EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

(Supersedes Statements on Auditing Standards [SAS] No. 122,* Statements on Auditing Standards: Clarification and Recodification, *as amended, Section 240,* Consideration of Fraud in a Financial Statement Audit *[AICPA,* Professional Standards, *AU-C sec. 240];

Amends:

- ***Statements on Auditing Standards (SAS) No. 117,* Compliance Audits, *as amended* [AICPA, *Professional Standards*, AU-C sec. 935]**
- ***Various other sections in SAS No. 122*, as amended [*AICPA,* Professional Standards*, AU-C secs. 200, 210, 230, 250, 260, 265, 300, 330, 450, 505, 530, 550, 580, and 805*]**
- ***SAS No. 128,* Using the Work of Internal Auditors, *as amended* [AICPA, *Professional Standards*, AU-C sec. 610]**
- ***SAS No. 130,* An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements, *as amended* [AICPA, *Professional Standards*, AU-C sec. 940]**
- ***SAS No. 142,* Audit Evidence, *as amended* [AICPA, *Professional Standards,* AU-C sec. 500]**
- ***SAS No. 143,* Auditing Accounting Estimates and Related Disclosures, *as amended* [AICPA, *Professional Standards*, AU-C sec. 540]**
- ***SAS No. 145,* Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, *as amended* [AICPA, *Professional Standards,* AU-C sec. 315]**
- ***SAS No. 146*, Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards, *as amended***

[AICPA, *Professional Standards*, AU-C sec. 220]

- ***SAS No. 149*, Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors) *[AICPA,* Professional Standards, *AU-C sec. 600*])**

July 2, 2025

Comments are requested by October 3, 2025

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

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Introduction

This memorandum provides background to the proposed Statement on Auditing Standards (SAS) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (proposed SAS).

If issued as final, the proposed SAS will supersede SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 240*, Consideration of Fraud in a Financial Statement Audit* (AU-C section 240).[1]

The proposed SAS would also amend the following SASs:

- SAS No. 117, *Compliance Audits*, as amended (AU-C section 935)
- SAS No. 122, as amended
    - — Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With GAAS* (AU-C sec. 200)
    - — Section 210, *Terms of the Engagement* (AU-C sec. 210)
    - — Section 230, *Audit Documentation* (AU-C sec. 230)
    - — Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AU-C sec. 250)
    - — Section 260, *The Auditor's Communication With Those Charged With Governance* (AU-C sec. 260)
    - — Section 265*, Communicating Internal Control Related Matters Identified in an Audit* (AU-C sec. 265)
    - — Section 300, *Planning an Audit* (AU-C sec. 300)
    - — Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AU-C sec. 330)
    - — Section 450, *Evaluation of Misstatements Identified During the Audit* (AU-C sec. 450)
    - — Section 505, *External Confirmations* (AU-C sec. 505)
    - — Section 530, *Audit Sampling* (AU-C sec. 530)
    - — Section 550, *Related Parties* (AU-C sec. 550)
    - — Section 580, *Written Representations* (AU-C sec. 580)
    - — Section 805, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)* (AU-C sec. 805)

[1] All AU-C sections can be found in AICPA *Professional Standards*.

- SAS No. 128, *Using the Work of Internal Auditors*, as amended (AU-C section 610)
- SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AU-C section 940)
- SAS No. 142, *Audit Evidence* (AU-C section 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*, as amended (AU-C section 540)
- SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, as amended (AU-C section 315)
- SAS No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, as amended (AU-C section 220)
- SAS No. 149, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)* (AU-C section 600)

Background

Public Interest Issues Addressed in the Proposed SAS

Trust in the financial reporting ecosystem is crucial for maintaining the integrity and reliability of financial statements. Research has shown that there continue to be questions about the auditor's responsibilities relating to fraud in an audit of financial statements. Each participant in the financial reporting ecosystem plays a role that contributes to high-quality financial reporting, as well as audit quality, particularly as it relates to fraud. Therefore, it is important to clarify the auditor's responsibilities relating to fraud, recognizing that broader efforts are needed, focusing not only on the auditor's role but also that of management, those charged with governance, and others in addressing this important issue.

Recognizing the importance of this topic, the AICPA Auditing Standards Board (ASB) formed the ASB Fraud Task Force (Fraud TF) to consider the implications when the auditor identifies fraud or suspected fraud in an audit of financial statements and to determine whether revisions to AU-C section 240 are needed to clarify the auditor's responsibilities relating to fraud. The ASB has undertaken extensive outreach on this topic to help identify areas in which extant AU-C section 240 could be enhanced (see the "ASB Research and Outreach" section of this explanatory memorandum) and has actively monitored developments relating to fraud in an audit of financial statements. In particular, the ASB and the Fraud TF followed the fraud project of the International Auditing and Assurance Standards Board (IAASB). (See the "IAASB Fraud Project" section of this explanatory memorandum for further information about the IAASB project.)

The ASB believes the proposed SAS will help auditors perform appropriate audit procedures when fraud or suspected fraud is identified in an audit of financial statements and will drive auditors to better exercise professional judgment and maintain professional skepticism in planning and performing their audits with respect to identifying, assessing, and responding to risks of material misstatement due to fraud, thereby improving audit quality. See the section "Fundamental Aspects of the Proposed SAS" for what the ASB believes are the fundamental aspects of the proposed SAS.

ASB Research and Outreach

Perspectives on the Auditor's Report and Transparency Related to Fraud

In March 2022, the ASB began conducting outreach and research related to fraud and going concern, including transparency in the auditor's report. As part of that project, the ASB undertook a research synthesis project that looked at academic studies between 2017 and 2022 in order to learn about the latest academic findings on the identification, assessment, and response to fraud risks.

In the summer of 2022, the ASB surveyed financial statement users and preparers in the United States to obtain their perspectives on the content of the auditor's report and transparency related to fraud in the auditor's report, including whether potentially enhanced disclosure about fraud would influence users of the auditor's report. The survey was distributed to multiple groups and 134 complete responses were collected. The ASB also conducted interviews with U.S.-based financial statement users and preparers in the fall of 2022 to obtain additional insights related to these matters. Twenty-six individuals were interviewed.

The outreach found that 62% of survey respondents strongly agree, agree, or somewhat agree with the statement that "the content and length of the current version of the auditor's report is appropriate and no additional information is necessary." A not insignificant proportion, 17%, do not believe additions to the report are needed because the current report is "too long." See the "Auditor's Report" section of this explanatory memorandum.

Research Synthesis Project Outcomes

At the May 2023 ASB meeting, the ASB discussed five key takeaways from the research synthesis project for which the ASB considered whether there might be practical and implementable guidance to be included in the proposed SAS or to be considered as possible nonauthoritative guidance.[2] The following table lists the key takeaways and how they have been considered in the proposed SAS.

Key Takeaways	Disposition
Identification of Fraud Risks The expression of audit partner leadership, professional skepticism, and viewpoints (i.e., tone from the top) can affect the sharing of information and the identification of fraud risk factors during fraud brainstorming sessions.	Addressed in paragraphs A32–A33, A50–A51, and A57 in the proposed SAS.
Identification of Fraud Risks The trait skepticism of individual auditors, including their self-esteem, autonomy, or likelihood of questioning inconsistencies, as well as the overall prevalence of high or low levels of	Addressed in paragraph A57 in the proposed SAS.

[2] See agenda item 9 of the discussion memorandum from the May 2023 ASB meeting at https://www.aicpa-cima.com/resources/article/asb-meeting-agenda-and-materials-may-16-17-2023.

Key Takeaways	Disposition
skepticism on an audit team, can influence the team's dynamics and the identification of fraud risk factors.	
Fraud Risk Assessment When performing preliminary analytical procedures related to fraud risk assessment, generating more explanations for unusual fluctuations can be counterproductive.	Because this is closely related to professional judgment, the ASB believes this may be better addressed as possible nonauthoritative guidance.
Fraud Risk Assessment When auditors consult with forensic specialists that possess a greater understanding of the client's business and engagement objectives, the audit team makes better risk assessments.	Addressed in paragraphs 23 and A42 in the proposed SAS.
Response to Fraud Risk Advising other auditors on the team and engaging forensic specialists on the team improves auditors' response to the risk of fraud, and capitalizing on the use of teammates could be effective (such as using two auditors instead of just one in client inquiries about fraud).	Addressed in paragraphs A42–A45, A58, A111, A168, A176, and A178 in the proposed SAS. The ASB also believes this topic may be addressed as possible nonauthoritative guidance.

Interviews With Forensic Professionals

Between July and September 2023, interviews with forensic professionals were conducted to help identify best practices relating to fraud in an audit of financial statements. Twenty-six professionals (almost all were Certified Public Accountants [CPAs] and either Certified Fraud Examiners [CFEs] or Certified Financial Forensics [CFFs]) were interviewed from firms of varying sizes. These interviews helped identify how auditors could incorporate aspects of a forensic mindset in the audit, provided recommendations about possible audit procedures to be performed relating to fraud that are not commonly performed in a financial statement audit, and provided recommendations on ways audit procedures could be changed to enhance the auditor's consideration of fraud.

Several key themes emerged from that process, as shown in the following table:

Key Theme	Disposition
Consider requiring or recommending a bookend brainstorming session or the concept of continuous brainstorming	Addressed in paragraphs 30 and A46 in the proposed SAS.
Further clarify who should be in the brainstorming session (consider including the entire engagement team rather than just key members of the engagement team)	The ASB retained the concept of key engagement team members and provided further guidance about including individuals with specialized skills in paragraph A58 in the proposed SAS. Further, paragraph .A48 of AU-C section 315 includes guidance relating to key engagement team members.

Key Theme	Disposition
Consider recommending the auditor hold the brainstorming session separately from the planning session	Because GAAS does not require a planning session, no specific changes were made in the proposed SAS.
Provide better guidance/examples on how to be unpredictable (as part of brainstorming session)	Addressed in paragraph A64 in the proposed SAS, including a reference to appendix B for possible examples of an element of unpredictability.
Discuss whether results from data analytics may indicate a fraud risk	Addressed in paragraph A60 in the proposed SAS.
Standard should discuss best methods for fraud inquiries (discussions) Better to be face-to-face	Addressed in paragraph A102 in the proposed SAS.
Need for increased level of curiosity; ask follow-up questions when necessary	Because this relates to proper staff training, the ASB believes this may be better addressed as possible nonauthoritative guidance
Fraud inquiries should be performed by experienced staff with additional staff observing and documenting (may be less experienced)	Addressed in paragraph A102 in the proposed SAS.
Perform fraud inquiries with employees in operations and/or vendors	Addressed in paragraphs A99–A101 in the proposed SAS.
Auditor to ask for documentation instead of placing reliance on inquiry alone	Addressed in paragraph A103 in the proposed SAS.
Be aware of management's major life events that may indicate red flags	Addressed in paragraph A61 in the proposed SAS.
Performing background checks on management	Addressed in paragraphs A71–A72 of Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management;* therefore no specific guidance included in proposed SAS.
If a whistleblower hotline exists, understand how it operates and inspect reports	Addressed in paragraphs 33, A9, A12, A30, A80–A82, A176, A177, A180, and appendix A in the proposed SAS.
Use data analytics to compare to industry peers and nonfinancial information	Addressed in paragraphs A65–A67 in the proposed SAS.

IAASB Fraud Project

In March 2025, the IAASB approved ISA 240 (Revised), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* as a final standard. The ASB has considered ISA 240 (Revised) in developing the changes to generally accepted auditing standards (GAAS) described in this exposure draft.

As mentioned previously, the ASB and the Fraud TF actively monitored that project. The ASB provided input to the development of the IAASB standard through feedback to the IAASB at various stages of drafting the proposed standard, including through U.S. representation on the IAASB and a formal comment letter on the IAASB's exposure draft.

The IAASB developed changes to extant ISA 240 to better reflect the auditor's consideration of fraud and improve the quality of financial statement audits by doing the following:

- Clarifying the role and responsibilities of the auditor for fraud in an audit of financial statements
- Promoting consistent behavior and facilitating effective responses to identified risks of material misstatement due to fraud through
    - establishing more robust requirements and
    - enhancing and clarifying application material where necessary
- Enhancing extant standards to reinforce the importance, throughout the audit, of the appropriate exercise of professional skepticism in fraud-related audit procedures
- Enhancing transparency on fraud-related procedures where appropriate, including strengthening communication with those charged with governance (TCWG) and reporting requirements in extant standards (including ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, which addresses key audit matters [KAMs])

ISA 240 (Revised) is effective for audits of financial statements for periods beginning on or after December 15, 2026.

PCAOB Fraud Project

The Fraud TF is also monitoring the PCAOB's fraud project. The PCAOB has a mid-term standard-setting project on its agenda (as of the November 2024 update) relating to fraud to consider how AS 2401, *Consideration of Fraud in a Financial Statement Audit*, should be revised to better align an auditor's responsibilities for addressing intentional acts that result in material misstatements in financial statements with the auditor's risk assessment, including addressing matters that may arise from developments in the use of technology. Mid-term standard-setting projects are projects in which PCAOB staff are actively engaged but PCAOB action is not anticipated in the next 12 months. As mid-term projects progress, they will be moved onto the PCAOB's short-term projects list. The Fraud TF will continue to monitor the PCAOB for further developments with its fraud project.

Convergence and the ASB Fraud Project

It is the ASB's strategy to converge its standards with those of the IAASB, as appropriate, while taking into consideration the standards of other standard setters. Accordingly, the ASB uses the corresponding ISA as the base when developing a new or revised standard. In developing the proposed SAS, the ASB used ISA 240 (Revised) as the base. However, the proposed SAS does not reflect any revisions related to the IAASB's auditor reporting changes in ISA 240 (Revised). If the ASB were to undertake an auditor reporting project, those revisions would be considered as part of a potential ASB auditor reporting project. See the "Auditor's Report" section of this explanatory memorandum.

The ASB has made certain changes to the language of ISA 240 (Revised) to use terms or phrases that are more common in the United States and to tailor examples and guidance to the U.S. environment. Further, the ASB retained certain requirements from extant AU-C section 240 that were expanded from the requirements of ISA 240. The ASB believes that such changes will not create substantive differences in the application between ISA 240 (Revised) and the proposed SAS.

Supplements to the Exposure Draft

The supplements to this exposure draft include the following:

- A comparison matrix of ISA 240 (Revised), the proposed SAS, extant AU-C section 240, and the rationale for the changes
- An analysis that provides a brief description of how the requirements in the proposed SAS differ from those in ISA 240 (Revised)

Written Representations

Paragraph 62 of ISA 240 (Revised) requires the auditor to obtain written representations from management and, where appropriate, those charged with governance relating to fraud and suspected fraud. Consistent with extant AU-C section 240, the ASB continues to believe that this requirement is more appropriately placed in AU-C section 580, *Written Representations*. Accordingly, the proposed SAS does not include requirements for written representations relating to fraud, but rather, such requirements will continue to reside in AU-C section 580 (see the "Amendments to Various Other SASs" section of this explanatory memorandum). Paragraph A2 of the proposed SAS contains a reference to AU-C section 580 and guidance for written representations relating to fraud. Appendix F to the proposed SAS reflects the proposed amendments to the written representation related to fraud in AU-C section 580. The placement of these requirements does not create differences between the ISAs as a whole and GAAS as a whole.

Auditor's Report

As discussed earlier in the "ASB Research and Outreach" section, the ASB performed outreach about whether potentially enhanced disclosure about fraud in the auditor's report would influence users of the auditor's report. ISA 240 (Revised) enhances the auditor's consideration of fraud-related matters when determining key audit matters (KAMs) to be communicated in the auditor's report. ISA 700 (Revised) requires auditors to communicate KAMs in accordance with ISA 701 for audits of listed entities. GAAS does not require the communication of KAMs. Given the results of the outreach, the recent effective date of the GAAS form of report (which is for audits of financial statements for periods ending on or after December 15, 2023), and GAAS not requiring communication of KAMs, the ASB agreed to consider any revisions affecting the auditor's report in a separate project.[3]

The ASB believes that any changes to the auditor's report should enhance the information provided; enhance audit quality; and establish reporting requirements that are also clear with regard to management's responsibility as the original source of entity-specific information.

Accordingly, if the ASB were to undertake an auditor reporting project, the project would consider the cumulative effect and usefulness of all proposed changes to the auditor's report from the IAASB fraud, going concern, and public interest entities (PIEs) projects.

The ASB work plan provides information about the current standard-setting projects and active projects under consideration and will reflect an auditor reporting project if the ASB undertakes such a project.

Definitions

The ASB has retained the extant definitions for *fraud*, *fraud risk factors*, and *significant unusual transactions* in the proposed SAS. Consistent with extant AU-C section 240, the definition of *fraud* in GAAS differs from that in ISA 240 (Revised).

Proposed SAS (and Extant AU-C Section 240)	ISA 240 (Revised) (and ISA 240)
Fraud. An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit	Fraud — An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

The ASB continues to believe that these differences are warranted because (*a*) the definition in ISA 240 (Revised) is too broad and could inappropriately expose auditors to additional liability in the United States, and (*b*) the meaning of *unjust* could be interpreted very broadly and subjectively in its application and could imply a scope well beyond the intent of the standard.

The ASB considered the differences in the definition of *fraud* in the development of the proposed SAS and believes that because the GAAS definition of fraud relates to an intentional act, involving the use of deception, that results in a "misstatement" of the financial statements (and not "material misstatement" of the financial statements) the differences in the definitions will not create a significant difference between the application of the ISAs and the application of GAAS. Further, paragraph 6 of ISA 240 (Revised) states that "although fraud is a broad legal concept, for the purposes of the ISAs, the auditor is concerned with a material misstatement of the financial

[3]The following AU-C sections encompass the foundational auditor reporting standards:

- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*,
- AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*,
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*, and
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*

statements due to fraud." This key concept is consistent with the proposed SAS. The ASB also notes the definitions in the proposed SAS are similar to those used in PCAOB standards.

Effective Date

If issued as final, the proposed SAS will be effective for audits of financial statements for periods ending on or after December 15, 2028. Early implementation would be permitted.

Request for Comment — Effective Date

1. Do respondents believe that if the final standard is issued no later than October 1, 2026, the proposed effective date for audits of financial statements for periods ending on or after December 15, 2028, is appropriate and provides adequate time for implementation? If not, respondents are asked to state their reasons and suggest an alternate effective date.

Fundamental Aspects of the Proposed Standard

I. Laying the Groundwork

The proposed SAS builds on the foundational concepts relating to an audit of financial statements in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, AU-C section 220, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (such as audit risk, obtaining an understanding of the entity, and identifying and responding to risk at the financial statement and assertion levels) as it relates to identifying and assessing (and responding to) the risks of material misstatement due to fraud.

The proposed SAS does not change the objectives of the auditor as it relates to fraud or suspected fraud, nor does it change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Rather, the proposed SAS includes requirements for the auditor in fulfilling that responsibility as it relates to fraud, including establishing required procedures for when the auditor has identified fraud or suspected fraud. See the section "Fraud or Suspected Fraud" in this explanatory memorandum for a discussion about the new performance requirements.

Paragraphs 1–3 of the proposed SAS explain the scope of the proposed SAS and lay out the responsibilities of the auditor, management, and those charged with governance.

The Auditor's Responsibilities Relating to Fraud (Par. 2–3 and A1–A2 of the proposed SAS)

The proposed SAS retains foundational concepts from extant AU-C section 240 and acknowledges that the primary responsibility for the prevention and detection of fraud rests with both management and those charged with governance of the entity. However, the ASB notes that the focus of the auditing standard relating to fraud in an audit of financial statements should be on the role and responsibilities of the auditor and, accordingly, the ASB included the auditor's responsibilities in the proposed SAS before those of management and those charged with governance. The responsibilities of the auditor have also been placed before the inherent limitations of the audit to make the auditor's responsibilities more succinct and unencumbered by language that may be construed as diminishing the auditor's responsibilities relating to fraud in an audit of financial statements.

While the placement of this content has been moved, the ASB did not seek to fundamentally change the key importance of management's role in the prevention and detection of fraud, or of the role of the auditor. Rather, the ASB focused on how certain aspects of the auditor's role could be clarified.

The Auditor's Responsibilities Relating to Nonmaterial Fraud

As stated in paragraph 6 of the proposed SAS, the auditor is concerned with a material misstatement of the financial statements due to fraud. New application material in paragraph A13 of the proposed SAS clarifies that even when an identified misstatement due to fraud is not "quantitatively material," it may nevertheless be "qualitatively material" depending on who instigated or perpetrated the fraud (for example, management of the entity) and why the fraud was perpetrated (for example, to manipulate key performance metrics).

Request for Comment — *Auditor's Responsibilities*

2. Do respondents agree that the proposed SAS clearly sets out the auditor's responsibilities relating to fraud in an audit of financial statements, including fraud that may not result in a material misstatement to the financial statements? Respondents are asked to state their reasons.

Key Concepts (Par. 4–14 and A3–A19 of the proposed SAS)

Paragraphs 4–14 describe the key concepts contained in the proposed SAS, many of which have not changed from extant, but rather have been enhanced to provide more guidance, including explaining the following:

a. The characteristics of fraud

b. Inherent limitations of an audit as it relates to fraud

c. Professional skepticism and professional judgment relating to identifying fraud or suspected fraud

d. When fraud or suspected fraud also constitutes an instance of noncompliance with laws and regulations

Relationship With Other AU-C Sections (Par. 15 and A20 of the proposed SAS)

Clarifying the Relationship Between the Proposed SAS and AU-C Section 250

To clarify the interrelationship between the proposed SAS and AU-C section 250, paragraph 14 of the proposed SAS explains that fraud *ordinarily* constitutes an instance of noncompliance with laws and regulations and includes an explicit reference to AU-C section 250 for when the auditor identifies fraud or suspected fraud that also constitutes an instance of noncompliance with laws and regulations. Further, paragraph A17 of the proposed SAS explains that the identification by the auditor of fraud or suspected fraud affecting the entity that has been perpetrated by a third party may also give rise to additional responsibilities for the auditor in accordance with AU-C section 250 and the AICPA Code of Professional Conduct.

Request for Comment — *Key Concepts and Relationship With Other AU-C Sections*

3. Do respondents agree that the proposed SAS clearly sets out the key concepts and relationship with other AU-C sections in paragraphs 4–15? Respondents are asked to state their reasons.
4. Do respondents agree that the terms "fraud," "suspected fraud," or "fraud or suspected fraud" are used appropriately throughout the proposed SAS? Respondents are asked to state their reasons.
5. Do respondents agree that the proposed SAS adequately explains the relationship between the proposed SAS and AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*? Respondents are asked to state their reasons.

Definition of Fraud (Par. 18 and A21–A28 of the proposed SAS)

Although the definition of fraud has not changed from extant AU-C section 240, paragraphs A21–A25 of the proposed SAS include additional guidance to explain the relationship of fraud with corruption, bribery, and money laundering, as well as fraud committed against the entity by third parties.

Relationship of Fraud With Corruption, Bribery, and Money Laundering

The proposed SAS includes new application material in paragraphs A21–A23 to help provide linkage about how corruption, bribery, or money laundering are addressed in AU-C section 250 and the AICPA Code of Professional Conduct, and to provide examples of how these concepts relate to the definition of fraud, while highlighting that the auditor does not make legal determinations about such acts.

Third-Party Fraud

The definition of fraud in the proposed SAS continues to refer to intentional acts committed against the entity by third parties. The proposed SAS includes new application material in paragraphs A24–A25 to further clarify what is meant by third-party fraud. This application material explains that third-party fraud is fraud or suspected fraud committed against the entity by parties external to the entity and provides examples. It also clarifies that the audit procedures in paragraphs 55–58 of the proposed SAS would apply when an intentional act by a third party is identified or suspected that may have resulted in misappropriation of assets or fraudulent financial reporting by the entity.

Scalability (Par. A86, A98, A115, and A120 of the proposed SAS)

The proposed SAS contains guidance about how the requirements can be scaled. Although the proposed SAS applies to all fraud or suspected fraud identified by the auditor, the nature, timing, and extent of the auditor's risk assessment and further audit procedures required by this proposed SAS may vary in relation to the assessment of the related risks of material misstatement due to fraud.

The proposed SAS contains scalability considerations specific to smaller or less complex entities (see application material in paragraphs A86, A98, A115, and A120 of the proposed SAS). These are intended to help the auditor by illustrating how a particular requirement in the proposed SAS can be "scaled up" for more complex entities or "scaled down" for audits of less complex entities.

The ASB included examples in the proposed SAS to demonstrate how the nature and extent of the auditor's fraud-related audit procedures may vary based on the nature and circumstances of the audit engagement, such as the following:

a. Determining the need for specialized skills, as well as the nature, timing, and extent of direction, supervision, and review in accordance with paragraphs 23–24 of the proposed SAS would allow the application of judgment by the engagement partner in light of the varying circumstances of an audit (see relevant application material in paragraphs A42 and A46 of the proposed SAS).

b. The appropriate timing of the communications with management and those charged with governance about matters related to fraud in accordance with paragraph 25 of the proposed SAS may vary depending on the significance and nature of the fraud-related matters and the expected actions to be taken by management or those charged with governance (see relevant application material in paragraph A49 of the proposed SAS).

c. The nature and extent of the auditor's work in accordance with paragraphs 55*b*–*c* of the proposed SAS (see the "Fraud or Suspected Fraud" section of this explanatory memorandum), and the documentation of such work, may vary based on the circumstances, depending in part on the results of inquiries made in accordance with paragraph 55*a* of the proposed SAS.

Request for Comment — *Scalability*

6. Do respondents agree that the requirements and application material in the proposed SAS are sufficiently scalable; that is, is the proposed SAS capable of being applied to the audits of entities with a wide range of sizes, complexities, and circumstances? Respondents are asked to state their reasons.

Reference to Relevant Requirements in Other AU-C Sections

The proposed SAS adds new and enhanced requirements that are based on AU-C section 315 and other AU-C sections. The linkage to other SASs is highlighted by using the phrase "in applying AU-C section …" and adding, in the related footnote, a reference to the relevant requirement in the other SASs. The phrase "In applying AU-C section…" signals that a requirement is intended to be applied in addition to or alongside performing the relevant requirements of the foundational standard. In making these changes, the ASB focused on presenting the foundational requirements with a fraud lens in the proposed SAS and attempted to minimize any duplication or repetition of the requirements from AU-C section 315 or other AU-C sections, particularly when enhancing or developing related application and other explanatory material in the proposed SAS. The proposed SAS has been organized to align with the structure of AU-C section 315 to clarify the relationship between the two through the use of similar headings.

Use of Technology

The proposed SAS includes considerations about the use of technology in application material paragraphs A7, A11, A39, A43, A60, A69, A74, A111, A113, A138, A141, A162, A167, A172, and in appendixes B and D. Those paragraphs describe how technology used by the entity could give rise to fraud risk factors or fraud risks and how automated tools and techniques may be used by the auditor to perform fraud-related audit procedures. This guidance is not meant to be all inclusive but rather to highlight areas that may be commonly observed in practice. The ASB believes that the consideration of the use of technology is supported by application material in AU-C section 315. Further, AU-C section 500 explains that the auditor's evaluation of information to be used as audit evidence may be enhanced by the use of automated tools and techniques.[4]

Supplements to the Exposure Draft

The supplements to this exposure draft include a flowchart that identifies the new and enhanced requirements in the proposed SAS relating to or based on other AU-C sections.

Request for Comment — *Linkages With Other AU-C Sections, Including the Use of Technology*

7. Do respondents agree that the proposed SAS has appropriate linkages to other AU-C sections (for example, AU-C section 200, AU-C section 220, AU-C section 315, AU-C section 330, AU-C section 500, AU-C section 520, and AU-C section 540)? Respondents are asked to state their reasons.

II. Maintaining Professional Skepticism Throughout the Audit (Par. 19–22 and A29–A40 of the proposed SAS)

The ASB recognizes the central role that professional skepticism plays in an audit and has emphasized the importance of maintaining professional skepticism in the key concepts section of the proposed SAS. Paragraph 19 of the proposed SAS retains the requirement in paragraph 12 of extant AU-C section 240 that the auditor maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

The ASB also included new application material in paragraph A32, which in turn refers to application material in AU-C section 220, to highlight, for example, how efforts to conceal fraud

[4] Paragraph .A3 of AU-C section 500, *Audit Evidence*.

could be manifested through pressures on the engagement team that impede the appropriate exercise of professional judgment or maintenance of professional skepticism and actions that may be taken to mitigate those impediments.

Remaining Alert for Information That Is Indicative of Fraud or Suspected Fraud (Par. 20 and A30–A34 of the proposed SAS)

The ASB introduced a new requirement in paragraph 20 and related application material in paragraphs A30–A34 to emphasize the importance of remaining alert throughout the audit for information that is indicative of fraud or suspected fraud. Paragraph A31, for example, highlights the importance of remaining alert when performing audit procedures near the end of the audit when time pressures to complete the audit engagement may exist that may impede the appropriate exercise of professional judgment or maintenance of professional skepticism.

Authenticity of Records and Documents (Par. 22 and A36–A40 of the proposed SAS)

Paragraph 22 of the proposed SAS retains the essential guidance from the lead-in sentence to paragraph .13 of extant AU-C section 240 that says, "Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine," because the ASB believes it is important to continue to reinforce this concept in the proposed SAS, and to remove it may have the unintended consequence of unnecessarily increasing the work effort as it pertains to considering the authenticity of records or documents obtained during the audit. This guidance is consistent with application material related to professional skepticism in paragraph .A26 of AU-C section 200.

Request for Comment — *Maintaining Professional Skepticism*
8. Do respondents agree that the proposed SAS appropriately reinforces maintaining professional skepticism about matters relating to fraud in an audit of financial statements? Respondents are asked to state their reasons.

III. Engagement Resources and the Auditor's Risk Identification and Assessment (Par. 23, 26–38, A41–A45, and A52–A117)

As stated previously, the proposed SAS builds on the foundational concepts relating to an audit of financial statements in AU-C section 315 and other AU-C sections. In developing the proposed changes relating to risk identification and assessment, the ASB focused on explaining how to perform the procedures required by AU-C section 315 and other AU-C sections with a fraud lens. The ASB believes that the requirements within the proposed SAS can be completed in conjunction with the procedures required in AU-C section 315 and other AU-C sections and does not require duplication of procedures performed (for example, the proposed SAS does not require a separate risk assessment to be completed by the auditor). See "Reference to Relevant Requirements in Other AU-C Sections" section of this explanatory memorandum.

To provide a fraud lens and enhance the auditor's risk identification and assessment process as it relates to fraud (including many aspects of the enhanced risk identification and assessment procedures in AU-C section 315), the following sections have been included in the proposed SAS that link to AU-C section 315 and other AU-C sections:

Supplements to the Exposure Draft

The supplements to this exposure draft include a flowchart that identifies the new and enhanced requirements in the proposed SAS relating to or based on other AU-C sections.

Engagement Resources

- **Engagement Resources.** Paragraph 23 of the proposed SAS adds a new requirement for the engagement partner to determine that members of the engagement team collectively have the appropriate competence and capabilities, including sufficient time and appropriate skills or knowledge to perform risk assessment procedures to identify and assess the risks of material misstatement due to fraud, design and perform further audit procedures to respond to those risks, or evaluate the audit evidence obtained. The ASB believes that the requirement is appropriate because it provides a fraud lens when applying paragraphs .25–.28 of AU-C section 220. Paragraph A42 of the proposed SAS includes new application material regarding individuals with specialized skills or knowledge or specialists that the engagement partner may consider involving in the audit.

Risk Assessment Procedures and Related Activities

- **Information from other sources.** Paragraph 27 of the proposed SAS enhances the requirement from paragraph .23 of extant AU-C section 240 to require the auditor to consider whether information from other sources obtained by the auditor indicates that one or more fraud risk factors are present. This requirement expands on paragraphs .15–.16 of AU-C section 315.

- **Retrospective review of the outcome of previous accounting estimates.** Paragraph 28 of the proposed SAS extends the requirement from paragraph .32 of extant AU-C section 240 for the auditor to perform a retrospective review of management judgments and assumptions related to accounting estimates reflected in the financial statements of the prior year, and not just those of *significant* accounting estimates. The ASB believes the requirement is appropriate because it is consistent with the scope of paragraph .13 of AU-C section 540 (which applies to all accounting estimates). The proposed SAS includes an amendment to paragraph .A57 of AU-C section 540 (see appendix F of the proposed SAS).

