

Auditing Standard

AUS 210
(January 2002)

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



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Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

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AUDITING STANDARD
**AUS 210 “THE AUDITOR’S RESPONSIBILITY TO
CONSIDER FRAUD AND ERROR IN AN AUDIT OF A
FINANCIAL REPORT”**

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MAIN FEATURES OF THE STANDARD

This Auditing Standard (AUS) establishes standards and provides guidance regarding the auditor’s consideration of fraud and error in relation to the audit of a financial report. The AUS expands the basic principles and essential procedures in relation to the risk of material misstatements as a result of fraud and error in an audit of a financial report by placing the following requirements on auditors.

- (a) The auditor in planning the audit, is required to discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial report resulting from fraud or error (paragraph .20). When planning the audit, AUS 210 also requires the auditor to make more extensive inquiries of management with respect to fraud or error (paragraph .22).
- (b) When assessing inherent and control risks, the auditor is required to assess how the financial report might be materially misstated as a result of fraud and error (paragraph .32). AUS 210 also requires the auditor as part of the assessment of inherent and control risks to consider whether fraud risk factors are present (examples of fraud risk factors are outlined in Appendix 1).
- (c) If fraud risk factors are identified as being present, AUS 210 requires the auditor to address these specifically in designing audit procedures, and to document these factors and the auditor’s response to them (paragraph .39).
- (d) The auditor is also required to consider whether a misstatement identified may be indicative of fraud, and if there is such an indication, there is a requirement for the auditor to consider the implications in relation to other aspects of the audit, including the reliability of management representations (paragraph .46).
- (e) The auditor should obtain written representations from management about the disclosure of all facts relating to any fraud or possible fraud and management’s belief that the effects of the uncorrected financial report misstatements aggregated by the auditor, are immaterial to the financial report taken as a whole (paragraph .51).
- (f) The auditor is required to communicate specific matters in relation to fraud or error to the appropriate level of management and those charged with governance (paragraph .56). For example, when material misstatements are identified as a result of error, AUS 210 requires that the auditor should communicate the misstatement to an appropriate level of management on a timely basis, and consider the need to report it to those charged with governance (paragraph .59). In addition, there is also a requirement that the auditor should

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inform those charged with governance of the uncorrected misstatements that were determined by management to be immaterial both individually and in aggregate, and were aggregated by the auditor during the audit (paragraph .60).

- (g) AUS 210 also:
 - (i) emphasises the distinction between management fraud and employee fraud and expands the discussion of fraudulent financial reporting; and
 - (ii) clarifies the discussion of the inherent limitations of an audit to detect fraud.
- (h) Finally, AUS 210 emphasises the importance of professional scepticism when planning and performing an audit, including being alert to evidence that brings into question the reliability of management representations. An attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of overgeneralising when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

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Introduction

- .01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on the auditor’s responsibility to consider fraud and error in an audit of a financial report. While this AUS focuses on the auditor’s responsibilities with respect to fraud and error, the primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity.
- .02 *When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial report resulting from fraud or error.*

Fraud and Error and their Characteristics

- .03 Misstatements in the financial report can arise from fraud or error. The term “error” refers to an unintentional misstatement in financial reports, including the omission of an amount or a disclosure, such as:
- (a) a mistake in gathering or processing data from which the financial report is prepared;
 - (b) an incorrect accounting estimate arising from oversight or misinterpretation of facts; and
 - (c) a mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
- .04 The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial report. Misstatement of the financial report may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as “management fraud”; fraud involving only employees of the entity is referred to as “employee fraud”. In either case, there may be collusion with third parties outside the entity.

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- .05 Two types of intentional misstatements are relevant to the auditor’s consideration of fraud - misstatements resulting from fraudulent financial reporting, and misstatements resulting from misappropriation of assets.
- .06 Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in the financial report to deceive financial report users. Fraudulent financial reporting may involve:
- (a) deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial report is prepared;
 - (b) misrepresentation in, or intentional omission from, the financial report of events, transactions or other significant information; and
 - (c) intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
- .07 Misappropriation of assets involves the theft of an entity’s assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.
- .08 Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target – particularly since the consequences to management of failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.
- .09 The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial report is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the

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auditor to determine intent, particularly in matters involving management judgement, such as accounting estimates and the appropriate application of accounting principles.

Responsibility of Those Charged with Governance and of Management

- .10 The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary by entity. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity. AUS 710 “Communicating to Management on Matters Arising from an Audit” defines ‘Management’ as the governing body, audit committee, individual members of the governing body, officer(s) and/or other person(s) having responsibility for planning and directing the activities of an entity¹.
- .11 It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, the integrity of an entity’s accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the law.
- .12 It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity’s business. This responsibility includes implementing and ensuring the continued operation of accounting and internal control systems which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements, whether caused by fraud or error. Accordingly, management assumes responsibility for any remaining risk.

