सत्यमेव जयते

Audit of Fraud
Fraud Detection Techniques
& Forensic Audit

Reading Material
Vol. III
Auditing Standards

Indian Audit & Accounts Department

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1. ASOSAI Guidelines on treatment of fraud and corruption

BASIC PRINCIPLES

Auditing Principle

"Auditing Principle" here refers to Basic Principles as given in the INTOSAI Standards.

3.1 The SAI should consider compliance with the INTOSAI auditing standards in all matters that are deemed material. (paragraph 1.0.6 (a))

INTOSAI Guidance

"INTOSAI Guidance" refers to the explanation of the Basic Principles, General Standards, Field Standards, and Reporting Standards given in the INTOSAI Standards.

In general terms, a matter may be judged material if knowledge of it would be likely to influence the user of the financial statements or the performance audit report. (paragraph 1.0.9)

Materiality is often considered in terms of value but the inherent nature or characteristics of an item or group of items may also render a matter material-for example, where the law or regulation requires it to be disclosed separately regardless of the amount involved. (paragraph 1.0.10)

In addition to materiality by value and by nature, a matter may be material because of the context in which it occurs. For example, considering an item in relation to:

(a) the overall view given to the financial information;

(b) the total of which it forms a part;

(c) associated terms;

(d) the corresponding amount in previous years. (paragraph 1.0.11)

ASOSAI Guideline 1

"ASOSAI Guideline" is the specific audit guideline on fraud and corruption as recommended by ASOSAI.

While determining materiality levels for different audit areas the SAI may take into account adjustments to the materiality level that may make audit more responsive to risk arising from fraud and corruption.

Auditing Principle

3.2 The SAI should apply its own judgment to the diverse situations that arise in the course of government auditing. (paragraph 1.0.6 (b))

INTOSAI Guidance

Audit evidence plays an important part in the auditor's decision concerning the selection of issues and areas for audit and the nature, timing and extent of audit tests and procedures. (paragraph 1.0.16)

ASOSAI Guideline 2

SAIs should apply its own judgement to determine the extent of audit investigation to be undertaken in cases of suspected fraud and corruption.

Auditing Principle

3.3 With increased public consciousness, the demand for public accountability of persons or entities managing public resources has become increasingly evident so that there is a need for the accountability process to be in place and operating effectively. (paragraph 1.0.6 (c))

ASOSAI Guideline 3

With an increasing concern on fraud and corruption SAIs are expected to demonstrate that the audit addresses these concerns. The SAIs should actively consider adopting a formal policy or strategy for deterring fraud and corruption.

Auditing Principle

3.4 Development of adequate information, control, evaluation and reporting systems within the government will facilitate the accountability process. Management is responsible for correctness and sufficiency of the form and content of the financial reports and other information. (paragraph 1.0.6 (d))

Appropriate authorities should ensure the promulgation of acceptable accounting standards for financial reporting and disclosure relevant to the needs of the government, and audited entities should develop specific and measurable objectives and performance targets. (paragraph 1.0.6 (e))

Consistent application of acceptable accounting standards should result in the fair presentation of the financial position and the results of operations. (paragraph 1.0.6 (f))

INTOSAI Guidance

The correctness and sufficiency of the financial reports and statements are the entity's expression of the financial position and the results of operations. It is also the entity's obligation to design a practical system which will provide relevant and reliable information. (paragraph 1.0.24)

The SAIs should work with the accounting standards setting organisations to help ensure that proper accounting standards are issued for the government. (paragraph 1.0.26)

ASOSAI Guideline 4

SAI should review whether applicable accounting standards ensure adequate recognition of assets and liabilities and disclosure of true financial position inclusive of any losses resulting from fraud and corruption. In case it observes any deficiency in this regard it should work with the audited entity and the accounting standard setting body to remove the deficiency.

ASOSAI Guideline 5

The responsibility for adequate and timely disclosure of any cases of fraud and corruption rest with the management and the responsibility of ensuring reliability and results of operation must include concerns arising from risk of fraud and corruption. Through its audit the SAI must evaluate and report on the adequacy and competence with which the management has discharged this responsibility.

Auditing Principle

3.5 The existence of an adequate system of internal control minimises the risk of errors and irregularities (paragraph 1.0.6 (g)).

INTOSAI Guidance

It is the responsibility of the audited entity to develop adequate internal control systems to protect its resources. It is not the auditor's responsibility. It is also the obligation of the audited entity to ensure that controls are in place and functioning to help ensure that applicable statutes and regulations are complied with, and that probity and propriety are observed in decision making. However, this does not relieve the auditor from submitting proposals and recommendations to the audited entity where controls are found to be inadequate or missing. (paragraph 1.0.31)

ASOSAI Guideline 6

SAIs should be alert to shortcomings in systems and controls that are likely to provide an environment conducive for fraud and corruption and should proactively report to the management to improve the control environment and minimize the risk of fraud and corruption.

Auditing Principle

3.6 Legislative enactments would facilitate the co-operation of audited entities in maintaining and providing access to all relevant data necessary for a comprehensive assessment of the activities under audit (paragraph 1.0.6 (h)).

INTOSAI Guidance

The SAI must have access to the sources of information and data as well as access to officials and employees of the audited entity in order to carry out properly its audit responsibilities. Enactment of legislative requirements for access by the auditor to such information and personnel will help minimise future problems in this area. (paragraph 1.0.33)

ASOSAI Guideline 7

Legislative enactment can ensure that all suspected and detected cases of fraud and corruption are reported to audit by the management. If considered necessary SAI can reinforce their mandate to investigate cases of fraud and corruption by seeking legislative enactments on these lines.

Auditing Principle

3.7 All audit activities should be within the SAI's audit mandate. (paragraph 1.0.6 (i))

INTOSAI Guidance

The full scope of government auditing includes regularity and performance audit. (paragraph 1.0.38)

Regularity audit embraces:

(a) attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements;

(b) attestation of financial accountability of the government administration as a whole;

(c) audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations;

(d) audit of internal control and internal audit functions;

(e) audit of the probity and propriety of administrative decisions taken within the audited entity; and

(f) reporting of any other matters arising from or relating to the audit that the SAI considers should be disclosed. (paragraph 1.0.39)

Performance audit is concerned with the audit of economy, efficiency and effectiveness and embraces:

(a) audit of the economy of administrative activities in accordance with sound administrative principles and practices, and management policies;

(b) audit of the efficiency of utilisation of human, financial and other resources, including examination of information systems, performance measures and monitoring arrangements, and procedures followed by audited entities for remedying identified deficiencies; and

(c) audit of the effectiveness of performance in relation to the achievement of the objectives of the audited entity, and audit of the actual impact of activities compared with the intended impact. (paragraph 1.0.40)

ASOSAI Guideline 8

Normally sensitization of different types of audits undertaken by SAIs to fraud and corruption can be brought about under their existing mandates. However, where SAIs feel constrained, they can seek additional mandate.