  The ASB also notes that the retrospective review required by the proposed SAS creates an additional requirement for the auditor to review management's judgments and assumptions and is therefore incremental to AU-C section 540, and as a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with AU-C section 540 may be carried out in conjunction with the review required by the proposed SAS.

- **Engagement team discussion.** Paragraph 29 of the proposed SAS enhances the requirements relating to the engagement team discussion, while also retaining the requirements from paragraph .15 of extant AU-C section 240. The engagement team discussion requirements were enhanced to help focus the auditor's considerations of fraud throughout the audit. The proposed SAS aligns the requirement closer to paragraph .17 of AU-C section 315 and enhances the discussion with the engagement team such that, in addition to what was required in paragraph .15 of extant AU-C section 240, the engagement team discussion would also be required to include the following:

- An exchange of ideas or brainstorming among the engagement team members about
  - The entity's culture, management's commitment to integrity and ethical values, and related oversight by those charged with governance
  - Fraud risk factors including how assets of the entity could be misappropriated by management, those charged with governance, employees, or third parties
  - Which types of revenue, revenue transactions, or relevant assertions may give rise to the risks of material misstatement due to fraud in revenue recognition
- A consideration of any fraud or suspected fraud, including allegations of fraud, that may affect the overall audit strategy and audit plan

Paragraphs A46 and A58 of the proposed SAS include new application material regarding when it may be beneficial to hold additional engagement team discussions and involve individuals with specialized skills or knowledge or specialists during engagement team discussions, respectively.

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control

- **Understanding the entity and its environment and the applicable financial reporting framework.** The ASB added a new requirement in paragraph 32 of the proposed SAS, which expands on paragraph .19 of AU-C section 315. The new requirement focuses on aspects of the auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's accounting policies that may lead to an increased susceptibility to misstatement due to management bias or other fraud risk factors (such as performance measures used, whether internal or external, that may create incentives or pressures to achieve financial performance targets).
- **Understanding the components of the entity's system of internal control.** Paragraphs 33–37 of the proposed SAS include a combination of new and enhanced requirements. These requirements expand on paragraphs .21–.22 and .24–.30 of AU-C section 315 and focus on aspects of the auditor's understanding of the components of the entity's system of internal control relating to the following:
  - How management communicates to its employees its views on business practices and ethical behavior with respect to the prevention and detection of fraud (par. 33*a*i)
  - The entity's whistleblower program (or other program to report fraud), if the entity has such a program, including how management and, if

applicable, those charged with governance address allegations of fraud made through the program (par. 33*a*ii)

— How those charged with governance exercise oversight of management's processes for identifying and responding to the fraud risks and the controls that management has established to address these risks (par. 33*a*iii)

— The entity's fraud risk assessment process (par. 34*a*)

— The entity's process that addresses the ongoing and separate evaluations for monitoring the effectiveness of controls to prevent or detect fraud (par. 35*a*i)

— How journal entries and other adjustments are initiated, processed, recorded, and corrected as necessary (given that fraud often involves the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries and other adjustments) (par. 36)

— Controls that address risks of material misstatement due to fraud at the assertion level that are designed to prevent or detect fraud (par. 37)

Control Deficiencies Within the Entity's System of Internal Control

- Paragraph 38 of the proposed SAS includes a new requirement for the auditor to determine whether, based on the auditor's understanding and evaluation of each of the components of the entity's system of internal control, there are deficiencies in internal control identified that are relevant to the prevention or detection of fraud. This requirement expands on paragraph .31 of AU-C section 315.

Request for Comment — *The Auditor's Risk Identification and Assessment*

9. Do respondents agree that the proposed SAS appropriately builds on the foundational requirements in AU-C section 315 and other AU-C sections to enhance the auditor's risk identification and assessment as it relates to fraud? Respondents are asked to state their reasons.

IV. Evaluation of Fraud Risk Factors (Par. 39 and A118–A120)

Paragraph 39 of the proposed SAS enhances the requirement in paragraph .24 of extant AU-C section 240. This paragraph requires the auditor to evaluate whether the audit evidence obtained from the risk assessment procedures and related activities indicates that one or more fraud risk factors are present. Essential material in extant AU-C section 240 (for example, the second sentence of paragraph 24) was moved and now appears as application material to the definition of *fraud risk factors* in paragraph A27 of the proposed SAS.

V. Identifying and Assessing the Risks of Material Misstatement Due to Fraud (Par. 40–42 and A121–A135)

Paragraph 40*a* of the proposed SAS enhances the requirement in paragraph .25 of extant AU-C section 240 by taking into account fraud risk factors and by more closely aligning it to AU-C section 315. This requirement expands on paragraphs .32–.38 of AU-C section 315. Paragraphs A122–A123 of the proposed SAS include new application material to highlight that the auditor's risk response is based on the identification and assessment of risks of material misstatement due to fraud at the financial statement and assertion levels. Paragraph A123 also provides examples of relevant assertions and the related classes of transactions, account balances, or disclosures that may be susceptible to material misstatement due to fraud.

Significant Risk

Paragraph 40*b* of the proposed SAS retains the requirement in paragraph .27 of extant AU-C section 240 to treat all assessed risks of material misstatement due to fraud as significant risks.

Risks of Material Misstatement Due to Fraud Related to Management Override of Controls — Financial Statement Level Risk

Paragraph 41 of the proposed SAS creates a new requirement for the auditor to treat the risk of management override of controls as a risk of material misstatement due to fraud at the financial statement level and to determine whether such risk affects the assessment of risks at the assertion level. This new requirement is intended to drive consistency in practice and aligns with paragraph .34*a* of AU-C section 315, which requires the auditor to determine whether risks of material misstatement at the financial statement level affect the assessment of risks at the assertion level. New application material in paragraphs A126–A127 of the proposed SAS provides further clarification and examples. The ASB believes that it is common practice for auditors to assess the risk of management override of controls at the financial statement level because such risk is typically pervasive to the financial statements and is present in all entities. Further, because all assessed risks of material misstatement due to fraud are required to be treated as significant risks (consistent with extant), the Fraud TF does not intend for this new requirement to create a significant difference from the work effort currently performed.

Request for Comment — *Management Override of Controls*

10. Do respondents agree that the risks of material misstatement due to fraud related to management override of controls should be treated as a risk of material misstatement due to fraud at the financial statement level? Respondents are asked to state their reasons.

Presumption of the Risks of Material Misstatement Due to Fraud in Revenue Recognition

Paragraph 42 of the proposed SAS has been enhanced by requiring the auditor to take into account related fraud risk factors when determining which types of revenue, revenue transactions, or relevant assertions give rise to risks of material misstatement due to fraud. This enhancement is intended to improve the auditor's determination of which types of revenue, revenue transactions, or assertions give rise to risks of material misstatement due to fraud.

The proposed SAS also includes new application material in paragraphs A130–A132 that provides examples of events or conditions relating to revenue that could give rise to fraud risk factors. It clarifies that the significance of fraud risk factors related to revenue recognition, individually or in combination, ordinarily makes it inappropriate for the auditor to rebut the presumption that there are risks of material misstatement due to fraud in revenue recognition.

> **Request for Comment — *Presumption of the Risks of Material Misstatement Due to Fraud in Revenue Recognition***
>
> 11. Do respondents agree that the proposed SAS appropriately addresses the risks of material misstatement due to fraud in revenue recognition? Respondents are asked to state their reasons.

VI. Responses to the Assessed Risks of Material Misstatement Due to Fraud (Par. 43–54 and A136–A172)

To drive more robust responses to assessed risks of material misstatement due to fraud, the proposed SAS introduces a new requirement in paragraph 43 for the auditor to design and perform audit procedures in response to assessed risks of material misstatement due to fraud, in a manner that is not biased toward obtaining audit evidence that may corroborate management's assertions or toward excluding audit evidence that may contradict such assertions.

Paragraphs 48–53 of the proposed SAS enhance the requirements from paragraph .32 of extant AU-C section 240 relating to the audit procedures responsive to risks of material misstatement due to fraud related to management override of controls, including the requirements relating to journal entries and other adjustments. In particular, paragraph 49 of the proposed SAS requires the auditor to design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In doing so, the auditor is required to identify controls over such journal entries and other adjustments, and in accordance with AU-C section 315, evaluate the design and determine whether the controls have been implemented, to provide a basis for the design of audit procedures. This requirement has been included in the proposed SAS to address the requirement in paragraph 27*b* of AU-C section 315 that refers the auditor to the proposed SAS for the applicable requirement.

VII. Fraud or Suspected Fraud (Par. 55–58 and A173–A189)

The proposed SAS introduces new requirements to clarify the auditor's response when fraud or suspected fraud is identified in an audit of financial statements. As noted previously, the objectives of the auditor have not changed from extant, including for the auditor to respond appropriately to fraud or suspected fraud identified during the audit. However, the proposed SAS now includes specific performance requirements in paragraphs 55–58 when fraud or suspected fraud is identified.

New and Enhanced Requirements and Application Material Relating to Fraud or Suspected Fraud

The new requirements in paragraphs 55–58 of the proposed SAS are considered some of the more significant changes from extant and have been proposed to clarify the auditor's responsibilities when fraud or suspected fraud is identified. In particular, paragraph 55 of the proposed SAS requires the auditor to obtain an understanding of the nature and circumstances of fraud or suspected fraud to determine the effect on the audit engagement. Although the need to obtain this understanding was implied in extant AU-C section 240, the requirement in paragraph 55 of the proposed SAS makes it explicit. The new requirements are similar to requirements for publicly traded companies under the Securities Exchange Act of 1934.[5]

The requirement in paragraph 55*a* of the proposed SAS describes how the auditor obtains an understanding of the nature and circumstances of fraud or suspected fraud, and paragraphs 55*b–c* provide the required elements of the auditor's understanding. As explained in paragraph A180 of the proposed SAS, the nature and extent of the auditor's work in accordance with paragraphs 55*b–c*, and the documentation of such work, may vary based on the circumstances, depending in part on the results of inquiries made in accordance with paragraph 55*a*. The auditor may use information obtained (1) from their understanding of the entity's whistleblower program in accordance with paragraph 33*a*ii of the proposed SAS, including the entity's process for investigating and remediating allegations of fraud that came through the entity's whistleblower program, and (2) through performing other risk assessment procedures, to satisfy the requirements in paragraph 55*b–c* of the proposed SAS, and determine whether fraud or suspected fraud is clearly inconsequential.

Based on the understanding obtained by the auditor in accordance with paragraph 55 of the proposed SAS, the engagement partner is then required to make determinations about the effect of fraud or suspected fraud on the audit engagement in accordance with paragraph 56 of the proposed SAS, except for when the fraud or suspected fraud is determined by the auditor to be clearly inconsequential.

The remaining requirements in paragraphs 57–58 of the proposed SAS do not significantly revise the corresponding requirements in paragraphs .35–.37 of extant AU-C section 240. They address the auditor's responsibilities when the auditor identifies a misstatement due to fraud and if the auditor determines the financial statements are materially misstated due to fraud (or the auditor is unable to obtain sufficient appropriate audit evidence to form a conclusion).

Request for Comment — *Fraud or Suspected Fraud*

12. Do respondents agree that the proposed SAS appropriately establishes proper work effort requirements and application material to address circumstances when instances of fraud or suspected fraud are identified in the audit? Respondents are asked to state their reasons.

VIII. Overall Evaluation Based on Audit Procedures Performed (Stand-Back) (Par. 59 and A190)

Paragraph 59 of the proposed SAS includes a stand-back provision that states that in applying AU-C section 330 the auditor should evaluate, based on the audit procedures performed and audit evidence obtained, whether (*a*) the assessments of the risks of material misstatement due to fraud remain appropriate and (*b*) sufficient appropriate audit evidence has been obtained in response to

[5] 15 U.S.C. § 78j-1.

the assessed risks of material misstatement due to fraud. The ASB believes that including such a stand-back in the proposed SAS reinforces the requirement in paragraphs 27–28 of AU-C section 330 and reflects the importance of the audit work performed relating to fraud. Further, the ASB believes the stand-back requirement in paragraph 59 of the proposed SAS is not inconsistent with the stand-back in paragraph .34 of extant AU-C section 240.

Placement of the Stand-Back Provision

The stand-back requirement in paragraph 59 of the proposed SAS has been placed after both the auditor's responses to the assessed risks of material misstatement due to fraud and the auditor's required procedures when fraud or suspected fraud is identified. The placement of this requirement is different from that of ISA 240 (Revised), where the requirement is placed prior to the auditor's required procedures relating to identified fraud or suspected fraud. The ASB believes the placement in the proposed SAS is appropriate because the auditor should consider all of the audit evidence obtained in order to perform this stand-back; the ASB is also of the view that such placement would not create a difference between the application of ISA 240 (Revised) and the proposed SAS.

Request for Comment — *Overall Evaluation Based on Audit Procedures Performed*

13. Do respondents agree that the proposed SAS should include a stand-back provision as included in paragraph 59 and, if so, where it is placed? Respondents are asked to state their reasons.

IX. Ongoing Nature of Communication With Management and Those Charged With Governance (Par. 25, 60, 61–63, A47–A51, and A191–A200)

Communication With Management and Those Charged With Governance in the Proposed SAS

The ASB believes that communication with management and those charged with governance about matters related to fraud is important in all stages of the audit and has reflected this in both requirements and application material throughout the proposed SAS. These communication requirements are not meant to be applied in a linear fashion but are intended to reflect the iterative nature of an audit. When matters related to fraud are communicated with management, those charged with governance, or others within the entity, this is intended to be a robust two-way and open dialogue with active participation by all parties.

Ongoing Nature of Communication With Management and Those Charged With Governance

A new overarching requirement was added in paragraph 25 of the proposed SAS for the auditor to communicate with management and those charged with governance matters related to fraud at appropriate times throughout the audit engagement. New application material in paragraphs A47–A51 highlights the importance of proper two-way communications between management or those charged with governance and the auditor, the extent and the timing of such communications, as well as assigning appropriate members within the engagement team with the responsibility for such communications.

Auditor Unable to Continue the Audit Engagement

Paragraph 60 of the proposed SAS retains the requirements in paragraph .38 of extant AU-C section 240 and continues to require the auditor to 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.

Communication With Management and Those Charged With Governance, and Reporting to an Appropriate Authority Outside the Entity

Paragraphs 61–63 of the proposed SAS enhance the requirements from paragraphs .39–.41 of extant AU-C section 240. One notable change is that if the auditor identifies fraud or suspected fraud involving (*a*) management, (*b*) employees who have significant roles in internal control, or (*c*) others, except for matters that are clearly inconsequential, the auditor is required to communicate these matters with those charged with governance on a timely basis. This differs from the requirement in paragraph .40*c* of extant AU-C section 240 that limits the auditor's responsibilities to "others, when fraud results in a material misstatement in the financial statements." In addition, the proposed SAS amends paragraph .12 of AU-C section 210 to require the auditor to inquire of the predecessor auditor about identified or suspected fraud involving "others, except for matters that are clearly inconsequential" to align with the proposed SAS.

The ASB believes it is appropriate to change the requirement in AU-C section 240 and AU-C section 210 to "others, except for matters that are clearly inconsequential" because this is consistent with the auditor's responsibilities to communicate matters with those charged with governance under paragraph .21 of AU-C section 250.

Request for Comment — *Communication With Those Charged With Governance*

14. Do respondents agree that the requirements for the auditor to communicate fraud or suspected fraud with those charged with governance are appropriate? Respondents are asked to state their reasons.
15. In particular, do respondents agree that it is appropriate for the auditor to communicate with those charged with governance identified fraud or suspected fraud involving others, except for matters that are clearly inconsequential, rather than when the fraud results in a material misstatement in the financial statements? Respondents are asked to state their reasons.

X. Documentation (Par. 65–66 and A203)

Paragraphs 65–66 of the proposed SAS build on the foundational standard on audit documentation in AU-C section 230, *Audit Documentation*, as well as the documentation requirements in AU-C section 315 and AU-C section 330. The following summarizes the more significant revisions to the documentation requirements in paragraphs .43–.46 of extant AU-C section 240:

a. Paragraph 65*a* of the proposed SAS is based on paragraph .43*a* of extant AU-C section 240. The requirement has been simplified to refer more broadly to "matters discussed" by the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud.

b. Paragraph 65*b* of the proposed SAS includes a new requirement that is aligned with paragraph .42*b* of AU-C section 315 for the auditor to document the key elements of the auditor's understanding obtained in accordance with paragraphs 32–37 of the proposed SAS, the sources of information from which the auditor's understanding was obtained, and the risk assessment procedures performed.

c. Paragraph 65*c* of the proposed SAS has been enhanced by requiring that, in addition to documenting the identified and assessed risks of material misstatement due to fraud at both the financial statement and assertion level as required by paragraphs .43*b* and .44*a* of extant AU-C section 240, the auditor also documents the rationale for the significant judgments made.

d. Paragraph 66*b* of the proposed SAS expands on the requirement from paragraph .44*b* of extant AU-C section 240 and requires the auditor to document the results of audit procedures performed to address the risk of management override of controls, the significant professional judgments made, and the conclusions reached.

e. Paragraph 66*c* of the proposed SAS adds a new requirement for the auditor to document fraud or suspected fraud identified, the results of audit procedures performed, the significant professional judgments made, and the conclusions reached.

f. Paragraph 66*d* of the proposed SAS enhances the communication and reporting requirements related to circumstances in which fraud or suspected fraud is identified in the audit. This requirement is based on paragraph .45 of extant AU-C section 240.

Request for Comment — Documentation

16. Do respondents agree with the revisions to the documentation requirements in the proposed SAS? Respondents are asked to state their reasons.

XI. Other Matters

Making Inquiries About Matters Related to Fraud

Extant AU-C section 240 included several requirements relating to making inquiries of management, those charged with governance, and others within the entity. The proposed SAS has relocated and enhanced these requirements and added new requirements. The requirements for making inquiries about matters related to fraud are now placed in the following sections of the proposed SAS:

- **Obtaining an understanding of the entity's system of internal control.** Paragraphs 33*b*–33*d* (control environment component), 34*b* (the entity's risk assessment process component), and 35*b* (the entity's process to monitor the system of internal control component) of the proposed SAS are based on requirements in extant AU-C section 240 and require the auditor to make inquiries of management, those charged with governance, appropriate individuals within the internal audit function (if the function exists), or other appropriate individuals within the entity about matters related to fraud. Enhancements include requiring the auditor to make inquiries of those charged with governance about whether they are aware of deficiencies in the system of internal control related to the prevention and detection of fraud and about the remediation efforts to address such deficiencies (see paragraph 33*d*iii of the proposed SAS). Enhancements also include more robust application material regarding inquiries of those charged with governance, management, and others within the entity and regarding inquiries of internal audit in paragraphs A87–A89, A99–A104, and A106–A108 of the proposed SAS, respectively.

- **Designing and performing audit procedures to test the appropriateness of journal entries and other adjustments.** Paragraph 50*a* of the proposed SAS retains paragraph .32*a*ii of extant AU-C section 240 and requires the auditor to make inquiries of individuals involved in the financial reporting process about their knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
- **If the auditor identifies fraud or suspected fraud.** A new requirement was added in paragraph 55*a* of the proposed SAS, which requires the auditor to make inquiries about the nature and circumstances of the matters with the appropriate level of management and, when appropriate in the circumstances, to make inquiries about fraud or suspected fraud with those charged with governance.

Request for Comment — Inquiries

17. Do respondents agree that the required inquiries about matters related to fraud are appropriate? Respondents are asked to state their reasons.

XII. Amendments to Various Other SASs

The ASB is proposing a number of amendments to other SASs, which arise from the proposed SAS. Most changes relate to the alignment of terminology and changes to clarify fraud-related responsibilities and procedures.

Written Representations

The proposed SAS amends the requirement in paragraph .12 of AU-C section 580. One notable change is that the auditor should request management to provide written representation that it has disclosed to the auditor its knowledge of any fraud or suspected fraud, including allegations of fraud, affecting the entity that involve (*a*) management, (*b*) employees who have significant roles in internal control, or (*c*) others, when the fraud could have an effect on the financial statements. This differs from the requirement in paragraph .12 of extant AU-C section 580 that limited the written representations to “others when the fraud could have a material effect on the financial statements.” The ASB believes it is appropriate to change to “others, when the fraud could have an effect on the financial statements” because it is consistent with the inquiries of management in paragraph 33 of the proposed SAS.

Audits of Group Financial Statements

The ASB proposed amendments to AU-C section 600. One proposed amendment is the addition of paragraph .47, which requires that the group auditor take responsibility for obtaining an understanding of identified fraud or suspected fraud. The ASB noted this change was necessary to clarify that the group auditor is permitted to take responsibility for the component auditor's design and performance of the procedures in paragraph .55 of AU-C section 240 of the proposed SAS.

Accordingly, the ASB revised paragraph .48*h* (formerly paragraph .47*h*) of AU-C section 600 to require the group auditor to request that the component auditor communicate fraud or suspected fraud involving others at entities or business units, except for matters that are clearly inconsequential to the component financial information. The ASB believed that this amendment was necessary, as the group auditor is now taking responsibility for all fraud or suspected fraud in proposed paragraph .47 and, as such, should be made aware of all instances of fraud or suspected fraud identified by the component auditor.

The ASB does not believe that this will result in a significant change in practice because paragraph .48*d* of AU-C section 600 (formerly paragraph .47*d*) requires the auditor to communicate information about instances of noncompliance with laws and regulations and, as noted in paragraph 14 of the proposed SAS, for purposes of GAAS, fraud ordinarily constitutes an instance of noncompliance with laws and regulations.

Request for Comment — Other Matters

18. Are there any other matters you would like to raise in relation to the proposed SAS? If so, clearly indicate the requirements, application material, appendix, or the theme or topic to which your comments relate.

Guide for Respondents

The ASB requests that respondents submit comments using the online survey, which provides an option for respondents to attach a letter before submitting the survey. Respondents may also address comments to commentletters@aicpa-cima.com. Responses submitted via email should be submitted in Word format or directly in the body of the email with the appropriate signature (*name*, *firm*). The ASB requests that all comments be submitted (via email or the survey) by October 3, 2025. Responses will be posted to the AICPA website as a PDF.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, when appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view, as well.

Comments will become part of the public record of the AICPA and will be available on the AICPA's website after October 3, 2025, until a final standard is issued.

Consideration of comments received may result in modification of the proposals in this exposure draft before they are issued in final form.

Supplements to the Exposure Draft

To assist respondents in identifying changes and responding to this request to comment on the proposed revisions included in this exposure draft, the Audit and Attest Standards staff has prepared the following documents:

- A comparison matrix of ISA 240 (Revised); the proposed SAS (ISA 240 (Revised) marked to highlight the differences between the proposed SAS and ISA 240 (Revised)); extant AU-C section 240; and the rationale for the changes
- Mapping of AU-C section 240 to the proposed SAS
- Flowchart that identifies the new and enhanced requirements in the proposed SAS to or based on other AU-C sections
- Draft appendix B, "Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards," which provides a brief description of how the requirements in the proposed SAS differ from those in ISA 240 (Revised)

The staff-prepared supplements to the exposure draft are available on the AICPA website at https://www.aicpa-cima.com/resources/landing/aicpa-exposure-drafts-of-proposed-sass-ssaes-and-sqmss. These are for informational purposes only and do not form part of the exposure draft; however, they may be useful for respondents in formulating comments.

Comment Period

The comment period for this exposure draft ends October 3, 2025.

Auditing Standards Board
(2024–2025)

Fraud Task Force

Heather Funsch, *Chair*
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Michael Bingham
Melissa Bonsall
Patricia Bottomly
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PROPOSED STATEMENT ON AUDITING STANDARDS

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

TABLE OF CONTENTS

Application Material

Proposed Statement on Auditing Standards *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

Introduction

Scope of This Proposed SAS

1. This proposed Statement on Auditing Standards (SAS) addresses the auditor's responsibilities relating to fraud in an audit of financial statements. The requirements and guidance in this proposed SAS refer to, or expand on, the application of other relevant AU-C sections, in particular AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*,[1] AU-C section 220, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. Accordingly, this proposed SAS is intended to be applied in conjunction with other relevant AU-C sections.

Responsibilities of the Auditor, Management, and Those Charged With Governance

Responsibilities of the Auditor

2. The following are the auditor's responsibilities relating to fraud when conducting an audit in accordance with generally accepted auditing standards (GAAS): (Ref: par. A1)

- *a.* Planning and performing the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud. These responsibilities include identifying and assessing risks of material misstatement in the financial statements due to fraud and designing and implementing responses to address those assessed risks.
- *b.* Communicating about matters related to fraud.

Responsibilities of Management and Those Charged With Governance

3. The primary responsibility for the prevention and detection of fraud rests with both management and those charged with governance of the entity. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating and maintaining a culture of honesty and ethical behavior that can be reinforced by active oversight by those charged with governance.

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[1] All AU-C sections can be found in AICPA *Professional Standards*.

Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manipulate earnings in order to influence the perceptions of financial statement users regarding the entity's performance. (Ref: par. A2)

Key Concepts in This Proposed SAS

Characteristics of Fraud

4. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. (Ref: par. A3)

5. Two types of intentional misstatements are relevant to the auditor — misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. (Ref: par. A4–A8)

Fraud or Suspected Fraud

6. Although fraud is a broad legal concept, for the purposes of GAAS, the auditor is concerned with a material misstatement of the financial statements due to fraud. Although the auditor may identify fraud or suspect fraud as defined by this proposed SAS, the auditor does not make legal determinations about whether fraud has actually occurred.

7. The auditor may identify fraud or suspected fraud when performing audit procedures in accordance with GAAS. Suspected fraud includes allegations of fraud that come to the auditor's attention during the course of the audit. (Ref: par. A9–A12 and A30)

8. The auditor's determination of whether a fraud or suspected fraud results in a material misstatement of the financial statements involves the exercise of professional judgment. For identified misstatements due to fraud, this includes consideration of the nature of the circumstances giving rise to the fraud. Judgments about materiality involve both qualitative and quantitative considerations. (Ref: par. A13)

Inherent Limitations

9. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. However, that does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud. Reasonable assurance is a high, but not absolute, level of assurance.[2]

10. Because of the significance of the inherent limitations of an audit as it relates to fraud, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with

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[2] Paragraph .06 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

GAAS.[3] However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence.[4] (Ref: par. A14)

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

Professional Skepticism and Professional Judgment

12. In accordance with AU-C section 200,[5] the auditor is required to plan and perform the audit with professional skepticism and to exercise professional judgment. The auditor is required by this proposed SAS to remain alert to the possibility that other audit procedures performed may bring information about fraud or suspected fraud to the auditor's attention. Accordingly, it is important that the auditor maintain professional skepticism throughout the audit, considering the potential for management override of controls, and recognizing that audit procedures that are effective for detecting error may not be effective in detecting fraud.

13. Professional judgment is exercised in making informed decisions about the courses of action that are appropriate in the circumstances, including when the auditor identifies fraud or suspected fraud. Professional skepticism supports the quality of judgments made by the engagement team and, through these judgments, supports the overall effectiveness of the engagement team in achieving quality at the engagement level. (Ref: par. A15–A16)

Noncompliance With Laws and Regulations

14. For the purposes of GAAS, fraud ordinarily constitutes an instance of noncompliance with laws and regulations. As such, when the auditor identifies fraud or suspected fraud that also constitutes an instance of noncompliance with laws and regulations, the auditor also has responsibilities in accordance with AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. (Ref: par. A17–A19)

Relationship With Other AU-C Sections

15. Some AU-C sections that address specific topics also have requirements and guidance that are applicable to the auditor's work on the identification and assessment of the risks of material misstatement due to fraud and responses to address such assessed risks of material misstatement due to fraud. In these instances, the other AU-C sections expand on how this proposed SAS is applied. (Ref: par. A20)

Effective Date

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[3] Paragraphs .A58–.A59 of AU-C section 200.

[4] Paragraph .A59 of AU-C section 200.

[5] Paragraph .17–.18 of AU-C section 200.

16. This proposed SAS would be effective for audits of financial statements for periods ending on or after December 15, 2028.

Objectives

17. The objectives of the auditor are to

a. identify and assess the risks of material misstatement of the financial statements due to fraud;

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

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

Definitions

18. For purposes of GAAS, the following terms have the meanings attributed as follows:

Fraud. An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit. (Ref: par. A21–A25)

Fraud risk factors. Events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. (Ref: par. A26–A28)

Significant unusual transactions. Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to timing, size, or nature.

Requirements

Professional Skepticism

19. In applying AU-C section 200,[6] the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: par. A29)

20. The auditor should remain alert throughout the audit for information that indicates that one or more fraud risk factors are present and for circumstances that may be indicative of fraud or suspected fraud. (Ref: par. A30–A34)

21. When responses to inquiries of management, those charged with governance, individuals within the internal audit function, or others within the entity are inconsistent or otherwise

[6] Paragraph .17 of AU-C section 200.

unsatisfactory, the auditor should further investigate the inconsistencies or unsatisfactory responses. (Ref: par. A35)

22. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a record or document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor should investigate further. (Ref: par. A36–A40)

Engagement Resources

23. In applying AU-C section 220,[7] the engagement partner should determine that members of the engagement team collectively have the appropriate competence and capabilities, including sufficient time and appropriate skills or knowledge to perform risk assessment procedures to identify and assess the risks of material misstatement due to fraud, design and perform further audit procedures to respond to those risks, or evaluate the audit evidence obtained. (Ref: par. A41–A45)

Engagement Performance

24. In applying AU-C section 220,[8] the engagement partner should determine that the nature, timing, and extent of direction, supervision, and review are responsive to the nature and circumstances of the audit engagement, considering matters identified during the course of the audit engagement, including (Ref: par. A46)

a. fraud risk factors,

b. fraud or suspected fraud, and

c. control deficiencies related to the prevention or detection of fraud.

Ongoing Nature of Communications With Management and Those Charged With Governance

25. The auditor should communicate with management and those charged with governance matters related to fraud at appropriate times throughout the audit engagement. (Ref: par. A47–A51)

Risk Assessment Procedures and Related Activities

26. In applying AU-C section 315,[9] the auditor should perform the procedures in paragraphs 27–39. In doing so, the auditor should consider whether one or more fraud risk factors are present. (Ref: par. A52)

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[7] Paragraphs .25–.28 of AU-C section 220, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

[8] Paragraph .30*b* of AU-C section 220.

[9] Paragraphs .13–.30 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

Information from Other Sources

27. In applying AU-C section 315,[10] the auditor should consider whether information from other sources obtained by the auditor indicates that one or more fraud risk factors are present. (Ref: par. A53–A54)

Retrospective Review of the Outcome of Previous Accounting Estimates

28. In applying AU-C section 540, *Auditing Accounting Estimates and Related Disclosures*,[11] the auditor should perform a retrospective review of management judgments and assumptions related to the outcome of previous accounting estimates or, when applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement due to fraud in the current period. In doing so, the auditor should take into account the characteristics of the accounting estimates in determining the nature and extent of that review. (Ref: par. A55–A56)

Engagement Team Discussion

29. In applying AU-C section 315,[12] when holding the engagement team discussion, the engagement partner and other key engagement team members should place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur. In doing so, the engagement team discussion should include the following: (Ref: par. A46, A57–A58, and A64)

- *a.* An exchange of ideas or brainstorming among the engagement team members about the following:
    - i. The entity's culture, management's commitment to integrity and ethical values, and related oversight by those charged with governance (Ref: par. A59)
    - ii. Fraud risk factors, including (Ref: par. A60–A62)
        - (1) incentives or pressures on management, those charged with governance, or employees to commit fraud;
        - (2) how one or more individuals among management, those charged with governance, or employees could perpetrate and conceal fraudulent financial reporting, including consideration of circumstances that might be indicative of manipulation of earnings or other financial measures and the practices that might be followed by management to manipulate earnings or other financial measures that could lead to fraudulent financial reporting;

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[10] Paragraphs .15–.16 of AU-C section 315.

