INFORMATION FOR USERS

This Staff Practice Alert was issued before the adoption and issue, for use by registered auditors in South Africa, of the following quality management standards in South Africa:

- International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (ISQM 1);
- International Standard on Quality Management (ISQM 2, *Engagement Quality Reviews* (ISQM 2); and
- International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements* (ISA 220 (Revised)).

Effective date:

a) Audits and reviews of financial statements for periods beginning on or after 15 December 2022; and
b) Other assurance and related services engagements beginning on or after 15 December 2022.

Implications of references to ISQC 1, ISA 220 and Quality Control made in this staff practice alert should be considered in the context of ISQM 1, ISQM 2 and ISA 220 (Revised).

STAFF AUDIT PRACTICE ALERT

June 2020

INDEPENDENT REGULATORY BOARD FOR AUDITORS

A SOUTH AFRICAN PERSPECTIVE ON THE AUDITOR'S CONSIDERATIONS RELATING TO FRAUD

This publication has been prepared by the Fraud Task Group of the Independent Regulatory Board for Auditors' (IRBA) Committee for Auditing Standards (CFAS). It does not constitute an authoritative pronouncement from the IRBA, nor does it amend or override the International Standards on Auditing, South African Standards on Auditing, South African Auditing Practice Statements or South African Guides (collectively called pronouncements).

Furthermore, this publication is not meant to be exhaustive. Reading this publication is not a substitute for reading the abovementioned pronouncements, as they are the authoritative texts.

The perpetration of fraud, causing material misstatements in the financial statements and/or non-compliance with laws and regulations, has become more prevalent at entities in South Africa over the past few years. Registered auditors (auditors) are required to be alert to the possibility of fraud, thereby enabling them to respond appropriately. Due to this prevalence, auditors have called for additional guidance relating to fraud. Consequently, the IRBA has responded to the needs identified on the auditor's considerations relating to fraud.

This IRBA Staff Audit Practice Alert serves to provide auditors with implementation guidance in responding to the risks of material misstatements due to fraud and/or non-compliance with laws and regulations.

INTRODUCTION

The International Standard on Auditing (ISA) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (ISA 240), deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised)[1] and ISA 330[2] are to be applied in relation to risks of material misstatement due to fraud[3].

[1] ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*. ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, was issued in December 2019 and is effective for audits of financial statements for periods beginning on or after 15 December 2021.

[2] ISA 330, *The Auditor's Responses to Assessed Risks*.

[3] ISA 240, paragraph 1.

In ISA 240, fraud is defined as 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[4].

The Fraud Triangle is a frequently referenced model for explaining the factors present when fraud occurs within an organisation. Refer to paragraph 25 that deals with fraud risk factors prevalent in the South African environment.

Source: Deloitte Touche Tohmatsu Limited, Global Fraud Brainstorming Template

Although fraud is a broad legal concept, for the purposes of the ISAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred[5].

While this publication is written in the context of an audit of financial statements, it can be used, when adapted as necessary, for engagements other than audits of financial statements. Refer to paragraphs 63-65 that deal with the auditor's responsibilities relating to fraud in engagements other than in an audit of financial statements.

It should be noted that the guidance included in this publication is not meant to be exhaustive.

This topic in relation to the auditor's considerations relating to fraud is not only important for South Africa, but is being considered internationally by the International Auditing and Assurance Standards Board (IAASB) and others. Refer to **Appendix A for further details on these developments**.

The release of this IRBA Staff Audit Practice Alert:

- Provides a South African perspective on the auditor's considerations relating to fraud.

[4] ISA 240, paragraph 12(a).

[5] ISA 240, paragraph 3.

- Responds to the immediate needs of auditors by providing implementation guidance on the auditor's considerations relating to fraud.

ISA 240 IN A "NUTSHELL"

- ISA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements.
- The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
- The auditor's objectives, in terms of ISA 240, are to: (a) identify and assess the risk of material misstatement of the financial statements due to fraud; (b) obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) respond appropriately to fraud or suspected fraud identified during the audit.
- The auditor maintains professional scepticism throughout the engagement, in accordance with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.
- ISA 240 follows the key phases of an audit engagement where fraud is considered in an audit of financial statements:
  - Discussion among the Engagement Team.
  - Risk Assessment Procedures and Related Activities.
  - Identification and Assessment of the Risks of Material Misstatement Due to Fraud.
  - Responses to the Assessed Risks of Material Misstatement Due to Fraud.
  - Evaluation of Audit Evidence.
  - Written Representations.
  - Communications to Management and with Those Charged with Governance.
  - Communications to Regulatory and Enforcement Authorities.
  - Documentation.

IMPLEMENTATION GUIDANCE TO RESPOND TO THE RISKS OF MATERIAL MISSTATEMENTS DUE TO FRAUD

1. The implementation guidance contained in this IRBA Staff Audit Practice Alert includes the following key themes:
    - The primary responsibility for the prevention and detection of fraud rests with those charged with governance of the entity and management;
    - The importance of applying professional scepticism and exercising professional judgment;
    - The auditor's responsibilities to identify, assess and respond to the risks of material misstatement due to fraud;
    - The auditor's considerations to respond to identified risks of material misstatement due to fraud, when there is a fraud investigation in progress;
    - The use of forensic experts during fraud discussions, fraud inquiries and the execution of the audit, when specific factors are identified; and
    - Guidance and examples to assist auditors in the application of the auditing standards and related guidance.