Responsibilities of the Auditor

- .13 As described in AUS 202 “Objective and General Principles Governing an Audit of a Financial Report” the objective of an audit of the financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an identified financial reporting framework. An

¹ AUS 104 “Glossary of Terms” defines “Governing body” as an entity’s board of directors, trustees or governors, or other equivalent body or person.

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audit conducted in accordance with AUSs is designed to provide reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

Inherent Limitations of an Audit

- .14 An auditor cannot obtain absolute assurance that material misstatements in the financial report will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial report will not be detected, even though the audit is properly planned and performed in accordance with AUSs. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgement, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only reasonable assurance that material misstatements in the financial report will be detected.
- .15 The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false. The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.
- .16 Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either

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direct employees to do something or solicit their help to assist management in carrying out a fraud, with or without the employees’ knowledge.

- .17 The auditor’s opinion on the financial report is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial report resulting from fraud or error does not, in and of itself, indicate:
- (a) a failure to obtain reasonable assurance;
 - (b) inadequate planning, performance or judgement;
 - (c) the absence of professional competence and due care; or,
 - (d) a failure to comply with Auditing Standards.

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

Professional Scepticism

- .18 The auditor plans and performs an audit with an attitude of professional scepticism in accordance with AUS 202, paragraph .06. Such an attitude is necessary for the auditor to identify and properly evaluate, for example:
- (a) matters that increase the risk of a material misstatement in the financial report resulting from fraud or error (for example management’s characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability);
 - (b) circumstances that make the auditor suspect that the financial report is materially misstated; and
 - (c) evidence obtained (including the auditor’s knowledge from previous audits) that brings into question the reliability of management representations.

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- .19 Unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents as genuine. Accordingly, an audit performed in accordance with AUSs rarely contemplates authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication.

Planning Discussions

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

Inquiries of Management²

- .22 ***When planning the audit, the auditor should make inquiries of management:***
- (a) ***to obtain an understanding of:***
 - (i) ***management’s assessment of the risk that the financial report may be materially misstated as a result of fraud; and***
 - (ii) ***the accounting and internal control systems management has put in place to address such risk;***
 - (b) ***to obtain knowledge of management’s understanding regarding the accounting and internal control systems in place to prevent and detect error;***

² In relation to inquiries from management, also see paragraph .37 of this AUS that recognises how the size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors.

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

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

.23 The auditor supplements the auditor’s own knowledge of the entity’s business by making inquiries of management regarding management’s own assessment of the risk of fraud and the systems in place to prevent and detect it³. In addition, the auditor makes inquiries of management regarding the accounting and internal control systems in place to prevent and detect error. Since management is responsible for the entity’s accounting and internal control systems and for the preparation of the financial report, it is appropriate for the auditor to inquire of management how it is discharging these responsibilities. Matters that might be discussed as part of these inquiries include:

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

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

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

.24 The nature, extent and frequency of management’s assessment of such systems and risk vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management’s assessment may be less formal and less frequent. The nature, extent and frequency of management’s assessment are relevant to the auditor’s understanding of the entity’s control environment. For

³ AUS 520 “Management Representations” recognises that representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. Therefore, in accordance with AUS 202, paragraph .06 the auditor exercises professional scepticism, and recognises that in planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw conclusions on which to base the audit opinion.

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example, the fact that management has not made an assessment of the risk of fraud may be indicative of the lack of importance that management places on internal control.

- .25 It is also important that the auditor obtains an understanding of the design of the accounting and internal control systems within the entity. In designing such systems, management makes informed judgements on the nature and extent of the control procedures it chooses to implement and the nature and extent of the risks it chooses to assume. As a result of making these inquiries of management, the auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties. Information from these inquiries may also be useful in identifying fraud risk factors that may affect the auditor’s assessment of the risk that the financial report may contain material misstatements caused by fraud.
- .26 It is also important for the auditor to inquire about management’s knowledge of frauds that have affected the entity, suspected frauds that are being investigated, and material errors that have been discovered. Such inquiries might indicate possible weaknesses in control procedures if, for example, a number of errors have been found in certain areas. Alternatively, such inquiries might indicate that control procedures are operating effectively because anomalies are being identified and investigated promptly.
- .27 Although the auditor’s inquiries of management may provide useful information concerning the risk of material misstatements in the financial report resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risk of material misstatements in the financial report resulting from management fraud. Accordingly, the auditor’s follow-up of fraud risk factors, as discussed in paragraph .39, is of particular relevance in relation to management fraud.