[11] Paragraph .13 of AU-C section 540, *Auditing Accounting Estimates and Related Disclosures.*

[12] Paragraphs .17 and .A48–.A51 of AU-C section 315.

(3) how assets of the entity could be misappropriated by management, those charged with governance, employees, or third parties

iii. Which types of revenue, revenue transactions, or relevant assertions may give rise to the risks of material misstatement due to fraud in revenue recognition

iv. How management may be able to override controls (Ref: par. A63)

b. The importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud

c. How the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud

d. A consideration of any fraud or suspected fraud that may affect the overall audit strategy and audit plan, including fraud that has occurred at the entity during the current or prior periods

30. Communication among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new information during the audit.

Analytical Procedures Performed and Unusual or Unexpected Relationships Identified

31. The auditor should determine whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud. (Ref: par. A65–A67)

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control

Understanding the Entity and Its Environment and the Applicable Financial Reporting Framework

32. In applying AU-C section 315,[13] based on the auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's accounting policies, the auditor should obtain an understanding of matters that may lead to an increased susceptibility to misstatement due to management bias or other fraud risk factors. (Ref: par. A68–A77)

Understanding the Components of the Entity's System of Internal Control

Control Environment

33. In applying AU-C section 315,[14] the auditor should do the following:

a. Obtain an understanding of

[13] Paragraph .19 of AU-C section 315.

[14] Paragraph .21 of AU-C section 315.

i. how management's oversight responsibilities are carried out, such as the entity's culture and management's commitment to integrity and ethical values, including how management communicates to its employees its views on business practices and ethical behavior with respect to the prevention and detection of fraud. (Ref: par. A78–A79)

ii. the entity's whistleblower program (or other program to report fraud), if the entity has such a program, including how management and, if applicable, those charged with governance address allegations of fraud made through the program. (Ref: par. A80–A82)

iii. when those charged with governance are separate from management, how those charged with governance exercise oversight of management's processes for identifying and responding to fraud risks and the controls that management has established to address these risks. (Ref: par. A83–A86)

b. When those charged with governance are separate from management, make inquiries of management regarding management's communications with those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity.

c. Make inquiries of management about whether the entity has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or lack thereof) of those transactions and whether such transactions involved related parties.

d. When those charged with governance are separate from management, make inquiries of those charged with governance about the following: (Ref: par. A87–A89)

i. Whether they have knowledge of any fraud or suspected fraud, including allegations of fraud, including those received from tips or complaints, affecting the entity, and if so, how they have responded to such matters

ii. Their views about whether and how the financial statements may be materially misstated due to fraud, including their views on possible areas that are susceptible to misstatement due to management bias or management fraud

iii. Whether they are aware of deficiencies in the system of internal control related to the prevention and detection of fraud, and the remediation efforts to address such deficiencies

iv. Whether the entity has entered into any significant unusual transactions

The Entity's Risk Assessment Process

34. In applying AU-C section 315,[15] the auditor should do the following:

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[15] Paragraph .22 of AU-C section 315.

a. Obtain an understanding of how the entity's risk assessment process (Ref: par. A90–A98 and A115)

i. identifies and monitors fraud risks related to the misappropriation of assets and fraudulent financial reporting, including any classes of transactions, account balances, or disclosures for which risks of fraud exist;

ii. assesses the significance of the identified fraud risks, including the likelihood of their occurrence; and

iii. addresses the assessed fraud risks.

b. Make inquiries of management and of other appropriate individuals within the entity, including personnel not directly involved in the financial reporting process, about (Ref: par. A99–A104)

i. whether they have knowledge of any fraud or suspected fraud, including allegations of fraud, affecting the entity;

ii. their views about whether and how the financial statements may be materially misstated due to fraud; and

iii. whether they are aware of any instances of management override of controls.

The Entity's Process to Monitor the System of Internal Control

35. In applying AU-C section 315,[16] the auditor should do the following:

a. Obtain an understanding of

i. aspects of the entity's process to monitor the system of internal control that address the ongoing and separate evaluations for monitoring the effectiveness of controls to prevent or detect fraud, and the identification and remediation of related control deficiencies identified; and (Ref: par. A105)

ii. if the entity has an internal audit function, the internal audit function's objectives in respect of monitoring controls over risks of fraud.

b. If the entity has an internal audit function, make inquiries of appropriate individuals within the internal audit function about whether (Ref: par. A106–A108)

i. they have performed any procedures to identify, detect, or investigate fraud or in respect of monitoring controls over risks of fraud during the period;

ii. they believe management and those charged with governance have satisfactorily responded to any findings resulting from these procedures;

iii. they have knowledge of any fraud or suspected fraud, including allegations of fraud, affecting the entity and to obtain their views about the risks of fraud;

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[16] Paragraph .24 of AU-C section 315.

iv. they are aware of deficiencies in the system of internal control related to the prevention and detection of fraud;

v. they are aware of any instances of management override of controls; and

vi. they are aware that the entity has entered into any significant unusual transactions.

The Information System and Communication

36. In applying AU-C section 315,[17] the auditor's understanding of the entity's information system and communication relevant to the preparation of the financial statements should include understanding how journal entries and other adjustments are initiated, processed, recorded, and corrected as necessary. (Ref: par. A109–A111)

Control Activities

37. In applying AU-C section 315,[18] the auditor's understanding of the entity's control activities component should include identifying controls that address risks of material misstatement due to fraud at the assertion level that are designed to prevent or detect fraud. (Ref: par. A112–A115)

Control Deficiencies Within the Entity's System of Internal Control

38. In applying AU-C section 315,[19] based on the auditor's understanding and evaluation of each of the components of the entity's system of internal control, the auditor should determine whether there are deficiencies in internal control identified that are relevant to the prevention or detection of fraud. (Ref: par. A116–A117)

Evaluation of Fraud Risk Factors

39. The auditor should evaluate whether the audit evidence obtained from the risk assessment procedures and related activities indicates that one or more fraud risk factors are present. (Ref: par. A26–A28 and A118–A120)

Identifying and Assessing the Risks of Material Misstatement Due to Fraud

40. In applying AU-C section 315,[20] the auditor should do the following:

a. Identify and assess the risks of material misstatement due to fraud and determine whether they exist at the financial statement level or at the assertion level for classes of transactions, account balances, and disclosures, taking into account fraud risk factors. (Ref: par. A121–A125)

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17 Paragraph .25 of AU-C section 315.

18 Paragraph .27*a* of AU-C section 315.

19 Paragraph .31 of AU-C section 315.

20 Paragraphs .32–.38 of AU-C section 315.

b. Treat those assessed risks of material misstatement due to fraud as significant risks. Accordingly, to the extent not already done so, the auditor should identify controls that address such significant risks, evaluate whether they have been designed effectively to address the risks of material misstatement, or designed effectively to support the operation of other controls, and determine whether the controls have been implemented.

Risks of Material Misstatement Due to Fraud Related to Management Override of Controls

41. Due to the unpredictable way in which management is able to override controls and irrespective of the auditor's assessment of the risk of management override of controls, the auditor should (Ref: par. A126–A127)

a. treat the risk of management override of controls as a risk of material misstatement due to fraud at the financial statement level and

b. determine whether such risk affects the assessment of risks at the assertion level.

Risks of Material Misstatement Due to Fraud in Revenue Recognition

42. When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that there are risks of material misstatement due to fraud in revenue recognition, determine which types of revenue, revenue transactions, or relevant assertions give rise to such risks, taking into account related fraud risk factors. (Ref: par. A128–A135)

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Designing and Performing Audit Procedures in a Manner That Is Not Biased

43. The auditor should design and perform audit procedures in response to the assessed risks of material misstatement due to fraud in a manner that is not biased toward obtaining audit evidence that may corroborate management's assertions or toward excluding audit evidence that may contradict such assertions.

Unpredictability in the Selection of Audit Procedures

44. In determining responses to address assessed risks of material misstatement due to fraud, the auditor should incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures. (Ref: par. A136–A137)

Overall Responses

45. In accordance with AU-C section 330,[21] the auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. (Ref: par. A138–A139)

46. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting, or a bias that may create a material misstatement.

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

47. In accordance with AU-C section 330,[22] the auditor should design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement due to fraud at the assertion level, and in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory. When evaluating audit evidence with respect to the assessed risks of material misstatement, the auditor maintains professional skepticism, including when considering information that may be used as audit evidence and what procedures would be appropriate in the circumstances. (Ref: par. A140–A147)

Audit Procedures Responsive to Risks of Material Misstatement Due to Fraud Related to Management Override of Controls

48. Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls, by designing and performing the audit procedures in accordance with paragraphs 49–53. In addition, the auditor should determine whether other audit procedures are needed in addition to those in paragraphs 49–53 in order to respond to the identified risk of management override of controls.

Journal Entries and Other Adjustments

49. The auditor should design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to the financial statements. In doing so, the auditor should identify controls over such journal entries and other adjustments, and in accordance with AU-C section 315, evaluate the design and determine whether the controls have been implemented, to provide a basis for the design of the audit procedures.[23] (Ref: par. A148–A154)

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[21] Paragraph .05 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

[22] Paragraph .06 of AU-C section 330.

[23] See paragraphs .27*b* and .30 of AU-C section 315.

50. In designing and performing audit procedures in accordance with paragraph 49, the auditor should do the following: (Ref: par. A109)

a. Make inquiries of individuals involved in the financial reporting process about their knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

b. Obtain audit evidence about the completeness of the population of journal entries recorded in the general ledger and other adjustments made throughout the period. (Ref: par. A155 and A162)

c. Consider fraud risk factors, the nature and complexity of accounts, and unusual entries processed.

d. Select journal entries recorded in the general ledger and other adjustments made at the end of a reporting period, including those posted directly to the financial statements. (Ref: par. A156–A158, A159 and A161–A162)

e. Determine the need to test journal entries recorded in the general ledger and other adjustments made throughout the period, including those posted directly to the financial statements. (Ref: par. A157–A158 and A160–A161)

Accounting Estimates

51. In applying AU-C section 540,[24] if indicators of possible management bias are identified, the auditor should evaluate whether they may represent a risk of material misstatement due to fraud. (Ref: par. A163–A165)

52. In performing the evaluation in accordance with paragraph 51, the auditor should

a. consider the audit evidence obtained from the retrospective review performed in accordance with paragraph 28, and

b. if indicators of possible management bias that may represent a risk of material misstatement due to fraud are identified, reevaluate the accounting estimates taken as a whole. (Ref: par. A165–A168)

Significant Unusual Transactions

53. The auditor should evaluate, given the auditor's understanding of the entity and its environment and other information obtained during the audit, whether the business purpose (or the lack thereof) of significant unusual transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. The procedures should include the following: (Ref: par. A169–A170)

a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and

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[24] Paragraph .32 of AU-C section 540.

other audit evidence about the business purpose (or the lack thereof) of the transaction

b. Determining whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures

c. Evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements

Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion

54. In applying AU-C section 520, *Analytical Procedures*,[25] the auditor should determine whether the results of analytical procedures that are performed near the end of the audit, when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity, indicate a previously unrecognized risk of material misstatement due to fraud. If not already performed when forming an overall conclusion, the analytical procedures relating to revenue required by paragraph 31 should be performed through the end of the reporting period. (Ref: par. A171–A172)

Fraud or Suspected Fraud (Ref: par. A9–A13, A30, and A173–A189)

55. If the auditor identifies fraud or suspected fraud, the auditor should obtain an understanding of the nature and circumstances of the matters to determine the effect on the audit engagement. In doing so, the auditor should do the following: (Ref: par. A175–A189)

a. Make inquiries about the nature and circumstances of the matters with the appropriate level of management and, when appropriate in the circumstances, make inquiries about the matters with those charged with governance.

b. If the entity has a process to investigate the matters, evaluate whether it is appropriate in the circumstances.

c. If the entity has implemented remedial actions to respond to the matters, evaluate whether they are appropriate in the circumstances.

56. Except for fraud or suspected fraud determined by the auditor to be clearly inconsequential based on the procedures performed in paragraph 55, the engagement partner should do the following: (Ref: par. A181–A183)

a. Determine whether

i. to perform additional risk assessment procedures to provide an appropriate basis for the identification and assessment of the risks of material misstatement due to fraud in accordance with AU-C section 315;

ii. to design and perform further audit procedures to appropriately respond to the risks of material misstatement due to fraud in accordance with AU-C section 330; and

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[25] Paragraph .06 of AU-C section 520, *Analytical Procedures*.

iii. there are additional responsibilities for the auditor under law, regulation, or relevant ethical requirements about the entity's noncompliance with laws or regulations in accordance with AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

b. If applicable, consider the effect on prior-period audits.

57. If the auditor identifies a misstatement due to fraud, the auditor should do the following: (Ref: par. A184–A189)

a. Determine whether the identified misstatement is material by considering the nature of the qualitative or quantitative circumstances giving rise to the misstatement.

b. Determine whether control deficiencies exist, including significant deficiencies or material weaknesses in internal control related to the prevention or detection of fraud, relating to the identified fraud or suspected fraud.

c. Determine the implications of the misstatement in relation to other aspects of the audit, including when the auditor has reason to believe that management is involved.

d. Reconsider the reliability of management's representations and audit evidence previously obtained, including when the circumstances or conditions giving rise to the misstatement indicate possible collusion involving employees, management, or third parties.

58. If the auditor determines that the financial statements are materially misstated due to fraud or the auditor is unable to obtain sufficient appropriate audit evidence to enable the auditor to conclude whether the financial statements are materially misstated due to fraud, the auditor should

a. determine the implications for the audit and the auditor's opinion on the financial statements in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*, and

b. if appropriate, obtain advice from legal counsel.

Overall Evaluation Based On Audit Procedures Performed

59. In applying AU-C section 330,[26] the auditor should evaluate, based on the audit procedures performed and audit evidence obtained, whether

a. the assessments of the risks of material misstatement due to fraud remain appropriate, and

b. sufficient appropriate audit evidence has been obtained in response to the assessed risks of material misstatement due to fraud. (Ref: par. A190)

Auditor Unable to Continue the Audit Engagement

[26] Paragraphs .27–.28 and .A76–.A79 of AU-C section 330.

60. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters circumstances that bring into question the auditor's ability to continue performing the audit engagement, the auditor should do the following:

a. Determine the professional and legal responsibilities applicable in the circumstances, including whether a requirement exists for the auditor to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities.

b. Consider whether it is appropriate to withdraw from the engagement, when withdrawal is possible under applicable law or regulation.

c. If the auditor withdraws,

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

   ii. determine whether there is a professional or legal requirement to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: par. A191–A194)

d. When law or regulation prohibits the auditor from withdrawing from the engagement, consider whether the circumstances will result in a disclaimer of opinion on the financial statements.

Communications With Management and Those Charged With Governance

Communication With Management

61. If the auditor identifies fraud or suspected fraud, the auditor should communicate these matters, on a timely basis with the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: par. A195–A196)

Communication With Those Charged With Governance

62. Unless all of those charged with governance are involved in managing the entity, if the auditor identifies fraud or suspected fraud, involving

a. management;

b. employees who have significant roles in internal control; or

c. others, except for matters that are clearly inconsequential,

the auditor should communicate these matters with those charged with governance on a timely basis. If the auditor identifies suspected fraud involving management, the auditor should communicate the suspected fraud with those charged with governance and discuss with them the nature, timing, and extent of audit procedures necessary to complete the audit. (Ref: par. A195 and A197–A199)

63. The auditor should communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to the responsibilities of those charged with governance. (Ref: par. A195 and A200)

Reporting to an Appropriate Authority Outside the Entity

64. If the auditor identifies fraud or suspected fraud, the auditor should determine whether the auditor has a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: par. A201–A202)

Documentation

65. The auditor should include the following in the audit documentation of the identification and assessment of the risks of material misstatement required by AU-C section 315: (Ref: par. A203)

- *a.* The matters discussed among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud in accordance with paragraph 29, how and when the discussion occurred, and the engagement team members who participated.
- *b.* Key elements of the auditor's understanding in accordance with paragraphs 32–37, the sources of information from which the auditor's understanding was obtained, and the risk assessment procedures performed.
- *c.* The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level, and the rationale for the significant judgments made.

66. In applying AU-C section 230, *Audit Documentation*,[27] the auditor should include the following in the audit documentation:

- *a.* If the auditor has concluded that the presumption that a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, the reasons for that conclusion.
- *b.* The results of audit procedures performed to address the risk of management override of controls, the significant professional judgments made, and the conclusions reached.
- *c.* Fraud or suspected fraud identified, the results of audit procedures performed, the significant professional judgments made, and the conclusions reached.
- *d.* The matters related to fraud or suspected fraud communicated with management, those charged with governance, regulatory and enforcement authorities, and others,

[27] Paragraphs .08–.12, .A9, and .A30 of AU-C section 230, *Audit Documentation.*

including how management and, where applicable, those charged with governance have responded to the matters.

Application and Other Explanatory Material

Responsibilities of the Auditor, Management, and Those Charged With Governance

Responsibilities of the Auditor (Ref: par. 2)

Considerations Specific to Governmental Entities and Not-for-Profit Organizations

A1. The auditor of governmental entities and not-for-profit organizations may have additional responsibilities relating to fraud, for example,

- as a result of being engaged to conduct an audit in accordance with law or regulation applicable to governmental entities and not-for-profit organizations,
- because of a governmental audit organization's mandate, or
- because of the need to comply with *Government Auditing Standards*.

Consequently, the responsibilities of the auditor of governmental entities and not-for-profit organizations may not be limited to consideration of risks of material misstatement of the financial statements and may also include a broader responsibility to consider risks of fraud.

Responsibilities of Management and Those Charged With Governance (Ref: par. 3)

Written Representations

A2. AU-C section 580, *Written Representations*, addresses obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. Although written representations are an important source of audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledges its responsibility for internal control designed, implemented, and maintained to prevent and detect fraud. Further, because management is in a unique position to perpetrate fraud, it is important for the auditor to consider all audit evidence obtained, including audit evidence that is consistent or inconsistent with other audit evidence in drawing the conclusion required in accordance with AU-C section 330.[28] AU-C section 580 also addresses circumstances in which the auditor has doubt about the reliability of written representations, including if written representations are inconsistent with other audit evidence. Doubts about the reliability of information from management may indicate a risk of material misstatement due to fraud.[29]

Key Concepts in This Proposed SAS

[28] Paragraph .28 of section 330.

[29] Paragraphs .22–.24 of AU-C section 580, *Written Representations*.

Characteristics of Fraud (Ref: par. 4–5)

A3. Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor's objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement whether due to fraud or error.[30]

A4. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act. The following provide examples of incentives or pressures to commit fraud, perceived opportunities to do so, and rationalizations of the act.

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

A5. Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users. It can be caused by the efforts of management to manipulate earnings to deceive financial statement users by influencing their perceptions about the entity's performance and profitability. Such earnings manipulation may start out with small actions, or adjustment of assumptions, and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in material fraudulent financial reporting. This could occur when

- management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements due to pressures to meet expectations or a desire to maximize compensation based on performance.
- management reduces earnings by a material amount to minimize tax.
- management inflates earnings to secure bank financing.

[30] Paragraph .12 of AU-C section 200.

- in governmental entities and not-for-profit organizations, management misreports or underreports expenditures, especially when such expenditures are subject to statutory limits.

A6. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information.
- Intentional misapplication of the applicable financial reporting framework relating to amounts, classification, manner of presentation, or disclosure.

A7. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as intentionally

- recording fictitious journal entries to manipulate operating results or achieve other objectives.
- inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- misstating disclosures, including omitting and obscuring disclosures, required by the applicable financial reporting framework or disclosures that are necessary to achieve fair presentation.
- concealing facts that could affect the amounts recorded in the financial statements.
- engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- altering records and terms related to transactions.
- altering reports that would highlight inappropriate activity or transactions.
- taking advantage of ineffectively designed information processing controls in information technology (IT) applications, including controls over and review of IT application event logs (for example, modifying the application logic, accessing a common database using generic access identification, or modifying access identification, to conceal activity).

A8. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management, who are usually better positioned to disguise or conceal misappropriations in ways that are difficult to detect. In addition, misappropriation of assets can involve third parties. Misappropriation of assets can be accomplished in a variety of ways and is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization. Examples of misappropriation of assets include the following:

- Embezzling funds (for example, misappropriating collections of accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts)
- Theft of assets (for example, stealing inventory for personal use, stealing scrap for resale, theft of digital assets by exploiting a private key and in doing so allowing the perpetrator to control the entity's funds, theft of intellectual property by colluding with a competitor to disclose technological data in return for payment)
- Causing an entity to pay for goods and services not received (for example, payments to fictitious suppliers, kickbacks paid by suppliers to the entity's purchasing agents in return for approving payment for inflated prices, or payments to fictitious employees)
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party)

Fraud or Suspected Fraud (Ref: par. 7 and 55–58)

A9. Audit evidence obtained when performing risk assessment procedures and further audit procedures in accordance with this proposed SAS may indicate the existence of fraud or suspected fraud, such as in the following examples:

- When obtaining an understanding of the entity's whistleblower program, the auditor identified a tip submitted to the entity's fraud reporting hotline that alleged that management had inflated earnings by entering into transactions with related parties that lacked a business purpose.
- When performing further audit procedures to respond to assessed risks of material misstatement due to fraud at the assertion level for inventory, the auditor obtained audit evidence that indicated the possible misappropriation of products from the entity's warehouse by employees.

A10. Audit procedures performed to comply with other AU-C sections may also bring instances of fraud or suspected fraud to the auditor's attention including, for example, procedures performed in accordance with AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*[31] when responding to assessed risks of material misstatement due to fraud arising from the consolidation process.

A11. The auditor may use automated tools and techniques to perform audit procedures related to identifying and assessing the risks of material misstatement due to fraud or when responding to assessed risks of material misstatement due to fraud. This may allow the auditor to evaluate large amounts of data more easily to, for example, provide deeper insights or identify unusual trends, which enhances the ability of the auditor to maintain professional skepticism and more

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[31] Paragraph .40*d* of AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*.

effectively challenge management's assertions. The auditor may also use automated tools and techniques to perform audit procedures related to journal entry testing in a more efficient and effective manner. However, the use of automated tools and techniques does not replace the need to maintain professional skepticism and to exercise professional judgment throughout the audit.

A12. For the purpose of this proposed SAS, allegations of fraud by another party involving the entity are treated by the auditor as suspected fraud once the allegations have come to the auditor's attention (for example, identified as a result of inquiries made by the auditor of management, or when obtaining an understanding of the entity's whistleblower program [or other program to report fraud]). The party making the allegations may be internal or external to the entity. Accordingly, the auditor performs audit procedures in accordance with paragraphs 55–58 to address the suspected fraud.

A13. Even when an identified misstatement due to fraud is not quantitatively material, it may be qualitatively material depending on the following:

- *Who instigated or perpetrated the fraud.* An otherwise insignificant fraud perpetrated by senior management or a public official is ordinarily considered qualitatively material irrespective of the amount involved. This may in turn give rise to concerns about the integrity of management responsible for the entity's system of internal control.
- *Why the fraud was perpetrated.* Misstatements that are not material quantitatively, either individually or in the aggregate, may have been made intentionally by management to manipulate key performance indicators in order to, for example, meet expectations, maximize compensation based on performance, or comply with the terms of debt covenants. In governmental entities, misstatements may have been made intentionally by management to achieve a surplus when a deficit is prohibited by legislation or to misreport expenses incurred to avoid breaching statutory limits.

Inherent Limitations (Ref: par. 10)

A14. The risk of not detecting a material misstatement resulting from fraud exists because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. Although the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in areas requiring judgment, such as accounting estimates, are caused by fraud or error.

Professional Skepticism and Professional Judgment (Ref: par. 13)

A15. Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management,*[32] requires the firm to design, implement, and operate a system of quality management for audits of financial statements. The firm's commitment to an effective system of quality management underpins the requirement for the auditor to maintain professional skepticism when performing the audit engagement. The governance and leadership component of the system of quality management establishes the environment that supports the design, implementation, and operation of the system of quality management. The firm is required to establish quality objectives that address the firm's governance and leadership, which includes the following:

- The firm demonstrates a commitment to quality through the culture that exists throughout the firm.
- Leadership of the firm demonstrates a commitment to quality through its actions and behaviors. For example, the tone at the top set by leadership contributes to the firm's culture, which in turn supports and encourages the auditor to focus on the auditor's responsibilities relating to fraud in an audit of financial statements.
- Resource needs, including financial resources, are planned for, and resources are obtained, allocated, or assigned in a manner that is consistent with the firm's commitment to quality. For example, resources with the appropriate specialized knowledge and skills that may be needed when performing audit procedures related to fraud in an audit of financial statements have been assigned.

A16. SQMS No. 1 also explains that the quality of professional judgments exercised by the firm is likely to be enhanced when individuals making such judgments demonstrate an attitude that includes an inquiring mind.[33]

Noncompliance With Laws and Regulations (Ref: par. 14)

A17. The identification by the auditor of fraud or suspected fraud affecting the entity that has been perpetrated by a third party (see paragraphs 18 and A24) may also give rise to additional responsibilities for the auditor in accordance with AU-C section 250.

A18. Complying with the requirements of this proposed SAS may also fulfill certain applicable requirements in AU-C section 250. For example, when performing tests of details on a bank's loan portfolio, the auditor identified a series of loans to newly formed entities connected to senior management that lacked appropriate documentation. The auditor determined the circumstances were indicative of fraudulent approvals of loans by senior management to related parties. After obtaining an understanding of the suspected fraud in accordance with paragraph 55, the auditor concluded the understanding was also sufficient to meet the requirement in paragraph .17*a* of AU-C section 250. The auditor evaluated the possible effect on the financial statements of the fine for the entity's suspected violation of banking regulations regarding related party lending in accordance with paragraph .17*b* of AU-C section 250.

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[32] SQMS No. 1, *A Firm's System of Quality Management* (QM section 10). All QM sections can be found in AICPA *Professional Standards*.

[33] Paragraph .A31 of SQMS No. 1.

A19. Law, regulation, or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the AICPA Code of Professional Conduct (AICPA code) requires the auditor to take steps to respond to identified or suspected noncompliance with laws and regulations.[34]

Relationship With Other AU-C Sections (Ref: par. 15)

A20. Appendix E, "Other AU-C Sections Addressing Specific Topics that Reference Fraud or Suspected Fraud," identifies other AU-C sections that address specific topics that reference fraud or suspected fraud.

Definitions (Ref: par. 18)

Relationship of Fraud to Corruption, Bribery, and Money Laundering (Ref: par. 18)

A21. Depending on the nature and circumstances of the entity, certain laws, regulations, or aspects of relevant ethical requirements dealing with corruption, bribery, or money laundering may be relevant to the auditor's responsibilities to consider laws and regulations in an audit of financial statements in accordance with AU-C section 250 and the AICPA code.[35]

A22. Corruption, bribery, and money laundering are forms of illegal or unethical acts. Corruption, bribery, and money laundering may be distinct concepts in law or regulation; however, they may also be fraudulent acts, or may be carried out to facilitate or conceal fraud. The following are examples of corruption, bribery, and money laundering:

- *Corruption involving fraud.* Management colluded with other competing parties to raise prices or lower the quality of goods or services for purchasers who wish to acquire products or services through a bidding process (such as bid rigging). The bid rigging included monetary payments by the designated winning bidder to colluding parties using fraudulent consulting contracts for which no actual work took place.
- *Bribery to conceal fraud.* Management offered inducements to employees for concealing the misappropriation of assets by management.
- *Money laundering to facilitate fraud.* An employee laundered money to an offshore bank account that was illegally obtained from embezzling payments for fictitious purchases of inventory through the creation of false purchase orders, supplier shipping documents, and supplier invoices.

A23. Although the auditor may identify or suspect corruption, bribery, or money laundering, as with fraud, the auditor does not make legal determinations about such acts.

Third-Party Fraud (Ref: par. 18)

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[34] For example, paragraphs .22–.23 of the "Responding to Noncompliance With Laws and Regulations" interpretation (ET section 1.180.010) under the "Integrity and Objectivity Rule" (ET section 1.100.001) of the AICPA Code of Professional Conduct provide requirements and application material relating to communication with respect to groups. All ET sections can be found in AICPA *Professional Standards.*

[35] Paragraph .06 of AU-C section 250 and paragraph .08 of ET section 1.180.010.

A24. Fraud or suspected fraud committed against the entity by parties external to the entity is generally described as "third-party fraud." Fraud, as defined in paragraph 18, can include an intentional act by a third party, and accordingly, if an intentional act by a third party is identified or suspected that may have resulted in misappropriation of the entity's assets or fraudulent financial reporting by the entity, the auditor performs the audit procedures in paragraphs 55–58.

A25. Parties external to the entity that may commit third-party fraud may include the following:

- Related parties, in which potential opportunities for collusion with management, overly complex transactions, or bias in the structure of transactions may exist, as explained in AU-C section 550, *Related Parties*.
- Third parties with which the entity has a relationship to support their business model, such as customers, suppliers, service providers, or other external parties known to the entity. These relationships may introduce the risk of collusion with employees or others in the entity to, for example, create fictitious transactions to manipulate financial results.
- Third parties unknown to the entity that may, for example, attempt to gain unauthorized access to an entity's IT environment that affects financial reporting or assets or disrupts the entity's business operations or financial reporting processes.

Fraud Risk Factors (Ref: par. 18 and 39)

A26. The presence of fraud risk factors may affect the auditor's assessment of inherent risk or control risk. Fraud risk factors may

- be inherent risk factors, insofar as they affect inherent risk, and may be due to management bias. They may also arise from other identified inherent risk factors (for example, complexity or uncertainty may create opportunities that result in a susceptibility to misstatement due to fraud). When fraud risk factors are inherent risk factors, the inherent risk is assessed before consideration of controls.
- relate to events or conditions that may exist in the entity's system of internal control that provide an opportunity to commit fraud and are relevant to the consideration of the entity's controls (that is, related to control risk), and may be an indicator that other fraud risk factors are present.

A27. Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

A28. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in appendix A, "Examples of Fraud Risk Factors." These illustrative fraud risk factors are classified based on the three conditions that are, individually or in combination, generally present when fraud exists:

- An incentive or pressure to commit fraud
- A perceived opportunity to commit fraud

- An attitude or rationalization that justifies the fraudulent action

The inability to observe one or more of these conditions does not necessarily mean that no risk of material misstatement due to fraud exists. Fraud risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information through, for example, the required understanding of the entity's control environment.[36] Although the fraud risk factors described in appendix A cover a broad range of situations that may be faced by auditors, they are only examples, and other fraud risk factors may exist.

Professional Skepticism (Ref: par. 12–13 and 19–22)

A29. Maintaining professional skepticism throughout the audit involves an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information intended to be used as audit evidence and identified controls in the control activities component, if any, over preparation and maintenance of the information. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A30. The manner in which circumstances that may be indicative of fraud or suspected fraud that affects the entity come to the auditor's attention throughout the audit may vary. For example, such information may come to the auditor's attention by the following persons:

- The auditor (such as when performing audit procedures in accordance with AU-C section 550, the auditor becomes aware of the existence of a related party relationship that management intentionally did not disclose to the auditor)
- Those charged with governance (such as when members of the audit committee conduct an independent investigation of unusual journal entries and other adjustments)
- Management (such as when evaluating the results of the entity's risk assessment process)
- Individuals within the internal audit function (such as when individuals conduct the annual compliance procedures related to the entity's system of internal control)
- An employee (such as by filing a tip using the entity's whistleblower program)
- A former employee (such as by sending a complaint via electronic mail to the internal audit function)

A31. Remaining alert for circumstances that may be indicative of fraud or suspected fraud throughout the audit is important, including when performing audit procedures near the end of the audit when time pressures to complete the audit engagement may exist. For example, audit evidence may be obtained near the end of the audit that may call into question the reliability of other audit evidence obtained or cast doubt on the integrity of management or those charged with governance. Appendix C, "Examples of Circumstances That May Be Indicative of Fraud or

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[36] Paragraph .21 of AU-C section 315.

Suspected Fraud," contains examples of circumstances that may be indicative of fraud or suspected fraud.

