies or legal booking keeping requirements?
- Does management attempt to restrict access to records, facilities, certain employees, customers, suppliers or others from who audit evidence may be sought?
- Is there an unwillingness to provide key electronic files for testing using computer-assisted audit techniques?
- Is information frequently presented at the last minute leaving little time to appropriately verify its contents?
- Are there indications of deficient controls or less than robust governance for the size of the business?
- Do management's explanations evolve over time, which may indicate they are not being transparent or presenting the full picture?
- Are responses from management and employees arising from our inquiries or analytical procedures inconsistent, vague or implausible?
- Is management dominant and/or aggressive when dealing with external or internal auditors? Do they question why we need to perform certain procedures or push back when we seek to obtain additional corroborating audit evidence?
- Does management take an unusual interest in the selection of accounting policies, how estimates are made, or transactions are accounted for? Does management appear to be more focused on a desired outcome than on ensuring the accounting treatment is appropriate?
- Is there an unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable?
- Is management involved in making journal entries, particularly when they would not normally do so, or need to override controls in order to do so?

We do not only think about the indicators individually, but also in the aggregate. When more than one indicator is present, collectively they may indicate a pattern of collusion and concealment, which may cause us to evaluate the implications for our audit.

## How do we apply professional skepticism? [ISA | 788.1400]

We apply professional skepticism by being alert to matters such as:

- audit evidence that contradicts other audit evidence we have obtained;
- information that brings into question the reliability of documents and responses to inquiries we plan to use as audit evidence; and
- conditions that may indicate possible fraud.

Professional skepticism also involves remaining alert to our biases and other circumstances that can cause us to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than interests of external users throughout the audit.

We maintain professional skepticism by asking whether the information and audit evidence we gather suggests that a material misstatement due to fraud may exist.

Applying professional skepticism does not mean that we assume management is dishonest or not. Rather, we exercise professional skepticism with balance. We do not accept less persuasive evidence merely because we believe management to be honest.

## What are examples of biases that may impede our ability to apply professional skepticism? [ISA | 788.1500]

Common biases that can undermine professional skepticism and ways to mitigate them include:

| Bias/trap and potential impact: | Ways to mitigate: |
|---|---|
| Rush-to-solve trap<br><br>The tendency due to time pressures to want to solve a problem by making a quick judgement.<br><br>Potential impact<br><br>Can lead to a limited understanding of a problem or alternative resulting in inappropriate conclusions. | • Awareness<br>• Plan your audit to allow sufficient time for the performance and appropriate review of audit procedures<br>• Document work performed routinely and in a timely manner to facilitate critical thinking and capture a more accurate and complete reflection of how the conclusions were reached<br>• Start working on the key decisions early in the process |
| Availability bias<br><br>The tendency to place more weight on events or experiences that immediately come to mind or are readily available than on those that are not.<br><br>Potential impact | • Awareness<br>• Consider why something comes to mind<br>• Vividness<br>• Recent events<br>• Make the opposing case<br>• Seek advice from others<br>• Obtain and consider objective data |

| | |
|---|---|
| Can lead to limited alternatives considered or evidence gathered related to those alternatives | |
| Overconfidence bias<br>The tendency to overestimate one's own ability to make accurate assessment of risks or other judgements or decisions.<br>Potential impact<br>Can lead to underinvesting in understanding issues, insufficient challenging of management views or limited consideration of potential alternatives. | • Awareness<br>• Challenge management's estimates and:<br>- Ask about potential causes of unexpected outcomes<br>- Ask for estimate or likelihood of unexpected outcomes<br>• Challenge extremely high or low estimates<br>• Maintain professional skepticism |
| Confirmation bias<br>The tendency to seek confirming information or to favor conclusions that are consistent with initial beliefs.<br>Potential impact<br>Can lead to only seeking evidence that is consistent with a client's explanation or a preferred outcome. | • Awareness<br>• Consider alternatives provided by others or yourself<br>• Seek disconfirming or more complete information<br>• Explicitly acknowledge and consider your preferences or motives |
| Anchoring bias<br>The tendency to make assessments in evaluating information by starting with an initial value and then adjusting sufficiently away from initial value in forming a final judgment.<br>Potential impact<br>Can lead to a lack of objectivity in assessing transactions, estimates and account balances. | • Awareness<br>• Make an independent judgement or estimate void of an anchor<br>• Solicit input from others, being careful not to provide anchor for their thinking<br>• Take steps to make judgements or formulate expectations prior to seeing preliminary outcomes<br>• Obtain benchmarking information |
| Groupthink | • Awareness<br>• Communicate individual opinions and thoughts |

| | |
|---|---|
| The tendency to think or make decisions as a group that discourages creativity or individual responsibility.<br>Potential impact<br>Can lead to limited alternatives considered or evidence gathered related to those alternatives. | • Encourage others to communicate their opinions and thoughts |
| Automation bias<br>The tendency to favor output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose.<br>Potential impact<br>Can lead to inappropriate reliance on information. | • Awareness<br>• Involve specific team members with expertise in IT |