Discussions with Those Charged with Governance

- .28 Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. Those charged with governance play an active role in oversight of how management has discharged its responsibilities. In such circumstances, auditors are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management. Such inquiries may provide insights regarding the susceptibility of the entity to management fraud, for example. The auditor may have an

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opportunity to seek the views of those charged with governance during, for example, a meeting with those charged with governance to discuss the general approach and overall scope of the audit. This discussion may also provide those charged with governance with the opportunity to bring matters of concern to the auditor’s attention.

.29 Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understand the nature of these responsibilities within an entity to ensure that the inquiries and communications described above are directed to the appropriate individuals.⁴

.30 In addition, following the inquiries of management described in paragraphs .22–.27 of this AUS, the auditor considers whether there are any matters of governance interest to be discussed with those charged with governance of the entity.⁵ Such matters may include for example:

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

Audit Risk

.31 AUS 402, paragraph .03 “Risk Assessments and Internal Controls,” defines ‘audit risk’ as the risk that the auditor gives an inappropriate audit opinion when the financial report is materially misstated. Such misstatements can result from either fraud or error. AUS 402 identifies the three components of audit risk and provides guidance

⁴ AUS 710, paragraph .02 “Communicating to Management on Matters Arising from an Audit” requires the auditor to communicate significant matters relating to the audit, or identified as a result of the audit procedures performed, to an appropriate level of management on a timely basis.

⁵ For a discussion of these matters, see AUS 710 “Communicating to Management on Matters Arising from an Audit” paragraphs .26 - .28.

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on how to assess these risks: inherent risk, control risk and detection risk.

Inherent and Control Risk

- .32 ***When assessing inherent risk and control risk in accordance with AUS 402 “Risk Assessments and Internal Controls” the auditor should consider how the financial report might be materially misstated as a result of fraud or error. In considering the risk of material misstatement resulting from fraud, the auditor should consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets.***
- .33 AUS 402 describes the auditor’s assessment of inherent risk and control risk, and how those assessments affect the nature, timing and extent of the audit procedures. In making those assessments, the auditor considers how the financial report might be materially misstated as a result of fraud or error.
- .34 The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, using the auditor’s knowledge of the business, the auditor may identify events or conditions that provide an opportunity, a motive or a means to commit fraud, or indicate that fraud may already have occurred. Such events or conditions are referred to as “fraud risk factors”. For example, a document may be missing, a general ledger may be out of balance, or an analytical procedure may not make sense. However, these conditions may be the result of circumstances other than fraud. Therefore, fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor’s assessment of inherent risk or control risk. Examples of fraud risk factors are set out in Appendix 1 to this AUS.
- .35 Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgement when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk.
- .36 Although the fraud risk factors described in Appendix 1 cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in

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

- .37 The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance, and the internal audit function. The auditor also considers what steps have been taken to enforce a formal code of conduct, and the effectiveness of the budgeting system. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, may have developed a culture that emphasises the importance of integrity and ethical behaviour through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.
- .38 The presence of fraud risk factors may indicate that the auditor will be unable to assess control risk at less than high for certain financial report assertions. On the other hand, the auditor may be able to identify internal controls designed to mitigate those fraud risk factors that the auditor can test to support a control risk assessment below high.

Detection Risk

- .39 ***Based on the auditor’s assessment of inherent and control risks (including the results of any tests of controls), the auditor should design substantive procedures to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial report taken as a whole will not be detected. In designing the substantive procedures, the auditor should address the fraud risk factors that the auditor has identified as being present.***
- .40 AUS 402 explains that the auditor’s control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk to an acceptably low level. In designing

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substantive procedures, the auditor addresses fraud risk factors that the auditor has identified as being present. The auditor’s response to those factors is influenced by their nature and significance. In some cases, even though fraud risk factors have been identified as being present, the auditor’s judgement may be that the audit procedures, including both tests of control and substantive procedures, already planned, are sufficient to respond to the fraud risk factors.

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

Procedures when Circumstances Indicate a Possible Misstatement

- .42 *When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial report resulting from fraud or error, the auditor should perform procedures to determine whether the financial report is materially misstated.*
- .43 During the course of the audit, the auditor may encounter circumstances that indicate that the financial report may contain a material misstatement resulting from fraud or error. Examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists are set out in Appendix 3 to this AUS.
- .44 When the auditor encounters such circumstances, the nature, timing and extent of the procedures to be performed depends on the auditor’s judgement as to the type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial report. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial report is materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor’s report, as discussed in paragraph .48 of this AUS.