A32. As explained in AU-C section 220,[37] conditions inherent in some audit engagements can create pressures on the engagement team that may impede the appropriate maintenance of professional skepticism when designing and performing audit procedures and evaluating audit evidence. Paragraphs A36–A38 of AU-C section 220 list examples of impediments to the maintenance of professional skepticism at the engagement level, unconscious or conscious biases that may affect the engagement team's professional judgments, and actions that may be taken to mitigate impediments to the maintenance of professional skepticism. The following are examples of situations and how the auditor exercised professional judgment and maintained professional skepticism:

- A lack of cooperation and undue time pressures imposed by management negatively affected the engagement team's ability to resolve a complex and contentious issue. These circumstances were, based on the engagement partner's professional judgment, indicative of possible efforts by management to conceal fraud. The engagement partner involved more experienced members of the engagement team to deal with members of management who were difficult to interact with and communicated with those charged with governance about the nature of the challenging circumstances, including the possible effect on the audit.
- Impediments imposed by management created difficulties for the engagement team in obtaining access to records, facilities, certain employees, customers, suppliers, and others. These circumstances were, based on the engagement partner's professional judgment, indicative of possible efforts by management to conceal fraud. The engagement partner reminded the engagement team not to be satisfied with audit evidence that was less than persuasive when responding to assessed risks of material misstatement due to fraud and communicated with those charged with governance about the nature of the challenging circumstances, including the possible effect on the audit.

A33. Circumstances may also be encountered that may create threats to compliance with relevant ethical requirements. As discussed in AU-C section 220[38], relevant ethical requirements, for example the AICPA Code of Professional Conduct, may contain provisions regarding the identification and evaluation of threats and how they are to be dealt with.[39]

A34. The auditor may also address the threat to compliance with relevant ethical requirements, such as the principle of integrity, by communicating on a timely basis with those charged with governance about the circumstances giving rise to the threat. This communication may include a

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[37] Paragraph .A35 of AU-C section 220.

[38] Paragraph .A47 of AU-C section 220.

[39] For example. The "Integrity and Objectivity Rule" (ET section 1.100.001) states that "in the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others." The interpretations under the "Integrity and Objectivity Rule" provide further guidance relating to certain circumstances. In the absence of an interpretation that addresses a particular relationship or circumstance, a member is required to apply the conceptual framework approach.

discussion about any inconsistencies in audit evidence obtained for which a satisfactory explanation has not been provided by management.

Inconsistent or Unsatisfactory Responses

A35. Inconsistent responses to inquiries may include inconsistencies between the different groups of individuals specified in paragraph 21 (such as management, those charged with governance, individuals within the internal audit function, or others within the entity) or among individuals within the same group. For example, the auditor may identify inconsistent responses among different individuals within management. Unsatisfactory responses to inquiries may include vagueness and implausibility. AU-C section 500, *Audit Evidence*, addresses inconsistencies in, or doubts about the reliability of, audit evidence.

Conditions That Cause the Auditor to Believe That a Record or Document May Not Be Authentic or That the Terms in a Document Have Been Modified

A36. AU-C section 500[40] requires the auditor to evaluate information to be used as audit evidence by taking into account the relevance and reliability of the information, including its source. The reliability of audit evidence depends on the nature and source of the audit evidence and the circumstances under which it is obtained. Authenticity is an attribute of the reliability of information to be used as audit evidence. The auditor may consider whether the source actually generated or provided the information, and was authorized to do so, and that the information has not been inappropriately altered.

A37. Audit procedures performed in accordance with AU-C section 500, this or other AU-C sections, or information from other sources, may bring to the auditor's attention conditions that cause the auditor to believe that a record or document may not be authentic or that terms in a document have been modified but not disclosed to the auditor. Paragraph 22 applies if the auditor identifies such conditions during the course of the audit. The auditor is not, however, required to perform procedures that are specifically designed to identify conditions that indicate that a record or document may not be authentic or that terms in a document have been modified.

A38. The following are examples of conditions that may indicate a record or document is not authentic or that terms in a document have been modified but not disclosed to the auditor:

- Unexplained alterations to documents received from external sources
- Serial numbers used out of sequence or duplicated
- Addresses and logos not as expected
- Document style different from others of the same type from the same source (for example, changes in fonts and formatting)
- Information that would be expected to be included is absent

[40] Paragraph .07 of AU-C section 500, *Audit Evidence*.

- Invoice references or descriptors that differ from other invoices received from the entity.
- Unusual terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms (for example, purchase costs that appear unreasonable for the goods or services being charged for)
- Information that appears implausible or inconsistent with the auditor's understanding and knowledge
- A change from authorized signatory
- Electronic documents with a last edited date that is after the date they were represented as finalized

A39. An audit performed in accordance with GAAS rarely involves the authentication of documents, nor is the auditor trained as, or expected to be, an expert in such authentication. When the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document may have been modified but not disclosed to the auditor, or that undisclosed side agreements may exist, the auditor may determine that additional audit procedures are necessary, including audit procedures to evaluate authenticity.[41] Such additional audit procedures may include the following:

- Inquiries of management or others within the entity
- Confirming directly with the third party
- Using the work of a specialist to evaluate the document's authenticity
- Using automated tools and techniques, such as document authenticity or integrity technology, to evaluate the authenticity of the record or document

A40. When the results of the additional audit procedures indicate that a record or document is not authentic or that the terms in a document have been modified, the auditor may determine that the circumstances are indicative of fraud or suspected fraud and, accordingly, performs audit procedures in accordance with paragraphs 55–58.

Engagement Resources (Ref: par. 23)

A41. AU-C section 220[42] explains that the engagement partner's determination of whether additional engagement-level resources are required to be assigned to the engagement team is a matter of professional judgment and is influenced by the nature and circumstances of the audit engagement, taking into account any changes that may have arisen during the engagement. Under SQMS No. 1, the resources assigned or made available by the firm to support the performance of audit engagements include (*a*) human resources, (*b*) technological resources, and (*c*) intellectual resources.[43]

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[41] Paragraph .A30 of AU-C section 500.

[42] Paragraph .A80 of AU-C section 220.

[43] Paragraph .A61 of AU-C section 220.

A42. Depending on the nature and circumstances of the audit engagement, the engagement partner may determine it is necessary to involve individuals with specialized skills or knowledge. These individuals may include specific engagement team members with specialized skills or knowledge, more experienced individuals, or forensic and other specialists, when determined to be necessary. The following are examples of individuals with specialized skills or knowledge or specialists the engagement partner may consider involving in the audit:

- The complexity of the industry or regulatory environment in a particular emerging market in which the entity operates may present an opportunity or pressure for management to engage in fraudulent financial reporting. An individual with specialized skills in specific emerging markets may assist in identifying fraud risk factors or where the financial statements may be susceptible to risks of material misstatement due to fraud.
- The entity is investigating fraud or suspected fraud that may have a material effect on the financial statements (such as when it involves senior management). In certain cases, the auditor may want to include an individual with forensic skills to assist in planning and performing audit procedures as it relates to the specific audit area in which the fraud or suspected fraud was identified or to evaluate the entity's investigation of fraud or suspected fraud.
- The entity is undergoing an investigation by an authority outside the entity for fraud or suspected fraud (for example, a materially misstated tax provision related to tax evasion). Tax specialists may assist with identifying those fraudulent aspects of the noncompliance or suspected noncompliance that may have a financial statement effect.
- The complexity of the entity's organizational structure and related party relationships, including the creation or existence of special purpose entities, may present an opportunity for management to fraudulently misrepresent the financial position or financial performance of the entity. A specialist in taxation law may assist in understanding the business purpose and activities or business units within complex organizations, including how the entity's structure for tax purposes may be different from its operating structure.
- The use of complex financial instruments or other complex financing arrangements may present an opportunity to fraudulently misstate balance sheet amounts. A valuation specialist may assist in understanding the product's structure, purpose, underlying assets, and market conditions, which may highlight fraud risk factors such as discrepancies between market conditions and the valuation of the structured product.

A43. Forensic skills, in the context of an audit of financial statements, may combine accounting, auditing, and investigative skills. Such skills may be applied to evaluate the entity's investigation (including the entity's evaluation of its accounting records to determine whether fraudulent financial reporting or misappropriation of assets has occurred) or to perform audit procedures. The use of forensic skills may also assist the auditor in evaluating whether management override of controls or intentional management bias in financial reporting exists. It may be helpful for individuals with forensic skills to assist the auditor when appropriate, when doing the following:

- Identifying and evaluating fraud risk factors

- Identifying and assessing the risks of material misstatement due to fraud
- Evaluating the effectiveness of controls implemented by management to prevent or detect fraud
- Assessing the authenticity of information intended to be used as audit evidence
- Gathering, analyzing, and evaluating information or data using automated tools and techniques to identify links, patterns, or trends that may be indicative of fraud or suspected fraud
- Applying knowledge of fraud schemes and techniques for interviews, information gathering, and data analytics in the detection of fraud
- Applying interview techniques when discussing sensitive matters with management and those charged with governance
- Analyzing financial and nonfinancial information by using automated tools and techniques to look for inconsistencies, unusual patterns, or anomalies that may indicate intentional management bias or that may be the result of management override of controls

A44. In determining whether the engagement team has the appropriate competence and capabilities, the engagement partner may consider matters such as experience in IT systems or IT applications used by the entity or automated tools or techniques that are to be used by the engagement team in planning and performing the audit (such as when testing a high volume of journal entries and other adjustments when responding to the risks related to management override of controls).

A45. In determining whether the members of the engagement team collectively have the appropriate competence and capabilities to respond to identified risks of material misstatement due to fraud, the engagement partner may consider, for example, the following:

- Assigning additional individuals with specialized skills and knowledge, such as forensic and other specialists
- Changing the composition of the engagement team to include more experienced individuals
- Assigning more experienced members of the engagement team to conduct certain audit procedures for those specific audit areas that require significant auditor attention, including making inquiries of management and, when appropriate in the circumstances, those charged with governance related to those specific audit areas

Engagement Performance (Ref: par. 24 and 29)

A46. Depending on the nature and circumstances of the audit engagement, the engagement partner's approach to direction, supervision, and review may include increasing the extent and frequency of the engagement team discussions. It may be beneficial to hold additional engagement team discussions based on the occurrence of events or conditions that have affected the entity. Such discussions may identify new, or provide additional information about existing, fraud risk factors (see appendix A for examples of fraud risk factors). These may include, for example, the following:

- Sudden changes in business activity or performance (such as a decrease in operating cash flows of an entity arising from economic conditions, resulting in increased internal pressure by management to meet earnings targets)
- Changes in the senior management of the entity (such as the chief financial officer resigns, providing an opportunity for other employees in the treasury department to commit fraud given the lack of senior management oversight)

Ongoing Nature of Communications With Management and Those Charged With Governance (Ref: par. 25)

A47. Robust two-way communication between management or those charged with governance and the auditor assists in identifying and assessing the risks of material misstatement due to fraud.

A48. The extent of the auditor's communications with management and those charged with governance depends on the fraud-related facts and circumstances of the entity, as well as the progress and outcome of the fraud-related audit procedures performed in the audit engagement.

A49. The appropriate timing of the communications may vary depending on the significance and nature of the fraud-related matters and the expected actions to be taken by management or those charged with governance. The following are examples of possible timing of communications in different scenarios:

- The auditor makes the required inquiries of management and those charged with governance about matters referred to in paragraphs 33*b–c* and 34*b* as early as possible in the audit engagement, for example, as part of the auditor's communications regarding planning matters.
- When AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, applies, the auditor may communicate preliminary views about key audit matters related to fraud when discussing the planned scope and timing of the audit.
- The auditor has specific discussions with management and those charged with governance as relevant audit evidence is obtained relating to the auditor's evaluation of each of the components of the entity's system of internal control and assessment of the risks of material misstatement due to fraud. These discussions may form part of the auditor's communications on significant findings from the audit.
- Communicating, on a timely basis in accordance with AU-C section 265, *Internal Control Related Matters Identified in an Audit*, significant deficiencies and material weaknesses in internal control (including those that are relevant to the prevention or detection of fraud) with the appropriate levels of management and those charged with governance may allow them to take necessary and timely remedial actions.

Assigning Appropriate Members of the Engagement Team With the Responsibility to Communicate With Management and Those Charged With Governance

A50. AU-C section 220[44] addresses the engagement partner's overall responsibility with respect to engagement resources and engagement performance. Due to the nature and sensitivity of fraud, particularly fraud involving senior management, assigning tasks or actions to appropriately skilled or suitably experienced members of the engagement team and providing appropriate levels of direction, supervision, and review of their work is also important for the required communications in accordance with this proposed SAS. This includes involving appropriately skilled or suitably experienced members of the engagement team when communicating matters related to fraud with management and those charged with governance.

A51. AU-C section 220[45] addresses the engagement partner's responsibility to make members of the engagement team aware of relevant ethical requirements. It is important, especially for those members of the engagement team who will be engaging with management and those charged with governance about matters related to fraud, to consider the content of the communications and the manner in which such communications are to be conducted.

Risk Assessment Procedures and Related Activities (Ref: par. 26)

A52. As explained in AU-C section 315,[46] obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control is a dynamic and iterative process of gathering, updating, and analyzing information and continues throughout the audit. Therefore, the auditor's expectations with respect to risks of material misstatements due to fraud may change as new information is obtained.

Information From Other Sources (Ref: par. 27)

A53. Information obtained from other sources in accordance with paragraphs .15–.16 of AU-C section 315 may be relevant to the identification of fraud risk factors by providing information and insights about the following:

- The entity and the industry in which the entity operates and its related business risks, which may create pressures on the organization to meet targeted financial results
- Management's commitment to integrity and ethical values
- Management's commitment to remedy known significant deficiencies or material weaknesses in internal control on a timely basis
- Complexity in the application of the applicable financial reporting framework due to the nature and circumstances of the entity that may create opportunities for management to perpetrate and conceal fraudulent financial activity

A54. Before accepting an engagement for an initial audit, including a reaudit engagement, when a predecessor auditor exists and management has authorized the predecessor auditor to respond to the auditor's inquiries, AU-C section 210, *Terms of Engagement,*[47] requires the

[44] Paragraphs .25–.28 and .29–.34 of AU-C section 220.

[45] Paragraph .17 of AU-C section 220.

[46] Paragraph .A56 of AU-C section 315.

[47] Paragraph .12 of AU-C section 210, *Terms of Engagement*.

auditor to inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including matters related to fraud or suspected fraud. Such information may give an indication of the presence of fraud risk factors or may give an indication of fraud or suspected fraud.

Retrospective Review of the Outcome of Previous Accounting Estimates (Ref: par. 28)

A55. The purpose of performing a retrospective review of management's judgments and assumptions related to accounting estimates reflected in the financial statements of a prior period is to evaluate whether an indication exists of a possible bias on the part of management. This review is not intended to call into question the auditor's professional judgments about previous period accounting estimates that were appropriate based on information available at the time they were made.

A56. A retrospective review is also required by AU-C section 540.[48] That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's previous accounting estimates, audit evidence about the outcome, or when applicable, the subsequent reestimation to assist in identifying and assessing the risks of material misstatement in the current period, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this proposed SAS may be carried out in conjunction with the review required by AU-C section 540.

Engagement Team Discussion (Ref: par. 29)

A57. As explained in AU-C section 220,[49] the engagement partner is responsible for creating an environment that emphasizes the importance of open and robust communication within the engagement team and for supporting the ability of engagement team members to raise concerns without fear of reprisal. The engagement team discussion enables the engagement team members to share insights in a timely manner based on their skills, knowledge, and experience about how and where the financial statements may be susceptible to material misstatement due to fraud.

A58. Individuals who have specialized skills or knowledge, such as forensic and other specialists, may be invited to attend the engagement team discussion to provide deeper insights about the susceptibility of the entity's financial statements to material misstatement due to fraud. The involvement and contributions of individuals with specialized skills or knowledge may elevate the quality of the discussion taking place.

A59. The exchange of ideas may serve to inform the auditor's initial perspective about the tone at the top. The conversation may include a discussion about the actions and behaviors of management and those charged with governance, including whether there are clear and

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[48] Paragraph .13 of AU-C section 540.

[49] Paragraph .14 of AU-C section 220.

consistent actions and communications about integrity and ethical behavior at all levels within the entity.

A60. The following approaches may be useful to facilitate the exchange of ideas:

- *"What-if" scenarios.* These may be helpful when discussing whether certain events or conditions create an environment at the entity in which one or more individuals among management, those charged with governance, or employees have the incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act, and if so, how the fraud may occur.

- *Automated tools and techniques.* These may be used to support the discussion about the susceptibility of the entity's financial statements to material misstatement due to fraud and in the identification of fraud risk factors. For example, automated tools and techniques may be used to support the identification of fraud risk factors, including techniques that further the understanding of incentives and pressures, such as industry or sector financial ratio benchmarking. Unusual relationships within the entity's current period data (such as financial and operating data) may indicate adverse ratios or trends compared to competitors or the entity's past performance.

A61. The exchange of ideas may include, among other matters, whether

- the interactions, as observed by the engagement team, among management (for example, between the chief executive officer and the chief financial officer) or between management and those charged with governance may indicate a lack of cooperation or mutual respect among the parties. This circumstance in turn may be indicative of an environment that is conducive to the existence of fraud.

- any unusual or unexplained changes in behavior or lifestyle of management or employees that have come to the attention of the engagement team may indicate the possibility of fraudulent activity.

- known information (for example, obtained through reading trade journals or accessing reports issued by regulatory bodies), about frauds affecting other entities that resulted in the misstatement of the financial statements of those entities, such as entities in the same industry or geographical region, may be indicative of risks of material misstatement due to fraud for the entity being audited.

- disclosures, or lack thereof, may be used by management to obscure a proper understanding of the entity's financial statements (for example, by including too much immaterial information, by using unclear or ambiguous language, or by a lack of disclosures such as those disclosures relating to off-balance-sheet financing arrangements or leasing arrangements).

- conditions or events exist that may raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time (for example, a drug patent of an entity in the pharmaceutical industry expired, leading to a decline in revenue). In such circumstances, there may be incentives or pressures for management to commit fraud in order to conceal the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.

- the entity has significant related party relationships and transactions (for example, the entity has a complex organizational structure that includes several special purpose entities controlled by management). These circumstances may provide the opportunity for management to perpetrate fraud, for example, by inflating earnings or concealing debt.
- the entity has other third-party relationships that give rise to a fraud risk factor or a risk of material misstatement due to third-party fraud.

A62. The following are examples of third-party relationships that may give rise to a fraud risk factor or a risk of material misstatement due to third-party fraud:

- Based on the auditor's understanding of the entity's information-processing activities, the auditor identified a fraud risk factor (that is, opportunity to commit fraud) resulting from management's lack of oversight over significant business processes outsourced to a third-party service provider.
- Based on the auditor's understanding of the entity's physical access controls, the auditor identified a fraud risk factor (that is, opportunity to commit fraud) resulting from the entity's lack of sufficient security at locations with a material amount of small, lightweight, high-value assets.
- Based on the auditor's understanding of revenue contracts, the auditor became aware that the entity is using consignment agreements, where third parties sell the entity's inventory on its behalf, and the entity earns revenue from these sales. The auditor identified a fraud risk factor (that is, incentive to commit fraud) resulting from the third party's incentive to underreport to the entity consigned sales in order for the third party to meet its own sales targets.

A63. The engagement team may consider other ways in which management may override controls beyond the use of journal entries and other adjustments, significant estimates, or transactions outside the normal course of business. Examples of such other ways may include the following:

- Creating fictious employee records or vendors in an attempt to transfer cash to personal accounts
- Modifying the timing of legitimate transactions to manipulate the financial records

A64. The engagement partner and other key engagement team members participating in the engagement team discussion may also, as applicable, use this as an opportunity to do the following:

- Remind engagement team members of their role in serving the public interest by performing quality audit engagements and the importance of engagement team members remaining objective in order to better facilitate the critical assessment of audit evidence obtained from persons within or outside the financial reporting or accounting functions, or outside the entity.
- When discussing how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud as required by paragraph 29*c*, consider the audit procedures that may be selected to respond appropriately to the

susceptibility of the entity's financial statements to material misstatement due to fraud, including whether certain types of audit procedures may be more effective than others and how to incorporate an element of unpredictability into the nature, timing, and extent of audit procedures to be performed. Appendix B, "Examples of Possible Audit Procedures to Address the Risks of Material Misstatement Due to Fraud," contains examples of procedures that incorporate an element of unpredictability.

Analytical Procedures Performed and Unusual or Unexpected Relationships Identified (Ref: par. 31)

A65. When performing analytical procedures in accordance with AU-C section 315[50], the auditor may identify fluctuations or relationships that are inconsistent with other relevant information or that significantly differ from expected values. The following are examples of analytical procedures the auditor may perform:

Analytical Procedure	Unexpected or Inconsistent Result of the Analytical Procedure
• A comparison of the entity's recorded sales volume to the entity's production capacity	• An excess of sales volume over production capacity may be indicative of fictitious sales or sales recorded before revenue recognition criteria have been met.
• A trend analysis of revenues by month compared to sales returns by month, including during and shortly after the reporting period	• An increase in sales returns shortly after the reporting period relative to sales returns during the month may indicate the existence of undisclosed side agreements with customers involving the return of goods, which, if known, would preclude revenue recognition.

A66. Analytical procedures may include data analysis techniques ranging from a high-level review of data patterns, relationships, and trends to highly sophisticated, technology-assisted analysis of detailed transactions using electronic tools, such as data mining, business intelligence, and file query tools. The degree of reliance that can be placed on such techniques is a function primarily of the source (for example, financial, nonfinancial), completeness, and reliability of the data, the level of disaggregation, and the nature of the analysis.

A67. Analytical procedures performed during planning may be helpful in identifying the risks of material misstatement due to fraud. However, if such analytical procedures use data aggregated at a high level, generally the results of those analytical procedures provide only a broad initial indication about whether a material misstatement of the financial statements may exist. Accordingly, the results of analytical procedures performed during planning that used data aggregated at a high level may be considered along with other information gathered by the auditor in identifying the risks of material misstatement due to fraud.

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[50] Paragraph .14*b* of AU-C section 315.

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control

The Entity and Its Environment (Ref: par. 32)

The Entity's Organizational Structure and Ownership, Governance, Objectives and Strategy, and Geographic Dispersion

A68. Understanding the entity's organizational structure and ownership may assist the auditor in identifying fraud risk factors. An overly complex organizational structure involving unusual legal entities or unnecessarily complex or unusual organizational structures compared to other entities in the same industry may indicate that a fraud risk factor is present. For example, when complex intercompany transactions exist, this increases the opportunity to manipulate balances or create fictitious transactions.

A69. Understanding the nature of the entity's governance arrangements may assist the auditor in identifying fraud risk factors. For example, poor governance or accountability arrangements may weaken oversight and increase the opportunity for fraud (see also paragraphs A78–A89). For example, if the entity is undergoing significant digital transformation activities, poor governance arrangements over newly implemented technologies affecting the entity's information system relevant to the preparation of the financial statements may increase the opportunity for fraud.

A70. Some entities may have assigned the responsibility for overseeing the processes for identifying and responding to fraud in the entity to a senior member of management or to someone with designated responsibility.

A71. Understanding the entity's objectives and strategy may assist the auditor in identifying fraud risk factors. Objectives and strategy affect expectations, internally and externally, and may create pressures on the entity to achieve financial performance targets. For example, when the entity has a very aggressive growth strategy, this may create pressures on personnel within the entity to commit fraud to meet the goals set.

A72. Understanding the entity's geographic dispersion may assist the auditor in identifying fraud risk factors. The entity may have operations in locations that may be susceptible to fraud or other illegal or unethical acts that may be carried out to facilitate or conceal fraud. The auditor may obtain information about these locations from a variety of internal and external sources, including searches of relevant databases. For example, the following:

- Weak legal and regulatory frameworks that create a permissive environment for fraudulent financial reporting without significant consequences
- Offshore financial centers that have less restrictive regulations and tax incentives that may facilitate fraud through money laundering
- Cultural norms in which bribery is an accepted practice of doing business that could lead to bribery being used to facilitate or conceal fraud

Industry and Regulatory Environment

A73. Understanding the industry and the regulatory environment in which the entity operates may assist the auditor in identifying fraud risk factors. The entity may operate in an industry that may be susceptible to fraud or other illegal or unethical acts that may be carried out to facilitate or conceal fraud. For example, the auditor may obtain an understanding about whether the entity operates in

- an industry in which there are greater opportunities to commit fraud. (For instance, in the construction industry, the revenue recognition policies may be complex and subject to significant judgment, which may create an opportunity to commit fraud.)
- an industry that is under pressure (for example, a high degree of competition or market saturation, accompanied by declining margins in that sector). Such characteristics may create an incentive to commit fraud because it may be harder to achieve the financial performance targets.
- a regulatory environment that may create incentives or pressures to commit fraud (for example, government programs with eligibility restrictions tied to size or financial measures).

Performance Measures Used, Whether Internal or External

A74. Performance measures, whether internal or external, may create pressures on the entity. These pressures, in turn, may motivate management or employees to take action to inappropriately improve the business's performance or to misstate the financial statements. Internal performance measures may include employee performance measures and incentive compensation policies. External performance measures may include expectations from shareholders or other users of the financial statements. Automated tools and techniques, such as analysis of disaggregated data by business segment or product line, may be used by the auditor to identify inconsistencies or anomalies in the data used in performance measures.

A75. Other matters that the auditor may consider include, for example, the following:

- *Management's compensation packages.* When a significant portion of management's compensation packages are contingent on achieving financial targets, management may have an incentive to manipulate financial results.
- *Negative media attention.* When management is under pressure or intense scrutiny to respond to unfavorable reports, management may have an incentive to manipulate financial results.
- *Interactions with lenders and other stakeholders.* When management is dependent on a particular lender or customer, management may have an incentive or pressure to manipulate financial results.

Considerations Specific to Governmental Entities

A76. In the case of governmental entities, legislators and regulators are often the primary users of the financial statements and may therefore have expectations in relation to external performance measures. The auditor may also consider the nature and extent of external scrutiny from other parties or citizens, as management of the governmental entity may have an incentive to manipulate financial results when it is under pressure or intense scrutiny.

Understanding the Applicable Financial Reporting Framework and the Entity's Accounting Policies (Ref: par. 32)

A77. Matters related to the applicable financial reporting framework that the auditor may consider when obtaining an understanding of where there may be an increased susceptibility to misstatement due to management bias or other fraud risk factors include the following:

- Areas in the applicable financial reporting framework that require
  - — a measurement basis that results in the need for a complex method relating to an accounting estimate.
  - — management to make significant judgments, such as accounting estimates with high estimation uncertainty or where an accounting treatment has not yet been established for new and emerging financial products (for example, types of digital assets).
  - — expertise in a field other than accounting, such as actuarial calculations, valuations, or engineering data, particularly where management can influence and direct work performed, and conclusions reached by management's specialists.
- Changes in the applicable financial reporting framework. For example, management may intentionally misapply new accounting requirements relating to amounts, classification, manner of presentation, or disclosures.
- The selection of and application of accounting policies by management. For example, management's choice of accounting policy is not consistent with similar entities in the same industry.
- The amount of an accounting estimate selected by management for recognition or disclosure in the financial statements. The following are examples of matters the auditor may consider in this regard:
  - — Management may consistently trend toward one end of a range of possible outcomes that provides a more favorable financial reporting outcome for management.
  - — Management may use a model that applies a method that is not established or commonly used in a particular industry or environment.

Understanding the Components of the Entity's System of Internal Control

Control Environment

The Entity's Culture and Management's Commitment to Integrity and Ethical Values (Ref: par. 33*a*i)

A78. Understanding aspects of the entity's control environment that address the entity's culture and understanding management's commitment to integrity and ethical values may assist the auditor in considering how management's attitude and tone at the top regarding the prevention and detection of fraud affect the auditor's risk assessment.

A79. In considering how management demonstrates a commitment to ethical behavior, the auditor may obtain an understanding through inquiries of management and employees, and through considering information from external sources, about the following:

- *Management's commitment to integrity and ethical values through its actions.* This is important as employees may be more likely to behave ethically when management is committed to integrity and ethical behaviors.
- *The entity's communications with respect to integrity and ethical values.* For example, the entity may have a mission statement, a code of ethics, or a fraud policy that sets out the expectations of entity personnel in respect to their commitment to integrity and ethical values regarding managing fraud risk. In larger or more complex entities, management may also have set up a process that requires employees to annually confirm that they have complied with the entity's code of ethics.
- *Whether the entity has developed fraud-awareness training.* For example, the entity may require employees to undertake ethics and code of conduct training as part of an ongoing or induction program. In a larger or more complex entity, specific training may be required for those with a role in the prevention and detection of fraud (for example, the internal audit function).
- *Management's response to fraudulent activity.* For example, when minor unethical practices are overlooked (for example, petty theft, expenses frauds), this may indicate that more significant frauds committed by key employees may be treated in a similarly lenient fashion.

The Entity's Whistleblower Program (or Other Program to Report Fraud) (Ref: par. 33*a*ii)

A80. Often fraud is discovered through tips or complaints submitted through an entity's whistleblower program or other processes that enable internal or external parties to raise tips or complaints regarding alleged or suspected fraud. Whistleblower programs, which some entities may refer to by other names, such as a fraud reporting hotline, are designed to gather, among other things, information from employees, customers, and other stakeholders about allegations of fraud affecting the entity. A whistleblower program is often an essential component of an entity's fraud risk management.

A81. The design of a whistleblower program will vary depending on the nature and complexity of the entity, including the entity's exposure to fraud risks. For example, more formalized whistleblower programs may include a dedicated email, website, or telephone reporting mechanism, formal training for all employees, periodic reporting to management and those charged with governance for matters reported through the program, or management of the program by a third party. Alternatively, whistleblower programs may consist of less formal processes, which may include verbal communication of the program or communication via the entity's website where tips or complaints can be received, along with monitoring performed by the entity's human resources personnel or by an independent party, such as external counsel.

A82. Obtaining an understanding of the entity's whistleblower program may assist the auditor in identifying risks of material misstatement due to fraud and may be achieved by

- obtaining an understanding of how the entity receives tips or complaints, the objectivity and competence of the individuals involved in administering the program, and the appropriateness of the entity's processes for addressing the matters raised, including its investigation and remediation processes and protections afforded to whistleblowers. In a larger or more complex entity, the lack of a whistleblower program, or an ineffective one, may be indicative of deficiencies in the entity's control environment.
- inspecting the whistleblower program files for any tips or complaints that may allege fraud but that are not under investigation by the entity, or for information that may raise questions about management's commitment to creating and maintaining a culture of honesty and ethical behavior.
- performing additional procedures related to allegations of fraud that are under investigation by the entity in accordance with the requirements in paragraphs 55–58.

Oversight Exercised by Those Charged With Governance (Ref: par. 33*a*iii)

A83. In some circumstances, governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of risks, including risks of fraud, and the controls that address such risks. Because the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the respective responsibilities of management and those charged with governance to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals with respect to the prevention and detection of fraud.[51]

A84. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of controls that prevent or detect fraud, and the competency and integrity of management. The auditor may obtain this understanding in several ways, such as by attending meetings during which such discussions take place, reading the minutes from such meetings, or making inquiries of those charged with governance.

A85. The effectiveness of oversight by those charged with governance is influenced by their objectivity and familiarity with the processes and controls management has put in place to prevent or detect fraud. For example, the oversight by those charged with governance of the effectiveness of controls to prevent or detect fraud is an important aspect of their oversight role, and the objectivity of such evaluation is influenced by their independence from management.

Scalability (Ref: par. 33*a*iii)

A86. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a smaller or less complex entity in which a single owner manages the entity and no one else has a governance role. In these cases, ordinarily, no action on the part of the auditor is necessary because no oversight exists separate from management.

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[51] Paragraphs .A6–.A12 of AU-C section 260, *The Auditor's Communication With Those Charged With Governance,* provide guidance about whom the auditor should be communicating with, including when the entity's governance structure is not well defined.

Inquiries of Those Charged With Governance (Ref: par. 33*d*)

A87. The auditor may also inquire of those charged with governance about how the entity assesses fraud risk and about the entity's controls to prevent or detect fraud, the entity's culture, and management's commitment to integrity and ethical values.