The auditor's objectives and management's responsibilities relating to fraud and the related expectation gap

2. The auditor's objectives, in terms of ISA 240, are to:
    - Identify and assess the risks of material misstatement of the financial statements due to fraud;
    - Obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
    - Respond appropriately to fraud or suspected fraud identified during the audit[6].
3. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management[7]. However, **it should be understood that the auditor cannot fully rely on those charged with governance of the entity and management to prevent and detect fraud that they may have perpetrated.** The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than that from employee fraud. This is because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed

[6] ISA 240, paragraph 11.
[7] ISA 240, paragraph 4.

to prevent similar frauds by other employees.[8] Refer to paragraphs 57-60 relating to management override of controls.

4. Section 76(3) of the Companies Act of South Africa[9] states that subject to Subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director-
   (a) in good faith and for a proper purpose;
   (b) in the best interests of the company; and
   (c) with the degree of care, skill and diligence that may reasonably be expected of a person-
      (i) carrying out the same functions in relation to the company as those carried out by that director; and
      (ii) having the general knowledge, skill and experience of that director.

5. Paragraph 3.84(k)(i)(a)-(d) in the JSE Limited (JSE) Listings Requirements contains a specific disclosure to be included in the CEO and Financial Director responsibility statement. This requires the CEO and Financial Director to confirm, among other things, that "(d) the internal financial controls are adequate and effective and can be relied upon in compiling the annual financial statements, having fulfilled our role and function within the combined assurance model pursuant to principle 15 of the King Code. Where we are not satisfied, we have disclosed to the audit committee and the auditors the deficiencies in design and operating effectiveness of the internal financial controls and any fraud that involves directors, and have taken the necessary remedial action". [Emphasis added.]

6. A report issued by the Association of Chartered Certified Accountants[10] notes that the auditor's responsibilities for identifying and reporting fraud are probably the area with the most misaligned expectations between the general public and the audit profession. Sir Donald Brydon, in his final report[11] (Brydon Report), states that: "Of all the topics covered by the Report, I have found the question of fraud and auditors' related responsibilities the most complex and most misunderstood in relation to auditors' duties."

7. In South Africa, the results of a recent research study[12] show that users of auditor's reports (including academics and bankers) attribute the responsibilities for the detection of all fraud to the auditors. The findings of the research, both past and present, and recent events have shown that South Africa is not exempt from the expectation gap between the

[8] ISA 240, paragraph 7.
[9] Companies Act, 2008 (Act No. 71 of 2008).
[10] Professional Insight Report – 9 May 2019: https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf.
[11] Assess, Assure and Inform: Improving Audit Quality and Effectiveness – *Report of the Independent Review into the Quality and Effectiveness of Audit*, paragraph 14.01. Sir Donald Brydon CBE. December 2019.
[12] Will the expanded audit report reduce the expectation gap for the responsibilities of auditors in South Africa? Maseko, K; Yasseen, Y; Padia, N; Brahmbhatt, Y (2018).

auditor's responsibilities to detect fraud and what the public and investor community want, which is for auditors to assume a significant role with regard to fraud.

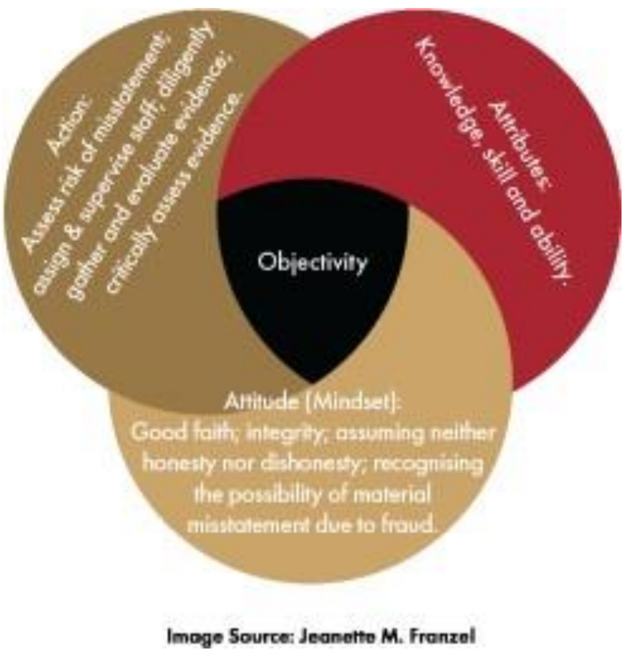
The importance of professional scepticism and professional judgment

8. The IRBA Public Inspections Reports include a number of significant reported findings relating to a possible lack of professional scepticism.

9. In accordance with ISA 200[13], the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance[14].

For the auditor to apply professional scepticism, it is necessary for the auditor to display certain attributes and attitudes as well as take certain actions.

Auditor Objectivity and Scepticism



[Source: Presentation at the American Accounting Association Annual Meeting]

10. Professional scepticism, as it relates to auditing, is essential to audit quality. This is because the public depends on auditors to obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatements, whether the misstatements are due to error or fraud[15]. Due to the characteristics of fraud, the auditor's

[13] ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15.

[14] ISA 240, paragraph 13.

[15] Accountancy SA, December/January 2019: Professional Scepticism and Fraud – Mario Fazekas.

professional scepticism is particularly important when considering risks of material misstatement due to fraud[16].

11. Professional scepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in light of the circumstances[17].

12. **Auditors are encouraged to develop a more sceptical mindset.**

HOW CAN AUDITORS FOSTER PROFESSIONAL SCEPTICISM?
• Professional scepticism means that the auditor starts from a neutral position. The auditor should rationally and logically consider all audit evidence, not just the audit evidence that management is presenting. In doing so, the auditor should: o Resist the temptation to accept an easy answer. o Consider audit evidence, viewpoints and disclosures that are supported by facts and then compare those to what management presents to avoid anchoring/confirmation bias. o Corroborate what management presents, and test and challenge management's representations. • It is important that each engagement team member has the self-confidence and the strength of character and resilience required to maintain an inquiring mind.