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- .45 The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, the auditor considers whether the assessment of the components of audit risk made during the planning of the audit may need to be revised and whether the nature, timing and extent of the auditor’s other procedures may need to be reconsidered (see AUS 402, paragraph .56). For example, the auditor considers:
- (a) the nature, timing and extent of substantive procedures;
 - (b) the assessment of the effectiveness of internal controls if control risk was assessed below high; and
 - (c) the assignment of audit team members that may be appropriate in the circumstances.

Considering Whether an Identified Misstatement may be Indicative of Fraud

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

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

- .48 *When the auditor confirms that, or is unable to conclude whether, the financial report is materially misstated as a result of fraud or error, the auditor should consider the implications for the audit.*

AUS 306 “Materiality and Audit Adjustments” and AUS 702 “The Audit Report on a General Purpose Financial Report” provide guidance on the evaluation and disposition of misstatements, and the effect on the auditor’s report.

Documentation

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

- .50 AUS 208 “Documentation” requires the auditor to document matters which are important in providing evidence to support the audit opinion, and states that the working papers include the auditor’s reasoning on all significant matters which require the auditor’s judgement, together with the auditor’s conclusion thereon. Because of the importance of fraud risk factors in the assessment of the inherent or control risk of material misstatement, the auditor documents fraud risk factors identified and the response considered appropriate by the auditor.

Management Representations

- .51 *The auditor should obtain written representations from management that:*
- (a) *it acknowledges its responsibility for the implementation and operations of accounting and internal control systems that are designed to prevent and detect fraud and error;*
 - (b) *it believes the effects of those uncorrected financial report misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial report taken as a whole. A summary of such items should be included in or attached to the written representation;*

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- (c) *it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and*
 - (d) *it has disclosed to the auditor the results of its assessment of the risk that the financial report may be materially misstated as a result of fraud.*
- .52 AUS 520 “Management Representations” provides standards on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial report, it is important that management acknowledges its responsibility for the accounting and internal control systems designed to prevent and detect fraud and error.
- .53 Because management is responsible for adjusting the financial report to correct material misstatements, it is important that the auditor obtains a written representation from management that any uncorrected misstatements resulting from either fraud or error are, in management’s opinion, immaterial, both individually and in the aggregate⁶. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial report misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, “We do not agree that items...and...constitute misstatements because *[description of reasons]*.”
- .54 The auditor may designate an amount below which misstatements need not be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial report. In so doing, the auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial report. The summary of uncorrected misstatements included in or attached to the written representation need not include such misstatements.
- .55 Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial report resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to the auditor all facts relating to any frauds or suspected frauds that it is aware of that may have affected the entity, and that management

⁶ See AUS 306 “Materiality and Audit Adjustments”.

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has disclosed to the auditor the results of management’s assessment of the risk that the financial report may be materially misstated as a result of fraud.

Communication

- .56 *When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor’s responsibility to communicate that information to management, those charged with governance and, in some circumstances, to regulatory and law enforcement authorities.*
- .57 Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take action as necessary. The determination of which level of management is the appropriate one is a matter of professional judgement and is affected by such factors as the nature, magnitude and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement or suspected fraud.
- .58 The determination of which matters are to be communicated by the auditor to those charged with governance is a matter of professional judgement and is also affected by any understanding between the parties as to which matters are to be communicated. Ordinarily, such matters include:
- (a) questions regarding management competence and integrity;
 - (b) fraud involving management;
 - (c) other fraud that results in a material misstatement of the financial report;
 - (d) material misstatements resulting from error;
 - (e) misstatements that indicate material weaknesses in internal control, including the design or operation of the entity’s financial reporting process; and
 - (f) misstatements that may cause future financial reports to be materially misstated.

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Communication of Misstatements Resulting from Error to Management and To Those Charged with Governance

- .59 ***If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with AUS 710 “Communicating to Management on Matters Arising from an Audit.”***
- .60 ***The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial report taken as a whole.***
- .61 As noted in paragraph .54 of this AUS, the uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.

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

- .62 ***If the auditor has:***
- (a) ***identified a fraud, whether or not it results in a material misstatement in the financial report; or***
 - (b) ***obtained evidence that indicates that fraud may exist (even if the potential effect on the financial report would not be material);***
- the auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance in accordance with AUS 710 “Communicating to Management on Matters Arising from an Audit”.***
- .63 When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of an appropriate level of management. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity’s organisation). The determination of which level of management is the appropriate one is also affected in these circumstances by the likelihood of collusion or the involvement of a member of management.