A88. Specific inquiries on areas that are susceptible to misstatement due to management bias or management fraud may relate to both inherent risk and control risk. Specific inquiries may include management judgment when accounting for complex accounting estimates or unusual or complex transactions, including those in controversial or emerging areas, which may be susceptible to fraudulent financial reporting.

A89. Inquiries about whether those charged with governance are aware of any control deficiencies related to the prevention and detection of fraud may inform the auditor's evaluation of the components of the entity's system of internal control. Such inquiries may highlight conditions within the entity's system of internal control that provide opportunities to commit fraud or that may affect management's attitude or ability to rationalize fraudulent actions. For example, understanding incentives or pressures on management that may result in intentional or unintentional management bias may inform the auditor's understanding of the entity's risk assessment process and the entity's understanding of business risks. Such information may affect the auditor's consideration of the effect on the reasonableness of significant assumptions made by, or the expectations of, management.

The Entity's Risk Assessment Process

The Entity's Process for Identifying, Assessing, and Addressing Fraud Risks (Ref: par. 34*a*)

A90. Management may place a strong emphasis on fraud prevention by implementing a fraud risk management program. The design of the fraud risk management program may be affected by the nature and complexity of the entity and may include the following elements:

- Establishing fraud risk governance policies
- Performing a fraud risk assessment
- Designing and deploying fraud-preventive and -detective control activities
- Conducting investigations
- Monitoring and evaluating the total fraud risk management program

Identifying Fraud Risks (Ref: par. 34*a*i)

A91. The entity's risk assessment process may include an assessment of the incentives, pressures, and opportunities to commit fraud, or how the entity may be susceptible to third-party fraud. An entity's risk assessment process may also consider the potential override of controls by management, as well as areas in which control deficiencies exist, including a lack of segregation of duties.

A92. When legal or regulatory requirements apply, management may consider risks relating to misappropriation of assets or fraudulent financial reporting in relation to the entity's compliance with laws or regulations. For example, a fraud risk may include the preparation of inaccurate information for a regulatory filing in order to improve the appearance of an entity's performance and thereby avoid inspection by regulatory authorities or penalties.

Considerations Specific to Governmental Entities

A93. For governmental entities, management may need to consider risks related to pressures to meet or stay within the approved budget, including expenditures subject to statutory limits.

Assessing the Significance of the Identified Fraud Risks and Addressing the Assessed Fraud Risks (Ref: par. 34*a*ii–iii)

A94. There are several approaches management may use to assess fraud risks, and the approach may vary depending on the nature and circumstances of the entity. The entity may assess fraud risks using different forms, such as a complex matrix of risk ratings or a simple narrative.

A95. When determining the likelihood of fraud, management may consider both probability and frequency (such as the number of fraud incidents that can be expected). Other factors that management may consider in determining the likelihood may include the volume of transactions or the quantitative benefit to the perpetrator.

A96. Management may address the likelihood of a fraud risk by taking action within the other components of the entity's system of internal control or by making changes to certain aspects of the entity or its environment. To address fraud risks, an entity may choose to cease doing business in certain locations, reallocate authority among key personnel, or make changes to aspects of the entity's business model. For example, during the entity's risk assessment process relating to third-party fraud, management identified an unusual level of disbursements to vendors who were recently added to the entity's approved-vendor database. Upon investigating the matter, management determined that purchasing and procurement personnel had colluded with those vendors when adding them to the database. Accordingly, management designed and implemented controls to require management validation of new vendors to prevent and detect the reoccurrence of vendor-related fraud.

A97. If the auditor identifies risks of material misstatement due to fraud that management failed to identify, the auditor is required to determine whether any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process and, if so, obtain an understanding of why the entity's risk assessment process failed to identify such risks of material misstatement.[52]

Scalability (Ref: par. 34*a*)

A98. In smaller and less complex entities, in particular, owner-managed entities, the way the entity's risk assessment process is designed, implemented, and maintained may vary with the entity's size and complexity. When there are no formalized processes or documented policies or

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[52] Paragraph .23*a* of AU-C section 315.

procedures, the auditor is still required to obtain an understanding of how management or, where appropriate, those charged with governance identify fraud risks related to the misappropriation of assets and fraudulent financial reporting, assess the significance of the identified fraud risks, and address the assessed risks.

Inquiries of Management and Others Within the Entity (Ref: par. 34*b*)

A99. Management accepts responsibility for the entity's system of internal control and for the preparation and fair presentation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own process for identifying and responding to the entity's fraud risks. The nature, extent, and frequency of management's risk assessment process may vary from entity to entity. In some entities, management's process may occur on an annual basis or as part of ongoing monitoring. In other entities, management's process may be less structured and less frequent. The nature, extent, and frequency of management's risk assessment process is relevant to the auditor's understanding of the entity's control environment. For example, if management does not have a risk assessment process, or if the entity's risk assessment process does not address the identified fraud risks, this may be indicative of the lack of importance that management places on internal control.

A100. Inquiries of management may provide useful information concerning the risks of material misstatement resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement resulting from management fraud. Inquiries of others within the entity, in addition to management, may provide additional insight into fraud-prevention controls, tone at the top, and culture of the organization. Such inquiries may be useful in providing the auditor with a perspective that is different from that of individuals in the financial reporting process. The responses from these inquiries may also serve to corroborate responses received from management or provide information regarding the possibility of management override of controls. The auditor may also obtain information about how effectively management has communicated standards of ethical behavior throughout the organization.

A101. The following are examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud:

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

A102. Inquiries of management and others within the entity are generally most effective when they involve an in-person discussion. The auditor may also determine it useful to provide the interviewee with specific questions in advance to facilitate the discussion and to allow the interviewee to provide written responses in advance of the discussion. Auditors may use professional judgment to determine the best method to conduct the inquiries (for example, whether to hold an in-person discussion or video call) and to determine who is best suited to perform the inquiries, such as whether to have senior members of the engagement team conduct the discussions.

A103. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with information from other sources.

A104. Inquiries of management and others within the entity may be most effective when they allow for a two-way dialogue with the interviewees and provide the opportunity for the auditor to ask probing and clarifying questions.

The Entity's Process to Monitor the System of Internal Control

Ongoing and Separate Evaluations for Monitoring the Effectiveness of Controls to Prevent or Detect Fraud (Ref: par. 35*a*)

A105. Matters that may be relevant for the auditor to consider when understanding those aspects of the entity's process that address the ongoing and separate evaluations for monitoring the effectiveness of controls to prevent or detect fraud, and the identification and remediation of related control deficiencies, may include the following:

- Whether management has identified particular operating locations or business segments for which fraud risk may be more likely to exist and whether management has introduced different approaches to monitor these operating locations or business segments
- How the entity monitors controls that address fraud risks in each component of the entity's system of internal control, including the operating effectiveness of anti-fraud controls, and the remediation of control deficiencies as necessary

Inquiries of Internal Audit (Ref: par. 35*b*)

A106. The internal audit function of an entity may perform assurance and advisory activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes. In that capacity, the internal audit function may identify frauds or be involved throughout a fraud investigation process. Inquiries of appropriate individuals within the internal audit function may therefore provide the auditor with useful information about instances of fraud, suspected fraud, or allegations of fraud, and the risk of fraud.

A107. AU-C section 315 and AU-C section 610, *Using the Work of Internal Auditors*, establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.[53]

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[53] Paragraphs .14*a* and .24*a*ii of AU-C section 315 and AU-C section 610, *Using the Work of Internal Auditors.*

A108. In applying AU-C section 315 and AU-C section 610 in the context of fraud, the auditor may, for example, inquire about the following:

- How the entity's risk assessment process addresses the risk of fraud
- The entity's processes and controls to prevent or detect fraud
- The entity's culture and management's commitment to integrity and ethical values
- The procedures performed, if any, by the internal audit function in investigating frauds and suspected violations of the entity's code of ethics and values
- Fraud-related reports, if any, or communications prepared by the internal audit function and whether management and those charged with governance have satisfactorily responded to any findings resulting from those reports
- Control deficiencies identified by the internal audit function that are relevant to the prevention and detection of fraud and whether management and those charged with governance have satisfactorily responded to any findings resulting from those deficiencies

The Information System and Communication (Ref: par. 36 and 50)

A109. Obtaining an understanding of the entity's information system and communication relevant to the preparation of the financial statements includes the manner in which an entity incorporates information from transaction processing into the general ledger. This ordinarily involves the use of journal entries, whether standard or nonstandard, or automated or manual. This understanding enables the auditor to identify the population of journal entries and other adjustments that is required to be tested in accordance with paragraph 50*b*. Obtaining an understanding of the population may provide the auditor with insights about journal entries and other adjustments that may be susceptible to unauthorized or inappropriate intervention or manipulation. This may assist the auditor in designing and performing audit procedures over journal entries and other adjustments in accordance with paragraphs 50*c* and 50*d*.

A110. Appendix D, "Additional Considerations That May Inform the Auditor When Selecting Journal Entries and Other Adjustments for Testing," discusses additional considerations when selecting journal entries and other adjustments for testing, including matters that the required understanding provides the auditor knowledge about.

A111. When performing risk assessment procedures, the auditor may consider changes in the entity's IT environment because of the introduction of new IT applications or enhancements to the IT infrastructure, which may affect the susceptibility of the entity to fraud or create vulnerabilities in the IT environment (such as changes to the databases involved in processing or storing transactions). An increased susceptibility to misstatement due to management bias or other fraud risk factors may exist when there are complex IT applications used to initiate or process transactions or information, such as the use of artificial intelligence or machine learning algorithms to calculate and initiate accounting entries. In such circumstances, the auditor may assign individuals with specialized skills and knowledge, such as forensic and IT specialists, or more experienced individuals to the engagement.

Control Activities (Ref: par.37)

A112. As noted in paragraph 40 of this proposed SAS, risks of material misstatement due to fraud are treated as significant risks. Management may make judgments about the nature and extent of the controls it chooses to implement and the nature and extent of the risks it chooses to accept given the nature and circumstances of the entity. In determining which controls to implement to prevent or detect fraud, management considers the risk that the financial statements may be materially misstated due to fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risk of material misstatement due to fraud to be achieved. For example, the auditor may learn that management has consciously chosen to accept the risks associated with lack of segregation of duties.

A113. Controls designed to prevent or detect fraud are generally classified as either preventive (designed to prevent a fraudulent event or transaction from occurring) or detective (designed to discover a fraudulent event or transaction after the fraud has occurred). Addressing fraud risks may involve a combination of manual and automated fraud prevention and detection controls that enable the entity to monitor for indicators of fraud within the scope of its risk tolerance. The following are examples of preventive and detective controls:

Preventive controls

- Clearly defined and documented decision-makers using delegations, authorizations, and other instructions
- Access controls, including those that address physical security of assets against unauthorized access, acquisition, use, or disposal, and those that prevent unauthorized access to the entity's IT environment and information, such as authentication technology
- Controls over the process to design, program, test, and migrate changes to the IT system
- Entry-level checks, probationary periods, suitability assessments, or security vetting in order to assess the integrity of new employees, contractors, or third parties
- Sensitive or confidential information cannot leave the entity's IT environment without authority or detection.

Detective controls

- Exception reports to identify activities that are unusual or not in the ordinary course of business for further investigation
- Mechanisms for employees of the entity and third parties to make anonymous or confidential communications to appropriate persons within the entity about identified or suspected fraud
- Fraud detection software programs incorporated into the IT infrastructure that automatically analyze transaction data or enable data monitoring and analysis to detect what is different from what is standard, normal, or expected and may therefore indicate fraud

A114. General IT controls may address the risks arising from the use of IT and may also be relevant to the prevention or detection of fraud. The following are examples of such controls:

- Controls that segregate access to make changes to a production (that is, end user) environment)
- Access controls to manage
  - — privileged access (such as controls over administrative or powerful users' access)
  - — provisioning (such as controls to authorize modifications to existing users' access privileges, including nonpersonal or generic accounts that are not tied to specific individuals within the entity)
- Review of system logs that track access to the information system, enabling user activity to be monitored and security violations to be reported to management

Scalability

A115. For some entities whose nature and circumstances are more complex, such as those operating in the insurance or banking industries, there may be more complex preventive and detective controls in place. These controls may also affect the extent to which specialized skills are needed to assist the auditor in obtaining an understanding of the entity's risk assessment process.

Control Deficiencies Within the Entity's System of Internal Control (Ref: par. 38)

A116. In performing the evaluations of each of the components of the entity's system of internal control, the auditor may determine that certain of the entity's policies in a component are not appropriate to the nature and circumstances of the entity. Such a determination may assist the auditor in identifying deficiencies in internal control that are relevant to the prevention and detection of fraud. If the auditor has identified one or more control deficiencies relevant to the prevention or detection of fraud, the auditor may consider the effect of those control deficiencies on the design of further audit procedures in accordance with AU-C section 330.

A117. AU-C section 265[54] establishes other requirements for identified deficiencies in internal control.

Evaluation of Fraud Risk Factors (Ref: par. 39)

A118. The significance of fraud risk factors varies widely. Some of these factors will be present in entities in which the specific conditions do not present risks of material misstatement. Accordingly, the determination regarding whether fraud risk factors, individually or in combination, indicate that there are risks of material misstatement due to fraud is a matter of professional judgment.

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[54] Paragraphs .09–.10 of AU-C section 265.

A119. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of fraud risk factors. For example, depending on the nature and circumstances of the entity, there may be factors that generally constrain improper conduct by management, such as the following:

- Effective oversight by those charged with governance
- An effective internal audit function
- The existence and enforcement of a written code of conduct
- The existence of an effective whistleblower program (or other program to report fraud)

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

Scalability

A120. In the case of a smaller or less complex entity, some or all of these considerations may not be applicable or may be less relevant. For example, a smaller or less complex entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a smaller or less complex entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual creates a conducive environment for management override of controls.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud (Ref: par. 40)

A121. In determining whether fraud risk factors, individually or in combination, indicate that there are risks of material misstatement due to fraud, the auditor may consider the following:

- *The likelihood and magnitude of fraud resulting from fraud risk factors.* Fraud risk factors influence the auditor's assessment of the likelihood and magnitude of a potential misstatement for the identified risks of misstatement due to fraud. Considering the degree to which fraud risk factors affect the susceptibility of an assertion to misstatement may assist the auditor in appropriately assessing risks of material misstatement at the assertion level due to fraud.
- *The volume or extent of fraud risk factors that relate to the same class of transactions, account balance, or disclosure.* When several fraud risk factors relate to the same class of transactions, account balance, or disclosure, it may indicate that there is a risk of material misstatement due to fraud at the assertion level.

A122. Determining whether the risks of material misstatement due to fraud exist at the financial statement level, or the assertion level for classes of transactions, account balances, and disclosures, may assist the auditor in determining appropriate responses to address the assessed risks of material misstatement due to fraud.

A123. Relevant assertions and the related classes of transactions, account balances, or disclosures that may be susceptible to material misstatement due to fraud include the following:

- *Accuracy or valuation of revenue from contracts with customers.* Revenue from contracts with customers may be susceptible to inappropriate estimates of the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.
- *Occurrence or classification of expenses.* Expenses may be susceptible to inclusion of fictitious or personal expenses to minimize tax or other statutory obligations.
- *Existence of cash balances.* Cash balances may be susceptible to the creation of falsified or altered external confirmations or bank statements.
- *Valuation of account balances involving complex accounting estimates.* Account balances involving complex accounting estimates such as goodwill and other intangible assets, impairment of inventories, expected credit losses, insurance contract liabilities, employee retirement benefits liabilities, environmental liabilities, or environmental remediation provisions may be susceptible to high estimation uncertainty, significant subjectivity, and management bias in making judgments about future events or conditions.
- *Classification.* Certain income or expenses may be susceptible to misclassification within the statement of comprehensive income, for example, to manipulate key performance measures.
- *Presentation of disclosures.* Disclosures may be susceptible to omission, or incomplete or inaccurate presentation, for example, disclosures relating to contingent liabilities, off-balance-sheet arrangements, financial guarantees, or debt covenant requirements.

A124. Evaluating the design of controls that address significant risks, or support the operation of other controls that address significant risks, involves the auditor's consideration of whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements due to fraud (that is, the control objective). The auditor determines whether identified controls have been implemented by establishing that the control exists and that the entity is using it. The controls in the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control are primarily indirect controls. For example, a whistleblower program (or other program to report fraud) may be an indirect control within the control environment. Indirect controls may not be sufficiently precise to prevent, detect, or correct misstatements due to fraud at the assertion level but support other controls and may therefore have an indirect effect on the likelihood that a misstatement due to fraud will be prevented or detected on a timely basis.

Considerations Specific to Governmental Entities

A125. In governmental entities, there are generally fewer incentives or motivations to commit fraudulent financial reporting. Misappropriation of assets (including the misuse of public money for private benefit) may be a more common type of fraud compared to fraudulent financial reporting. In addition, there may be more opportunities for third parties to commit fraud through grant programs, contracts, and social welfare or benefit programs.

Risks of Material Misstatement Due to Fraud Related to Management Override of Controls (Ref: par. 41)

A126. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. See also paragraphs 48–53.

A127. In certain circumstances, the auditor may determine that the risks of material misstatement due to fraud related to management override of controls affect individual assertions and related significant classes of transactions, account balances, and disclosures. In such cases, in addition to the requirements in paragraphs 49–53, the auditor identifies these risks at the assertion level and designs and performs further audit procedures to address the assessed risks of material misstatement due to fraud at the assertion level in accordance with paragraph 47. The following are examples.

- Based on the risk assessment procedures performed, the auditor identified an aggressive employee performance measure in management's incentive program related to the reduction in operating expenses in the entity's profit and loss statement. Therefore, the auditor determined that the risk of management override of controls also exists at the assertion level and identified a risk of material misstatement due to fraud related to management override of controls at the assertion level. The auditor determined that the risk relates to the completeness of expenses, because the calculation of the performance measure may be susceptible to manipulation from management via adjustments made to the expense accounts. In addition to the procedures performed as described in paragraphs 49–53, the auditor designed and performed further audit procedures to address this significant risk.
- Based on the risk assessment procedures performed, the auditor identified a pressure on management to meet the financial ratios for the entity's loan covenants to avoid insolvency. In particular, the debt ratio is at heightened risk of not being met. Therefore, the auditor identified a risk of material misstatement due to fraud related to management override of controls at the assertion level. The auditor determined that the risk relates to the valuation of inventory and completeness of liabilities, because the valuation methods may be susceptible to inappropriate adjustment, or records may be manipulated to understate net liabilities, which may affect the entity's compliance with loan covenants. In addition to the procedures performed as described in paragraphs 49–53, the auditor designed and performed further audit procedures to address this significant risk.

Risks of Material Misstatement Due to Fraud in Revenue Recognition (Ref: par. 42)

A128. Material misstatement due to fraudulent financial reporting in revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may also result from an understatement of revenues such as through improperly deferring revenues to a later period.

A129. The risks of material misstatement due to fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures on or incentives for management to commit fraudulent financial reporting through inappropriate revenue recognition when, for example, performance is measured in terms of year-over-year revenue growth or profit. There may be greater risks of material misstatement due to fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales or that have business arrangements with complex revenue recognition implications (for example, licenses of intellectual property or percentage of completion) that are susceptible to management bias when determining revenue recognition.

A130. Understanding the entity's business and its environment, the applicable financial reporting framework, and the entity's system of internal control helps the auditor understand the nature of the revenue transactions, the applicable revenue recognition criteria, and the industry practice related to revenue. This understanding may assist the auditor in identifying events or conditions relating to the types of revenue, revenue transactions, or relevant assertions that could give rise to fraud risk factors.

A131. The following are examples of events or conditions relating to revenue and revenue transactions that could give rise to fraud risk factors:

- When there are changes in the financial reporting framework relating to revenue recognition, which may present an opportunity for management to commit fraudulent financial reporting or bring to light the lack of (or deficiency in) controls for managing changes in the financial reporting framework
- When an entity's accounting principles for revenue recognition are more aggressive than, or inconsistent with, its industry peers
- When the entity operates in emerging industries
- When revenue recognition involves complex accounting estimates
- When revenue recognition is based on complex contractual arrangements with a high degree of estimation uncertainty, for example, construction-type or production-type contracts (such as tolling arrangements) and multiple-element arrangements
- When contradictory evidence is obtained from performing risk assessment procedures
- When the entity has a history of significant adjustments for the improper recognition of revenue (such as premature recognition of revenue)
- When circumstances indicate the recording of fictitious revenues
- When circumstances indicate the omission of required disclosures or presentation of incomplete or inaccurate disclosures regarding revenue, for example, to manipulate the entity's financial performance due to pressures to meet expectations, or due to the incentive for management to maximize compensation linked to the entity's financial performance
- When the entity is part of an unnecessarily complex structure, increasing the risk of undisclosed transactions with related parties

A132. If fraud risk factors related to revenue recognition are present, determining whether such fraud risk factors indicate a risk of material misstatement due to fraud is a matter of professional judgment. The significance of fraud risk factors (see paragraphs A118–A120) related to revenue recognition, individually or in combination, ordinarily makes it inappropriate for the auditor to rebut the presumption that there are risks of material misstatement due to fraud in revenue recognition.

A133. There may be limited circumstances in which it may be appropriate to rebut the presumption that there are risks of material misstatement due to fraud in revenue recognition. The auditor may conclude that no risks of material misstatement due to fraud exist relating to revenue recognition when fraud risk factors are not significant. Examples of revenue and revenue transactions that may not give rise to fraud risk factors include the following:

- *Lease revenue from a single unit of rental property, or multiple rental properties, with a single tenant.* Based on the risk assessment procedures performed, the auditor determined that lease revenue is not a key performance indicator for the lessor because it is predictable and stable. Therefore, there are no significant incentives or pressures related to lease revenue.
- *Simple or straightforward ancillary revenue sources, which are determined by fixed rates or externally published rates* (for example, interest or dividend revenue from investments with level 1 inputs). Based on the risk assessment procedures performed, the auditor determined that there are no significant incentives or pressures related to the interest or dividend revenue from investments because the transactions are recorded in a highly automated system with no significant opportunities for management to manipulate the interest or dividend revenue from investments.

A134. Paragraph 65 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

Considerations Specific to Governmental Entities

A135. In governmental entities, there may be fewer incentives or pressures to engage in fraudulent financial reporting by intentionally overstating or understating revenue, but there may be fraud risks related to expenditures, especially when such expenditures are subject to statutory limits.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Unpredictability in the Selection of Audit Procedures (Ref: par. 44)

A136. Incorporating an element of unpredictability in the selection of the nature, timing, and extent of audit procedures to be performed is essential, particularly where individuals within the entity who are familiar with the audit procedures normally performed on engagements may be better positioned to conceal fraudulent financial reporting and misappropriation of assets. It is therefore important that the auditor maintains an open mind to new ideas or different perspectives when selecting the audit procedures to be performed to address the risks of material misstatement due to fraud. The following are examples of ways in which the auditor may incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures to be performed relating to fraud:

- Performing tests of detail in which the auditor performed substantive analytical procedures in previous audits
- Adjusting the timing of audit procedures from what would otherwise be expected
- Using different sampling methods or using different approaches to stratify the population
- Performing audit procedures at different locations or at locations on an unannounced basis
- Performing substantive analytical procedures at a more detailed level or lowering thresholds when performing substantive analytical procedures for further investigation of unusual or unexpected relationships
- Using automated tools and techniques, such as anomaly detection or statistical methods, on an entire population to identify items for further investigation

A137. The extent to which the auditor chooses to incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures is a matter of professional judgment. The auditor may, when incorporating an element of unpredictability in the selection of the nature, timing, and extent of audit procedures, refer to appendix B of this proposed SAS for examples of possible audit procedures to use when addressing the assessed risks of material misstatement due to fraud.

Overall Responses (Ref: par. 45)

A138. In accordance with paragraph 40*b*, assessed risks of material misstatement due to fraud at the financial statement level are also treated as significant risks. This has a significant bearing on the auditor's general approach and, as a consequence, the auditor's overall responses to such risks. The following are examples of overall responses to address risks of material misstatement due to fraud at the financial statement level:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions
- Increased recognition of the need to corroborate management's explanations or representations concerning significant matters
- Increased involvement of auditor's specialists to assist the engagement team with complex or subjective areas of the audit
- Changing the composition of the engagement team by, for example, requesting that more experienced individuals with greater skills or knowledge or specific expertise are assigned to the engagement
- Increasing the extent and frequency of the direction and supervision of engagement team members and conducting a more detailed review of their work
- Using direct extraction methods or technologies when obtaining data from the entity's

information system for use in automated tools and techniques to address the risk of data manipulation

- Increased emphasis on tests of details

A139. Management bias in the selection and application of accounting principles may individually or collectively indicate fraudulent financial reporting. The selection and application of accounting principles may involve matters such as contingencies, fair value measurements, revenue recognition, accounting estimates, related party transactions, or other transactions without a clear business purpose.

Audit Procedures Responsive to the Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: par. 47)

A140. In accordance with paragraph 40*b*, assessed risks of material misstatement due to fraud are treated as significant risks. AU-C section 330 requires the auditor to obtain more persuasive evidence the higher the auditor's assessment of risk. When obtaining more persuasive audit evidence to respond to assessed risks of material misstatement due to fraud, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant and reliable, for example, by placing more emphasis on obtaining third-party evidence or by obtaining audit evidence from a number of independent sources.

A141. The following are examples of how the auditor may design the further audit procedures whose nature, timing, and extent are responsive to the risks of material misstatement due to fraud:

Nature

- The auditor identifies that management is under pressure to meet earnings expectations and a related risk may exist that management is inflating sales by entering into sales agreements that include terms precluding revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts but also to confirm the details of the sales agreements, including date, any rights of return, and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations with inquiries of nonfinancial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing

- The auditor may conclude that performing substantive testing at or near the period-end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period-end would not be effective. In contrast, because an intentional misstatement — for example, a misstatement involving improper revenue recognition — may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.

Extent

- The auditor may use automated tools and techniques to perform more extensive testing of digital information. Such automated techniques may be used to test all items in a population, select specific items for testing that are responsive to risks of material misstatement due to fraud, or select items for testing when performing audit sampling. For example, the auditor may stratify the population based on specific characteristics to obtain more relevant audit evidence that is responsive to the risks of material misstatement due to fraud.

External Confirmation Procedures

A142. In applying AU-C section 330,[55] external confirmation procedures may be considered useful when seeking audit evidence that is not biased toward corroborating or contradicting a relevant assertion in the financial statements, especially in instances in which risks of material misstatement due to fraud have been identified related to the class of transactions, account balance, or disclosure.

A143. Proposed SAS *External Confirmation Procedures*[56] requires the auditor to maintain control over the confirmation requests and to evaluate the implications of management's refusal to allow the auditor to send a confirmation request. If the auditor is unable to maintain control over the confirmation procedures or obtains an unsatisfactory response about why management refuses to allow the auditor to send a confirmation request, as applicable, then this may be an indication of a fraud risk factor.

A144. The use of external confirmation procedures may be more effective or provide more persuasive audit evidence over the terms and conditions of a contractual agreement (for example, the auditor may request confirmation of the contractual terms for a specific class of revenue transactions, such as pricing, payment and discount terms, applicable guarantees and the existence, or absence, of any side agreements).

A145. Because all responses carry some risk of interception, alteration, or fraud, proposed SAS *External Confirmations,*[57] includes factors that may indicate doubts about the reliability of an external confirmation response to a confirmation request. The following are examples of circumstances that may indicate doubts about the reliability of an external confirmation response to a confirmation request:

- An external confirmation response is sent from an address (physical or electronic mail) other than the address on the confirmation request.
- An external confirmation response does not include a copy of the original confirmation request, email chain, or any other information indicating that the confirming party is responding to the auditor's confirmation request.
- An external confirmation response contains unusual restrictions or disclaimers.

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55 Paragraph .19 of AU-C section 330.

56 Paragraph .07 and .08 of AU-C section 505, *External Confirmations.*

57 Paragraph .A12 of AU-C section 505.

A146. Proposed SAS *External Confirmations*[58] includes requirements and guidance for the auditor when an external confirmation response to a confirmation request indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party. For example, an external confirmation response to a bank confirmation request indicated that a bank account, in the name of a wholly owned subsidiary incorporated in an offshore financial center, did not exist.

Examples of Other Further Audit Procedures

A147. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud are presented in appendix B. Appendix B includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks of Material Misstatement Due to Fraud Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: par. 49–50)

Why the Testing of Journal Entries and Other Adjustments Is Performed

A148. Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by

- recording inappropriate or unauthorized journal entries in the general ledger and other adjustments throughout the period or at period-end, or
- making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidation adjustments, report combinations, and reclassifications.

A149. Testing the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries made directly to the financial statements such as eliminating adjustments for transactions, unrealized profits, and intra-group account balances at the group level) may assist the auditor in identifying fraudulent journal entries and other adjustments.

A150. The auditor's consideration of the risks of material misstatement associated with management override of controls over journal entries[59] is important because automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that management may inappropriately override such automated processes and controls, for example, by changing the amounts being automatically posted in the general ledger or to the financial reporting system. Further, when information technology is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information

[58] Paragraphs .14 and .A30–A31 of AU-C section 505.

[59] Paragraph .27*b* of AU-C section 315.

systems.

A151. In planning the audit,[60] drawing on the experience and insight of the engagement partner or other key members of the engagement team may be helpful in designing audit procedures to test the appropriateness of journal entries and other adjustments (for example, to address the risk of management override of controls), including planning for the appropriate resources, and determining the nature, timing, and extent of the related direction, supervision, and review of the work being performed.

Identifying Controls Over Journal Entries and Other Adjustments (Ref: par. 49)

A152. AU-C section 315[61] requires the auditor to

- identify controls in accordance with this proposed SAS, focusing on controls over journal entries that address risks of material misstatement due to fraud related to management override of controls, and
- evaluate their design and determine whether they have been implemented.

A153. Information from understanding controls over journal entries associated with the risk of material misstatement due to fraud related to management override of controls, or the absence of such controls, may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risks of material misstatement due to fraud.

A154. Paragraphs 49–50 of this proposed SAS require the auditor to design and perform audit procedures to test the appropriateness of journal entries and are specifically focused on the risks of material misstatement due to fraud (see appendix D for additional considerations when testing journal entries).

Obtaining Audit Evidence About the Completeness of the Population of Journal Entries and Other Adjustments (Ref: par. 50*b*)

A155. The population of journal entries may include manual adjustments, or other "top-side" adjustments, that are made directly to the amounts reported in the financial statements. Failing to obtain audit evidence about the completeness of the population may limit the effectiveness of the audit procedures in responding to the risk of management override of controls associated with fraudulent journal entries and other adjustments.

Selecting Journal Entries and Other Adjustments (Ref: par. 50*d* and 50*e*)

A156. Prior to selecting items to test, the auditor may need to consider whether the integrity of the population of journal entries and other adjustments has been maintained throughout all stages of information processing based on the auditor's understanding and evaluation of the entity's information system and controls (for example, general IT controls that safeguard and maintain the integrity of financial information) in accordance with the requirements of AU-C section

[60] Paragraphs .05, .09, and .14 of AU-C section 300, *Planning an Audit.*

[61] Paragraphs .27*b* and .30 of AU-C section 315.

315.[62]

A157. The auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control may assist the auditor in selecting journal entries and other adjustments for testing. The process of selecting journal entries and other adjustments for testing may be enhanced if the auditor leverages insights based on the auditor's understanding about the following matters:

- How the financial statements (including events and transactions) may be susceptible to material misstatement due to fraud, particularly in areas where fraud risk factors are present
- The application of accounting principles and methods that may be susceptible to material misstatement due to management bias
- Deficiencies in internal control that present opportunities for those charged with governance, management, or others within the entity to commit fraud

A158. Appendix D provides additional considerations that may be used by the auditor when selecting journal entries and other adjustments for testing.

Timing of Testing Journal Entries and Other Adjustments (Ref: par. 50*d* and 50*e*)

A159. Fraudulent journal entries and other adjustments are often made at the end of a reporting period; consequently, paragraph 50*d* requires the auditor to select journal entries and other adjustments made at that time. For example, among the journal entries and other adjustments most susceptible to management override of controls are manual adjusting journal entries and other adjustments made directly to the financial statements that occur after the closing of a financial reporting period and have little or no explanatory support.