Auditing Principle

3.8 SAIs should work towards improving techniques for auditing the validity of performance measures. (paragraph 1.0.6 (j))

INTOSAI Guidance

The expanding audit role of the auditors will require them to improve and develop new techniques and methodologies to assess whether reasonable and valid performance measures are used by the audited entity. The auditors should avail themselves of techniques and methodologies of other disciplines. (Paragraph 1.0.46)

ASOSAI Guideline 9

The auditor should make the management aware that the absence or lack of application of reliable and valid performance measures and indicators could increase the possibility of occurrence of fraud and corruption.

GENERAL STANDARDS

General Standard

"General Standard" here refers to General Standards as given in the INTOSAI Standards.

3.9 The SAI should adopt policies and procedures to recruit personnel with suitable qualifications. (paragraph 2.1.2 (a))

The SAI should adopt policies and procedures to support the skills and experience available within the SAI and identify the skills which are absent; provide a good distribution of skills to auditing tasks and assign a sufficient number of persons for the audit; and have proper planning and supervision to achieve its goals at the required level of due care and concern. (paragraph 2.1.2 (d))

INTOSAI Guidance

It should be open to the SAI to acquire specialised skills from external sources if the successful carrying out of an audit so requires in order that the audit findings, conclusions and recommendations are perceptive and soundly based and reflect an adequate understanding of the subject area of the audit. It is for the SAI to judge, in its particular circumstances, to what extent its requirements are best met by in-house expertise as against employment of outside experts. (paragraph 2.1.18)

ASOSAI Guideline 10

The SAI should have an adequate inventory of skills to deal with cases of fraud and corruption. In the detailed examination of cases of fraud and corruption where an SAI feels the need to involve outside professional expertise, such professional opinion should only serve to augment the audit conclusion, the ultimate responsibility for the conclusion remaining with the SAI.

General Standard

3.10 The SAI should adopt policies and procedures to develop and train SAI employees to enable them to perform their tasks effectively, and to define the basis for the advancement of auditors and other staff. (paragraph 2.1.2 (b))

INTOSAI Guidance

The SAI should take adequate steps to provide for continuing professional development of its personnel, including, as appropriate, provision of in-house training and encouragement of attendance at external courses. (paragraph 2.1.6)

The SAI should establish and regularly review criteria, including educational requirements, for the advancement of auditors and other staff of the SAI. (paragraph 2.1.8)

ASOSAI Guideline 11

In considering the portfolio of skills that the SAI should have to meet the requirements of its audit mandate, the SAI should pay particular attention to training its auditors to deal with concerns about fraud and corruption, including experience gained from past fraud and corruption cases. Training could include developing forensic auditing skills provided that forensic investigation is covered by the mandate of the SAI.

SAIs could consider sharing of information and knowledge of techniques, procedures and skill development in order to develop expertise in this area.

General Standard

3.11 The SAI should adopt policies and procedures to prepare manuals and other written guidance and instructions concerning the conduct of audits. (paragraph 2.1.2 (c))

INTOSAI Guidance

Communication to staff of the SAI by means of circulars containing guidance, and the maintenance of an up-to-date audit manual setting out the SAI's policies, standards and practices, is important in maintaining the quality of audits. (paragraph 2.1.14)

ASOSAI Guideline 12

SAI should consider reviewing the manuals, policies and prospectus from the perspective of conducting audits that are sensitive to fraud and corruption and dealing with suspected cases of the nature.

General Standard

3.12 The auditor and the SAI must be independent. (paragraph 2.2.1 (a))

SAIs should avoid conflict of interest between the auditor and the entity under audit. (paragraph 2.2.1 (b))

INTOSAI Guidance

While the SAI must observe the laws enacted by the legislature, adequate independence requires that it not otherwise be subject to direction by the legislature in the programming, planning and conduct of audits. The SAI needs freedom to set priorities and program its work in accordance with its mandate and adopt methodologies appropriate to the audits to be undertaken. (paragraph 2.2.9)

The legal mandate should provide for full and free access by the SAI to all premises and records relevant to audited entities and their operations and should provide adequate powers for the SAI to obtain relevant information from persons or entities possessing it. (paragraph 2.2.19)

ASOSAI Guideline 13

The SAIs need to demonstrate that they are independent not only in a legal sense but in a practical sense as well so that they can perform an effective role against fraud and corruption. Demonstration of independence in practical audit work includes avoidance of any possible conflict of interest situation.

The SAI should be in a position to carry out an independent risk assessment and prioritize its audit planning accordingly.

Where necessary the SAI should work for legislation that would allow it access to all records and information required in the examination of cases of fraud and corruption.

ASOSAI Guideline 14

Without compromising on their independence to plan and conduct audit the SAIs should consider establishment of means to receive and process information from the public on suspected cases of fraud and corruption.

General Standard

3.13 The auditor and the SAI must exercise due care and concern in complying with the INTOSAI auditing standards. This embraces due care in specifying, gathering and evaluating evidence, and in reporting findings, conclusions and recommendations. (paragraph 2.2.1(d))

INTOSAI Guidance

The SAI must be, and be seen to be, objective in its audit of entities and public enterprises. It should be fair in its evaluations and in its reporting of the outcome of audits. (paragraph 2.2.40)

ASOSAI Guideline 15

Since complete evidence about cases of fraud and corruption may not be available to the SAI, due care should be exercised in arriving at an audit conclusion. In many circumstances additional tests may have to be performed and additional evidence acquired than would normally be considered appropriate and necessary for arriving at an audit opinion.

ASOSAI Guideline 16

In investigating and reporting cases of fraud and corruption the SAIs should be aware of the risk that perpetrators of fraud and corruption seek protection for their acts by accusing the auditors of libel and slander. The SAIs could consider working towards changes in their legislation which protects their auditors against such allegations and likely legal proceedings.

FIELD STANDARDS

Planning

Field Standard

“Field Standard” here refers to Field Standards as given in the INTOSAI Standards.