13. It is essential for the engagement partner and other senior members of the engagement team to lead by example by displaying the correct tone-at-the-top in their application of professional scepticism in performing the audit and in their direction, supervision and review of the engagement team members' work.

14. Possible actions that the engagement team may take to mitigate impediments to the exercise of professional scepticism at the engagement level may include modifying the nature, timing and extent of direction; supervision or review by involving more experienced engagement team members; more in-person oversight on a more frequent basis; and more in-depth reviews of certain working papers for areas with a fraud risk or a risk of non-compliance with laws or regulations[18].

The extent of professional scepticism applied by the auditor exists on a scepticism continuum. Where the auditor finds him/herself on the scepticism continuum is influenced by the auditor exercising professional judgment as to the trust he/she

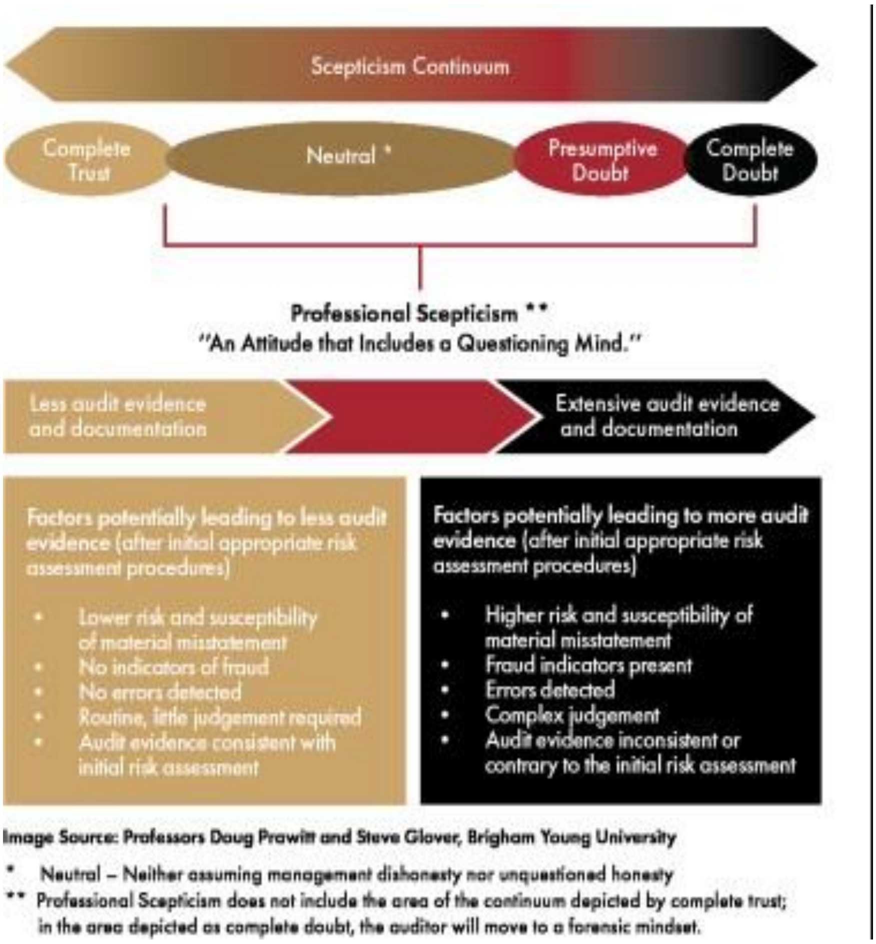
[16] ISA 240, paragraph A8.

[17] ISA 200, paragraph A22.

[18] Proposed ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*, paragraph A37 – March 2020 IAASB Meeting, Agenda item 2-B.

places in management of the entity, and other factors. This influences the extent of audit evidence to be obtained by the auditor and the documentation required.

The Application of Professional Scepticism



[Source: Publication - 'Enhancing Auditor Professional Skepticism']

15. **Auditors are reminded that professional judgment needs to be exercised throughout the audit and appropriately documented. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence**[19].

GUIDANCE ON DOCUMENTING PROFESSIONAL JUDGMENT
Consider documenting the following professional judgments about fraud-related audit procedures: • The procedures performed to obtain the information necessary to identify and assess the risks of material misstatement due to fraud, which include:

[19] ISA 200, paragraph A29.

- Understanding the entity and its environment, including the entity's internal control, and risk assessment-related procedures.
- Analytical procedures.
- Inquiries of management, the audit committee, internal audit and others.
- Fraud risk factors identified that indicate incentive or pressure to perpetrate fraud, an opportunity to carry out the fraud, or an attitude or rationalisation that justifies the fraudulent action.

- The discussion among engagement team members and brainstorming sessions held in planning the audit regarding the susceptibility of the entity's financial statements to be materially misstated due to fraud, including:
  - The audit team members who participated.
  - How and when the discussions took place.
  - The matters discussed.
- The risks of material misstatement due to fraud that were identified at the financial statement and assertion levels; the linkage of those risks to the auditor's response; and the nature, timing and extent of such audit procedures.
- The results of the procedures performed to address the assessed risks of material misstatement due to fraud, including those procedures performed to further address the risk of management override of controls.
- In relation to the risk of material misstatement due to fraud in revenue recognition:
  - If the auditor has not identified, in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor's conclusion, including the types of revenue, revenue transactions and the assertions that may not give rise to such risks.
  - Where improper revenue recognition as a risk of material misstatement due to fraud was identified, pinpointing where such fraud may be permutated in the revenue process.