A160. Paragraph 50*e* requires the auditor to determine whether there is also a need to test journal entries and other adjustments throughout the period because material misstatements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished. The auditor may determine to test journal entries throughout the period, for example, when identifying

- risks of material misstatement that may be strongly linked to fraud schemes that can occur over a long period of time (for example, complex related party transaction structures that may obscure their economic substance).
- anomalies or outliers in the journal entry data throughout the period that may be detected using automated tools and techniques.

Examining the Underlying Support for Journal Entries and Other Adjustments Selected (Ref: par. 50*d* and 50*e*)

A161. When testing the appropriateness of journal entries and other adjustments, the auditor

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[62] Paragraphs .25–.30 of AU-C section 315.

may need to obtain and examine supporting documentation to determine the business purpose (or lack thereof) for recording them, including whether the recording of the journal entry reflects the substance of the transaction and complies with the applicable financial reporting framework.

Considering the Use of Automated Tools and Techniques When Testing Journal Entries and Other Adjustments (Ref: par. 50*b* and 50*d*)

A162. The auditor may consider the use of automated tools and techniques when testing journal entries and other adjustments (for example, determining the completeness of the population or selecting items to test). Such consideration may be affected by the entity's use of technology in processing journal entries and other adjustments.

Accounting Estimates (Ref: par. 51–52)

Why the Review of Accounting Estimates for Management Bias Is Performed

A163. The preparation and fair presentation of the financial statements requires management to make a number of judgments or assumptions that affect accounting estimates and to monitor the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. For example, this may be achieved by understating or overstating provisions or reserves in order to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions about the entity's performance and profitability.

A164. AU-C section 315 provides guidance that management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (that is, indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional.[63]

Indicators of Possible Management Bias

A165. AU-C section 540[64] includes a requirement and related application material addressing indicators of possible management bias.

A166. Indicators of possible management bias in how management made the accounting estimates that may represent a risk of material misstatement due to fraud include the following:

- Changes in methods, significant assumptions, sources, or items of data selected that are not based on new circumstances or new information, which may not be reasonable in the circumstances nor in compliance with the applicable financial reporting framework
- Adjustments made to the output of the models that are not appropriate in the

[63] Paragraph 2 of appendix B, "Understanding Inherent Risk Factors," of AU-C section 315.

[64] Paragraphs .32 and .A133–.A136 of AU-C section 540.

circumstances when considering the requirements of the applicable financial reporting framework

A167. The auditor may use automated tools and techniques to review accounting estimates for management bias, for example, by

- analyzing the activity in an estimate account during the period and comparing it to the current and prior-period estimates.
- benchmarking assumptions used for the estimate, using data visualization to understand the location of point estimates within the range of acceptable outcomes.
- using predictive analytics to identify the likelihood of future outcomes based on historical data.

A168. If there are indicators of possible management bias that may be intentional, the auditor may consider it appropriate to involve individuals with forensic skills in performing the review of accounting estimates for management bias, in accordance with paragraphs 51–52. Applying forensic skills through analyzing accounting records, conducting interviews, reviewing internal and external communications, investigating related party transactions, or reviewing controls may also assist the auditor in evaluating whether the indicators of possible management bias represent a material misstatement due to fraud.

Significant Unusual Transactions (Ref: par. 53)

A169. Indicators that may suggest that significant unusual transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include the following:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and documentation is inadequate.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve nonconsolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- There are unusual activities with no logical business rationale.
- Transactions involve related parties or relationships or transactions with related parties previously undisclosed to the auditor.
- Transactions involve other parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.
- Transactions lack commercial or economic substance or are part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or

economic substance, individually or in the aggregate (for example, a transaction is entered into shortly prior to period-end and is unwound shortly after period-end).

- Transactions occur with a party that falls outside the definition of a related party (as defined by the applicable financial reporting framework), with either party able to negotiate terms that may not be available for other, more clearly independent parties on an arm's-length basis.
- Transactions exist to enable the entity to achieve certain financial targets.

A170. Procedures for evaluating significant unusual transactions may include evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any. Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion (Ref: par. 54)

A171. AU-C section 520 explains that the analytical procedures designed and performed near the end of the audit may identify a previously unrecognized risk of material misstatement. The auditor may perform the analytical procedures at a more granular level for certain higher-risk classes of transactions, account balances, and disclosures to determine whether certain trends or relationships may indicate a previously unidentified risk of material misstatement due to fraud. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving period-end revenue and income are particularly relevant. These may include the following:

- Uncharacteristically large amounts of income being reported in the last few weeks of the reporting period
- Unusual transactions
- Income or expenses that are inconsistent with trends in cash flow from operations, such as
    - — uncharacteristically low amounts of revenue or expenses at the start of the subsequent period or
    - — uncharacteristically high levels of refunds or credit notes at the start of the subsequent period

A172. The auditor may use automated tools and techniques to identify unusual or inconsistent transaction posting patterns in order to determine whether a previously unrecognized risk of material misstatement due to fraud exists.

Fraud or Suspected Fraud (Ref: par. 55–58)

A173. If the auditor identifies fraud or suspected fraud, the firm's policies or procedures may include actions for the engagement partner to take, depending on the facts and circumstances of the audit engagement and the nature and circumstances of the fraud. Examples of actions may include one or more of the following:

- Consulting with others in the firm
- Obtaining legal advice from external counsel to understand the engagement partner's options and the professional or legal implications of taking any particular course of action
- Consulting on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality)

A174. In accordance with AU-C section 220,[65] the engagement partner is required to take responsibility for making the engagement team aware of the firm's policies or procedures related to relevant ethical requirements. This includes the responsibilities of members of the engagement team when they become aware of an instance of noncompliance with laws and regulations by the entity, which includes instances of fraud.

Obtaining an Understanding of the Fraud or Suspected Fraud

A175. The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the fraud or suspected fraud. Due to the nature and sensitivity of fraud or suspected fraud involving senior management, the auditor may determine it more appropriate to make inquiries about the matter with those charged with governance.

A176. When obtaining an understanding of the fraud or suspected fraud, the auditor may do one or more of the following, depending on the facts and circumstances of the audit engagement and the nature of the fraud:

- Inspect the entity's whistleblower program files for additional information, if applicable.
- Make further inquiries of
  - — the entity's in-house counsel or external legal counsel.
  - — individuals within the internal audit function (if the function exists).
- Involve an auditor's specialist, such as an individual with forensic skills.

Evaluating the Entity's Process to Investigate and Remediate the Fraud or Suspected Fraud

A177. The nature and extent of the entity's process to investigate the fraud or suspected fraud undertaken by management or those charged with governance may vary based on the circumstances and may be influenced by the entity's assessment of the significance of fraud risks relevant to the entity's financial reporting objectives. For example, an entity's whistleblower

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65 Paragraph .17*c* of AU-C section 220.

program (or other program to report fraud) may set out policies or procedures to be followed in relation to investigation and remediation of matters, including the establishment of thresholds for taking further action.

A178. The following examples illustrate how the nature and extent of the entity's process undertaken by management or those charged with governance to investigate the fraud or suspected fraud may vary based on the nature and circumstances of the fraud:

- New allegations of fraud were made by a disgruntled former employee. Management followed the policies and procedures in place at the entity and referred the matter to the legal and human resources departments. Because the entity's policies and procedures were followed and prior allegations with similar facts and circumstances had been investigated and determined to be without merit, management determined that no further action was necessary.
- A suspected fraud involving a senior member of management was reported to those charged with governance by an employee. As a result, those charged with governance followed the policies and procedures in place at the entity, including engaging a certified fraud examiner to perform an independent forensic investigation.

A179. When evaluating the appropriateness of the entity's investigation process and remedial actions implemented to respond to the fraud or suspected fraud in accordance with paragraphs 55*b* and 55*c*, the auditor may consider the following:

- In relation to the entity's process to investigate the fraud or suspected fraud:
  - — The objectivity and competence of individuals involved in the entity's process to investigate the fraud or suspected fraud
  - — The nature, timing, and extent of procedures to investigate the fraud or suspected fraud, including identification of root causes, if applicable
- In relation to the entity's actions to remediate the fraud or suspected fraud:
  - — Whether the remedial actions address the root causes
  - — Whether the remedial actions are proportionate to the severity and pervasiveness of the identified fraud or suspected fraud and the urgency with which the matter needs to be addressed, including how management
    - o responded to any misstatements that were identified (for example, the timeliness of when the identified misstatements were corrected by management)
    - o responded to the fraud (for example, disciplinary or legal sanctions imposed on the individuals involved in perpetrating the fraud)
    - o addressed control deficiencies, if any, regarding the prevention or detection of the fraud

A180. The nature and extent of the auditor's work in accordance with paragraph 55*b*–*c*, and the documentation of such work, may also vary based on the circumstances, depending in part on the results of inquiries made in accordance with paragraph 55*a*. Auditors may use information obtained (1) from their understanding of the entity's whistleblower program in accordance with paragraph 33*a*ii, including the entity's process for investigating and remediating allegations of fraud that came through the entity's whistleblower program, and (2) through performing other risk assessment procedures, to satisfy the requirements in paragraph 55*b–c*, and determine whether a fraud or suspected fraud is clearly inconsequential. For example, based on an understanding of the suspected fraud obtained through understanding the entity's whistleblower program, the engagement partner determined the suspected fraud was clearly inconsequential because it was limited to the misappropriation of immaterial assets by employees.

Impact on the Overall Audit Strategy

A181. The understanding obtained about the fraud or suspected fraud affects the engagement partner's determination of whether and how to adjust the overall audit strategy, including determining whether there is a need to perform additional risk assessment procedures or further audit procedures, especially in circumstances in which information comes to the engagement partner's attention that differs significantly from the information available when the overall audit strategy was originally established.[66]

A182. As described in AU-C section 220,[67] in fulfilling the requirement in paragraph 56, the engagement partner may obtain information from other members of the engagement team (such as component auditors).

A183. Based on the understanding obtained about the fraud or suspected fraud and the effect on the overall audit strategy, the engagement partner may determine that it is necessary to discuss an extension of the audit reporting deadlines with management and those charged with governance, where an extension is possible under applicable law or regulation. If an extension is not possible, AU-C section 705 addresses the implications for the auditor's opinion on the financial statements. For example, based on an understanding of the suspected fraud, the engagement partner believed the integrity of management was in question. Given the significance and pervasiveness of the matter, the engagement partner determined that no further work was to be performed across the entire audit engagement until the matter had been appropriately resolved.

The Auditor Identifies a Misstatement Due to Fraud

A184. AU-C section 450, *Evaluation of Misstatements Identified During the Audit,* and AU-C section 700, *Forming an Opinion and Reporting on Financial Statements,* establish requirements and provide guidance on the evaluation of misstatements and the effect on the auditor's opinion in the auditor's report.

A185. The following are examples of qualitative or quantitative circumstances that may be relevant when determining whether the misstatement due to fraud is material:

- The misstatement involves those charged with governance, management, related parties, or third parties, bringing into question the integrity or competence of those involved.

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[66] Paragraphs .10 and .A17 of AU-C section 300.

[67] Paragraph .09 of AU-C section 220.

- The misstatement affects compliance with law or regulation, which may also affect the auditor's consideration of the integrity of management, those charged with governance, or employees.
- The misstatement affects compliance with debt covenants or other contractual requirements, which may cause the auditor to question the pressures being exerted on management to meet certain earnings expectations.
- The misstatement affects key performance indicators, such as net income and working capital, that may have an effect on the calculation of compensation arrangements for senior management at the entity.
- The misstatement affects multiple reporting periods, such as when a misstatement has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.

Considerations Specific to Governmental Entities

- The misstatement affects the determination of whether there is a surplus or deficit reported for the period or whether the governmental entity has met or exceeded its approved budget, including when relevant, whether its expenses are within statutory limits.

A186. The implications of an identified misstatement due to fraud on the reliability of information intended to be used as audit evidence depends on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of information previously obtained and intended to be used as audit evidence may be called into question as doubts may exist about the completeness and truthfulness of representations made and about the authenticity of accounting records and documentation.

A187. Because fraud involves incentive or pressure to perpetrate fraud, a perceived opportunity to do so, or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Misstatements, such as numerous misstatements at a business unit or geographical location even though the cumulative effect is not material, may also be indicative of a risk of material misstatement due to fraud.

Determining if Control Deficiencies Exist

A188. AU-C section 265[68] provides requirements and guidance about the auditor's communication of significant deficiencies and material weaknesses in internal control identified during the audit to those charged with governance. Examples of matters related to fraud or suspected fraud that the auditor may consider when determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency or material weakness include

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68 Paragraphs .09–.10 and .A7–.A12 of AU-C section 265.

- the susceptibility to loss due to fraud of the related asset or liability.
- the importance of the controls to the financial reporting process (that is, controls over the prevention and detection of fraud).

A189. The following are examples of indicators of deficiencies in internal control related to fraud or suspected fraud:

- Evidence of ineffective aspects of the control environment, such as the identification of management fraud, whether or not material, that was not prevented by the entity's system of internal control
- The lack of a process to investigate fraud or suspected fraud, or a process to investigate fraud or suspected fraud that is not appropriate in the circumstances
- The lack of, or ineffective, remediation measures implemented by management to prevent or detect the reoccurrence of fraud or suspected fraud

Overall Evaluation Based on Audit Procedures Performed (Ref: par. 59)

A190. The evaluation required by paragraph 59 is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insights about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures.

Auditor Unable to Continue the Audit Engagement (Ref: par. 60)

A191. Examples of circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include the following:

- The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements.
- The auditor's consideration of the risks of material misstatement due to fraud or the results of audit procedures performed indicate a material and pervasive fraud.
- The auditor has significant concern about the competence or integrity of management or those charged with governance.

A192. Because of the variety of circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A193. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by engagement. In some circumstances, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities. Given the nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to the person or persons who engaged the auditor, regulators, or others.[69]

Considerations Specific to Governmental Entities and Not-for-Profit Organizations

A194. For governmental entities and not-for-profit organizations, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the entity's legal mandate, public interest considerations, contractual requirements, or law or regulation.

Communications With Management and Those Charged With Governance (Ref: par. 61–63)

A195. Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligation of confidentiality and obligation to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Communication With Management (Ref: par. 61)

A196. If the auditor identifies fraud or suspected fraud, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable, even if the matter may be considered clearly inconsequential (for example, a minor misappropriation of funds by an employee at a low level in the entity's organization).

Communication With Those Charged With Governance (Ref: par. 62)

A197. The auditor's communication with those charged with governance may be made orally or in writing. AU-C section 260, *The Auditor's Communication With Those Charged With Governance*, identifies factors the auditor considers in determining whether to communicate orally or in writing.[70] Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor communicates such matters on a timely basis and may consider it necessary to also communicate such matters in writing.

A198. In some cases, the auditor may consider it appropriate to communicate with those charged with governance fraud or suspected fraud involving others that the auditor determined to be clearly inconsequential. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard. The auditor may reach agreement in advance with those charged

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[69] Ethical requirements under the "Responding to Noncompliance With Laws and Regulations" interpretation of the "Integrity and Objectivity Rule" of the AICPA Code of Professional Conduct set out the member's responsibilities when encountering noncompliance or suspected noncompliance with laws and regulations, including fraud, and guide the member in evaluating the implications of the matter and the possible courses of action when responding to it.

[70] Paragraph .A44 of AU-C section 260.

with governance on the nature of matters that would be considered clearly inconsequential and, thus, need not be communicated.

A199. When the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: par. 63)

A200. In accordance with AU-C section 265, the auditor is required to communicate with those charged with governance significant deficiencies and material weaknesses in internal control identified during the audit. This includes the absence of controls to address risks of material misstatement due to fraud when those matters are determined to be significant deficiencies or material weaknesses. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example, the following:

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

Reporting to an Appropriate Authority Outside the Entity (Ref: par. 64)

A201. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, in certain circumstances, the duty of confidentiality may be overridden by statute, regulation, courts of law, specific requirements of audits of entities that receive government financial assistance, or waived by agreement. In some circumstances, the auditor has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some circumstances, the auditor has a duty to report misstatements to authorities when management and those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in these circumstances.

Considerations Specific to Governmental Entities and Not-for-Profit Organizations

A202. For governmental entities and not-for-profit organizations, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related law or regulation.

Documentation (Ref: par. 65)

A203. AU-C section 230[71] addresses circumstances in which the auditor identifies information that is inconsistent with the auditor's final conclusion regarding a significant matter and requires the auditor to document how the auditor addressed the inconsistency.

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[71] Paragraphs .12 and .A17–.A18 of AU-C section 230.

A204.

Appendix A — Examples of Fraud Risk Factors (Ref: par. A28 and A46)

The fraud risk factors identified in this appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration — that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (1) incentives and pressures, (2) opportunities, and (3) attitudes and rationalizations. Although the risk factors cover a broad range of situations, they are only examples, and accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different sizes or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

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

Incentives and Pressures

Financial stability or profitability is threatened by economic, industry, geopolitical, or entity operating conditions, such as (or as indicated by) the following:

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Increased volatility in financial and commodity markets due to fluctuations in interest rates and inflationary trends
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements
- Pandemics or wars triggering major disruptions in the entity's operations, financial distress, and severe cash flow shortages

- Economic sanctions imposed by governments and international organizations, including on the entity's companies and products

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend-level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
- Need to obtain additional debt or equity financing, or qualify for government assistance or incentives, to avoid bankruptcy or foreclosure or to stay competitive — including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as mergers and acquisitions, business combinations, or contract awards
- Management enters into significant transactions that place undue emphasis on achieving key performance indicators to stakeholders (such as meeting earnings per share forecasts or maintaining the stock price)
- A need to achieve financial targets required in bond covenants
- Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both
- Negative media attention on the entity or key members of management

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (e.g., bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, cash flow, or other key performance indicators[72]
- Personal guarantees of debts of the entity
- Management or operating personnel are under excessive pressure to meet financial targets established by those charged with governance, including sales or profitability incentive goals

[72] Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

Considerations Specific to Governmental Entities

- Governmental entities subject to statutory limits on their spending, which may result in inaccurate reporting of expenditure incurred

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Related party transactions that are also significant unusual transactions
- Significant transactions with related parties whose financial statements are not audited or are audited by another firm
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant or highly complex transactions or significant unusual transactions, especially those close to period-end, that pose difficult "substance over form" questions
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
- Use of business intermediaries for which there appears to be no clear business justification
- Modifying, revoking, or amending revenue contracts through the use of side agreements that are typically executed outside the recognized business process and reporting channels
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
- Nontraditional entry to capital markets by the entity, for example, through an acquisition by, or merger with, a special purpose acquisition company
- Aggressive stock promotions by the entity through press releases, investment newsletters, website coverage, online advertisements, email, or direct mail
- Contractual arrangements lacking a business purpose

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls
- Oversight by those charged with governance over the financial reporting process and internal control is not effective
- Weakened control environment triggered by a shift in focus by management and those charged with governance to address more immediate needs of the business, such as financial and operational matters
- The exertion of dominant influence by or over a related party

The organizational structure is complex or unstable, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- Overly complex IT environment relative to the nature of the entity's business, legacy IT systems from acquisitions that were never integrated into the entity's financial reporting system, or ineffective IT general controls
- High turnover of senior management, legal counsel, or those charged with governance

Deficiencies in internal control are a result of the following:

- Inadequate process to monitor the entity's system of internal control, including automated controls and controls over interim financial reporting (where external reporting is required)
- Inadequate fraud risk management program, including lack of a whistleblower program
- Inadequate controls due to changes in the current environment, for example, increased data security risks from using unsecured networks that make the entity's data and information more vulnerable to cybercrime
- High turnover rates in accounting, IT, or the internal audit function, or employment of staff in these areas who are not effective
- Accounting and information systems that are not effective, including situations involving significant deficiencies or material weaknesses in internal control
- Weak controls over budget preparation and development and compliance with law or regulation

Attitudes and Rationalizations

- Management and those charged with governance have not created a culture of honesty and ethical behavior. For example, communication, implementation, support, or enforcement of the entity's values or ethical standards by management and those charged with governance are not effective, or there is communication of inappropriate values or ethical standards.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- There is a known history of violations of securities law or other law and regulation, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of law or regulation, including those dealing with corruption, bribery, and money laundering.
- There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.

- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management and those charged with governance demonstrate an unusually high tolerance to risk or display an unusually high standard of lifestyle, a pattern of significant personal financial issues, or frequently engage in high-risk activities.
- Management and those charged with governance make materially false or misleading statements in other information included in the entity's annual report (for example, key aspects of the entity's business, products, or technology).
- Management fails to remedy known significant deficiencies or material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Management applies aggressive valuation assumptions in mergers and acquisitions to support high purchase prices or overvalue acquired intangible assets.
- Management rationalizes the use of unreasonable assumptions affecting the timing and amount of revenue recognition, for example, in an attempt to alleviate the negative effects of severe economic downturns.
- Management rationalizes the use of unreasonable assumptions used in projections to account for impairment of goodwill and intangible assets, for example, to avoid recognizing significant impairment losses.
- There is low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- There is a dispute between shareholders in a closely held entity.
- Management makes recurring attempts to justify marginal or inappropriate accounting on the basis of materiality.
- There is a strained relationship between management and the current or predecessor auditor, as exhibited by the following:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
    - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report
    - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

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

Incentives and Pressures

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

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefit plans
- Promotions, compensation, or other rewards inconsistent with expectations

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when the following characteristics or circumstances exist:

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lacking observable identification of ownership

Inadequate controls over assets may increase the susceptibility to misappropriation of those assets. For example, misappropriation of assets may occur because the following exist:

- Inadequate segregation of duties or independent checks
- Inadequate oversight of senior management expenditures, such as travel and other re-imbursements
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations
- Inadequate job applicant screening of employees with access to assets
- Inadequate recordkeeping with respect to assets

- Inadequate system of authorization and approval of transactions (e.g., in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of IT, which enables IT employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer system event logs
- Inadequate controls in supplier management, including changes in the supply chain, that may expose the entity to fictitious suppliers or unvetted suppliers that pay kickbacks or are involved in other fraudulent or illegal activities
- Lack of oversight by those charged with governance over how management used financial aid from governments and local authorities (such as bailouts during pandemics, wars, or impending industry collapse)

Considerations Specific to Governmental Entities

- Trust funds under administration — Governmental entities often manage assets on behalf of others, including vulnerable individuals, which can be more susceptible to misuse.
- The nature of certain revenue transactions (e.g., taxes and grants) may provide a greater opportunity to manipulate the timing or amount of revenue recognized in the current period.

Attitudes and Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriation of assets
- Disregard for controls over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated
- The belief by some government or other officials that their level of authority justifies a certain level of compensation and personal privileges
- Tolerance of petty theft
- Rationalizing misappropriations committed during severe economic downturns by intending to pay back the entity when circumstances return to normal

A205.

Appendix B — Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud (Ref: par. A64, A137, and A147)

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples, and accordingly, they may not be the most appropriate procedure, or may not be necessary, in every circumstance. Also, the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

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

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis (for example, observing inventory at locations where auditor attendance has not been previously announced or counting cash on a particular date on a surprise basis)
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period-end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period
- Altering the audit approach in the current year (for example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information)
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear to have an unusual nature or amount
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions
- Performing substantive analytical procedures using disaggregated data (for example, comparing sales and cost of sales by location, line of business, or month to expectations developed by the auditor)
- Conducting interviews of personnel involved in areas in which a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk
- Conducting interviews with personnel outside of the financial reporting function, for example, sales and marketing personnel

- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components
- If the work of a specialist becomes particularly significant with respect to a financial statement item for which the assessed risk of material misstatement due to fraud is high, performing additional procedures relating to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments (for example, an allowance for sales returns) were resolved with the benefit of hindsight
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods
- Using automated tools and techniques, such as data mining, to test for anomalies in a population (for example, using automated tools and techniques to identify numbers that have been used frequently because management or employees posting fraudulent journal entries and other adjustments may have an unconscious bias causing them to use the same number repetitively)
- Testing the integrity of computer-produced records and transactions
- Seeking additional audit evidence from sources outside of the entity being audited

Considerations Specific to Governmental Entities or Not-for-Profit Organizations

- Testing whether grants or loans provided to third parties have met the relevant eligibility criteria and have been properly authorized and accounted for by the governmental entity or not-for-profit organization
- Testing whether write-offs and other adjustments of tax and levy receivable balances or loan balances have been appropriately authorized

Specific Responses — Misstatement Resulting From Fraudulent Financial Reporting

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

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods or with revenue related to cash collections (Automated tools and techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.)

- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting is often influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented (For example, acceptance criteria, delivery and payment terms, the absence of future or continuing supplier obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions are often relevant in such circumstances.)
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions
- Being physically present at one or more locations at period-end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded
- Examining customer correspondence files at the entity for any unusual terms or conditions that raise questions about the appropriateness of revenue recognized
- Analyzing the reasons provided for product returns received shortly after the end of the financial year (for example, product not ordered, entity shipped more units than ordered)
- Determining whether revenue transactions are recorded in accordance with the applicable financial reporting framework and the entity's accounting policies (For example, goods shipped are not recorded as sales unless there is a transfer of legal title in accordance with the shipping terms, particularly when the entity uses a freight forwarder or a third-party warehouse or fulfillment center.)

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period
- Performing additional procedures during the observation of the count; for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (such as hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals (using the work of a specialist may be helpful in this regard)

- Comparing the quantities for the current period with prior periods by class or category of inventory, location, or other criteria, or comparing quantities counted with perpetual records
- Using automated tools and techniques to further test the compilation of the physical inventory counts (for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication)
- Verifying the accurate calibration of tools that are used to record, measure, or weigh the quantity of inventory items (for example, scales, measuring devices, or scanning devices)
- Using a specialist to confirm the nature of inventory quantities for specialized products (For example, the weight of precious gemstones may be determinable, but a specialist may assist with determining the cut, color, and clarity of the gemstones.)

Management Estimates

- Using a specialist to develop an independent estimate for comparison with management's estimate
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate

Specific Responses — Misstatements Due to Misappropriation of Assets

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

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

- Counting cash or securities at or near year-end
- Confirming directly with customers the account activity (including credit memo and sales return activity, as well as dates payments were made) for the period under audit
- Analyzing recoveries of written-off accounts
- Analyzing inventory shortages by location or product type
- Comparing key inventory ratios to industry norms
- Reviewing supporting documentation for reductions to the perpetual inventory records
- Performing a computerized match of the supplier list with a list of employees to identify matches of addresses or phone numbers

- Performing a computerized search of payroll records to identify duplicate addresses, employee identification numbers, or taxing authority numbers or bank accounts
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations
- Analyzing sales discounts and returns for unusual patterns or trends
- Confirming specific terms of contracts with third parties
- Obtaining evidence that contracts are being carried out in accordance with their terms
- Reviewing the propriety of large and unusual expenses
- Reviewing the authorization and carrying value of senior management and related party loans
- Reviewing the level and propriety of expense reports submitted by senior management

A206.

Appendix C — Examples of Circumstances That May Be Indicative of Fraud or Suspected Fraud (Ref: par. A31)

The following are examples of circumstances that may indicate that the financial statements may contain a material misstatement due to fraud.

Discrepancies in the Accounting Records

- Transactions that are not recorded in a complete or timely manner or are improperly recorded by amount, accounting period, classification, or entity policy
- Unsupported or unauthorized balances or transactions
- Last-minute adjustments that significantly affect financial results (such as inventory adjustments)

Conflicting or Missing Evidence

- Missing documents
- Missing approvals or authorization signatures
- Signature or handwriting discrepancies and invalid electronic signatures
- Documents that appear to have been altered
- Unavailability of documents other than photocopied or electronically transmitted documents when documents in original form are expected to exist
- Significant unexplained items on reconciliations
- Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships (for example, receivables growing faster than revenues)
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures
- Unusual discrepancies between the entity's records and confirmation replies
- Large numbers of credit entries and other adjustments made to accounts receivable records
- Subsidiary ledgers that do not reconcile with control accounts
- Unexplained or inadequately explained differences between the accounts receivable subledger and the control account, or between the customer statements and the accounts receivable subledger
- Unexplained fluctuations in stock account balances, inventory variances, and turnover rates
- Missing inventory or physical assets of significant magnitude
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies

- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated
- Inability to produce evidence of key systems development and program-change testing and implementation activities for current-year system changes and deployments
- Information about overly optimistic projections, obtained from listening to the entity's earning's calls with analysts or by reading analysts' research reports, that is contrary to information presented in the entity's internal forecasts used for budgeting purposes

Conditions Relating to Governmental Entities or Not-for-Profit Organizations

- Significant transfers or transactions between funds or programs, or both, lacking supporting documents
- Abnormal budget conditions, such as
    - significant budget adjustments
    - requests for additional funding
    - budget adjustments made without approval
    - large amounts of overspending or underspending
    - programs with an emphasis on spending money quickly
- Procurement conditions, such as
    - lack of procurement legislation
    - complex or unclear legislation
    - involvement of significant monetary amounts (such as in the defense area)
    - investigation by regulatory authorities
    - complaints received from potential suppliers about questionable practices related to awarding of contracts
    - former government officials functioning as executives of companies to which contracts have been awarded
- Program conditions, such as
    - newly implemented programs without existing management and accountability structures
    - programs established for political purposes
    - programs established to deal with an immediate emergency or loss
    - programs experiencing unusual growth due to conditions beyond the control of management
- Grant or donor funding conditions, such as
    - noncompliance with grant requirements
    - unclear grant requirements

  - grants not reaching the intended recipient
  - complaints from intended recipients or interest groups, and lack of monitoring of grantee compliance with applicable law or regulation

Problematic or Unusual Relationships Between the Auditor and Management

- Denial of access to records, facilities, certain employees, customers, suppliers, or others from whom audit evidence might be sought
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
- Undue time pressures imposed by management to resolve complex or contentious issues
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
- Unusual delays by the entity in providing requested information
- An unwillingness to facilitate auditor access to key electronic files for testing through the use of automated tools and techniques
- An unwillingness to allow a discussion between the auditor and management's third-party specialist (such as a specialist in taxation law)
- An unwillingness by management to permit the auditor to meet privately with those charged with governance
- An unwillingness to correct a material misstatement in the financial statements or in other information included in the entity's annual report
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable
- An unwillingness to address identified deficiencies in internal control on a timely basis
- An unwillingness to allow the auditor to send a confirmation request
- An unwillingness to provide a requested written representation

Other

- Extensive use of suspense accounts
- Accounting policies that appear to be at variance with industry norms
- Frequent changes in accounting estimates that do not appear to result from changed circumstances
- Tolerance of violations of the entity's code of conduct
- Discrepancy between earnings and lifestyle
- Unusual, irrational, or inconsistent behavior

- Allegations of fraud through anonymous emails, letters, telephone calls, tips, or complaints that may come to the attention of the auditor
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties
- Controls or audit logs being switched off

A207.

Appendix D — Additional Considerations That May Inform the Auditor When Selecting Journal Entries and Other Adjustments for Testing (Ref: par. A110, A154, and A158)

The following considerations may be relevant when selecting journal entries and other adjustments for testing:

- *Understanding the entity's information system and communication relevant to the preparation of the financial statements*[73] (see also paragraph 36 of this proposed SAS). Obtaining this required understanding provides the auditor with knowledge about the following:
  - — The entity's policies and procedures regarding (including the individuals within the entity responsible for) how transactions are initiated, recorded, processed, corrected as necessary, incorporated in the general ledger, and reported in the financial statements
  - — The types of journal entries (whether standard or nonstandard) incorporated in the general ledger and, in turn, reported in the financial statements, including other adjustments made directly to the financial statements
  - — The process of how journal entries and other adjustments are recorded or made (whether automated or manual) as well as the supporting documentation required, based on the entity's policies and procedures
  - — The entity's financial statement closing process
- *Understanding the entity's controls designed to prevent or detect fraud over journal entries*[74] (see also paragraphs 37 and 49 of this proposed SAS). For many entities, routine processing of transactions involves a combination of manual and automated controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated controls across one or multiple IT systems. Where IT is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
  - — The types of controls designed to prevent or detect fraud over journal entries may include authorizations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls.
  - — The requirement in paragraphs 37 and 49 of this proposed SAS covers controls over journal entries that address risks of material misstatement due to fraud at the assertion level and that could be susceptible to unauthorized or inappropriate intervention or manipulation. These controls include the following:

[73] Paragraph .25 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

[74] Paragraphs .26–.30 of AU-C section 315.