3.14 The auditor should plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner. (paragraph 3.0.3 (a))

INTOSAI Guidance

In planning an audit, the auditor should:

(a) identify important aspects of the environment in which the audited entity operates;

(b) develop an understanding of the accountability relationships;

(c) consider the form, content and users of audit opinions, conclusions or reports;

(d) specify the audit objectives and the tests necessary to meet them;

(e) identify key management systems and controls and carry out a preliminary assessment to identify both their strengths and weaknesses;

(f) determine the materiality of matters to be considered;

(g) review the internal audit of the audited entity and its work program;

(h) assess the extent of reliance that might be placed on other auditors, for example, internal audit;

(i) determine the most efficient and effective audit approach;

(j) provide for a review to determine whether appropriate action has been taken on previously reported audit findings and recommendations; and

(k) provide for appropriate documentation of the audit plan and for the proposed fieldwork. (paragraph 3.1.3)

The following planning steps are normally included in an audit:

(a) collect information about the audited entity and its organization in order to assess risk and to determine materiality;

(b) define the objective and scope of the audit;

(c) undertake preliminary analysis to determine the approach to be adopted and the nature and extent of enquiries to be made later;

(d) highlight special problems foreseen when planning the audit;

(e) prepare a budget and a schedule for the audit;

(f) identify staff requirements and a team for the audit; and

(g) familiarise the audited entity about the scope, objectives and the assessment criteria of the audit and discuss with them as necessary. (paragraph 3.1.4)

The SAI may revise the plan during the audit when necessary.

ASOSAI Guideline 17

While planning his audit the auditor should assess the risk that fraud may cause the financial statements to contain material misstatement or record material irregular transactions.

• The auditor may keep in view that the risk of fraud and corruption could be higher in certain organization like those involved in procurement of goods and services.

• The auditor may keep in view that when a fraud is conducted there is a deliberate effort to conceal the facts and distract the auditor.

• For planning the audit the auditor should have a complete understanding of the auditee including the environment in which the entity operates the level of internal control and the past performance of the auditee especially previous instances of fraud and corruption.

ASOSAI Guideline 18

Based on the risk assessment the auditor should develop the audit objective and design audit procedures so as to have reasonable expectation of detecting and evaluating material misstatement and irregularities arising from fraud and corruption. In case of high risk audit the audit team should be selected keeping in view the requirement of such audit.

ASOSAI Guideline 19

The SAI should keep in view the need for flexibility in terms of budget, time and expertise of the audit team particularly when fraud and corruption are suspected or discovered in the course of audit.

Supervision and Review

Field Standard

3.15 The work of the audit staff at each level and audit phase should be properly supervised during the audit; and documented work should be reviewed by a senior member of the audit staff. (paragraph 3.0.3 (b))

INTOSAI Guidance

All audit work should be reviewed by a senior member of the audit staff before the audit opinions or reports are finalised. It should be carried out as each part of the audit progresses. Review brings more than one level of experience and judgment to the audit task and should ensure that:

(a) all evaluations and conclusions are soundly based and are supported by competent, relevant and reasonable audit evidence as the foundation for the final audit opinion or report;

(b) all errors, deficiencies and unusual matters have been properly identified, documented and either satisfactorily resolved or brought to the attention of a more senior SAI officer(s); and

(c) changes and improvements necessary to the conduct of future audits are identified, recorded and taken into account in later audit plans and in staff development activities.(paragraph 3.2.4)

ASOSAI Guideline 20

For ensuring that all audits dealing with actual cases of fraud and corruption are adequately supervised, the SAI should develop policies, including a comprehensive supervision checklist, regarding supervision levels and procedures for managing the investigation of fraud and corruption.

When fraud and corruption are suspected in the course of audit the auditor should report the matter to the official of the SAI in accordance with the SAI's policy on supervision levels.

Study and Evaluation of Internal control

Field Standard

3.16 The auditor, in determining the extent and scope of the audit, should study and evaluate the reliability of internal control. (paragraph 3.0.3 (c))

INTOSAI Guidance

The study and evaluation of internal control should be carried out according to the type of audit undertaken.(paragraph 3.3.2)

Where accounting or other information systems are computerized, the auditor should determine whether internal controls are functioning properly to ensure the integrity, reliability and completeness of the data. (paragraph 3.3.4)

ASOSAI Guideline 21

The changes and improvements in the internal control system made by management when there have been previous instances of fraud and corruption or in response to changes in the auditee environment should be particularly studied and evaluated during audit.

ASOSAI Guideline 22

Increasing use of IT systems by auditees requires that the auditor should have access to reliable and verifiable system-based audit trails to evaluate the internal control. For meeting this objective legislation or executive guidance should ensure that audit is viewed as a stakeholder in the system development.

Compliance With Applicable Laws and Regulations

Field Standard

3.16 In conducting regularity (financial) audits, a test should be made of compliance with applicable laws and regulations. The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of regularity audits. The auditor also should be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of regularity audits.

In conducting performance audits, an assessment should be made of compliance with applicable laws and regulations when necessary to satisfy the audit objectives. The auditor should design the audit to provide reasonable assurance of detecting illegal acts that could significantly affect audit objectives. The auditor also should be alert to situations or transactions that could be indicative of illegal acts that may have an indirect effect on the audit results.

Any indication that an irregularity, illegal act, fraud or error may have occurred which could have a material effect on the audit should cause the auditor to extend procedures to confirm or dispel such suspicions. (paragraph 3.0.3 (d))

INTOSAI Guidance

The auditor also should be alert to situations or transactions that could be indicative of illegal acts that may indirectly impact the results of the audit. When audit steps and procedures indicate that illegal acts have or may have occurred, the auditor needs to determine the extent to which these acts affect the audit results. (paragraph 3.4.4)

Without affecting the SAI's independence, the auditors should exercise due professional care and caution in extending audit steps and procedures relative to illegal acts so as not to interfere with potential future investigations or legal proceedings. Due care would include consulting appropriate legal counsel and the applicable law enforcement organisations to determine the audit steps and procedures to be followed. (paragraph 3.4.7)

ASOSAI Guideline 23

Whenever a material instance of failure to comply with the applicable laws and regulations is observed the auditor should without automatically assuming the management and staff are dishonest investigate the control failure with an appropriate degree of professional skepticism. He may also examine if the supporting evidence has been tampered in any manner or any individual(s) could have benefited from the material violation.