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- .64 If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial report or has been unable to evaluate whether the effect is material, the auditor:
- (a) discusses the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved, and with management at the highest level; and
 - (b) if appropriate, suggests that management consult with legal advisers.

Communication of Material Weaknesses in Internal Control

- .65 ***The auditor should communicate to management any material weaknesses in internal control related to the prevention or detection of fraud and error, which have come to the auditor’s attention as a result of the performance of the audit. The auditor should also be satisfied that those charged with governance have been informed of any material weaknesses in internal control related to the prevention and detection of fraud that either have been brought to the auditor’s attention by management or have been identified by the auditor during the audit.***
- .66 When the auditor has identified any material weaknesses in internal control related to the prevention or detection of fraud or error, the auditor communicates these material weaknesses in internal control to management. Because of the serious implications of material weaknesses in internal control related to the prevention and detection of fraud, it is also important that such deficiencies be brought to the attention of those charged with governance.
- .67 If the integrity or honesty of management or those charged with governance are doubted, the auditor ordinarily considers seeking legal advice to assist in the determination of the appropriate course of action.

Communications to Regulatory and Enforcement Authorities

- .68 The auditor’s professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. However, the auditor’s duty of

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confidentiality may be overridden by statute, or courts of law⁷. The auditor considers seeking legal advice in such circumstances⁸.

Auditor Unable to Complete the Engagement

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

- (a) *consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;*
- (b) *in exceptional circumstances⁹, consider the possibility of withdrawing from the engagement; and*
- (c) *if the auditor withdraws:*
 - (i) *discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and*
 - (ii) *consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s withdrawal from the engagement and the reasons for the withdrawal.*

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

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

⁷ For example, under the *Banking Act 1959* (sections 16B and 16C) the auditor of an authorised deposit-taking institution has a statutory duty to report the occurrence of fraud and material error to supervisory authorities.

⁸ Guidance for the auditor on compliance with Laws and Regulations and communication with regulatory and enforcement authorities is contained in AUS 218 “Consideration Of Laws and Regulations in an Audit of a Financial Report”.

⁹ See the Australian Securities & Investments Commission Policy Statement 26 “Resignation of Auditors” for guidance on resignation of auditors under the *Corporations Act 2001*.

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- (b) the auditor’s consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
 - (c) the auditor has significant concern about the competence or integrity of management or those charged with governance.
- .71 Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor’s conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of continuing association with the entity.
- .72 The auditor has professional and legal responsibilities in such circumstances. For example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action.

Communication with a Proposed Successor Auditor

- .73 ***As stated in the “Joint Code of Professional Conduct” issued by CPA Australia and The Institute of Chartered Accountants in Australia (“the Code”), on receipt of an inquiry from a proposed successor auditor, the existing auditor should advise whether there are any professional reasons why the proposed successor auditor should not accept the appointment. If the client denies the existing auditor permission to discuss its affairs with the proposed successor auditor or limits what the existing auditor may say, that fact should be disclosed to the proposed successor auditor.***
- .74 The auditor may be contacted by a proposed successor auditor inquiring whether there are any professional reasons why the proposed successor auditor should not accept the appointment. The professional responsibilities of existing and proposed successor auditors are set out in some detail in the Code. Legal responsibilities

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of the auditor are outlined in the *Corporations Act 2001* and other relevant legislation¹⁰.

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

Operative Date

- .76 This AUS is operative in relation to financial reporting periods ending on or after 31 December 2002, although earlier application is encouraged. This AUS supersedes AUS 210 “Irregularities, Including Fraud, Other Illegal Acts and Errors” issued in October 1995, and subsequently amended in February 1999, in respect of considerations of fraud and error.

Compatibility with International Standards on Auditing

- .77 The basic principles and essential procedures of this AUS and of International Standard on Auditing ISA 240 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” are consistent in all material respects.

¹⁰ Guidance on the Auditor’s responsibility to report contraventions in the *Corporations Act 2001* is contained in Appendix 3 of AUS 218 “Consideration Of Laws And Regulations in an Audit of a Financial Report”. There could also be other relevant legislation that could apply to audits other than those performed under the *Corporations Act 2001*.

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APPENDIX 1

*EXAMPLES OF RISK FACTORS RELATING TO MISSTATEMENTS
RESULTING FROM FRAUD*

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

Fraud Risk Factors Relating to Misstatements Resulting from Fraudulent Financial Reporting

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

- Management’s Characteristics and Influence over the Control Environment;
- Industry Conditions; and
- Operating Characteristics and Financial Stability.