    - *Controls over nonstandard journal entries.* When the journal entries are automated or manual and are used to record nonrecurring, unusual transactions or adjustments
    - *Controls over standard journal entries.* When the journal entries are automated or manual and are susceptible to unauthorized or inappropriate intervention or manipulation

- *The effectiveness of controls that have been implemented over journal entries and other adjustments*. Effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- *The identification and assessment of the risks of material misstatement due to fraud*. The evaluation of information obtained from the risk assessment procedures and related activities, including the consideration of information obtained from other sources, could indicate the presence of fraud risk factors. Such fraud risk factors, particularly events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalizations that enable management to justify override of controls, may assist the auditor in identifying specific classes of journal entries and other adjustments for testing. These may include journal entries and other adjustments susceptible to unauthorized or inappropriate intervention or manipulation resulting from the following:
    - — Pressures or incentives to meet or exceed performance measures used, internally and externally (for example, auto-reversing journal entries made at year-end)
    - — Pressures or incentives to minimize or avoid taxes (for example, inappropriate journal entries to record premature or delayed revenue or expense recognition)
    - — Pressures to comply with debt repayment or other debt covenant requirements (for example, inappropriately offsetting assets and liabilities in the balance sheet by directly making adjustments to the financial statements to achieve a debt covenant on the entity's debt-to-equity ratio, even when the conditions for a right of setoff are not met)
    - — Opportunities, arising from the inappropriate segregation of duties, for any individual in the entity to conceal or perpetrate fraud in the normal course of that individual's duties (for example, journal entries and other adjustments relating to transactions affecting assets, where the individual is responsible for
        - the custody of assets, or
        - the authorization or approval of the related transactions affecting those assets, and
        - the recording or reporting of related transactions)
    - — Opportunities arising from deficiencies in internal control (for example, journal entries and other adjustments related to purchase payments to unauthorized suppliers or made by terminated or transferred employees)

- Opportunities arising from privileged access granted to individuals involved in the financial statement closing process (for example, journal entries and other adjustments made by individuals with administrative or powerful users' access)
- Opportunities arising from calculations based on end-user computing tools that support accounting estimates susceptible to misstatement due to management bias or fraud (for example, journal entries and other adjustments based on calculations of impairment of goodwill and other intangible assets using spreadsheet software)

- *The characteristics of fraudulent journal entries and other adjustments*. Inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries
  - made to unrelated, unusual, or seldom-used accounts.
  - made by individuals who typically do not make journal entries.
  - recorded at the end of the period or as post-closing entries that have little or no explanation or description.
  - made either before or during the preparation of the financial statements that do not have account numbers.
  - containing round numbers or numbers with consistent endings.

  The auditor may use recent information, such as data on actual perpetrated frauds or reports regarding trends in occupational fraud, to inform the auditor about characteristics of fraudulent journal entries.

- *The nature and complexity of the accounts*. Inappropriate journal entries or adjustments may be applied to accounts that
  - contain transactions that are complex or unusual in nature.
  - contain significant estimates and period-end adjustments.
  - have been prone to misstatements in the past.
  - have not been reconciled on a timely basis or contain unreconciled differences.
  - contain intercompany transactions or transactions with related parties.
  - are otherwise associated with an identified risk of material misstatement due to fraud.

- *Journal entries and other adjustments processed outside the normal course of business*. Nonstandard journal entries may not be subject to the same nature and extent of controls as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements.

A208.

Appendix E — Other AU-C Sections Addressing Specific Topics That Reference Fraud or Suspected Fraud (Ref: par. A20)

This appendix identifies other AU-C sections with specific requirements that refer to fraud or suspected fraud. The list does not include other AU-C sections with requirements that refer to fraud or error (such as AU-C section 210, *Terms of Engagement*, AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*). This list is not a substitute for considering the requirements and related application and other explanatory material in generally accepted auditing standards (GAAS).

- Paragraph .12 of AU-C section 210, *Terms of Engagement*
- Paragraph .19 of AU-C section 402*, Audit Considerations Relating to an Entity Using a Service Organization*
- New paragraph .06 of AU-C section 450, *Evaluation of Misstatements Identified During the Audit,* as amended by this proposed SAS
- Paragraphs .08*b* and .11 of AU-C section 505*, External Confirmations*
- Paragraph .32 of AU-C section 540*, Auditing Accounting Estimates and Related Disclosures*
- Paragraphs .21, .25*f*, and .26*a*i of AU-C section 550, *Related Parties*
- Paragraphs .40*d*, new paragraph .47, former paragraph .47*h* (renumbered as .48*h*), former paragraph .73 (renumbered as .74), former paragraph .75*d* (renumbered as .76*d*), and former paragraph .77*g* (renumbered as .78*g*) of AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to-Auditors)*, as amended by this proposed SAS.
- Paragraphs .16–.17, .29*b*, .54, and .57*f* of AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

A209.

Appendix F — Amendments to Various Statements on Auditing Standards (SASs), as Amended, and to Various Sections in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as Amended

This appendix addresses the amendments to certain AU-C sections in AICPA *Professional Standards*. This table is a reference tool for these amendments.

SAS/AU-C Section	***Title***	***Paragraphs Amended***
SAS No. 117		
935	*Compliance Audits*	.17
SAS No. 122		
200	*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*	.10, .A26, .A58
210	*Terms of Engagement*	.12, .A31
230	*Audit Documentation*	.A9, .A30
250	*Consideration of Laws and Regulations in an Audit of Financial Statements*	.A4
260	*The Auditor's Communication With Those Charged With Governance*	.A58
265	*Communicating Internal Control Related Matters Identified in an Audit*	.A9, .A24
300	*Planning an Audit*	.A6, .A27
330	*Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	.24, .A9, .A12, .A60, .A76
450	*Evaluation of Misstatements Identified During the Audit*	New .06, former .06 (renumbered as .07), .A1, new .A7, former .A7 (renumbered as .A8), former .A29 (renumbered as .A30)
505	*External Confirmations*	.03, .08, .11, .A5, .A10, .A23, .A25, .A30
530	*Audit Sampling*	.A9, .A19
550	*Related Parties*	.01, .05, .12−.13, .21, .26, .A18, .A20, .A28, .A33, .A37, .A41
580	*Written Representations*	.12, .A35
805	*Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*	.A14
SAS No. 128		
610	*Using the Work of Internal Auditors*	.A32, .A43
SAS No. 130		
940	*An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of*	.17, .A26

SAS/AU-C Section	Title	Paragraphs Amended
	Financial Statements	
SAS No. 142		
500	*Audit Evidence*	.A30
SAS No. 143		
540	*Auditing Accounting Estimates and Related Disclosures*	.07, .A11, .A57, .A136, .A151
SAS No. 145		
315	*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	.06, .12, .27, .39, .A17, .A49, .A58, .A83, .A99, .A124−.A125, .A179, .A181−.A182, .A250, .A275−.A277
SAS No. 146		
220	*Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*	.A35−.A38, .A56, .A65, .A74, .A77, .A122
SAS No. 149		
600	*Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*	New .47, former .47*h* (renumbered as .48*h*), former .73 (renumbered as .74), former .75 (renumbered as .76), former.77*g* (renumbered as .78*g*), .A17, .A103, .A125, .A151, .A159, .A204, .A228

(***Boldface italics*** denotes new language. Deleted text is in ~~strikethrough~~.)

Amendment to SAS No. 117, *Compliance Audits*, as Amended (AU-C Section 935)

1. This amendment would become effective for compliance audits for fiscal periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.16.]

Requirements

…

Performing Risk Assessment Procedures (Ref: par. .A14–.A19)

...

.17 In adapting and applying the requirements of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, to identify controls that address risks of material noncompliance, [fn 2] the auditor should perform risk assessment procedures, beyond inquiry, to evaluate whether the following controls that address risks of material noncompliance are effectively designed and determine whether those controls have been implemented:

a. Controls over journal entries and other adjustments as required by ***proposed SAS*** ~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~

b. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which include

i. controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, and

ii. controls that are required to be tested for operating effectiveness by the governmental audit requirement as required by paragraph .25 of this section

c. Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to identify and assess risks of material noncompliance and design further audit procedures

fn 2 [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 935.]

Amendments to Various Sections in SAS No. 122, as Amended (AU-C Sections 200, 210, 230, 250, 260, 265, 300, 330, 450, 505, 530, 550, and 805)

AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With GAAS*

2. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.09.]

Introduction

…

An Audit of Financial Statements

…

.10 The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation. [fn 2]

fn 2 For examples, see section 260, *The Auditor's Communication With Those Charged With Governance*; section 265, *Communicating Internal Control Related Matters Identified in an Audit*; and paragraph***s 61−64***~~.42~~ of ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.

[No amendment to paragraphs .11−.A25.]

Application and Other Explanatory Material

…

Professional Skepticism

…

.**A26** The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. [fn 11] In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), GAAS require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter. [fn 12]

[fn 11] [Footnote text omitted for purposes of this proposed SAS.]

[fn 12] ***Paragraph 22 of proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*,*** ~~P~~*p*aragraph .10 of section 500, and paragraphs .10–.11 and .16 of section 505, *External Confirmations*.

[No amendment to paragraphs .A27−.A57.]

Sufficient Appropriate Audit Evidence and Audit Risk (Ref: par. .19)

…

Inherent Limitation of an Audit

…

Other Matters That Affect the Inherent Limitations of an Audit

.A58 In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include the following:

- Fraud, particularly fraud involving senior management or collusion. See ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*,~~ for further discussion.

…

[No further amendment to AU-C section 200.]

AU-C Section 210, *Terms of Engagement*

3. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.11.]

Requirements

…

Initial Audits, Including Reaudit Engagements — Communications With the Predecessor Auditor

…

.12 If, pursuant to paragraph .11, management authorizes the predecessor auditor to respond to the auditor's inquiries, the auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including (Ref: par. .A30–.A33)

a. identified or suspected fraud involving

   i. management,

   ii. employees who have significant roles in internal control, or

   iii. others***, except for matters that are clearly inconsequential*** ~~when the fraud resulted in a material misstatement in the financial statements~~.

b. matters involving noncompliance or suspected noncompliance with laws and regulations that came to the predecessor auditor's attention during the audit, other than when matters are clearly inconsequential.

[No amendment to paragraphs .13−.A30.]

Application and Other Explanatory Material

…

Initial Audits, Including Reaudit Engagements — Communications With the Predecessor Auditor (Ref: par. .11−.15)

…

.A31 The inquiries specified in paragraph .12*a–b* are consistent with matters that the predecessor auditor communicated with those charged with governance as required by ~~section 240~~***proposed SAS***~~,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ [fn 14] and section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, [fn 15] respectively.

fn 14 Paragraph ***62***.~~40~~ of ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.

fn 15 [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 210.]

AU-C Section 230, *Audit Documentation*

4. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.A8.]

*Documentation of Compliance With GAAS (Ref: par. .08*a*)*

…

.A9 Audit documentation provides evidence that the audit complies with GAAS. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

…

- Regarding requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  - — For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's ~~exercise~~ ***maintenance*** of professional skepticism in accordance with GAAS, for example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, documenting how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion about the sufficiency and appropriateness of the audit evidence obtained.

…

[No amendment to paragraphs .A10–.A29.]

Exhibit — Audit Documentation Requirements in Other AU-C Sections

.A30 The following lists the main paragraphs in other AU-C sections that contain specific documentation requirements. This list is not a substitute for knowledge of the AU-C sections:

…

c. Paragraphs ~~.43−.46~~***65−66*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**

…

[No further amendment to AU-C section 230.]

AU-C Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

5. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.A3.]

Application and Other Explanatory Material

Responsibility for Compliance With Laws and Regulations (Ref: par. .03−.08)

…

Responsibility of the Auditor

…

.A4 Noncompliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of noncompliance, regardless of materiality, may affect other aspects of the audit, including, for example, the auditor's consideration of the integrity of management or employees. Noncompliance can result from fraudulent activity. ***Proposed SAS***~~Section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*,~~ addresses the auditor's responsibility if fraud or suspected fraud is detected.

[No further amendment to AU-C section 250.]

AU-C Section 260, *The Auditor's Communication With Those Charged With Governance*

6. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.A57.]

Application and Other Explanatory Material

…

Exhibit — Requirements to Communicate With Those Charged With Governance in Other AU-C Sections

.A58 Requirements for the auditor to communicate with those charged with governance are included in other AU-C sections. This section does not change the requirements in

a. paragraph .20*b* of section 210, *Terms of Engagement*

b. paragraphs ~~.21, .38*ci*, and .39–.41~~ ***25, 33*****d*****, 55*****a*****, 60*****ci*****, and 62−63*** of ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~*Consideration of Fraud in a Financial Statement Audit*~~

…

[No further amendment to AU-C section 260.]

AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit*

7. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.A8.]

Application and Other Explanatory Material

…

Evaluating Identified Deficiencies in Internal Control (Ref: par. .09–.10)

…

.A9 Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in internal control will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

…

- The importance of the controls, such as the following, to the financial reporting process:

…

— Controls over the prevention ~~and~~***or*** detection of fraud

…

[No amendment to paragraphs .A10−.A23.]

…

Communication of Deficiencies in Internal Control (Ref: Par. .11−.16)

...

Communication of Deficiencies in Internal Control to Management (Ref: par. .12)

…

*Communication of Significant Deficiencies and Material Weaknesses in Internal Control to Management (Ref: par. .12*a*)*

…

.A24 Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements and provides guidance on the reporting of identified or suspected noncompliance with laws and regulations, including when those charged with governance are themselves involved in such noncompliance. fn 6 ***Proposed SAS***~~Section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management. fn 7

fn 6 [Footnote text omitted for purposes of this proposed SAS.]

fn 7 Paragraph ~~.40~~***62*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement*~~ ~~Audit~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No further amendment to AU-C section 265.]

AU-C Section 300, *Planning an Audit*

8. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.A5.]

Application and Other Explanatory Material

…

Involvement of Key Engagement Team Members (Ref: par. .05)

.A6 Section 315 requires a discussion among the audit team about the susceptibility of the entity's financial statements to material misstatement. fn 6 This discussion also may include the discussion regarding the risks of material misstatement due to fraud, as required by ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**. fn 7 The objective of this discussion is for members of the audit team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

fn 6 [Footnote text omitted for purposes of this proposed SAS.]

fn 7 Paragraph***s*** ~~.15~~***29−30*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

…

[No amendment to paragraphs .A7−.A26.]

Appendix — Considerations in Establishing the Overall Audit Strategy (Ref: par. .07–.08 and .A9–.A12)

.A30~~.A27~~

This appendix provides examples of matters the auditor may consider in managing quality at the engagement level. Many of these matters will influence the auditor's overall audit strategy and detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. Although some of the following matters may be required by other AU-C sections, not all matters are relevant to every audit engagement, and the list is not necessarily complete.

…

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

The following examples illustrate significant factors, preliminary engagement activities, and knowledge gained on other engagements:

…

- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and ~~exercise~~ professional skepticism in gathering and evaluating audit evidence

…

[No further amendment to AU-C section 300.]

AU-C Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

9. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.23.]

Requirements

…

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Relevant Assertion Level

…

Substantive Procedures

…

Timing of Substantive Procedures

…

.24 If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. See ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.[fn 2]

[fn 2] Paragraphs ~~.35–.36~~*57* of ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.

[No amendment to paragraphs .25−.A8.]

Application and Other Explanatory Material

…

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Relevant Assertion Level

The Nature, Timing, and Extent of Further Audit Procedures (Ref: par. .06)

…

.A9 Because effective internal controls generally reduce but do not eliminate the risk of material misstatement, tests of controls reduce but do not eliminate the need for substantive procedures. In addition, analytical procedures alone may not be sufficient in some cases. For example, when auditing certain estimation processes, such as the allowance for doubtful accounts, the auditor may perform substantive procedures beyond analytical procedures (for example, examining cash collections subsequent to the period-end) due to the risk of management override of controls [fn 8] or the subjectivity of the account balance.

[fn 8] The auditor is required by paragraphs ~~.31–.33~~***41 and 48–53*** of ~~section 240~~ ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** to perform audit procedures responsive to risks related to management override of controls.

[No amendment to paragraphs .A10−.A11.]

*Responding to the Assessed Risks at the Assertion Level (Ref: par. .07*a*)*

…

Timing

.A12 The auditor may perform tests of controls or substantive procedures at an interim date or at the period-end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to or at the period-end rather than at an earlier date or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of ***material misstatement due to*** fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from the interim date to the period-end would not be effective.

[No amendment to paragraphs .A13−.A59.]

Substantive Procedures (Ref: par. .18)

…

Substantive Procedures Responsive to Significant Risks (Ref: par. .22)

.A60 Paragraph .22 requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, substantive procedures that take into account the types of potential misstatements that could result from significant unusual transactions may be necessary, including procedures performed pursuant to paragraph ~~.32~~***53*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A61−.A75.]

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: par. .27−.28)

.A76 An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based. For example

…

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks of material misstatement***, whether due to fraud or error,*** and the effect on the significant classes of transactions, account balances, or disclosures and their relevant assertions. Section 315 contains further guidance on revising the auditor's risk assessment. [fn 15]

[fn 15] [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 330.]

AU-C Section 450, ***Evaluation of Misstatements Identified During the Audit***

10. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01−.05. Former paragraph .06, renumbered as paragraph .07, included for contextual purposes.]

Requirements

…

Consideration of Identified Misstatements as the Audit Progresses

.06 If the auditor identifies a misstatement, the auditor should evaluate whether such a misstatement is indicative of fraud. (Ref: par. .A7)

~~**.06**~~ *.07* The auditor should determine whether the overall audit strategy and audit plan need to be revised if

a. the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or (Ref: par. ~~.A7~~ ***.A8***)

b. the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with section 320. [fn 1] (Ref: par. ~~.A8~~ ***.A9***)

[fn 1] [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to former paragraphs .07−.12, renumbered as paragraphs .08−.13.]

Application and Other Explanatory Material

Definitions

Misstatement (Ref: par. .04)

.A1 Misstatements may result from fraud or error, such as

…

Other examples of misstatements arising from fraud are provided in ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**. [fn 5]

[fn 5] Paragraphs ~~.A1–.A8~~***A5–A8*** of ***proposed SAS*** ~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No amendment to paragraphs .A2−.A6. Former paragraph .A7, renumbered as paragraph .A8, included for contextual purposes.]

…

Consideration of Identified Misstatements as the Audit Progresses (Ref: par. .06−.07)

.A7 The nature of identified misstatements and the circumstances of their occurrence may indicate that the misstatements may be a result of fraud. In such cases, the auditor also performs the procedures required by proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,** ***fn 7 recognizing that an instance of fraud is unlikely to be an isolated occurrence.

***fn 7 Paragraphs 55–58 of proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.**

[Subsequent footnotes renumbered.]

~~.A7~~ *.A8* A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, when the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

[No amendment to former paragraphs .A8−.A28, renumbered as paragraphs .A9−.A29.]

Evaluating the Effect of Uncorrected Misstatements (Ref: par. *.11–.12*)

…

~~.A29~~ *.A30* ***Proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~ explains how the implications of a misstatement that is, or may be, the result of fraud are required to be considered with regard to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements. fn ~~19~~ ***20*** Depending on the circumstances, misstatements in disclosures could also be indicative of fraud and, for example, may arise from the following:

- Misleading disclosures that have resulted from bias in management's judgments
- Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements

When considering the implications of misstatements in classes of transactions, account balances, and disclosures, the auditor ***maintains*** ~~exercises~~ professional skepticism in accordance with section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*. fn ~~20~~ ***21***

…

fn ~~19~~ ***20*** Paragraph ~~.35~~*57* of ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

fn ~~20~~ ***21*** [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 450.]

AU-C Section 505, *External Confirmations*[*]

11. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.02.]

Introduction

…

External Confirmation Procedures to Obtain Audit Evidence

…

.03 Other AU-C sections recognize the importance of external confirmations as audit evidence; for example

…

- ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~,~~ indicates that the auditor may design ***external*** confirmation ***procedures*** ~~requests~~ to obtain ***audit evidence*** ~~additional corroborative information~~ as a response to address the assessed risks of material misstatement due to fraud at the assertion level. [fn 8]

[fn 8] Paragraph*s* ~~.A43~~***A145–A149*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

…

[No amendment to paragraphs .04–.07.]

Requirements

...

Management's Refusal to Allow the Auditor to Perform External Confirmation Procedures

.08 If management refuses to allow the auditor to perform external confirmation procedures, the auditor should

[*] AU-C section 505 is proposed to be amended by proposed SAS *External Confirmations*, effective for audits of financial statements for periods ending no earlier than December 15, 2027. The proposed amendment to AU-C section 505 does not affect the context of the amendment proposed in this appendix and, therefore, has not been reflected in this appendix.

a. inquire about management's reasons for the refusal and seek audit evidence about their validity and reasonableness; (Ref: par. .A9)

b. evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk*s* of ***material misstatement due to*** fraud, and on the nature, timing, and extent of other audit procedures; and (Ref: par. .A10)

c. perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: par. .A11)

[No amendment to paragraphs .09–.10.]

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests

…

.11 If the auditor determines that a response to a confirmation request is not reliable, the auditor should evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk*s* of ***material misstatement due to*** fraud, and on the related nature, timing, and extent of other audit procedures. (Ref: par. .A23)

[No amendment to paragraphs .12–.A4.]

Application and Other Explanatory Material

…

External Confirmation Procedures

…

Designing Confirmation Requests (Ref: par. .07*c*)

…

.A5 Factors to consider when designing confirmation requests include the following:

- The assertions being addressed.
- Specific identified risks of material misstatement, including ***risks of material misstatement due to*** fraud~~ risks~~.

…

[No amendment to paragraphs .A6–.A9.]

Management's Refusal to Allow the Auditor to Perform External Confirmation Procedures

…

Implications for the Assessment of Risks of Material Misstatement (Ref: par. .08*b*)

.A10 The auditor may conclude from the evaluation in paragraph .08*b* that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures, in accordance with section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. [fn 11] For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation, in accordance with ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~.[fn 12]

[fn 11] [Footnote text omitted for purposes of this proposed SAS.]

[fn 12] Paragraph ~~.24~~***39*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A11–.A22.]

…

Unreliable Responses (Ref: par. .11)

.A23 When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with section 315. [fn 15] For example, an unreliable response may indicate a fraud risk factor that requires evaluation, in accordance with ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~. [fn 16]

[fn 15] [Footnote text omitted for purposes of this proposed SAS.]

[fn 16] Paragraph ~~.24~~***39*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.**~~section 240~~

[No amendment to paragraph .A24.]

Nonresponses and Oral Responses (Ref: par. .12)

…

.A25 A nonresponse to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level and modify planned audit procedures, in accordance with section 315. [fn 17] For example, a fewer or greater number of responses to confirmation requests than anticipated may indicate a previously unidentified fraud risk factor that requires evaluation, in accordance with ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~. [fn 18]

[fn 17] [Footnote text omitted for purposes of this proposed SAS.]

[fn 18] Paragraph ~~.24~~ ***39*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A26−.A29.]

Exceptions (Ref: par. .14)

.A30 Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by section ***450,* Evaluation of Misstatements Identified During the Audit**,~~ 240~~ to evaluate whether such misstatement is indicative of fraud. [fn 19] Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

[fn 19] Paragraph ***.06*** ~~.35~~of section ***450***~~240~~**, Evaluation of Misstatements Identified During the Audit**.

[No further amendment to AU-C section 505.]

AU-C Section 530, ***Audit Sampling***

12. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.A8.]

Application and Other Explanatory Material

…

Sample Design, Size, and Selection of Items for Testing

Sample Design (Ref: par. .06)

…

.A9 The auditor's consideration of the purpose of the audit procedure, as required by paragraph .06, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the assertions are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client are not considered a misstatement. Also, an incorrect posting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in relation to the relevant assertion even though it may have an important effect on other areas of the audit, such as the assessment of the risk***s*** of ***material misstatement due to*** fraud or the adequacy of the allowance for doubtful accounts.

[No amendment to paragraphs .A10–.A18.]

Performing Audit Procedures (Ref: par. .10–.11)

…

.A19 In some circumstances, the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, the entity might not be able to locate supporting documentation. The auditor's treatment of unexamined items will depend on their effect on the auditor's evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it may not be necessary to examine the items, for example, if the aggregate amount of the unexamined items, if treated as misstatements or deviations, would not cause the auditor's assessment of the amount of the misstatement or deviation in the population to exceed tolerable misstatement or tolerable deviation, respectively. However, when this is not the case, the auditor is required by paragraph .11 to perform alternative procedures that provide sufficient appropriate audit evidence to form a conclusion about the sample item and use the results of these procedures in assessing the sample results. If alternative procedures cannot be satisfactorily performed in these cases, the auditor is required to treat the items as misstatements or deviations, as appropriate, in evaluating the results of the sample. ***Proposed SAS***~~Section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*,~~ also requires the auditor to consider whether the reasons for the auditor's inability to examine the items have implications with regard to assessing risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations.

[No further amendment to AU-C section 530.]

AU-C Section 550, *Related Parties*

13. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements. [fn 1] Specifically, it expands on how section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; and ***Proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**, are to be applied regarding risks of material misstatement associated with related party relationships and transactions.

[fn 1] [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .02–.04.]

Responsibilities of the Auditor

…

.05 In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present, as required by ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240,~~ because fraud may be more easily committed through related parties. [fn 5]

[fn 5] Paragraph ~~.24~~***39*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No amendment to paragraphs .06–.11.]

Requirements

Risk Assessment Procedures and Related Activities

.12 As part of the risk assessment procedures and related activities that ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~ and section 315 require the auditor to perform during the audit, the auditor should perform the audit procedures and related activities set out in paragraphs .13–.19 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. [fn 8] [fn 9]

[fn 8] Paragraph ***26***~~.16~~ of ~~section 240~~***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[fn 9] [Footnote text omitted for purposes of this proposed SAS.]

Understanding the Entity's Related Party Relationships and Transactions

.13 In connection with the engagement team discussion(s) that ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~ and section 315 require, the auditor should include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. [fn 10] [fn 11] (Ref: par. .A7–.A8)

[fn 10] Paragraphs ~~.15~~***29–30*** of ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[fn 11] [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .14–.20.]

Identification and Assessment of the Risks of Material Misstatement Associated With Related Party Relationships and Transactions

…

.21 If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor should consider such information when identifying and assessing the risks of material misstatement due to fraud, in accordance with ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~. fn 14 (Ref: par. .A32–.A34)

fn 14 Paragraph ~~.24~~*39* of ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .22–.25.]

Responses to the Risks of Material Misstatement Associated With Related Party Relationships and Transactions

…

Identified Related Party Transactions That Are Required to Be Disclosed or Determined to Be a Significant Risk

.26 For identified significant related party transactions that are required to be disclosed in the financial statements or determined to be a significant risk, the auditor should fn 16

a. read the underlying contracts or agreements, if any, and evaluate whether

i. the business purpose (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. fn 17 (Ref: par. .A42–.A43)

…

fn 16 [Footnote text omitted for purposes of this proposed SAS.]

fn 17 Paragraph ~~.32c~~*53* of ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .27−.A17.]

Application and Other Explanatory Material

…

Risk Assessment Procedures and Related Activities

Understanding the Entity's Related Party Relationships and Transactions

…

The Entity's Controls Over Related Party Relationships and Transactions (Ref: par. .15)

...

.A18 In meeting the requirement of section 315 to obtain an understanding of the entity's system of internal control, the auditor may consider features or elements relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as the following: fn 27

…

- The existence of ~~whistle-blowing policies and procedures~~ ***a whistleblower program (or other program to report fraud)***, when applicable

fn 27 [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to paragraph .A19.]

.A20 Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. fn 28 The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (*a*) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (*b*) colluding with such parties or controlling their actions. Examples of possible fraud include the following:

…

fn 28 Paragraph***s*** ~~.31~~***41 and A7*** of ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A21–.A27.]

Remaining Alert for Related Party Information When Reviewing Records or Documents

…

Identification of Significant Unusual Transactions (Ref: par. .18)

...

.A28 *Understanding the nature of significant unusual transactions (Ref: par. .18a).* Inquiring into the nature of the significant unusual transactions involves obtaining an understanding of the business purpose of the transactions and the terms and conditions under which these have been entered into. fn 29

fn 29 Paragraph ~~.32*c*~~***53*** of ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A29–.A32.]

Identification and Assessment of the Risks of Material Misstatement Associated With Related Party Relationships and Transactions

Fraud Risk Factors Associated With a Related Party With Dominant Influence (Ref: par. .21)

...

.A33 Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor. [fn 31] Indicators of dominant influence exerted by a related party include the following:

…

fn 31 ***Appendix A, "Examples of Fraud Risk Factors,"*** ~~Paragraph .A76~~ of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A34–.A36.]

Responses to the Risks of Material Misstatement Associated With Related Party Relationships and Transactions (Ref: par. .22)

…

.A37 If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

…

- Review of employee ~~whistle-blowing~~***whistleblower*** reports when these are retained

[No amendment to paragraphs .A38–.A40.]

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

…

*Intentional Nondisclosure by Management (Ref: par. .25*f)

.A41 The requirements and guidance in ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~ regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant when management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor also may consider whether it is necessary to reevaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor. [33]

fn 33 [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 550.]

AU-C Section 580, *Written Representations*

14. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendments to paragraphs .01–.11.]

Requirements

…

Other Written Representations

Fraud

.12 The auditor should request management to provide written representations that it

a. acknowledges its responsibility for the design, implementation, and maintenance of internal ~~controls~~ ***control*** to prevent and detect fraud ***and has appropriately fulfilled those responsibilities***;

b. has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;

c. has disclosed to the auditor its knowledge of ***any*** fraud or suspected fraud***, including allegations of fraud,*** affecting the entity involving

i. management,

ii. employees who have significant roles in internal control, or

iii. others when the fraud could have ***an*** ~~a material~~ effect on the financial statements; and

d. has disclosed to the auditor its knowledge of ~~any allegations of fraud or~~ suspected fraud***, including allegations of fraud,*** affecting the entity's financial statements communicated by employees, former employees, regulators, or others. (Ref: par. .A11)

[No amendment to paragraphs .13–.A34.]

[Subsequent footnotes renumbered. No amendment to paragraphs .A12–.A34.]

Exhibit A — Illustrative Representation Letter

.A35 The following illustrative letter includes written representations that are required by this and other AU-C sections in effect for audits of financial statements for periods ending on or after December 15, 2012. It is assumed in this illustration that the applicable financial reporting framework is accounting principles generally accepted in the United States, that the requirement in section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to obtain a written representation is not relevant, and that no exceptions exist to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

…

We confirm that [*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves] [as of (date of auditor's report),*]:

…

Information Provided

…

- We have [*no knowledge of ~~any~~*] [*disclosed to you all information that we are aware of regarding*] ***any*** fraud or suspected fraud that affects the entity and involves:
  — Management;
  — Employees who have significant roles in internal control; or
  — Others when the fraud could have ***an***~~a material~~ effect on the financial statements (par. .12*c*)
- We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] ~~allegations of fraud, or~~ suspected fraud, ***including allegations of fraud,*** affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (par. .12*d*)

…

[No further amendment to AU-C section 580.]

AU-C Section 805, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*

15. This amendment would become effective for single financial statements or specific elements, accounts, or items of a financial statement as of or for periods ending on or after December 15, 2028.

[No amendments to paragraphs .01–.A13.]