Audit Evidence

Field Standard

3.18 Competent, relevant and reasonable evidence should be obtained to support the auditor's judgement and conclusions regarding the organisation, program, activity or function under audit. (paragraph 3.0.3 (e))

INTOSAI Guidance

Auditors should have a sound understanding of techniques and procedures such as inspection, observation, enquiry and confirmation, to collect audit evidence. The SAI should ensure that the techniques employed are sufficient to reasonably detect all quantitatively material errors and irregularities. (paragraph 3.5.3)

ASOSAI Guideline 24

When auditors suspect the possibility of fraud and corruption, they should establish whether it has taken place and there has been resultant effect on the financial reporting, especially whether the certificate requires the qualification.

ASOSAI Guideline 25

When auditors intend to report on fraud and corruption, they should ensure the reliability of audit evidence by verifying it with source documents including third party evidence. Auditors should carefully determine how much evidence they should gather in support of audit conclusions. Auditors should also keep in view that the evidence gathered by them and the conclusion drawn by them could become the basis of legal or disciplinary proceedings. (Some of the sources of evidence and factors that may be considered in searching for evidence are listed in Appendix.)

ASOSAI Guideline 26

Since many records are produced by computers in the usual and ordinary course of work, auditors should understand how to collect and handle those records as audit evidence. Collecting computer evidence requires careful planning and execution. Auditors should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence.

Analysis of Financial Statements

Field Standard

3.19 In regularity (financial) audit, and in other types of audit when applicable, auditors should analyse the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements should be performed to such a degree that a rational basis is obtained to express an opinion on financial statements. (paragraph 3.0.3 (f))

INTOSAI Guidance

Financial statement analysis aims at ascertaining the existence of the expected relationship within and between the various elements of the financial statements, identifying any unexpected relationships and any unusual trends. (paragraph 3.6.2)

ASOSAI Guideline 27

Auditors need to be alert to deviations from acceptable accounting standards including disclosure requirements particularly when there is suspicion of fraud and corruption.

REPORTING STANDARDS

"Reporting Standard" here refers to Reporting Standards given in the INTOSAI Standards.

Reporting Standard

3.20 At the end of each audit the auditor should prepare a written opinion or report, as appropriate, setting out the findings in an appropriate form; its content should be easy to understand and free from vagueness or ambiguity, include only information which is supported by competent and relevant audit evidence, and be independent, objective, fair and constructive. (paragraph 4.0.7 (a))

It is for the SAI to which they belong to decide finally on the action to be taken in relation to fraudulent practices or serious irregularities discovered by the auditors. (paragraph 4.0.7 (b))

INTOSAI Guidance

In formulating and following up recommendations, the auditor should maintain objectivity and independence and thus focus on whether identified weaknesses are corrected rather than on whether specific recommendations are adopted. (paragraph 4.0.26)

ASOSAI Guideline 28

When in the opinion of the auditor the financial statements include material fraudulent transactions, or such transactions have not been adequately disclosed, or the audit conducted by the auditor leads him to the conclusion that instance(s) of fraud and/or corruption have taken place and when the auditor has adequate evidence to support his conclusion, he should qualify the audit certificate and/or ensure that his findings are adequately included in his audit report. However, the term fraud or corruption may not be used in a conclusive sense unless such action is established in a court of law.

ASOSAI Guideline 29

The report may contain auditor's recommendations for the changes in the system and procedures that could prevent recurrence of such instances.

ASOSAI Guideline 30

In following up on reported cases of fraud and corruption the auditor should determine whether the necessary action is being taken with due regard to urgency that the situation demands and become aware of the changes in the systems and procedures which could be validated through subsequent audits.

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Statement on Auditing Standard No.99

The following is an overview of the organization and content of SAS No. 99:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics.

- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present.

- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism.

- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by

  a. Inquiring of management and others within the entity about the risks of fraud.

  b. Considering the results of the analytical procedures performed in planning the audit.

  c. Considering fraud risk factors.

  d. Considering certain other information.

- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud.

- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation.

- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. The section requires the auditor to respond to the results of the risk assessment in three ways:

  a. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned.

  b. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls. The procedures include

- o Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

- o Reviewing accounting estimates for biases that could result in material misstatement due to fraud.

- o Evaluating the business rationale for significant unusual transactions.

- · *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications.

- · *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others.

- · *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements.

In addition, SAS No. 99 amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, Professional Standards, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"), and SAS No. 85, *Management Representations* (AICPA, Professional Standards, vol. 1, AU sec. 336).

SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of this Statement is permissible.

The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements

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Appendices

The following is the text of the Auditing and Assurance Standard (AAS) 4 (Revised)[*]*, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices" issued by the Institute. The Standard was originally issued in June 1987 and was titled, "Fraud and Error".*

[*] Issued in January, 2003.

Introduction

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the auditor's responsibility to consider fraud and error in an audit of financial statements. While this AAS focuses on the auditor's responsibilities with respect to fraud and error, the primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. In this Standard, the term 'financial information' encompasses 'financial statements'. In some circumstances, specific legislations and regulations may require the auditor to undertake procedures additional to those set out in this AAS.

2. **When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error.**

Fraud and Error and Their Characteristics

3. Misstatements in the financial statements can arise from fraud or error. The term "error" refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, such as:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

4. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a

material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity.

5. Two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

6. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents 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 measurement, recognition, classification, presentation, or disclosure.

7. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

8. Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example, because the individuals are living beyond their means. Fraudulent financial reporting may

be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

9. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.

Responsibility of Those Charged With Governance and of Management

10. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary from entity to entity. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity.

11. It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, the integrity of an entity's accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the laws and regulations.

12. It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective

of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes implementing and ensuring the continued operation of accounting and internal control systems, which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements, whether caused by fraud or error. Accordingly, management assumes responsibility for any remaining risk.

Responsibilities of the Auditor

13. As described in AAS 2, "Objective and Scope of the Audit of Financial Statements", the objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. An audit conducted in accordance with the auditing standards generally accepted in India[1[1]] is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

Inherent Limitations of an Audit

14. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the auditing standards generally accepted in India. An audit does not guarantee that all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is

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1[1] Paragraph 15 of AAS 28, "*The Auditor's Report on Financial Statements*" describes auditing standards generally accepted in India.

persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only a reasonable assurance that material misstatements in the financial statements will be detected.

15. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud, generally, involves 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 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 involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

16. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist management in carrying out a fraud, with or without the employees' knowledge.

17. The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the

subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

(a) failure to obtain reasonable assurance,

(b) inadequate planning, performance or judgment,

(c) absence of professional competence and due care, or,

(d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

Professional Skepticism

18. The auditor plans and performs an audit with an attitude of professional skepticism. Such an attitude is necessary for the auditor to identify and properly evaluate, for example:

¨ Matters that increase the risk of a material misstatement in the financial statements resulting from fraud or error (for instance, management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability).