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

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

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

- (a) There is motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:
 - (i) a significant portion of management’s compensation is represented by bonuses, share options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow;
 - (ii) there is excessive interest by management in maintaining or increasing the entity's share price or earnings trend

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- through the use of unusually aggressive accounting practices;
 - (iii) management commits to analysts, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts; and
 - (iv) management has an interest in pursuing inappropriate means to minimise reported earnings for tax-motivated reasons;
- (b) There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:
- (i) management does not effectively communicate and support the entity’s values or ethics, or management communicates inappropriate values or ethics;
 - (ii) management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance;
 - (iii) management does not monitor significant controls adequately;
 - (iv) management fails to correct known material weaknesses in internal control on a timely basis;
 - (v) management sets unduly aggressive financial targets and expectations for operating personnel;
 - (vi) management displays a significant disregard for regulatory authorities; and
 - (vii) management continues to employ ineffective accounting, information technology or internal auditing staff.
- (c) Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.
- (d) There is a high turnover of management, legal advisers or board members.
- (e) There is a strained relationship between management and the current or predecessor auditor. Specific indicators might include the following:
- (i) frequent disputes with the current or a predecessor auditor on accounting, auditing or reporting matters;

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- (ii) unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor’s report;
 - (iii) formal or informal restrictions on the auditor that inappropriately limit the auditor’s access to people or information, or limit the auditor’s ability to communicate effectively with those charged with governance; and
 - (iv) domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work.
- (f) There is a history of contraventions of the *Corporations Act 2001*, or claims against the entity or its management alleging fraud or violations of securities laws.
- (g) The corporate governance structure is weak or ineffective, which may be evidenced by, for example:
- (i) a lack of members of the board who are independent of management; and
 - (ii) little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.

2. *Fraud Risk Factors Relating to Industry Conditions*

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

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

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

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

- (a) Inability to generate cash flows from operations while reporting earnings and earnings growth.

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- (b) Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures).
- (c) Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgements or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity (for example, the ultimate collectibility of receivables, the timing of revenue recognition, the realisability of financial instruments based on highly-subjective valuation of collateral or difficult-to-assess repayment sources, or a significant deferral of costs).
- (d) Significant related party transactions which are not in the ordinary course of business.
- (e) Significant related party transactions which are not audited or are audited by another firm.
- (f) Significant, unusual or highly complex transactions (especially those close to the end of the period) that pose difficult questions concerning substance over form.
- (g) Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- (h) An overly complex organisational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose.
- (i) Difficulty in determining the organisation or person (or persons) controlling the entity.
- (j) Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- (k) Especially high vulnerability to changes in interest rates.
- (l) Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain.
- (m) Unrealistically aggressive sales or profitability incentive programs.
- (n) A threat of imminent bankruptcy, foreclosure or hostile takeover.
- (o) Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported.

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- (p) A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Fraud Risk Factors Relating to Misstatements Resulting from Misappropriation of Assets

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

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

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

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

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

- (a) Large amounts of cash on hand or processed.
- (b) Inventory characteristics, such as small size combined with high value and high demand.
- (c) Easily convertible assets, such as bearer bonds, diamonds or computer chips.
- (d) Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.

2. Fraud Risk Factors Relating to Controls

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

- (a) Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations).
- (b) Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation.
- (c) Inadequate record keeping for assets susceptible to misappropriation.
- (d) Lack of an appropriate segregation of duties or independent checks.
- (e) Lack of an appropriate system of authorisation and approval of transactions (for example, in purchasing).

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- (f) Poor physical safeguards over cash, investments, inventory or fixed assets.
- (g) Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
- (h) Lack of mandatory vacations for employees performing key control functions.

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APPENDIX 2

*EXAMPLES OF MODIFICATIONS OF PROCEDURES IN RESPONSE TO
THE ASSESSMENT OF FRAUD RISK FACTORS*

The following are examples of possible responses to the auditor’s assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets. The auditor exercises judgement to select the most appropriate procedures in the circumstances. The procedures identified may not be the most appropriate nor necessary in each circumstance. The auditor’s response to fraud risk factors is discussed in paragraphs .40–.41 of this AUS.

Overall Considerations

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

- (a) *Professional scepticism.* The application of professional scepticism may include:
 - (i) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions; and
 - (ii) increased recognition of the need to corroborate management explanations or representations concerning material matters.
- (b) *Assignment of members of the audit team.* The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor’s assessment of the level of risk for the engagement. In addition, the extent of supervision needs to recognise the risk of material misstatement resulting from fraud and the qualifications of members of the audit team performing the work.
- (c) *Accounting principles and policies.* The auditor may decide to further consider management’s selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalising versus expensing.
- (d) *Controls.* The auditor’s ability to assess control risk below high may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity’s internal control sufficient to plan the audit. In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the fraud risk factors identified.