Application and Other Explanatory Material

…

Considerations When Planning and Performing the Audit (Ref: par. .12–.13)

.A14 An AU-C section is relevant to the audit when the AU-C section is in effect and the circumstances addressed by the AU-C section exist. [fn 9] Even when only a specific element of a financial statement is the subject of the audit, AU-C sections such as ***proposed SAS*** ~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial**

Statements ~~*Consideration of Fraud in a Financial Statement Audit*~~, section 550, *Related Parties*, and section 570 are, in principle, relevant. This is because the specific element could be misstated as a result of fraud, the effect of related party transactions, or the incorrect application of the going concern assumption under the applicable financial reporting framework.

fn 9 [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 805.]

Amendment to SAS No. 128, *Using the Work of Internal Auditors*, as Amended (AU-C Section 610)

16. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.A31.]

Application and Other Explanatory Material

…

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used in Obtaining Audit Evidence

…

Using the Work of the Internal Audit Function in Obtaining Audit Evidence

Discussion and Coordination With the Internal Audit Function in Obtaining Audit Evidence (Ref: par. .20)

…

.A32 Communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention. fn 14 The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any ~~actual,~~ ***fraud or*** suspected~~, or alleged~~ fraud, ***including allegations of fraud,*** the external auditor can take this into account in the external auditor's identification of ~~risk~~***risks*** of material misstatement due to fraud in accordance with ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.

fn 14 [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A33–.A42.]

Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

…

Determining the Nature and Extent of Work That Can Be Assigned to Internal Auditors Providing Direct Assistance (Ref: par. .27)

…

.A43 In determining the nature of work that may be assigned to internal auditors providing direct assistance, the external auditor is careful to limit such work to those areas that would be appropriate for internal auditors to be assigned. Examples of activities and tasks that would not be appropriate for internal auditors to provide direct assistance include the following:

- Making required inquiries of entity personnel or those charged with governance related to the identification of fraud risks and determining the procedures to respond to such risks [fn 15]
- Determination of unpredictable audit procedures as addressed in ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~

[fn 15] Paragraphs ~~.17–.21~~***33–35*** of ~~section 240,~~ ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.

[No further amendment to AU-C section 610.]

Amendment to SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements,* as Amended (AU-C Section 940)

17. This amendment would become effective for integrated audits for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.16.]

Requirements

…

Planning the Audit of ICFR

…

Addressing the Risk of Fraud

…

.17 ***Proposed SAS*** ~~Section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*,~~ requires the auditor to consider whether ~~other~~ information ***from other sources*** obtained by the auditor indicates ***that one or more fraud risk factors are present***~~risks of material misstatement due to fraud~~.[fn 4] If the auditor identifies deficiencies in controls designed to prevent, or detect and correct, misstatements caused by fraud during the audit of ICFR, the auditor should take into account those deficiencies when developing the response to risks of material misstatement ***due to fraud*** during the financial statement audit. [fn 5]

[fn 4] Paragraph ~~.23~~*27* of ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*~~.

[fn 5] See paragraphs ~~.28–.33~~*43–53* of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .18–.A25.]

Application and Other Explanatory Material

…

Planning the Audit of ICFR (Ref: par. .14)

…

Addressing the Risk of Fraud (Ref: par. .16–.17)

.A26 ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~addresses the auditor's identification and assessment of the risks of material misstatement due to fraud. [fn 16] Controls that might address these risks include

- controls over significant unusual transactions, particularly those that result in late or unusual journal entries.
- controls over journal entries and ***other*** adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant accounting estimates; and
- controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

[fn 16] Paragraphs ~~.25–.27~~*40–42* of ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No further amendment to AU-C section 940.]

Amendment to SAS No. 142, *Audit Evidence*, as Amended (AU-C Section 500)

18. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.A29.]

Application and Other Explanatory Material

…

Evaluating Information to Be Used as Audit Evidence (Ref: par. .07−.08)

…

Relevance and Reliability of the Information, Including Its Source (Ref: par. .07*a*)

…

Relevance and Reliability

…

.A30 *Authenticity*. An audit performed in accordance with GAAS rarely involves the authentication of documents, nor is the auditor trained as, or expected to be, an expert in such authentication. When the auditor identifies conditions that cause the auditor to believe that a document may not be authentic, that terms in a document may have been modified but not disclosed to the auditor, or that undisclosed side agreements may exist, the auditor may determine that additional audit procedures are necessary, including audit procedures to evaluate authenticity. Such audit procedures may include

- confirming directly with the third party.
- using the work of a specialist to assess the document's authenticity. [fn 23]

[fn 23] Paragraph ~~.A11~~***A39*** of ***proposed SAS*** ~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~*Consideration of Fraud in a Financial Statement Audit*.~~

[No further amendment to AU-C section 500.]

Amendment to SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*, as Amended (AU-C Section 540)

19. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.06.]

Introduction

…

Key Concepts of This Section

.07 The ~~exercise~~ ***maintenance*** of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity, or other inherent risk factors. Similarly, ***maintaining*** ~~the exercise of~~ professional skepticism is important when there is greater susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk. (Ref: par. .A11)

[No amendment to paragraphs .08−.A10.]

…

Application and Other Explanatory Material

…

Key Concepts of This Section

…

Professional Skepticism (Ref: par. .07)

.A11 Paragraphs .A60, .A95–.A96, .A137, and .A139 are examples of paragraphs that describe ways in which the auditor can ***maintain*** ~~exercise~~ professional skepticism. Paragraph .A151 provides guidance on ways in which the auditor's ***maintenance*** ~~exercise~~ of professional skepticism may be documented and includes examples of specific paragraphs in this section for which documentation may provide evidence of the ***maintenance*** ~~exercise~~ of professional skepticism.

[No amendment to paragraphs .A12−.A56.]

…

Risk Assessment Procedures and Related Activities

Obtaining an Understanding of the Entity and Its Environment (Ref: par. .12)

…

Reviewing the Outcome or Re-estimation of Previous Accounting Estimates (Ref: par. .13)

…

.A57 A retrospective review of management judgments and assumptions related to ~~significant~~ accounting estimates is required by ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**. fn 41 As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this section may be carried out in conjunction with the review required by ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~.

fn 41 Paragraph ~~.32*b*(ii)~~***28*** of ***proposed SAS***~~section 240, *Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No amendment to paragraphs .A58−.A135.]

Indicators of Possible Management Bias (Ref: par. .32)

…

.A136 In addition, in applying ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements, ***even if they are individually reasonable***, ***are indicators of*** ~~indicate a~~ possible ***management*** bias that may represent a material misstatement due to fraud. fn 65 Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Indicators of possible management bias that may also be a fraud risk factor may cause the auditor to reassess whether the auditor's risk assessments, in particular, the assessment of ***risks of material misstatement due to*** fraud~~ risks~~, and related responses remain appropriate.

fn 65 Paragraph*s* ~~.32*b*~~***51−52*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

No amendment to paragraphs .A137−.A150.]

…

.A151 Section 230 fn 78 notes that although there may be no single way in which the auditor's ***maintenance*** ~~exercise~~ of professional skepticism is documented, the audit documentation may, nevertheless, provide evidence of the auditor's ***maintenance*** ~~exercise~~ of professional skepticism. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion about the sufficiency and appropriateness of the audit evidence obtained. Examples of other requirements in this section for which documentation may provide evidence of the ~~exercise~~ ***maintenance*** of professional skepticism by the auditor include the following:

…

fn 78 [Footnote text omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 540.]

Amendment to SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, as Amended (AU-C Section 315)

20. This amendment would become effective for audits of financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.05.]

Introduction

…

Key Concepts in This Section

…

.06 Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by this section, the significance of fraud is such that further requirements and guidance are included in ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**, in relation to risk assessment procedures and related activities to obtain information that is used to identify, assess, and respond to the risks of material misstatement due to fraud.

[No amendment to paragraphs .07–.11.]

Definitions

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

…

Inherent risk factors. Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors [fn 11] insofar as they affect inherent risk.

…

[fn 11] Paragraphs ~~.A28–.A32~~***A26–A28*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~**The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

…

Significant risk. An identified risk of material misstatement (Ref: par. .A15)

…

ii. that is to be treated as a significant risk in accordance with the requirements of other AU-C sections. [fn 13]

[fn 13] Paragraph ~~.27~~***40*****b** of ***proposed SAS***~~,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~and paragraph .20 of section 550, *Related Parties*.

[No amendment to paragraphs .13–.26.]

Requirements

…

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: par. .A55–.A57)

…

Understanding the Components of the Entity's System of Internal Control (Ref: par. .A100–.A111)

...

Information System and Communication, and Control Activities (Ref: par. .A140–.A147)

...

Control Activities

…

.27 The auditor should identify the following controls that address risks of material misstatement at the assertion level:

a. Controls that address a risk that is determined to be a significant risk (Ref: par. .A180–.A181)

b. Controls over journal entries and other adjustments as required by ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~ fn 14 (Ref: par. .A182–.A183)

c. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (Ref: par. .A184–.A186)

d. Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph .13 with respect to risks at the assertion level (Ref: par. .A187–.A188)

fn 14 Paragraph***s*** ~~32*a*(i)~~***49–50*** of ~~section~~ ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No amendment to paragraphs .28–.38.]

…

Evaluating the Audit Evidence Obtained From the Risk Assessment Procedures

.39 The auditor should evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement***, whether due to fraud or error***. If not, the auditor should perform additional risk assessment procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor should take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management. (Ref: par. .A261–.A263)

[No amendment to paragraphs .40–.A16.]

Application and Other Explanatory Material

…

Risk Assessment Procedures and Related Activities (Ref: par. .13–.18)

.A17 The risks of material misstatement to be identified and assessed include both those due to fraud and those due to error, and both are covered by this section. However, the significance of fraud is such that further requirements and guidance are included in ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~in relation to risk assessment procedures and related activities to obtain information that is used to identify and assess the risks of material misstatement due to fraud. [fn 19] In addition, the following AU-C sections provide further requirements and guidance on identifying and assessing risks of material misstatement regarding specific matters or circumstances:

…

[fn 19] Paragraphs ~~.12–.27~~*26–42* of ~~section 240~~***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

[No amendment to paragraphs .A18–.A48.]

Engagement Team Discussion (Ref: par. .17–.18)

Why the Engagement Team Is Required to Discuss the Application of the Applicable Financial Reporting Framework and the Susceptibility of the Entity's Financial Statements to Material Misstatement

…

.A49 The discussion among the engagement team about the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement accomplishes the following:

…

Proposed SAS **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~ requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur. [fn 28]

[fn 28] Paragraph .~~15~~*29* of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A50–.A57.]

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: par. .19–.31)

…

Why an Understanding of the Entity and Its Environment, and the Applicable Financial Reporting Framework, Is Required (Ref: par. .19–.20)

.A58 The auditor's understanding of the entity and its environment and the applicable financial reporting framework assist the auditor

a. in understanding the events and conditions that are relevant to the entity, and

b. in identifying how inherent risk factors affect the susceptibility of assertions to misstatement in the preparation of the financial statements, in accordance with the applicable financial reporting framework, and the degree to which they do so.

Such information establishes a frame of reference within which the auditor identifies and assesses risks of material misstatement. This frame of reference also assists the auditor in planning the audit, exercising professional judgment, and maintaining professional skepticism throughout the audit, for example, when

- identifying and assessing risks of material misstatement of the financial statements in accordance with this section or other relevant AU-C sections (for example, relating to risks of ***material misstatements due to*** fraud in accordance with ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~ or when identifying or assessing risks related to accounting estimates in accordance with section 540);

…

[No amendment to paragraphs .A59–.A82.]

The Entity and Its Environment (Ref: par. .19)

...

*Measures Used by Management to Assess the Entity's Financial Performance (Ref: par. .19*a*iii)*

Why the Auditor Understands Measures Used by Management

.A83 An understanding of the entity's measures assists the auditor in considering whether such measures, whether used externally or internally, create pressures on the entity to achieve performance targets. These pressures may motivate management to take actions that increase the susceptibility to misstatement due to management bias or fraud (for example, to improve the business performance or to intentionally misstate the financial statements) (see ***proposed SAS* The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~ section 240~~ for requirements and guidance in relation to the risks of ***material misstatement due to*** fraud).

[No amendment to paragraphs .A84–.A98.]

...

How Inherent Risk Factors Affect Susceptibility of Assertions to Misstatement (Ref: par. .19**c*****)***

…

The Effect of Inherent Risk Factors on a Class of Transactions, Account Balance, or Disclosure

...

.A99 Events or conditions that may affect susceptibility to misstatement due to management bias may also affect susceptibility to misstatement due to other fraud risk factors. Accordingly, this may be relevant information for use in accordance with ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~, [fn 38] which requires the auditor to evaluate whether the ***audit evidence obtained*** ~~information obtained~~ from the ~~other~~ risk assessment procedures and related activities indicates that one or more fraud risk factors are present.

[fn 38] Paragraph ~~.24~~ ***39*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A100–.A123.]

…

Control Environment, the Entity's Risk Assessment Process, and the Entity's Process to Monitor the System of Internal Control (Ref: par. .21–.24)

…

Obtaining an Understanding of the Entity's Risk Assessment Process (Ref: par. .22–.23)

<u>Understanding the Entity's Risk Assessment Process (Ref: par. .22*a*)</u>

.A124 As explained in paragraph .A71, not all business risks give rise to risks of material misstatement, whether due to error or fraud. In understanding how management and those charged with governance have identified business risks relevant to the preparation of the financial statements, and decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance, has done the following:

…

- Considered the potential for fraud when considering the risks to achieving the entity's objectives [fn 40]

[fn 40] Paragraph ~~.18~~***34*****b*****i*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

.A125 Paragraph .22 of this section requires the auditor to obtain an understanding of the entity's process for identifying business risks. ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~ [fn 41] requires the auditor to ***obtain an understanding of how the entity's risk assessment***

process identifies and monitors fraud risks related to the misappropriation of assets and fraudulent financial reporting, including any ~~make inquiries of management regarding, among other things, management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or~~ classes of transactions, account balances, or disclosures for which ~~a risk~~***risks*** of fraud ~~is likely to~~ exist***; assess the significance of the identified fraud risks, including the likelihood of their occurrence; and address the assessed fraud risks. The proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ***also requires the auditor to make inquires of management and of other appropriate individuals within the entity, including personnel not directly involved in the financial reporting process.***[fn 41]

~~fn 41 Paragraph .17 of section 240.~~
fn 41 Paragraph 34 of proposed SAS **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.**

[No amendment to paragraphs .A126–.A178.]

Control Activities (Ref: par. .26–.31)

...

Scalability (Ref: par. .26)

…

.A179 It may be less practicable to establish segregation of duties in less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~, domination of management by a single individual can be a potential control deficiency because there is an opportunity for management override of controls. [fn 47]

fn 47 Paragraph ~~.A32~~***A122*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

*Controls That Address Risks of Material Misstatement at the Assertion Level (Ref: par. .27*a*)*

<u>Controls That Address Risks That Are Determined to Be Significant Risks (Ref: par. .27*a*)</u>

[No amendment to paragraph .A180.]

.A181 ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~Section 240~~ [fn 49] requires the auditor to understand controls related to assessed risks of material misstatement due to fraud (which are treated as significant risks) and further explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented, and maintained to prevent and detect fraud.

fn 49 Paragraphs ~~.27~~***37, 40*****b*****,*** and ~~.A37~~ ***A112*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

Controls Over Journal Entries and Other Adjustments (Ref: par. .27*b*)

.A182 How an entity incorporates information from transaction processing in the general ledger ordinarily involves the use of journal entries, whether standard or nonstandard, or automated or manual. ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~ ***includes additional requirements for*** ~~requires~~ the auditor to obtain an understanding of ***journal entries and other adjustments and for the auditor to design and perform audit procedures to test the appropriateness of journal entries and other adjustments.*** ~~the entity's financial reporting process and controls over journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.~~ fn 50

fn 50 Paragraph***s*** ~~.32~~***36–37 and 49–50*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~.

[No amendment to paragraphs .A183–.A249.]

Assessing Risks of Material Misstatement at the Assertion Level

…

Significant Risks (Ref: par. .36)

…

Determining Significant Risks

…

.A250 The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk and, therefore, are significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another AU-C section. ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~ and section 550 provide further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud and related party transactions that are also significant unusual transactions. fn 67 fn 68 Examples are as follows:

…

fn 67 Paragraphs ~~.25–.27~~***40–42*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section~~ 240.

fn 68 [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A251–.A274.]

Appendix B — Understanding Inherent Risk Factors (Ref: par. .12, .19, .A9–.A11, .A34, .A69, .A94–.A99, and .A230)

.A275

This appendix provides further explanation about inherent risk factors as well as matters that the auditor may consider in understanding and applying the inherent risk factors in identifying and assessing the risks of material misstatement at the assertion level.

The Inherent Risk Factors

1. *Inherent risk factors* are characteristics of events or conditions that affect susceptibility of an assertion about a class of transactions, account balance, or disclosure, to misstatement, whether due to fraud or error, and before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors [fn 1] insofar as they affect inherent risk. In obtaining the understanding of the entity and its environment, and the applicable financial reporting framework and entity's accounting policies, in accordance with paragraph .19*a–b*, the auditor also understands how inherent risk factors affect susceptibility of assertions to misstatement in the preparation of the financial statements.

[fn 1] Paragraphs ~~.A28–.A32~~***.A26–.A28*** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**.

2. Inherent risk factors relating to the preparation of information required by the applicable financial reporting framework (referred to in this paragraph as *required information*) include the following:

…

- *Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk*. Susceptibility to management bias results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include incentives or pressures insofar as they affect inherent risk (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio) and opportunity, not to maintain neutrality. Factors relevant to the susceptibility to misstatement due to fraud in the form of fraudulent financial reporting or misappropriation of assets are described in ***proposed SAS***~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~*Consideration of Fraud in a Financial Statement Audit*~~. [fn 2]

fn 2 Paragraphs ~~.A1–.A5~~***A3–A8*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statement**s ~~section 240~~**.**

[No further amendment to appendix B.]

Appendix C — Understanding the Entity's System of Internal Control (Ref: par. .12, .21–.31, .A100–.A212)

.A276

[No amendment to paragraphs 1–5.]

Components of the Entity's System of Internal Control

Control Environment

…

6. The control environment encompasses the following elements:

…

b. *When those charged with governance are separate from management, how those charged with governance demonstrate independence from management and exercise oversight of the entity's system of internal control.* An entity's control consciousness is influenced by those charged with governance. Considerations may include whether there are sufficient individuals who are independent from management and objective in their evaluations and decision making; how those charged with governance identify and accept oversight responsibilities and whether those charged with governance retain oversight responsibility for management's design, implementation, and conduct of the entity's system of internal control. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of ~~whistle-blower procedures~~ ***the entity's whistleblower program (or other program to report fraud)***.

…

[No further amendment to appendix C.]

Appendix D — Considerations for Understanding an Entity's Internal Audit Function (Ref: par. .A31–.A32 and .A134)

.A277

This appendix provides further considerations relating to understanding the entity's internal audit function when such a function exists.

[No amendment to paragraphs 1–4.]

Inquiries of the Internal Audit Function

…

5. In addition, in accordance with ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**, [fn 2] if the internal audit function provides information to the auditor regarding any ~~actual,~~***fraud or*** suspected~~, or alleged~~ fraud, ***including allegations of fraud,*** the auditor takes this into account in the auditor's identification of ~~risk~~ ***risks*** of material misstatement due to fraud.

[fn 2] Paragraph ~~.19~~***35*****b** of ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~***The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*****.**

[No further amendment to appendix D. No further amendment to AU-C section 315.]

Amendment to SAS No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards,* as Amended (AU-C Section 220)

21. This amendment would become effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2028.

[No amendment to paragraphs .01–.A34.]

Application and Other Explanatory Material

…

Leadership Responsibilities for Managing and Achieving Quality in Audits (Ref: par. .13–.15)

…

Professional Skepticism

.A35 The engagement partner is responsible for emphasizing the importance of each engagement team member maintaining professional skepticism throughout the audit engagement. Conditions inherent in some audit engagements can create pressures on the engagement team that may impede the appropriate exercise of professional ***judgment or maintenance of professional*** skepticism when designing and performing audit procedures and evaluating audit evidence. Accordingly, when developing the overall audit strategy in accordance with section 300, *Planning an Audit*, the engagement team may need to consider whether such conditions exist in the audit engagement and, if so, what actions the firm or the engagement team may need to undertake to mitigate such impediments.

.**A36** Impediments to the ~~exercise~~ ***maintenance*** of professional skepticism at the engagement level may include the following:

…

.A37 Unconscious or conscious auditor biases may affect the engagement team's professional judgments, including, for example, in the design and performance of audit procedures, or the evaluation of audit evidence. Examples of unconscious auditor biases that may impede the ~~exercise~~ ***maintenance*** of professional skepticism and, therefore, the reasonableness of the professional judgments made by the engagement team in complying with the requirements of this section may include the following:

…

.A38 Possible actions that the engagement team may take to mitigate impediments to the ~~exercise~~ ***maintenance*** of professional skepticism at the engagement level may include the following:

…

- Modifying the nature, timing, and extent of direction, supervision, or review by involving more experienced engagement team members, more in-person oversight on a more frequent basis, or more in-depth reviews of certain working papers for
  - — complex or subjective areas of the audit,
  - — areas that pose risks to achieving quality on the audit engagement,
  - — areas ***where there may be a higher risk of material misstatement, including a risk of material misstatement due to fraud***~~with a fraud risk~~, and
  - — identified or suspected noncompliance with laws or regulations

…

[No amendment to paragraphs .A39–.A55.]

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: par. .22–.24)

.A56 Information obtained during acceptance and continuance may also be relevant in complying with the requirements of other sections, as well as this section, for example, with respect to the following:

…

- Identifying and assessing risks of material misstatement, whether due to error or fraud, in accordance with section 315 and ***proposed SAS***~~section 240,~~ ~~*Consideration of Fraud in a Financial Statement Audit*~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**

…

[No amendment to paragraphs .A57−.A64.]

Engagement Resources (Ref: par. .25−.28)

…

Technological Resources

.A65 The use of technological resources on the audit engagement may assist the auditor in obtaining sufficient appropriate audit evidence. Technological resources may include tools that allow the auditor to more effectively and efficiently manage the audit. Technological tools may also allow the auditor to evaluate large amounts of data more easily to, for example, provide deeper insights, identify unusual trends, or more effectively challenge management's assertions, which enhances the ability of the auditor to exercise ***professional judgment or maintain*** professional skepticism. Technological tools may also be used to conduct meetings and provide communication tools to the engagement team. Inappropriate use of technological resources may, however, increase the risk of overreliance on the information produced for decision-making purposes or may create threats to complying with relevant ethical requirements, for example, requirements related to confidentiality.

…

[No amendment to paragraphs .A66−.A73.]

Competence and Capabilities of the Engagement Team (Ref: par. .26)

.A74 When determining that the engagement team has the appropriate competence and capabilities, the engagement partner may take into consideration such matters as the team's

…

- ability to ~~exercise~~ ***maintain*** professional skepticism and ***exercise*** professional judgment.

…

[No amendment to paragraphs .A75−.A76.]

Project Management

…

.A77 Project management techniques and tools may support the engagement team in managing the quality of the audit engagement by, for example,

- increasing the engagement team's ability to ~~exercise~~ ***maintain*** professional skepticism through alleviating budget or time constraints that may otherwise impede the ~~exercise~~ ***maintenance*** of professional skepticism.

…

[No amendment to paragraphs .A78−.A121.]

Engagement Performance

…

Documentation (Ref: par. .41)

.A122 When dealing with circumstances that may pose risks to achieving quality on the audit engagement, the ~~exercise~~ ***maintenance*** of professional skepticism, and the documentation of the auditor's consideration thereof, may be important. For example, if the engagement partner obtains information that may have caused the firm to decline the engagement (see paragraph .24), the documentation may include explanations of how the engagement team dealt with the circumstance.

…

[No further amendment to AU-C section 220.]

Amendment to SAS No. 149, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)* (AU-C Section 600)

22. This amendment would become effective for audits of group financial statements for periods ending on or after December 15, 2028.

[No amendment to paragraphs .01–.46.]

Requirements

…

Responding to the Assessed Risks of Material Misstatement

…

Fraud or Suspected Fraud

Considerations When Component Auditors Are Involved

…

.47 ***In applying proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*,*** *fn 23* ***the group auditor should take responsibility for obtaining an understanding of identified fraud or suspected fraud.***

fn 23 ***Paragraph 55 of proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.**

[Subsequent footnotes renumbered.]

Evaluating the Component Auditor's Communications and the Adequacy of Their Work

~~.47~~*.48* The group auditor should request the component auditor to communicate matters relevant to the group auditor's conclusion with regard to the group audit. Such communication should include the following: (Ref: par. .A159)

…

h. Fraud or suspected fraud involving

i. component management,

ii. employees at entities or business units who have significant roles in the group's system of internal control at the component, or

iii. others at entities or business units***, except for matters that are clearly inconsequential*** ~~where the fraud resulted in a material misstatement of~~ ***to*** the component financial information

…

[No amendment to former paragraphs .48–.72, renumbered as paragraphs .49–.73.]

Communication With Group Management and Those Charged With Governance of the Group

Communication With Group Management

…

~~.73~~*.74* If fraud ***or suspected fraud*** has been identified by the group auditor or brought to its attention by a component auditor (see paragraph .47*h*) or referred-to auditor, or information indicates that a fraud ***or suspected fraud*** may exist, the group auditor should communicate this on a timely basis to the appropriate level of group management to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: par. .A204)

[No amendment to former paragraph .74, renumbered as paragraph .75.]

Communication With Those Charged With Governance of the Group

~~.75~~*.76* The group auditor should communicate the following matters with those charged with governance of the group, in addition to those required by section 260, *The Auditor's Communication With Those Charged With Governance*, and other AU-C sections: (Ref: par. .A207)

a. An overview of the work to be performed at the components of the group, including the basis for the decision to make reference to the audit of a referred-to auditor in the auditor's report on the group financial statements, and the nature of the group auditor's planned involvement in the work to be performed by component auditors (Ref: par. .A208)

b. Instances when the group auditor's review of the work of a component auditor gave rise to a concern about the quality of that component auditor's work and how the group auditor addressed the concern

c. Any limitations on the scope of the group audit, for example, significant matters related to restrictions on access to people or information

d. Fraud or suspected fraud involving

i. group management~~,~~ ***or*** component management~~,~~***;***

ii. employees at entities or business units who have significant roles in the group's system of internal control~~,~~***;*** or

iii. others at entities or business units***, except for matters that are clearly inconsequential to*** ~~in which a material misstatement of~~ the group financial statements ~~has or may have resulted from fraud~~

[No amendment to former paragraph .76, renumbered as paragraph .77.]

Documentation

~~.77~~*.78* In accordance with section 230, [fn 25] the audit documentation for a group audit engagement needs to be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing, and extent of audit procedures performed, the evidence obtained, and the conclusions reached with respect to significant matters arising during the group audit. In applying section 230, [fn 26] the group auditor should include in the audit documentation the following: (Ref: par. .A210–.A212, .A222–.A225)

…

g. Matters related to communications with component auditors, including

i. matters, if any, related to fraud ***or suspected fraud***, related parties, or going concern communicated in accordance with paragraph .34 and

ii. matters relevant to the group auditor's conclusion with regard to the group audit, in accordance with paragraph .47, including how the group auditor has addressed significant matters discussed with component auditors, component management, or group management.

…

[fns 25–26] [Footnote text omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A1–.A16.]

Application and Other Explanatory Material

Scope of This Section (Ref: par. .01−.02)

...

Professional Skepticism (Ref: par. .11)

…

.A17 The maintenance of professional skepticism in a group audit may be affected by matters such as the following:

- Component auditors in different locations may be subject to varying cultural influences, which may affect the nature of the biases to which they are subject.
- The complex structure of some groups may introduce factors that give rise to increased susceptibility to risks of material misstatement. In addition, an overly complex organizational structure may be a fraud risk factor in accordance with

proposed SAS ~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~*Consideration of Fraud in a Financial Statement Audit*~~, [fn 33] and therefore may require additional time or expertise to understand the business purpose and activities of certain entities or business units.

…

[fn 33] Appendix A***, "Examples of Fraud Risk Factors,"*** of ***proposed SAS*** ~~section 240,~~ **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~*Consideration of Fraud in a Financial Statement Audit*~~.

[No amendment to paragraphs .A18–.A102.]

Understanding the Group and Its Environment, the Applicable Financial Reporting Framework, and the Group's System of Internal Control (Ref: par. .32)

…

Engagement Team Discussion (Ref: par. .32)

…

.A103 The discussion provides an opportunity to do the following:

…

- Exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error. ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~Section 240~~ [fn 67] requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur.

…

- Discuss fraud ***or suspected fraud*** that has been identified or information that indicates existence of fraud.

…

[fn 67] Paragraph .~~15~~*29* of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~.

[No amendment to paragraphs .A104–.A124.]

Identifying and Assessing the Risks of Material Misstatement (Ref: par. .35)

Fraud

.A125 In applying ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~, [fn 74] the auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud and to design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. Information used to identify and assess the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management's assessment of the risk that the group financial statements may be materially misstated due to fraud
- Group management's process for identifying and responding to the ***fraud*** risks ~~of fraud~~ in the group financial statements, including any specific fraud risks identified by group management, or classes of transactions, account balances, or disclosures for which a ***fraud*** risk ~~of fraud~~ is higher
- Whether there are particular components that are more susceptible to risks of material misstatement due to fraud
- Whether any fraud risk factors or indicators of management bias exist in the consolidation process
- How those charged with governance of the group monitor group management's processes for identifying and responding to the ***fraud*** risks ~~of fraud~~ in the group, and the controls group management has established to mitigate these risks
- Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function (and when appropriate, component management, the component auditors, and others) to the group auditor's inquiry about whether they have knowledge of any ***fraud or*** ~~actual,~~ suspected ***fraud, including allegations of***~~, or alleged~~ fraud***,*** affecting a component or the group

fn 74 Paragraphs ~~.26 and .31~~***40 and 47*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~.

[No amendment to paragraphs .A126–.A150.]

Responding to the Assessed Risks of Material Misstatement (Ref: par. .39)

...

Element of Unpredictability

.A151 Incorporating an element of unpredictability in the type of work to be performed, the entities or business units at which procedures are performed, and the extent to which the group auditor is involved in the work, may increase the likelihood of identifying a material misstatement of the components' financial information that may give rise to a material misstatement of the group financial statements due to fraud. [fn 80]

fn 80 Paragraph .~~29c~~***44*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements** ~~section 240~~.

[No amendment to paragraphs .A152–.A158.]

Evaluating the Component Auditor's Communications and the Adequacy of Their Work

Communication About Matters Relevant to the Group Auditor's Conclusion With Regard to the Group Audit (Ref: par. .47)

.A159 Although the matters required to be communicated in accordance with paragraph .47 are relevant to the group auditor's conclusion with regard to the group audit, certain matters may be communicated during the course of the component auditor's procedures. In addition to the matters in paragraphs .34 and .68, such matters may include, for example

…

- newly arising significant risks of material misstatement, including risks of ***material misstatement due to*** fraud;
- ***fraud or*** ~~actual,~~ suspected~~, or alleged~~ fraud involving component management or employees that could have a material effect on the group financial statements;

…

[No amendment to paragraphs .A160–.A203.]

Communication With Group Management and Those Charged With Governance of the Group

Communication With Group Management (Ref: par. .72–.74)

…

.A204 ***Proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~Section 240~~ [fn 89] contains requirements and guidance on the communication of fraud ***or suspected fraud*** to management and~~, when management may be involved in the fraud,~~ to those charged with governance.

[fn 89] Paragraphs .~~40–.42~~***61–63*** of ***proposed SAS*** **The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**~~section 240~~.

[No amendment to paragraphs .A205–.A227.]

Appendix A — Understanding the Group's System of Internal Control (Ref: par. .A98)

.A228

[No amendment to paragraphs 1–2.]

The Group's Risk Assessment Process

3. The group auditor's understanding of the group's risk assessment process may include matters such as group management's risk assessment process, that is, the process for identifying, analyzing, and managing business risks, including ~~the~~ ***fraud*** risk ~~of fraud~~, that may result in material misstatement of the group financial statements. It may also include an understanding of how sophisticated the group's risk assessment process is and the involvement of entities and business units in this process.

[No further amendment to appendix A. No further amendment to AU-C section 600.]