## What are examples of additional impediments on exercising professional skepticism? [ISA | 788.157463]

Additional examples include but are not limited to:

| **Impediments** | **Potential impact** |
|---|---|
| Budget constraints | Discourage the use of sufficiently experienced or technically qualified resources for the effective understanding, assessment of and responses to risks and informed questioning of management. |
| Tight deadlines | Negatively affect the behavior of those who perform the work as well as those who direct, supervise and review. For example, external time pressures may create restrictions to analyze complex information effectively. |
| Lack of cooperation or undue pressures imposed by management | Negatively affect the engagement team's ability to resolve complex or contentious issues. |

| | |
|---|---|
| Insufficient understanding of the entity and its environment, its system of internal control and the applicable financial reporting framework | Constrain the ability of the engagement team to make appropriate judgments and an informed questioning of management's assertions. |
| Difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others | Cause us to bias the selection of sources of audit evidence and seek audit evidence from sources that are more easily accessible. |
| Overreliance on automated tools and techniques | Result in the engagement team not critically assessing audit evidence. |

### What are possible actions that we can take to mitigate impediments in applying professional skepticism?

[ISA | 788.157464]

Possible actions to mitigate impediments may include:

- Remaining alert to changes in the nature or circumstances of the audit engagement that necessitate additional or different resources for the engagement, and requesting additional or different resources from those individuals within the firm responsible for allocating or assigning resources to the engagement.
- Explicitly alerting the engagement team to instances or situations when vulnerability to unconscious or conscious auditor biases may be greater (e.g. areas involving greater judgment) and emphasizing the importance of seeking advice from more experienced members of the engagement team in planning and performing audit procedures.
- Changing the composition of the engagement team, for example, requesting that more experienced individuals with greater skills or knowledge or specific expertise are assigned to the engagement.
- Involving more experienced members of the engagement team when dealing with members of management who are difficult or challenging to interact with.
- Involving specific team members or KPMG specialists to assist the engagement team with complex or subjective areas of the audit.
- Modifying the nature, timing and extent of direction, supervision or review by involving more experienced engagement team members, more in-person oversight on a more frequent basis or more in-depth reviews of certain working papers for:
  - Complex or subjective areas of the audit;
  - Areas that pose risks to achieving quality on the audit engagement;
  - Areas with a fraud risk; and
  - Identified or suspected instance of non-compliance with laws or regulations, including illegal acts.
- Setting expectations for:

- Less experienced members of the engagement team to seek advice frequently and in a timely manner from more experienced engagement team members or the engagement partner; and
- More experienced members of the engagement team to be available to less experienced members of the engagement team throughout the audit engagement and to respond positively and in a timely manner to their insights, requests for advice or assistance.

- Communicating with those charged with governance when management imposes undue pressure or the engagement team experiences difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others from whom audit evidence may be sought.

### What is contradictory, or disconfirming audit evidence? [ISA | 788.11474]

Contradictory, or disconfirming audit evidence is evidence obtained in the audit that seems to contradict the evidence on which we based our original risk assessments (and in some cases, the amount or disclosure being audited). We may come across contradictory audit evidence while performing procedures on a specific account balance, or in an unrelated manner.

> Example: Contradictory audit evidence may exist in the form of information that an entity is insolvent, and therefore it may not be able to repay the outstanding accounts receivables balance, and the client has not created an allowance for doubtful accounts related to this receivable. The evidence is "contradictory" because it contradicts the client's premise, i.e. that the amount is collectible and no allowance is necessary.

### Who is responsible for applying professional skepticism? [ISA | 788.1600]

It is the responsibility of each individual involved in the engagement to appropriately apply professional skepticism throughout the audit, including when identifying and assessing risks of material misstatement (RMMs), including RMMs due to fraud - i.e., fraud risks, performing tests of controls and substantive procedures to respond to identified RMMs, and evaluating the results of the audit.

The engagement partner is responsible for setting an appropriate tone that promotes:

- emphasizing the importance of each engagement team member to exercise and maintain a questioning mind throughout the audit; and
- exercising professional skepticism in gathering and evaluating audit evidence.

