Committee: IAASB
Meeting Location: New York
Meeting Date: May 11-13, 2003

Auditor’s Responsibility for Fraud

Objectives of Agenda Item
1. To provide IAASB with a status update
2. To consider and discuss the black letter requirements in the first draft of the ED

Background
IAPC approved revisions to ISA 240 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” in March 2001. The IAASB also accepted an invitation to participate in a US Fraud Task Force with the view to developing common basic principles and essential procedures.

In June 2002, the IAASB commented on the US ASB exposure draft on Consideration of Fraud in a Financial Statement Audit. The US SAS 99 was issued in October 2002.

At its October 2002 meeting, the Consultative Advisory Group discussed the scope of the project and there was consensus that ISA 240 should be updated to converge with the US SAS 99 and to align with the proposed Audit Risk Standards.

Decisions made at the IAASB December 2002 and March 2003 meetings
• The revision of ISA 240 should be built from the existing ISA, and not based on the US SAS 99, as the latter is very detailed and does not follow an ISA structure.
• The basic principles and essential procedures contained in the US SAS 99 should be incorporated as appropriate into the revised ISA 240.
• Elements of fraud and error should be dealt with separately. ISA 240 should only deal with fraud. The guidance on error from extant ISA 240 will be repositioned to other existing ISAs.
• The proposed revised ISA 240 should provide guidance on aggressive earnings management.
• The exhibit appended to the US SAS 99 should not be appended to the proposed revised ISA 240.
• The timetable for the project has been accelerated with the view to have the final standard approved in February or March 2004.

Activities Since Last IAASB Discussions
The Task Force met on April 21-22, 2003 to discuss a first draft of the exposure draft. The following issues were discussed and agreed by the Task Force.
1. CONCEPT OF REASONABLE ASSURANCE AS IT RELATES TO FRAUD

IAASB commented on the US ASB exposure draft on Consideration of Fraud in a Financial Statement Audit that “As a further step to narrow the expectation gap we would support undertaking an additional project to consider how the concept of reasonable assurance applies to fraud and error. One of the outputs of this project might be proposed revisions to the wording of the standard audit report to clarify the auditor’s responsibility with respect to the detection of fraud.”

In light of the earlier decisions made by IAASB and the comments above, the Task Force will not be debating the concept of reasonable assurance as it relates to fraud, particularly management fraud.

2. AGGRESSIVE EARNINGS MANAGEMENT

The Task Force discussed the nature of the guidance to be included in the draft ED and concluded that the emphasis should be placed on circumstances that could lead to aggressive earnings management, rather than attempting to provide a definition that may not be universally accepted in practice. A discussion of earnings management can be found in paragraphs X, X.

3. MANDATORY AUDIT PROCEDURES

The draft ED indicates that management is in a unique position to perpetrate fraud because of management’s ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. The level of risk of management override of controls will vary from entity to entity, but the risk is nevertheless present in all entities. Consequently, in addition to overall responses to address the risk of material misstatement due to fraud and responses to address the assessed risk of material misstatement due to fraud, the draft ED requires the auditor to perform further procedures to specifically respond to the risk of management override of controls.

4. COMMUNICATION WITH A PROPOSED SUCCESSOR AUDITOR

The Task Force discussed whether the paragraphs dealing with communication with a proposed successor auditor (extant ISA 240 73-75) should be retained in the draft ED and concluded that the guidance dealing with such communications is appropriately dealt with in the Code of Ethics. Consequently, the Task Force is proposing to delete the following paragraphs:

As stated in the “Code of Ethics for Professional Accountants” issued by the International Federation of Accountants (“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.

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 responsibilities of existing and proposed successor auditors are set out in some detail in the Code; however, the professional and legal responsibilities of each auditor may vary by country.

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 in each country 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.

5. BLACK LETTER PARAGRAPHS AND OTHER GUIDANCE TO BE MOVED TO EXISTING ISA’S

As discussed at the IAASB December 2002 meeting, the guidance on error from extant ISA 240 will be repositioned to other existing ISAs. The Task Force has identified the following black lettered paragraphs and guidance that need to be repositioned.

22. When planning the audit, the auditor should make inquiries of management…(d) to determine whether management has discovered any material errors.

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

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 ISA 260, “Communication of Audit Matters with Those Charged with Governance.”

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

The Task Force is liaising with the Materiality Task Force to consider the appropriate location for some of the above paragraphs and is proposing amendments to ISA 260 “Communication of Audit Matters with Those Charged with Governance” and ISA 580 “Management Representations”.

6. COMMUNICATION, DOCUMENTATION AND APPENDICES

These sections appear in shaded text in the draft ED as they have not been debated by the Task Force. They have been included for information in order to present to the IAASB a complete first draft of the ED.
Material Presented

Agenda Paper 9-A
Black lettered paragraphs
(Pages 701 – 704)

Agenda Paper 9-B
Comparison of black lettered paragraphs in draft ED with black
lettered paragraphs in extant ISA 240.
(Pages 705 – 712)

Agenda Paper 9-C
Draft ED – presented to provide context for black lettered paragraphs
(Pages 713 – 746)

Action Requested

1. IAASB is asked to review the proposed black lettered paragraphs for the draft ED. The Draft
   ED is presented to provide context for the black lettered paragraphs.

2. IAASB is asked to provide any editorial comments on the draft ED directly to staff.