Fraud discussions among engagement team members

16. ISA 315 (Revised) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity[20].

[20] ISA 240, paragraph 16.

17. **Auditors are encouraged to make use of forensic experts during the fraud discussions among engagement team members.** This is highlighted in the Financial Reporting Council's Audit Quality Thematic Review: Fraud Risk and Laws and Regulations (January 2014) as a good practice observation; and it is further noted that for the larger, more complex entities, including a forensic expert in these discussions would improve the effective identification of potential risks of material misstatement due to fraud.

18. Research[21] also suggests that having the engagement partner or a forensic expert run the fraud discussions is an example of best practice that auditors can use to improve the effectiveness of fraud brainstorming discussions. The matters contained in paragraph A12 of ISA 240 provide a useful list for the engagement partner to discuss with engagement team members.

19. Besides the involvement of a forensic expert in fraud discussions, **it is also encouraged, due to the prevalence of IT-related fraud, that an IT expert be involved in the fraud discussions among engagement team members**[22]. In addition to the involvement of a forensic expert and an IT expert, engagement team members should consider whether any other experts should be involved in fraud discussions due to other unique elements pertaining to the client, or the industry in which the client operates. For example:
    - Clients in the mining industry – experts dealing in environmental rehabilitation matters or with life of mine models.
    - Clients in the construction industry – experts in engineering and quantity surveying.
    - Clients in the property industry – experts in property valuation.
    - Clients in the insurance industry – actuarial experts.

20. Research shows that high-quality fraud discussions among engagement team members facilitate effective links between auditors' fraud risk assessments and their fraud-related testing, as well as the ultimate detection of fraud[23]. Paragraphs 17-19 provide examples of characteristics of high-quality fraud discussions.

21. Fraud discussions are usually held face-to-face. Electronic techniques used for fraud discussions are also successful and may be more successful in some cases – for example, computer-mediated discussions or where each engagement team member completes the task as an individual without interaction, and then their unique ideas are combined after the completion of the task.

22. **Auditors are encouraged to document the fraud discussions among engagement team members and are required to document the significant decisions reached during these discussions**[24]**.** Research shows that the specificity of documentation of the

[21] A Synthesis of Fraud-Related Research (2013) with reference to Brazel et al. (2010).
[22] ISA 240, paragraph A35.
[23] A Synthesis of Fraud-Related Research (2013) with reference to Brazel et al. (2010).
[24] ISA 240, paragraph 45(a).

fraud discussions affects auditors' subsequent fraud risk assessments, the obtaining of audit evidence and audit evidence evaluation[25].

Making inquiries of management and others within the entity

23. To meet the inquiry requirements of ISA 240[26], auditors are encouraged to conduct face-to-face interviews with management, others within the entity, individuals within the internal audit function (if such a function exists at the entity) and those charged with governance of the entity, as appropriate. The interviews may be performed in conjunction with requiring those individuals to complete a questionnaire.

24. **It is recommended that these discussions be performed by a senior or more experienced member of the engagement team. The value of these discussions may be improved if a forensic expert is involved to conduct the interviews, where additional fraud risk factors are identified in relation to the individual from whom inquiries are made.**

Fraud risk factors prevalent in the South African environment

25. Appendix 1 of ISA 240 contains examples of fraud risk factors that may be faced by auditors in a broad range of situations. Examples relating to the two types of fraud relevant to the auditor's consideration are presented separately as follows:

    - Risk factors relating to misstatements arising from fraudulent financial reporting; and
    - Risk factors arising from misstatements arising from the misappropriation of assets.

    For each of these types of fraud, the risk factors are further classified based on the following three conditions contained in the fraud risk triangle, and which are generally present when material misstatements due to fraud occur (please refer to the Fraud Triangle diagram in the Introduction section of this publication):

    - Incentives/pressures;
    - Opportunities; and
    - Attitudes/rationalisations.

    Although the fraud risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors.

[25] A Synthesis of Fraud-Related Research (2013) with reference to Hammersley et al. (2010).

[26] ISA 240, paragraphs 18-22.

EXAMPLES OF FRAUD RISK FACTORS THAT ARE PREVALENT IN THE SOUTH AFRICAN ENVIRONMENT (There may be some overlap between these examples of fraud risk factors and those contained in Appendix 1 of ISA 240)			
Fraud Risk Factor[27]	**Opportunity**	**Attitude**	**Incentive**
• Poor controls present at public sector-related entities.	X	X	X
• Trend of decline in the South African economy and poor economic growth prospects.			X
• Historical trend of decline in the value of the rand and the possible pressure created on some businesses.			X
• High unemployment.	X	X	X
• Impact of natural disasters and/or pandemics.	X	X	X
• Poor performance of certain regulatory and law enforcement agencies.	X	X	X
• Complicated and protracted procurement processes.	X		X
• Non-compliance with procurement processes.	X	X	X
• Overly complicated structures to achieve a simple outcome.	X		
• Significant transactions with non-profit organisations.	X		
• Poor performance of state-owned entities.	X		X
• The occurrence of "state capture", mostly accompanied by an inappropriate relationship between the private sector or private individuals and the public sector or public sector officials.	X	X	X
• High crime rates, and therefore the need by criminals to "wash" the proceeds in the form of cash through the formal economy.		X	X
• Significant size of the informal economy.	X		X

[27] Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances; some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances.