### When do we apply professional skepticism? [ISA | 788.1700]

We apply professional skepticism throughout the audit, including when we respond to RMMs, particularly fraud risks. We apply professional skepticism particularly when we:

- perform engagement acceptance or continuance, including evaluating the integrity of management;
- identify and assess RMMs;
- design and perform audit procedures to address RMMs, including the nature, timing and extent of our audit procedures;
- evaluate management judgments; and
- determine our overall conclusion on the audit evidence obtained.

## Why do we apply professional skepticism when responding to fraud risks? [ISA | 788.1800]

Applying professional skepticism can be particularly relevant when responding to fraud risks as it enhances the effectiveness of our audit procedures. We also reduce the risk that we may:

- overlook unusual transactions or circumstances;
- misinterpret audit results and reach the wrong conclusion; and
- use inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results.

## How do we apply professional skepticism when we review documents and records? [ISA | 788.1900]

When we review documents and records, we apply professional skepticism by considering their reliability, as fraud, including fraudulent financial reporting and 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. We may accept records and documents as genuine unless we have a reason to believe the contrary.

If we doubt the reliability of information or find indications of possible fraud - e.g. if conditions identified during the audit lead us to believe that a document is inauthentic or its terms have been falsified - we investigate further and determine whether to modify or add new audit procedures to resolve the matter.

> For example, when designing our response to an assessed RMM related to the risk of management override of controls, we inspect a selection of manual journal entries that have certain characteristics that could indicate a higher risk of fraud. If we examine the supporting documentation for those entries and find them vague or unclear, we apply professional skepticism by obtaining more persuasive audit evidence - e.g. from a third party - before we conclude whether fraud is indicated, rather than by obtaining other potentially less reliable internal evidence or inquiry alone.

## To what extent do we rely on representations from management? [ISA | 788.11475]

As part of evaluating audit results, we conclude on whether sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. In order to accomplish this, we do not simply rely on explanations from management or those charged with governance. A common pitfall of auditors is to 'audit by conversation', which means to obtain evidence merely from discussions with the entity's representatives, without appropriate audit evidence; this does not display professional skepticism. Instead, we don't just accept the entity's explanation but seek to obtain appropriately persuasive audit evidence.

Representations from management or those charged with governance are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base our audit opinion(s).

### What conditions may cause us to believe that a document may be inauthentic or has been modified? [ISA | 788.11476]

The following conditions may cause us to believe that a document may be inauthentic or has been modified:

- significant delays in management providing requested documents;
- evidence of alterations to documents;
- documents missing signatures or that are incomplete;
- discrepancies in accounting records and documents; or
- conflicting or missing documents.

#### How do we "investigate further", if we identify conditions that cause us to believe that a document may not be authentic or has been modified? [ISA | 788.11477]

When we identify conditions that cause us to believe that a document may not be authentic, that terms in a document have been modified but not disclosed to us, or that undisclosed side agreements may exist, we perform procedures to further investigate such as:

- confirming directly with the third party; and
- using the work of a KPMG specialist to assess the authenticity of a document

An audit rarely involves the authentication of documents, nor are we trained as, or expected to be, an expert in such authentication.

### How do we demonstrate our professional skepticism? [ISA | 788.2000]

We demonstrate our professional skepticism by maintaining the proper mindset and evidencing our application of professional skepticism throughout the audit and our audit documentation.

For example, we can evidence our professional skepticism by documenting:

- our revisions to risk assessment as a result of identified disconfirming evidence;
- significant decisions reached by the engagement team;
- our additional questions in response to inquiries and other information obtained from management and those charged with governance;
- how we incorporate unpredictability in our audit plan;
- how we evaluate disconfirming evidence and the impact to the audit, including changes in our audit strategy; and
- how we evaluate the reasonableness of management assumptions and challenge those assumptions.

## Examples

### How do we respond to contradictory or disconfirming audit evidence? [ISA | 788.11488]

**Fact pattern**

ABC Company recorded accounts receivable from its customer, XYZ Company, in the amount of CU1 million. This balance has been confirmed with the customer. The balance is past due by over 90 days, and no allowance for doubtful accounts has been recorded. Unrelated to our audit procedures, the engagement team comes across an article in the news that indicates that XYZ Company may become insolvent.