¨ Circumstances that make the auditor suspect that the financial statements are materially misstated.

¨ Evidence obtained (including the auditor's knowledge from previous audits) that brings into question the reliability of management representations.

19. However, unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents as genuine. Accordingly, an audit performed in accordance with auditing standards generally accepted in India rarely contemplate authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication.

Planning Discussions

20. **In planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.**

21. Such discussions would involve considering, for example, in the context of the particular entity, where errors may be more likely to occur or how fraud might be perpetrated. Based on these discussions, members of the audit team may gain a better understanding of the potential for material misstatements in the financial statements resulting from fraud or error in the specific areas of the audit assigned to them, and how the results of the audit procedures that they perform may affect other aspects of the audit. Decisions may also be made as to which members of the audit team will conduct certain inquiries or audit procedures, and how the results of those inquiries and procedures will be shared.

Inquiries of Management

22. When planning the audit, the auditor should make inquiries of management:

(a) to obtain an understanding of:

(i) management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(ii) the accounting and internal control systems management has put in place to address such risk;

(b) to obtain knowledge of management's understanding regarding the accounting and internal control systems in place to prevent and detect error;

(c) to determine whether management is aware of any known fraud that has affected the entity or suspected fraud that the entity is investigating; and

(d) to determine whether management has discovered any material errors.

23. The auditor supplements his own knowledge of the entity's business by making inquiries of management regarding management's own assessment of the risk of fraud and the systems in place to prevent and detect it. In addition, the auditor makes inquiries of management regarding the accounting and internal control systems in place to prevent and detect error. Since management is responsible for the entity's accounting and internal control systems and for the preparation of the financial statements, it is appropriate for the auditor to inquire of management how it is discharging these responsibilities. Matters that might be discussed as part of these inquiries include:

(a) whether there are particular subsidiary locations, business segments, types of transactions, account balances or financial statement categories where the possibility of error may be high, or where fraud risk factors may exist, and how they are being addressed by management;

(b) the work of the entity's internal audit function and whether internal audit has identified fraud or any serious weaknesses in the system of internal control; and

(c) how management communicates to employees its view on responsible business practices and ethical behaviour, such as through ethics policies or codes of conduct.

24. The nature, extent and frequency of management's assessment of such systems and risk vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal and less frequent. 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 be indicative of the lack of importance that management places on internal control.

25. It is also important that the auditor obtains an understanding of the design of the accounting and internal control systems within the entity. In designing such systems, management makes informed judgments on the nature and extent of the control procedures it chooses to implement and the nature and extent of the risks it chooses to assume. As a result of making these inquiries of management, the auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties. Information from these inquiries may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risk that the financial statements may contain material misstatements caused by fraud.

26. It is also important for the auditor to inquire about management's knowledge of frauds that have affected the entity, suspected frauds that are being investigated, and material errors that have been discovered. Such inquiries might indicate possible weaknesses in control procedures if, for example, a number of errors have been found in certain areas. Alternatively, such inquiries might indicate that control procedures are operating effectively because anomalies are being identified and investigated promptly.

27. Although the auditor's inquiries of management may provide useful information concerning the risk of material misstatements in the financial statements resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risk of material misstatements in the financial statements

resulting from management fraud. Accordingly, the auditor's follow-up of fraud risk factors, as discussed in paragraph 39, is of particular relevance in relation to management fraud.

Discussions with Those Charged with Governance

28. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In case of clients whose corporate governance practices are well developed and those charged with governance play an active role in oversight of how management has discharged its responsibilities, auditors are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management. Such inquiries may, for example, provide insights regarding the susceptibility of the entity to management fraud. The auditor may have an opportunity to seek the views of those charged with governance during, for example, a meeting with the audit committee to discuss the general approach and overall scope of the audit and eliciting views of independent directors. This discussion may also provide those charged with governance with the opportunity to bring matters of concern to the auditor's attention.

29. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the nature of these responsibilities within an entity to ensure that the inquiries and communications described above are directed to the appropriate individuals[2[2]].

30. In addition, following the inquiries of management described in paragraphs 22-27, the auditor considers whether there are any matters of governance interest to

[2[2]] AAS 27, *"Communications of Audit Matters with Those Charged with Governance"*, paragraph 8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

be discussed with those charged with governance of the entity[3[3]]. Such matters may include for example:

- Concerns about the nature, extent and frequency of management's assessments of the accounting and control systems in place to prevent and detect fraud and error, and of the risk that the financial statements may be misstated.
- A failure by management to address appropriately material weaknesses in internal control identified during the prior period's audit.
- The auditor's evaluation of the entity's control environment, including questions regarding management's competence and integrity.
- The effect of any matters, such as those above, on the general approach and overall scope of the audit, including additional procedures that the auditor may need to perform.

Audit Risk

31. AAS 6 (Revised), "Risk Assessments and Internal Control," paragraph 3, states that "audit risk" is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Such misstatements can result from either fraud or error. AAS 6 (Revised) identifies the three components of audit risk i.e., inherent risk, control risk and detection risk, and also provides guidance on how to assess these risks.

Inherent Risk and Control Risk

32. **When assessing inherent risk and control risk in accordance with AAS 6 (Revised), "Risk Assessments and Internal Control", the auditor should consider how the financial statements might be materially misstated as a result of fraud or error. In considering the risk of material misstatement resulting from fraud, the**

3[3] For a discussion of these matters, see AAS 27, "*Communications of Audit Matters with Those Charged with Governance*," paragraphs 11-14.

auditor should consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets.

33. AAS 6 (Revised), "Risk Assessments and Internal Control", describes the auditor's assessment of inherent risk and control risk, and how those assessments affect the nature, timing and extent of the audit procedures. In making those assessments, the auditor considers how the financial statements might be materially misstated as a result of fraud or error.

34. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, using the auditor's knowledge of the business, the auditor may identify events or conditions that provide an opportunity, a motive or a means to commit fraud, or indicate that fraud may already have occurred. Such events or conditions are referred to as "fraud risk factors". For example, a document may be missing, a general ledger may be out of balance, or an analytical procedure may not make sense. However, these conditions may be the result of circumstances other than fraud. Therefore, fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of inherent risk or control risk. Examples of fraud risk factors are set out in Appendix 1 to this AAS.

35. Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk.

36. Although the fraud risk factors described in Appendix 1 cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in

different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor uses professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.

37. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance, and the internal audit function. The auditor also considers what steps have been taken to enforce a formal code of conduct, and the effectiveness of the budgeting system. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behaviour 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. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.

38. The presence of fraud risk factors may indicate that the auditor will be unable to assess control risk at less than high for certain financial statement assertions. On the other hand, the auditor may be able to identify internal controls designed to mitigate those fraud risk factors that the auditor can test to support a control risk assessment below high.

Detection Risk

39. **Based on the auditor's assessment of inherent and control risks (including the results of any tests of controls), the auditor should design substantive**

procedures to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial statements taken as a whole will not be detected. In designing the substantive procedures, the auditor should address the fraud risk factors that the auditor has identified as being present.

40. AAS 6 (Revised) “Risk Assessments and Internal Control”, explains that the auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk to an acceptably low level. In designing substantive procedures, the auditor addresses fraud risk factors that the auditor has identified as being present. The auditor's response to those factors is influenced by their nature and significance. In some cases, even though fraud risk factors have been identified as being present, the auditor's judgment may be that the audit procedures, including both tests of control, and substantive procedures, already planned, are sufficient to respond to the fraud risk factors.

41. In other circumstances, the auditor may conclude that there is a need to modify the nature, timing and extent of substantive procedures to address fraud risk factors present. In these circumstances, the auditor considers whether the assessment of the risk of material misstatement calls for an overall response, a response that is specific to a particular account balance, class of transactions or assertion, or both types of response. The auditor considers whether changing the nature of audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors. Examples of response procedures are set out in Appendix 2 to this AAS, including examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

Procedures when Circumstances Indicate a Possible Misstatement

42. **When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.**

43. During the course of the audit, the auditor may encounter circumstances that indicate that the financial statements may contain a material misstatement resulting from fraud or error. Examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists are set out in Appendix 3 to this AAS.

44. When the auditor encounters such circumstances, the nature, timing and extent of the procedures to be performed depends on the auditor's judgment as to the type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial statements. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial statements are materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor's report, as discussed in paragraph 48.

45. The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, the auditor considers whether the assessment of the components of audit risk made during the planning of the audit may need to be revised and whether the nature, timing and extent of the auditor's other procedures may need to be reconsidered. {See AAS 6 (Revised), "Risk Assessments and Internal Control," paragraphs 40 and 47} For example, the auditor would consider:

¨ The nature, timing and extent of substantive procedures.

¨ The assessment of the effectiveness of internal controls if control risk was assessed below high.

- The assignment of audit team members that may be appropriate in the circumstances.

Considering Whether an Identified Misstatement may be Indicative of Fraud

46. **When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.**

47. If the auditor has determined that a misstatement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organizational position of the person or persons involved. For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material misstatement due to fraud. This is because both the manner of operating the fund and its size tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem. In such circumstances, the auditor reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence. If management, particularly at the highest level, is involved in fraud, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements.

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Evaluation and Disposition of Misstatements, and the Effect on the Auditor's Report

48. **When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud or error, the auditor should consider the implications for the audit.** AAS 13, "Audit Materiality," paragraphs 12-16, and AAS 28, “The Auditor’s Report on Financial Statements”, paragraphs 37-47, provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's report. Where a significant fraud has occurred or the fraud is committed by those charged with governance, the auditor should consider the necessity for a disclosure of the fraud in the financial statements. If adequate disclosure is not made the auditor should consider the necessity for a suitable disclosure in his report.

Documentation

49. **The auditor should document fraud risk factors identified as being present during the auditor's assessment process (see paragraph 32) and document the auditor's response to any such factors (see paragraph 39). If during the performance of the audit, fraud risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor should document the presence of such risk factors and the auditor's response to them.**

50. The auditor must document matters which are important in providing evidence to support the audit opinion, and the working papers must include the auditor's reasoning on all significant matters which require the auditor's judgment, together with the auditor's conclusion thereon. Because of the importance of fraud risk factors in the assessment of the inherent or control risk of material misstatement, the auditor documents fraud risk factors identified and the response considered appropriate by the auditor. (Reference may also be had to AAS 3, “Documentation”).

Management Representations

51. The auditor should obtain written representations from management that:

(a) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(b) it believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(c) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(d) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

52. AAS 11, "Representations by Management" provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that management acknowledges its responsibility for the accounting and internal control systems designed to prevent and detect fraud and error.

53. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from either fraud or error are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items …… and ……. constitute misstatements because [description of reasons]."

54. The auditor may designate an amount below which misstatements need not be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. In so doing, the auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial statements. The summary of uncorrected misstatements included in or attached to the written representation need not include such misstatements.

55. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtains a written representation from management confirming that it has disclosed to the auditor all facts relating to any frauds or suspected frauds that it is aware of that may have affected the entity, and that management has disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud.

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Communication

56. **When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor's responsibility to communicate that information to management, those charged with governance and, in some circumstances, when so required by the laws and regulations, to regulatory and enforcement authorities also.**

57. Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take necessary action. 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 nature, magnitude and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one

level above the persons who appear to be involved with the misstatement or suspected fraud.

58. The determination of which matters are to be communicated by the auditor to those charged with governance is a matter of professional judgment and is also affected by any understanding between the parties as to which matters are to be communicated. Ordinarily, such matters include:

- Questions regarding management competence and integrity.
- Fraud involving management.
- Other frauds which result in a material misstatement of the financial statements.
- Material misstatements resulting from error.
- Misstatements that indicate material weaknesses in internal control, including the design or operation of the entity's financial reporting process.
- Misstatements that may cause future financial statements to be materially misstated.

Communication of Misstatements Resulting From Error to Management and to Those Charged With Governance

59. **If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance.**

60. **The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.**

61. As noted in paragraph 54, the uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.

Communication of Misstatements Resulting From Fraud to Management and to Those Charged with Governance

62. **If the auditor has:**

(a) identified a fraud, whether or not it results in a material misstatement in the financial statements; or

(b) obtained evidence that indicates that fraud may exist (even if the potential effect on the financial statements would not be material);

the auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance.

63. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter is brought to the attention of an appropriate level of management. 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 also affected in these circumstances by the likelihood of collusion or the involvement of a member of management.

64. If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor:

(a) discusses the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved, and with management at the highest level; and

(b) if appropriate, suggests that management consult legal counsel.