EXAMPLES OF FRAUD RISK FACTORS THAT ARE PREVALENT IN THE SOUTH AFRICAN ENVIRONMENT (There may be some overlap between these examples of fraud risk factors and those contained in Appendix 1 of ISA 240)			
Fraud Risk Factor[27]	**Opportunity**	**Attitude**	**Incentive**
• Undocumented or illegal workforce.		X	
• Porous land borders and seaports.	X	X	
• Lack of prosecution, and/or lack of successful prosecution of white-collar crime.	X	X	X
• Sophistication and connectivity of the South African economy makes the flow of money seamless and fast.	X		X
• Significant related party transactions (or transactions with parties that are not clearly defined as related parties, in accordance with ISA 550[28]) with entities audited by another firm.	X		X
• Increased falsification of qualifications provided by job applicants going undetected due to inadequate job applicant screenings of employees who nowmay have access to assets.	X		X
• Broad-Based Black Economic Empowerment fronting.		X	X
• Onerous tax compliance requirements and tax violations, deviations and evasion.		X	X
• Greater tolerance for fraud and corruption and the lack of consequences, enforcement and accountability thereof.	X	X	X

Identification and assessment of the risks of material misstatement due to fraud

26. In accordance with ISA 315 (Revised), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures[29].

27. In identifying and assessing the risk of material misstatement due to fraud, the auditor should always keep in mind **how** and **where** fraud could be perpetrated.

[28] ISA 550, *Related Parties*.

[29] ISA 240, paragraph 26.

GUIDANCE FOR THE IDENTIFICATION AND ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD

- Start by understanding the organisation's ethical and anti-fraud culture by, for example, doing the following:
  - Understand and be aware of the inherent fraud risks for the industry in which the client operates.
  - Determine whether there is a fraud and ethics policy, an independently managed whistleblowing hotline and regular follow-up on the items reported.
  - Determine whether there are regular fraud, bribery and corruption, and money laundering risk assessments being conducted.
  - Assess whether management has determined the top fraud risks in the business and how these risks are mitigated.
  - Understand what anti-fraud, anti-bribery and corruption, and anti-money laundering programmes are in place to prevent, detect and respond to fraud.
  - Analyse data on the financial, vendor and employee database to identify key fraud red flags.
- In defining **how** and **where** the fraud risk could be perpetrated, the auditor should remain cognisant of, for example, the following indicators:
  - Inconsistencies in responses from inquiries of management and those charged with governance.
  - Weak internal control environments or instances where management has overridden internal controls.
  - Instances of non-compliance with laws and regulations or failure by management to report any legislative contraventions to the relevant regulators and authorities and/or internally to the relevant governance committees.
  - Existing fraud allegations against management and those charged with governance.
  - Weak or non-existent processes by management for identifying fraud.
  - High tolerance for poor financial disciplines and errors in the financial information.
  - Unnecessary challenges, criticisms or disagreements by management with the auditors; or regular changes in audit and other professional service providers.
  - Management's bonuses and incentives heavily/solely reliant on meeting financial targets.
  - Fraudulent financial reporting indicated by, for example, the following:
    - Management attempting to present disclosures in a manner that may obscure a proper understanding of the circumstances, events or transactions.
    - Changes in accounting policies and/or estimates that are not justifiable.

        - Concealing/misrepresenting prior period errors.
- Considerations as to **where** fraud could be perpetrated include:
    - Financial statement items with high volumes of transactions.
    - Financial statement items that affect key metrics, such as earnings before interest, taxes, depreciation and amortisation (EBITDA), price earnings ratio, etc.
    - Financial statement items that rely on significant judgment or have high levels of estimation uncertainty.
    - Related party transactions or transactions that are not transparent and at arm's length.
- Considerations as to **how** fraud could be perpetrated include:
    - Misappropriation of assets.
    - Fraudulent financial reporting.
    - Collusion and price fixing.
    - Money laundering.
    - Bribery and corruption.
    - Customs fraud (in the case of imports/exports businesses where agents or third-party intermediaries are used).
    - Tax evasion.
    - Cover-quoting and anti-competitive bidding processes.
    - System or master file data manipulation.
    - Manipulation of results/metrics in order to qualify for government funding or relief programmes.
    - Payment for goods/services not received or for lower-quality goods/services.
    - Excessive prices paid for goods/services.

28. The risk assessment procedures, in accordance with ISA 315 (Revised), include the following:
    - Inquiries of management, appropriate individuals within the internal audit function (if the function exists), and others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
    - Analytical procedures.
    - Observation and inspection[30].

29. **The auditor is encouraged to evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor is**

[30] ISA 315 (Revised), paragraph 6.

encouraged to perform additional risk assessment procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor is encouraged to take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management[31].

30. **The auditor is reminded that the assessed risks of material misstatement due to fraud are treated as significant risks** and, accordingly, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks[32].

31. Although permitted, auditors often combine their fraud risk identification and assessment with the identification and assessment of other risks of material misstatement. However, when the combined risk identification and assessment is performed, auditors often do not identify which of those risks of material misstatement are due to fraud.

32. **Auditors are encouraged to clearly identify which of the risks of material misstatements are due to fraud and are therefore a significant risk** (refer to paragraph 31), when a combined risk identification and assessment is performed.

Presumed risk of fraud in revenue recognition

33. There is a presumption that there are risks of fraud in revenue recognition[33].

34. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks[34].

35. It is important that the assessment of risks of material misstatements due to fraud in revenue recognition is performed with sufficient granularity to identify the specific risks of material misstatement due to fraud in all types of revenue, revenue transactions and related assertions, in order to develop an appropriate audit response.