**Analysis**

The engagement team does not ignore this information, but questions ABC Company as to why the allowance for doubtful accounts does not include a provision for this customer. If ABC Company provides a plausible explanation, then the engagement team does not rely on the explanation, but investigates further and seeks objective evidence. For example, if ABC Company says that they know XYZ Company well, and have a longstanding relationship with them, and know they are committed to paying the amount, the engagement team documents the conversation and then seeks objective evidence. The evidence the team finds may either confirm (support) the entity's position, such as appropriately sourced subsequent payments on account, or contradict the entity's position, such as no subsequent payments, downgraded credit ratings or other media coverage that are an indication that the customer may not be able to pay.

# 3 If there are inconsistencies or doubts, modify or perform additional audit procedures and evaluate the effect on our audit [ISA | 2703]

## What do we do?

IF conditions are identified that indicate there are inconsistencies or that cause doubts over the reliability of the information used in our audit, THEN modify or perform additional audit procedures AND evaluate the effect on the other aspects of our audit.

## Why do we do this?

Whenever there are inconsistencies in information or in the results of our audit procedures, or doubts over the reliability of the information used in our audit, we modify or perform additional audit procedures to resolve the condition and evaluate the effect on the other aspects of our audit. If these conditions exist and are not addressed in our audit response, the information is not sufficiently reliable, and does not provide the evidence we are trying to obtain.

## Execute the Audit

### What are the conditions that affect the reliability of the information used in our audit? [ISA | 2703.1300]

When performing our audit procedures, we may come across conditions that affect the reliability of the information used in our audit. These conditions include:

(1) information obtained from one source that is inconsistent with information obtained from another.

For example, this can occur when we are performing a particular audit procedure and (i) we obtain information from another source that is inconsistent with or contradicts the information we obtained from management -or- (ii) we identify that the information used in our procedure is inconsistent with or contradicts the same information used in other parts of the audit.

(2) the results of an audit procedure are inconsistent with the results of another audit procedure.

For example, this can occur when we are performing a particular audit procedure and we identify that the results of that procedure contradict the results of our other procedure(s).

(3) circumstances that cause us to have doubt about the reliability of the information.

For example:

- indications that a document may not be authentic;

- indications that a document may have been modified and the modifications were not disclosed to us as the auditor or that undisclosed side agreements may exist; or

- findings identified from the audit procedures we perform to evaluate the reliability of the information / RDEs used in our audit.

## What do we do when we identify conditions that affect the reliability of the information used in our audit? [ISA | 2703.1400]

We modify our planned audit procedures or perform additional procedures to resolve the matter and evaluate the effect, if any, on the other aspects of our audit by performing the activity 'Continue to assess RMMs, and revise audit approach as necessary'.

The effect on our audit varies depending on the condition that was identified and the specific facts and circumstances. We may determine that the information only impacts a particular RMM we are testing or we may identify that there is a more widespread or pervasive issue e.g., indication of fraud that may lead us to question the integrity of management.

### What if we identify information that is inconsistent with or contradicts our final conclusions? [ISA | 2703.11649]

Whenever we identify information related to significant findings or issues that is inconsistent with or contradicts our final conclusions (e.g. disconfirming evidence), we retain documentation of the resolution (see activity 'Document how we addressed information that is inconsistent with conclusions on significant matters').

### What if we doubt the authenticity of information or believe that it has been inappropriately modified? [ISA | 2703.11650]

Whenever we doubt the authenticity of information or believe that it has been inappropriately modified, we investigate further. We understand the specific facts and circumstances surrounding the information in question and, where applicable, obtain additional information that corroborates our understanding. For example, if we identify a document that may not be authentic, we may:

- obtain the same document from another source or directly from the original source, where applicable, and compare them
- use the work of a KPMG specialist to assess the document's authenticity.

### What if the information has multiple RDEs and we conclude that one of the RDEs is not reliable? [ISA | 2703.11651]

Although we evaluate and conclude on the reliability of each data element that is relevant (RDE) to our audit procedure, we always 'step-back' and consider the information as a whole. Specifically, we consider whether the findings from our procedures (i.e. a deficient RDE) is indicative of issues with the other RDEs in the information. This is because data elements in the information are often inter-dependent.

If we conclude that one of the RDEs is not reliable and determine that there is an inter-dependency with other RDEs in the information, we conclude that the information as a whole is not reliable and evaluate the effect on our audit, including the impact on all the procedures in which that information is used in our audit.

## Do we authenticate all information that we use in our audit? [ISA | 2703.1500]

No, we are not experts in document authentication. However, we maintain an awareness and apply professional skepticism when we inspect information obtained from the entity or third parties that is used in our audit. We perform appropriate audit procedures to determine whether the information used in our audit is sufficiently reliable.

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