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However, this consideration also needs to include an added sensitivity to management’s ability to override such controls.

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

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

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

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

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

The following are specific examples of responses:

- (a) Visit locations or perform certain tests on a surprise or unannounced basis. For example, observe inventory at locations where auditor attendance has not been previously announced or count cash at a particular date on a surprise basis.
- (b) Request that inventories be counted at a date closer to the end of the reporting period.

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- (c) Alter the audit approach in the current year. For example, contact major customers and suppliers orally in addition to sending written confirmation, send confirmation requests to a specific party within an organisation, or seek more and different information.
- (d) Perform a detailed review of the entity’s adjusting entries at the end of the reporting period and investigate any that appear unusual as to nature or amount.
- (e) For significant and unusual transactions, particularly those occurring at or near the end of the reporting period, investigate the possibility of related parties and the sources of financial resources supporting the transactions.
- (f) Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to expectations developed by the auditor.
- (g) Conduct interviews of personnel involved in areas for which there is a concern about the risk of material misstatement resulting from fraud, to obtain their insights about the risk and whether, or how, controls address the risk.
- (h) When other independent auditors are auditing the financial report of one or more subsidiaries, divisions or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement resulting from fraud resulting from transactions and activities among these components is adequately addressed.
- (i) If the work of an expert becomes particularly significant with respect to a financial report item for which the risk of misstatement due to fraud is high, perform additional procedures relating to some or all of the expert’s assumptions, methods or findings to determine that the findings are not unreasonable, or engage another expert for that purpose.
- (j) Perform audit procedures to analyse selected opening balance sheet accounts of previously audited financial reports to assess how certain issues involving accounting estimates and judgements, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- (k) Perform procedures on account or other reconciliations prepared by the entity, including consideration of reconciliations performed at interim periods.
- (l) Perform computer-assisted techniques, such as data mining to test for anomalies in a population.
- (m) Test the integrity of computer-generated records and transactions.

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- (n) Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses — Misstatements Resulting from Fraudulent Financial Reporting

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

- (a) *Revenue recognition.* If there is a risk of material misstatement resulting from fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements, inasmuch as the appropriate accounting is often influenced by such terms or agreements.
- (b) *Inventory quantities.* If there is a risk of material misstatement resulting from fraud relating to inventory quantities, reviewing the entity’s inventory records may help to identify locations, areas or items for specific attention during or after the physical inventory count. Such a review may lead, for example, to a decision to observe inventory counts at certain locations on an unannounced basis, or to ask management to ensure that counts at all locations subject to count are performed on the same date.
- (c) *Non-standard journal entries.* If there is a risk of material misstatements resulting from fraudulent financial reporting, performing tests of non-standard journal entries to confirm that they are adequately supported and reflect underlying events and transactions may help in identifying fictitious entries of aggressive recognition practices. While there is not generally accepted definition of non-standard journal entries, in general, they are financial report changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

Specific Responses – Misstatements Resulting from Misappropriations of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement resulting from fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions.

Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial report, it may be

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useful for the auditor to obtain an understanding of the control procedures related to the prevention and detection of such misappropriation and to test the operating effectiveness of such controls.

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APPENDIX 3

*EXAMPLES OF CIRCUMSTANCES THAT INDICATE THE POSSIBILITY
OF FRAUD OR ERROR*

The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial report may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; not all of these circumstances are likely to be present in all audits, nor is the list necessarily complete. Circumstances that indicate a possible misstatement are discussed in paragraphs .43 - .44 of this AUS.

- (a) Unrealistic time deadlines for audit completion imposed by management.
- (b) Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
- (c) Limitation in audit scope imposed by management.
- (d) Identification of important matters not previously disclosed by management.
- (e) Significant difficult-to-audit figures in the accounts.
- (f) Aggressive application of accounting principles.
- (g) Conflicting or unsatisfactory evidence provided by management or employees.
- (h) Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
- (i) Information provided unwillingly or after unreasonable delay.
- (j) Seriously incomplete or inadequate accounting records.
- (k) Unsupported transactions.
- (l) Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year end.
- (m) Transactions not recorded in accordance with management’s general or specific authorisation.
- (n) Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.

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- (o) Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
- (p) Significant differences from expectations disclosed by analytical procedures.
- (q) Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
- (r) Evidence of an unduly lavish lifestyle by officers or employees.
- (s) Unreconciled suspense accounts.
- (t) Long outstanding account receivable balances.