36. Understanding the client's accounting policy on revenue recognition and disaggregated revenue analytics may assist in the auditor's risk identification and assessment relating to improper revenue recognition.

37. In determining risks of material misstatement due to fraud, engagement team members should consider which specific fraud schemes could be perpetrated by a client, based on how it contracts with customers and records revenue, and then identify the relevant assertions.

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[31] Adapted from ISA 315 (Revised 2019), paragraph 35. Although neither ISA 240 nor ISA 315 (Revised) includes a "stand back" requirement, the auditor is encouraged to do so.

[32] ISA 240, paragraph 28.

[33] ISA 240, paragraph 27.

[34] ISA 240, paragraph 27.

38. The auditor should also consider the attitude of management towards addressing identified control weaknesses, including those related to revenue management. For example, management might not address control weaknesses identified by internal and external auditors.

39. The nature of revenue transactions, estimation and complexity of the revenue recognition process may afford differing opportunities or means for management to engage in fraudulent financial reporting.

40. Subsequent to identifying the possible fraud schemes relevant to the entity, the auditor should consider the entity's attitude towards fraud, i.e. why it would be inclined to commit fraud and how these fraud schemes can be implemented.

41. As part of assessing why management would perpetrate fraud, the auditor shouldconsider incentives, for example, key metrics in financial information, debt covenants in place or any regulatory requirements with which the client is required to comply. How management will implement a fraud scheme speaks to the opportunity to commit fraud.

42. The auditor's understanding of the revenue process, in accordance with ISA 315 (Revised), should assist in identifying where in the revenue process management could implement a fraud scheme. For example, where the auditor deems there is an incentive for management to increase revenue through the manipulation of prices or performance obligations, the auditor should determine where in that process this could occur. This could be perpetrated, for example, through unauthorised master data changes or unauthorised changes to invoices. Both of these highlight the risks of material misstatement due to fraud in revenue recognition relating to the accuracy assertion. Pinpointing the risks of material misstatement due to fraud will result in more appropriate audit procedures to respond to those risks.

43. Some risks of material misstatement due to fraud may be pervasive, yet still exist at the assertion level. For example, the segregation of duties risk may impact multiple assertions and affect more points in the revenue process where management can implement a fraud scheme.

44. The presumption that there are risks of material misstatement due to fraud in revenue recognition may be rebutted[35]. When deciding whether the auditor may rebut the presumed risk of material misstatement due to fraud in revenue recognition, the auditor should consider the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures; (b) opportunities; and (c) attitudes/rationalisations.

45. If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall include in the audit documentation

[35] ISA 240, paragraph A31.

the reasons for that conclusion[36].

46. The following are uncomplicated examples of circumstances, including details of the types of revenue streams, where the presumption of risks of material misstatement due to fraud in revenue recognition could possibly be rebutted:

- A holding company that earns interest income on a positive bank balance.
- A company within a group that only receives dividend income from a 100%-held subsidiary.
- A holding company that on-charges operating costs in terms of an agreement with a fellow group company.
- A company, which is an importer and distributor of a simple product line with few variants, that supplies a very limited number of customers; and where revenue recognition takes place on delivery of the product by the company. There are no cash sales.

EXAMPLES OF FRAUD SCHEMES IN REVENUE RECOGNITION
Timing of revenue recognition **Example 1:** • A manufacturing entity changed its quarter-end from 29 March to 31 March to make up for a revenue shortfall. The two additional days permitted the entity to record an additional R359 million in sales. **Example 2:** • A software entity sold long-term licenses. Customers paid upfront for the multi-year licenses. Despite the long-term nature of these contracts, the company recognised the present value of all licensing revenue for the entire contract immediately. Since all licensing revenue was recorded at the beginning of the contract, and cash was not collected for many years to come, the entity recorded large amounts of long-term receivables on the balance sheet. A regulator found that the entity prematurely recognised more than R59 billion from at least 363 contracts.
Recording fictitious revenue **Example 3:** • A fast-food chain sold equipment to the value of R12.5 million to a potential subsidiary right before the deal closed. As part of the deal, the fast-food chain increased the amount that it would pay to acquire the subsidiary by the same amount for which the equipment was sold. This arrangement clearly had no real net economic impact, so no revenue should have been recorded. However, the fast-food chain entity recorded the sale of equipment as revenue, rather than as an offset to the increased franchise

[36] ISA 240, paragraph 48.

purchase price. This ruse helped the entity maintain its streak of exceeding the market expectations. **Example 4:** • A trading firm grossed up its revenue to appear to be a larger company. The firm was entitled to a commission, based on the trades that it made (as it was acting as an agent). However, the firm accounted for trades considerably more aggressively. Instead of only recording the commission as revenue, the firm recognised the entire value of the asset traded, even though it never owned the asset.
Overstating revenue through misclassification **Example 5:** • A healthcare information company improperly included in its revenue a R224 million share of the profits from an investment in a joint venture. This misclassification resulted in sales being overstated by more than 10%.
Understating sales using an electronic sales suppression tool **Example 6:** • A restaurant manager installed phantomware software[37] on the restaurant's sales registers. The restaurant manager used the hidden menu to access the program, deleted all cash sale transactions on the sales registers after the transactions had occurred, and stole the cash sale proceeds. The deleted cash sales transactions could not be traced on the sales registers. This resulted in restaurant sales and the related tax liability being understated by 15%.

Knowledge, skill and ability required of auditors

47. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialised skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement[38].

