

Current Affairs Noticeboard

Significant changes in auditing standards on fraud

The media release accompanying the release of AUS 210 *The Auditors Responsibility to Consider Fraud in an Audit of a Financial Report* states that the standard requires auditors to focus upon areas where there is a risk of material misstatements resulting from fraud. In particular three significant areas are identified in the media release. The first is the standard

emphasises the need for the auditor to maintain an attitude of professional scepticism throughout the audit, notwithstanding the auditor's past experience about the honesty and integrity of management and those charged with governance (AARF, 2004).

In 1997, the Institute of Chartered Accountants in Australia commissioned a report on fraud and this report stated that:

Research suggests that the most common reason for auditors not detecting material fraud appears to be inappropriate reactions to various warning signals and an associated lack of "professional scepticism" (Smith and Grabosky, 1998, p.54).

What does the requirement for auditors to maintain an attitude of professional scepticism mean? Para .23 of AUS 210 (ISA 240 (Revised) para .23) defines professional scepticism as "an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist". Para 6 of *AUS 202- Objective and General Principles Governing an Audit of a Financial Report* contains a discussion of the old notion of professional scepticism and under this notion it is noted that the auditor in planning and performing the audit "neither assumes that management is dishonest nor assumes unquestioned honesty" (ISA 200:.06).

In line with Lucy's comments that the auditor is now meant to be bloodhound, the auditor must continually be watchful for fraud. Previously it was felt that fraud was not a principle objective of the audit and the auditor was only liable for the detection of well known frauds and those that were reasonably be expected to be detected in the course of the audit . With the exception of well known frauds, it was felt that the auditor did not have to actively search for frauds. One significant factor causing this change in emphasis in fraud detection is the rampant existence of earnings management in the recent corporate collapses and accounting scandals. Being based upon improving profit by choice of accounting policies and use of accounting estimates,

earnings management could be regarded as an accounting fraud that the auditing profession needs to address.

Another significant area noted in the media release is that the standard

requires the audit engagement team to discuss how the financial report may be susceptible to material misstatement due to fraud and what audit procedures would be more effective for their detection ... (AARF, 2004b).

You should read Bartlett et al., 2004, for details on issues that could be discussed by engagement teams. However later in this edition we will discuss articles that appeared in the *Australian Financial Review* outlining particular frauds. These particulars could also be discussed by the audit team.

The third significant area noted in the media release is that the standard requires

requires the auditor to design and perform audit procedures to respond to the risks of material misstatement due to fraud, including procedures to address the risk of management override of controls (AARF, 2004).

The profession's previous position of management's override of controls is summed in para .09 of AUS 202 – *Objective and General Principles Governing an Audit of a Financial Report*. This paragraph notes that an audit has inherent limitations. One factor noted in this paragraph causing these limitations is "the inherent limitations of internal control (for example, the possibility of management override ...)". The reference to management override is deleted from para .06 of ISA 200 - *Objective and General Principles Governing an Audit of a Financial Report*. Paragraphs .74 to .76 of AUS 210 give guidance on audit procedures to be adopted where management overrides controls. (Paragraphs .74 to .76 of ISA 240 (Revised)). The audit procedures are directed at detecting management override of controls in the areas of determining the appropriateness of journal entries recoded in the general ledger, reviewing accounting estimates for bias and ensuring the rationale for significant transactions are within the normal course of business. Paragraphs .77 to .82 gives guidance on these matters (ISA 240, paragraphs .74 to .82). For further guidance on the nature of audit procedures designed to detect fraud arising from management override of controls you should read the above paragraphs in detail.

Questions

1. Discuss the factors you would consider are relevant in determining the degree that auditors are required to detect fraud.

2. Discuss why auditors should conduct audit procedures to test for management override of controls relating to the appropriateness of journal entries recoded in the general ledger, reviewing accounting estimates for bias and ensuring the rationale for significant transactions are within the normal course of business.

References

Australian Accounting Research Foundation (AARF), 2004, *Media Release: New Fraud Standard Issued by the AuASBr*, June, www.aarf.asn.au

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Bartlett Nigel, Endo Richard, Tonkin Campbell and Williams Alastair, 2004, Audit planning for the detection of fraud, in Johnson R (ed), *Readings in Auditing*, John Wiley & Sons Australia, Ltd, Brisbane, pp.58-70.

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