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APPENDIX 4

*THE AUDITOR’S CONSIDERATION OF FRAUD AND ERROR IN AN
AUDIT OF A FINANCIAL REPORT IN THE PUBLIC SECTOR*

“Public sector” refers to Commonwealth, State, Territorial and Local governments and related entities. This Appendix provides further discussion of the auditor’s consideration of fraud and error in the “public sector”. The AUS identifies the basic principles and essential procedures to be applied in determining the conduct of the audit with respect to fraud or error. The auditor of the public sector entity also needs to exercise professional judgement when applying the basic principles and essential procedures in this AUS.

Irrespective of whether an audit engagement is being conducted in the private or public sectors, the basic auditing principles remain the same. However, the application of the principles needs to be amplified or supplemented to accommodate the public sector circumstances and perspective of individual jurisdictions.

In respect of paragraph .02 of this AUS, it has to be noted that the nature and the scope of the public sector audit may be affected by legislation, regulation, ordinances and ministerial directives relating to the detection of fraud and error. In addition to any formally mandated responsibility to detect fraud, the use of public funds requires auditors to be responsive to public expectations regarding the detection of fraud. Public expectations regarding the use of public funds will often mean that a public sector auditor will need to consider what action to take in relation to the fraud or error, even where the fraud or error is not material to the financial report or affects the auditor’s report on the financial report.

Paragraphs .32-.38 of this AUS deal with inherent and control risks. In the public sector, a number of jurisdictions have issued policy and/or guidance material related to fraud control. The public sector auditor is expected to assess the adequacy of fraud controls and compliance with fraud strategy requirements mandated by legislation or government.

Paragraphs .56-.68 of this AUS set out the communication responsibilities to management and those charged with governance. In advising management of any observed weaknesses in internal controls, the public sector auditor needs to be conscious of the expectations in relation to fraud prevention and detection in the public sector and frame the advice accordingly. Some public sector auditors also have additional responsibilities because of specific provisions of the audit mandate or related legislation or regulation. An example of such specific provisions include requirements to report instances where public monies have not been expended for the purposes for which they were appropriated.

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Paragraphs .69–.72 outline the issues an auditor should consider if the auditor concludes that it is not possible to continue the audit. Paragraphs .73–.75 set out the requirements concerning communication with a proposed successor auditor. In the public sector, the responsibilities of the auditor are usually set out in legislation and the auditor will not have the option to withdraw from the engagement. However the public sector auditor has wider reporting powers, such as to Parliament, by which greater attention can be drawn to the issues of concern. In situations analogous to a private sector auditor considering withdrawal from an engagement, the public sector auditor will need to consider the appropriate use of these reporting powers.

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BACKGROUND TO REVISION

This section does not form part of the standard. It is a summary of the reasons for the current revision to the Standard and of key issues which have been considered by the Auditing & Assurance Standards Board (AuASB) as part of this revision.

1. This Auditing Standard AUS 210 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of a Financial Report” replaces the former AUS 210 “Irregularities, Including Fraud, Other Illegal Acts and Errors”, issued in October 1995¹¹, to further clarify existing practice regarding the auditor’s consideration of fraud and error when planning, performing and reporting in the audit of a financial report.
2. The International Auditing Practices Committee (IAPC) of the International Federation of Accountants has revised and extended the existing International Standard on Auditing, ISA 240 “The Auditors Responsibility to Consider Fraud and Error in an Audit of Financial Statements”. The revised ISA 240 necessitated a revision of AUS 210 which was compatible with the original ISA 240.
3. Prior to revision, the former AUS 210 “Irregularities, Including Fraud, Other Illegal Acts and Errors” also included Auditing Standards dealing with “Other Illegal Acts” and was compatible with the basic principles and essential procedures in the International Standard on Auditing ISA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”. The basic principles and essential procedures relating to “Other Illegal Acts” as per the former AUS 210 “Irregularities, Including Fraud, Other Illegal Acts and Errors” are now addressed as “non-compliance” with laws and regulations in a separate Auditing Standard AUS 218 “Consideration of Laws and Regulations in an Audit of a Financial Report”.
4. It is therefore recommended that the revised AUS 210 “The Auditor’s Responsibility to Consider Fraud and Error in an audit of a Financial Report” be read in conjunction with AUS 218.

¹¹ Subsequently amended in February 1999.

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5. The revised Auditing Standard AUS 210 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of a Financial Report” also results in a minor revision being made to the requirements of AUS 202 “Objectives and General Principles Governing an Audit of a Financial Report” paragraph .06, in relation to professional scepticism exercised by the auditor when planning and performing the audit.