48. An auditor is not required or expected to have the qualifications or competencies and skills of a forensic expert. However, the audit firm may consider it necessary to provide training to its engagement partners and engagement teams on the best practices and procedures performed by a forensic expert. The training may specifically include:
    - Forensic interview best practices (**Appendix B**).
    - How to perform background checks and analyse relationships of, for example, politically connected persons.
    - Basic fraud prevention, detection and investigation skills.

[37] Phantomware software allows a program to operate on a sales register, and this can alter the data that has been recorded.

[38] ISA 240, paragraph A35.

- Report writing skills that should incorporate general communication and persuasion skills.
- Auditor ethics that should incorporate elements of persuasion and communication to be performed in an ethical way.

Use of forensic experts on audit engagements

49. **Auditors are encouraged to make use of forensic experts on audit engagements while executing audit procedures. However, it is understood that a forensic expert may not be used on every audit engagement, and that professional judgment is exercised in making this decision.** If the decision is made not to use a forensic expert, the auditor should document the auditor's professional judgment exercised in this decision.

50. In determining whether a forensic expert may be used on an audit engagement, the audit firm may consider it necessary to develop a risk assessment tool that contains specific considerations to be made by the engagement partner and the engagement team in deciding whether a forensic expert may be used on the audit engagement. **It may be appropriate for the audit firm to make it mandatory for this risk assessment tool to be used on every audit engagement.**

CONSIDERATIONS THAT THE ENGAGEMENT PARTNER AND TEAM MAY MAKE IN DECIDING WHETHER TO USE A FORENSIC EXPERT ON AN AUDIT ENGAGEMENT

A forensic expert may be used on an audit engagement where the following factors are present:

- There are fraud allegations against management of the entity.
- Senior management of the entity has been suspended on allegations of fraud.
- There is a known history of instances of fraud committed by management.
- The entity is subject to a fraud investigation by law enforcement agencies.
- The entity is subject to an ongoing fraud investigation or litigation.
- The entity has a significant risk of material misstatement due to fraud.
- There are opportunities or incentives for management to perpetrate fraud.

Responding to the assessed risks of material misstatement due to fraud (other than those relating to management override of controls)

51. ISA 330 deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor, in accordance with ISA 315 (Revised)[39], in an audit of financial statements[40].

[39] ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*.

[40] ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 1.

52. In accordance with ISA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level[41]. Also, in accordance with ISA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level[42].

THE RELATIONSHIP BETWEEN THE ASSESSED RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD AND THE AUDITOR'S RESPONSE THERETO

In designing the further audit procedures to be performed, the auditor is required to obtain more persuasive audit evidence, the higher the auditor's assessment of risk[43].

The application material in paragraph A19 of ISA 330 goes on to say that when obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third-party evidence or obtaining corroborating evidence from a number of independent sources.

Paragraph A34 of ISA 240 states that determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional scepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

The auditor uses professional judgment in determining a carefully calculated appropriate and proportional response. In accordance with paragraph 30 of ISA 240, in determining the overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor is required to:

- Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement;
- Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
- Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

[41] ISA 240, paragraph 29.

[42] ISA 240, paragraph 31.

[43] ISA 330, paragraph 7(b).

GUIDANCE FOR AUDITORS IN RESPONDING TO RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD
Create an audit environment that is conducive to identifying fraud • Create an environment and the mechanisms that allow any engagement team member to raise/communicate identified or suspected fraud, including escalation protocols and alternative mechanisms to raise suspected fraud. • Consider the rotation of engagement team members and/or their responsibilities. • The engagement quality control reviewer should effectively challenge the engagement team in areas of significant judgment and follow-up on areas of concern. • The engagement partner should remind engagement teams of the importance of maintaining professional scepticism and remaining alert for instances of fraud throughout the audit. • The engagement team should allow sufficient time for the performance and appropriate review of fraud-related procedures. • The firm should institute regular fraud awareness/detection training sessions.
Build an element of unpredictability into audit procedures • Consider selecting items, in addition to the original sample, or performing additional/different procedures to those performed in previous audits. • Rotationally test accounts below materiality and non-significant components. • Attend cash, inventory counts and other key operational/control procedures with little/no notice.
Be on the lookout for information/action that is inconsistent with information obtained during the audit • Talk to employees outside of the finance function. Perform additional inquiries or follow-up inquiries throughout the audit. • Focus on current-year engagement specific facts and circumstances, rather than anchoring to prior-year documentation or another engagement. • Remain alert for adverse media coverage or other information available in the public arena. • Observe operations during the audit for any unusual activity. • Arrange in-person meetings and interviews. Avoid only dealing with management via e-mail, phone calls, collaboration platforms, etc.
Be wary of limitations imposed by management • Be extra sceptical when: o Denied or given limited access to information, people, customers, suppliers, shareholders, directors, etc.

- Management takes an unreasonable amount of time to provide information.
- Management wants to screen all information prior to it being made available to the auditors.
- Management wants to be present in consultations held by the auditor with client staff.
- Management refuses to have a single auditor for all components in a group audit.

Corroborate the relevance and reliability of information received from management

- Obtain supporting documentation to corroborate management's explanations.
- Where possible, obtain information independently/externally from management.
- Remain aware of electronic documents (e-mails, PDFs, Excel, etc.) that may have been manipulated or created retrospectively, for example, electronic signatures may be used to create documents retrospectively, and forensic technology analysis may be required to detect such manipulation.