Communication of Material Weaknesses in Internal Control

65. **The auditor should communicate to management any material weaknesses in internal control related to the prevention or detection of fraud and error, which have come to the auditor's attention as a result of the performance of the audit. The auditor should also be satisfied that those charged with governance have been informed of any material weaknesses in internal control related to the prevention and detection of fraud that either have been brought to the auditor's attention by management or have been identified by the auditor during the audit.**

66. When the auditor has identified any material weaknesses in internal control related to the prevention or detection of fraud or error, the auditor communicates these material weaknesses in internal control to management. Because of the serious implications of material weaknesses in internal control related to the prevention and detection of fraud, it is also important that such deficiencies be brought to the attention of those charged with governance.

67. If the integrity or honesty of management or those charged with governance are doubted, the auditor ordinarily considers seeking legal advice to assist in the determination of the appropriate course of action.

Communication to Regulatory and Enforcement Authorities

68. The auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. However, the auditor's legal responsibilities may vary and in certain circumstances, statute, the law or courts of law may override the duty of confidentiality. For example, under the regulatory framework for Non-Banking Financial Companies, an obligation is cast upon the auditor to report to the Reserve

Bank of India any adverse or unfavourable remarks in his report. In such circumstances, the auditor may consider seeking legal advice.

Auditor Unable to Complete the Engagement

69. **If the auditor concludes that it is not possible to continue performing the audit as a result of a misstatement resulting from fraud or suspected fraud, the auditor should:**

(a) consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) consider the possibility of withdrawing from the engagement; and

(c) if the auditor withdraws:

(i) discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

70. The auditor may encounter exceptional circumstances that bring into question the auditor's ability to continue performing the audit, for example, in circumstances where:

(a) the entity does not take the remedial action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

(b) the auditor's consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) the auditor has significant concern about the competence or integrity of management or those charged with governance.

71. 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 continuing association with the entity.

72. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary in different circumstances. For example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action.

Communication with an Incoming Auditor

73. **Clause 8 of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down that a Chartered Accountant in practice would be guilty of professional misconduct if he accepts a position as an auditor, previously held by another chartered accountant without first communicating to him in writing. On receipt of an inquiry from a incoming auditor, the existing auditor should advise whether there are any professional reasons why the incoming auditor should not accept the appointment. If the client denies the existing auditor**

permission to discuss its affairs with the incoming auditor or limits what the existing auditor may say, that fact should be disclosed to the incoming auditor.

74. The auditor may be contacted by an incoming auditor inquiring whether there are any professional reasons why the incoming auditor should not accept the appointment. The responsibilities of existing and incoming auditor are set out in the Code of Ethics, issued by the Institute of Chartered Accountants of India.

75. The extent to which an existing auditor can discuss the affairs of a client with an incoming auditor will depend on whether the existing auditor has obtained the client's permission to do so, and on the professional and legal responsibilities relating to such disclosure. Subject to any constraints arising from these responsibilities, the existing auditor advises the incoming auditor whether there are any professional reasons not to accept the appointment, providing details of the information and discussing freely with the incoming auditor all matters relevant to the appointment. If fraud or suspected fraud was a factor in the existing auditor's withdrawal from the engagement, it is important that the existing auditor take care to state only the facts (not his or her conclusions) relating to these matters.

Effective Date

76. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods commencing on or after 1st April 2003.

Compatibility with International Standard on Auditing (ISA) 240

The auditing standards established in this Auditing and Assurance Standard are generally consistent in all material respects with those set out in International Standard on Auditing (ISA) 240 on The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements.

Appendix 1

Examples of Risk Factors Relating to Misstatements Resulting from Fraud

The fraud risk factors identified in this Appendix are examples of such factors typically faced by auditors in a broad range of situations. However, the fraud risk factors listed below are only examples; not all of these factors are likely to be present in all audits, nor is the list necessarily complete. Furthermore, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk. Fraud risk factors are discussed in paragraphs 34-38.

Fraud Risk Factors Relating to Misstatements Resulting from Fraudulent Financial Reporting

Fraud risk factors that relate to misstatements resulting from fraudulent financial reporting may be grouped in the following three categories:

1. Management's Characteristics and Influence over the Control Environment.
2. Industry Conditions.
3. Operating Characteristics and Financial Stability.

For each of these three categories, examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting are set out below:

1. Fraud Risk Factors Relating to Management's Characteristics and Influence over the Control Environment

A. These fraud risk factors pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

- There is motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:

- ü A significant portion of management's compensation is represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.
- ü There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
- ü Management commits to analysts, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.
- ü Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.

B. There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:

- ¨ Management does not effectively communicate and support the entity's values or ethics, or management communicates inappropriate values or ethics.
- ¨ Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.
- ¨ Management does not monitor significant controls adequately.
- ¨ Management fails to correct known material weaknesses in internal control on a timely basis.
- ¨ Management sets unduly aggressive financial targets and expectations for operating personnel.
- ¨ Management displays a significant disregard for regulatory authorities.

¨ Management continues to employ ineffective accounting, information technology or internal auditing staff.

¨ Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.

¨ There is a high turnover of management, counsel or board members.

¨ There is a strained relationship between management and the current or predecessor auditor. Specific indicators might include the following:

ü Frequent disputes with the current or a predecessor auditor on accounting, auditing or reporting matters.

ü Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.

ü Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information, or limit the auditor's ability to communicate effectively with those charged with governance.

ü Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.

¨ There is a history of securities law violations, or claims against the entity or its management alleging fraud or violations of securities laws.

¨ The corporate governance structure is weak or ineffective, which may be evidenced by, for example:

ü A lack of members who are independent of management.

- ü Little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.

2. Fraud Risk Factors Relating to Industry Conditions

These fraud risk factors involve the economic and regulatory environment in which the entity operates.

- ¨ New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
- ¨ A high degree of competition or market saturation, accompanied by declining margins.
- ¨ A declining industry with increasing business failures and significant declines in customer demand.
- ¨ Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

3. Fraud Risk Factors Relating to Operating Characteristics and Financial Stability

These fraud risk factors pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

- ¨ Inability to generate cash flows from operations while reporting earnings and earnings growth.
- ¨ Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures).
- ¨ Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a

financially disruptive effect on the entity (for example, the ultimate collectibility of receivables, the timing of revenue recognition, the realisability of financial instruments based on highly-subjective valuation of collateral or difficult-to-assess repayment sources, or a significant deferral of costs).

- Significant related party transactions which are not in the ordinary course of business.
- Significant related party transactions which are not audited or are audited by another firm.
- Significant, unusual or highly complex transactions (especially those close to year-end) that pose difficult questions concerning substance over form.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or person (or persons) controlling the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- A threat of imminent bankruptcy, foreclosure or hostile takeover.
- Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported.

¨ A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Fraud Risk Factors Relating to Misstatements Resulting from Misappropriation of Assets

Fraud risk factors that relate to misstatements resulting from misappropriation of assets may be grouped in the following two categories:

1. Susceptibility of Assets to Misappropriation.
2. Controls.

For each of these two categories, examples of fraud risk factors relating to misstatements resulting from misappropriation of assets are set out below. The extent of the auditor's consideration of the fraud risk factors in category 2 is influenced by the degree to which fraud risk factors in category 1 are present.

1. Fraud Risk Factors Relating to Susceptibility of Assets to Misappropriation

These fraud risk factors pertain to the nature of an entity's assets and the degree to which they are subject to theft.

¨ Large amounts of cash on hand or processed.

¨ Inventory characteristics, such as small size combined with high value and high demand.

¨ Easily convertible assets, such as bearer bonds, diamonds or computer chips.

¨ Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.

2. Fraud Risk Factors Relating to Controls

These fraud risk factors involve the lack of controls designed to prevent or detect misappropriation of assets.

- Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations).
- Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation.
- Inadequate record keeping for assets susceptible to misappropriation.
- Lack of an appropriate segregation of duties or independent checks.
- Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing).
- Poor physical safeguards over cash, investments, inventory or fixed assets.
- Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
- Lack of mandatory vacations for employees performing key control functions.

Appendix 2

Examples of Modifications of Procedures in Response to the Assessment of Fraud Risk Factors in Accordance with Paragraphs 39-41

The following are examples of possible responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets. The auditor exercises judgment to select the most appropriate procedures in the circumstances. The procedures identified may neither be the most appropriate nor necessary in each circumstance. The auditor's response to fraud risk factors is discussed in paragraphs 40-41.

Overall Considerations

Judgments about the risk of material misstatements resulting from fraud may affect the audit in the following ways:

i. *Professional skepticism*: The application of professional skepticism may include: (i) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (ii) increased recognition of the need to corroborate management explanations or representations concerning material matters.

ii. *Assignment of members of the audit team*: The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor's assessment of the level of risk for the engagement. In addition, the extent of supervision needs to recognize the risk of material misstatement resulting from fraud and the qualifications of members of the audit team performing the work.

iii. *Accounting principles and policies*: The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalizing versus expensing.

iv. *Controls:* The auditor's ability to assess control risk below high may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity's internal control sufficient to plan the audit. In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the fraud risk factors identified. However, this consideration also needs to include an added sensitivity to management's ability to override such controls.

The nature, timing and extent of procedures may need to be modified in the following ways:

- The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more audit evidence may be needed from independent sources outside the entity.
- The timing of substantive procedures may need to be altered to be closer to, or at, year-end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive procedures should be performed near or at year-end because it would not be possible to control the incremental audit risk associated with that fraud risk factor.
- The extent of the procedures applied will need to reflect the assessment of the risk of material misstatement resulting from fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate.

The auditor considers whether changing the nature of the audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors.

Considerations at the Account Balance, Class of Transactions and Assertion Level

Specific responses to the auditor's assessment of the risk of material misstatement resulting from fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas will need to be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the fraud risk factors or conditions identified.

The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis. For example, observe inventory at locations where auditor attendance has not been previously announced or count cash at a particular date on a surprise basis.
- Request that inventories be counted at a date closer to the year-end.
- Alter the audit approach in the current year. For example, contact major customers and suppliers orally in addition to sending written confirmation, send confirmation requests to a specific party within an organization, or seek more and different information.
- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any entries that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigate the possibility of related parties and the sources of financial resources supporting the transactions.
- Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to expectations developed by the auditor.
- Conduct interviews of personnel involved in areas for which there is a concern about the risk of material misstatement resulting from fraud, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement resulting from fraud resulting from transactions and activities among these components is adequately addressed.
- If the work of an expert becomes particularly significant with respect a financial statement item for which the risk of misstatement due to fraud is high, perform additional procedures relating to some or all of the expert's assumptions,

methods or findings to determine that the findings are not unreasonable, or engage another expert for that purpose.

- Perform 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.
- Perform procedures on account or other reconciliation(s) prepared by the entity, including consideration of reconciliation(s) performed at interim periods.
- Perform computer-assisted techniques, such as data mining to test for anomalies in a population.
- Test the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses-Misstatements Resulting from Fraudulent Financial Reporting

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

- *Revenue recognition:* If there is a risk of material misstatement resulting from fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements, inasmuch as the appropriate accounting is often influenced by such terms or agreements.
- *Inventory quantities*: If there is a risk of material misstatement resulting from fraud relating to inventory quantities, reviewing the entity's inventory records may help to identify locations, areas or items for specific attention during or after the physical inventory count. Such a review may lead, for example, to a decision to observe inventory counts at certain locations on an unannounced basis, or to

ask management to ensure that counts at all locations subject to count are performed on the same date.

- *Non-standard journal entries*: If there is a risk of material misstatements resulting from fraudulent financial reporting, performing tests of non-standard journal entries to confirm that they are adequately supported and reflect underlying events and transactions may help in identifying fictitious entries of aggressive recognition practices. While there is not generally accepted definition of non-standard journal entries, in general, they are financial statement changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

Specific Responses - Misstatements Resulting from Misappropriations of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement resulting from 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. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, it may be useful for the auditor to obtain an understanding of the control procedures related to the prevention and detection of such misappropriation and to test the operating effectiveness of such controls.

Appendix 3

Examples of Circumstances that Indicate the Possibility of Fraud or Error

The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; neither all of these circumstances are likely to be present in all audits nor is the list necessarily complete. Circumstances that indicate a possible misstatement are discussed in paragraphs 43-44.

- Unrealistic time deadlines for audit completion imposed by management.
- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
- Limitation in audit scope imposed by management.
- Identification of important matters not previously disclosed by management.
- Significant difficult-to-audit figures in the accounts.
- Aggressive application of accounting principles.
- Conflicting or unsatisfactory evidence provided by management or employees.
- Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
- Information provided unwillingly or after unreasonable delay.
- Seriously incomplete or inadequate accounting records.
- Unsupported transactions.
- Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year-end.
- Transactions not recorded in accordance with management's general or specific authorization.

- Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.
- Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
- Significant differences from expectations disclosed by analytical procedures.
- Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
- Evidence of an unduly lavish lifestyle by officers or employees.
- Unreconciled suspense accounts.
- Long outstanding account receivable balances.

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