Involve the relevant specialists/experts when required

- Depending on the circumstances, it may be appropriate to involve specialists/experts in the following fields:
  - **Forensics –** especially where there is an increased likelihood or occurrence of fraud and provide guidance on potential legislative contraventions/reporting obligations.
  - **IT –** especially where there is high IT complexity and dependency, increased risk of data manipulation or susceptibility of the system to cyber-attacks.
  - **Tax –** especially where there are unusual/complex tax arrangements, numerous uncertain tax positions, or incentives for management to misstate their tax liabilities.
  - **Valuations –** especially where valuations are highly subjective, assumptions are difficult to support, or the valuation method selected is rarely used.

Review and follow-up on internal investigations

- Most instances of fraud are detected through tip-offs. Inquire whether there are any investigations in progress and review the reports when they are made available.
- Consider reports that were not investigated and establish the reasons thereof, particularly in respect of allegations made against those charged with governance.
- If there is a fraud hotline, inquire whether it is managed by an independent third party or within the entity. If managed within the entity, there is a higher risk of completeness of reported and investigated cases.

53. Auditors are reminded to consider the following matters in connection with the auditor's considerations relating to fraud:

- In the performance of an audit, public interest considerations and achieving audit quality are more important than commercial considerations and a profit incentive. Of particular importance in promoting an internal culture based on quality is the need for the firm's leadership to recognise that the firm's business strategy is subjectto the overriding requirement for the firm to achieve quality in all engagements thatthe firm performs[44].
- Client relationship acceptance/continuance decisions should be "signed off" by the engagement partner on a timely basis; and negative media coverage about a client should be taken into account when making client relationship acceptance/continuance decisions.
- The performance of robust analytical procedures to evaluate whether unusual or unexpected relationships that may indicate the existence of "upfront" risks of material misstatement due to fraud.
- Based on the risks of material misstatement due to fraud, making the audit of tax balances a focus area, since the risk of tax fraud in South Africa is high, especially among small and medium-sized entities.
- Based on the risks of material misstatement due to fraud, making the audit of related parties a focus area, since the risk of fraud between related parties is high.
- The possibility of IT-related fraud ("cyber-fraud").
- The auditor's further audit procedures should take into account that the higher the risk of material misstatement due to fraud, the more persuasive the audit evidence needs to be.
- The potential impact that fraud may have on the auditor's report and the auditor's opinion expressed on the financial statements.

54. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional scepticism[45].

55. Although the requirements for responding to the assessed risks of material misstatement due to fraud (other than those relating to management override of controls) contained in ISA 240 refer mostly to responding in accordance with ISA 330, the application material[46] in ISA 240 provides useful guidance for auditors in this regard.

56. In addition, examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2 of ISA 240. The appendix

[44] ISQC 1, *Quality Control for Firms That Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Service Engagements*, paragraph A5. ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, with similar guidance is expected to be approved by the IAASB at its September 2020 meeting and issued thereafter.

[45] ISA 240, paragraph A34.

[46] ISA 240, paragraphs A34-A41.

includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets[47].

Seven critical things that auditors should do differently and which will enhance professional scepticism abilities[48]:

- The way auditors audit tends to make them predictable. If, for example, I am responsible for the petty cash and I get told that the auditors will be arriving next week Monday, do you think my petty cash will balance? Of course, it will! Surely auditors want to obtain an accurate picture of how the organisation is operating; so, a surprise audit would be the most reliable way to achieve this! Therefore, an element of unpredictability is crucial.
- Auditors get provided with a boardroom and they sit in there for two weeks examining the balance sheet, income statement and requesting samples of documents. In conjunction with this, auditors should be walking around, talking to employees, observing what is being done, who is saying what and so on. That's how you will get a more truthful picture of the business, plus you will be provided with opportunities to chat to staff members and try to discern truth from deception.
- At one of our clients, the procurement manager said I should speak only to him as his staff do not know anything. My immediate desire was to chat to his subordinates; so, I waited until he was out and approached staff (in private) who said they were told not to talk to me. So, I pressured them and said, "time is money and I need answers now" and they would start answering me. The one employee said: "This is not how I usually do my job, but my boss said that while you were here, I should tell you that I always follow the standard operating procedures!"
- In addition to talking with management and employees, auditors are encouraged to contact a few vendors and clients to confirm transactions and agreements – remember, what management says is not audit evidence on its own.
- At one client we requested sample documents and a few hours later we had not received them, so I went looking for the person. I found him in his boss's office stamping documents that were unstamped, signing unsigned documents and creating missing documents! So, now I ask where documents, like invoices, are kept and then request the employee to take me there. When we arrive at the storeroom or strong room, I take out my list and say, please find these for me. I then see immediately if documents are missing or incomplete.
- Try and have a certified fraud examiner as part of the audit team.
- Do not get too friendly with the client.

[47] ISA 240, paragraph A41.

[48] Article: ACCOUNTANCY SA, PROFESSIONAL SCEPTICISM AND FRAUD, written by Mario Fazekas.

Management override of controls

57. Internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. For example, the possibility of controls being circumvented by collusion or inappropriate management override[49], when the controls otherwise appear to be operating effectively.

58. ISA 240 requires an auditor to, irrespective of the auditor's assessment of the risks of management override of controls, design and perform audit procedures to:
    - Test journal entries;
    - Review accounting estimates; and
    - Evaluate the business rationale of significant transactions outside the normal course of business[50].

59. Although journal entries, accounting estimates and significant transactions outside the normal course of business are identified as areas where there is a risk of material misstatement due to fraud as a result of management override of controls and where the auditors are required to design and perform procedures, these are not the only areas where there may be a risk of material misstatement due to fraud as a result of management override of controls.

60. The auditor should consider the following examples of ways that management could override controls and, based on the auditor's assessment of the risks of material misstatement due to fraud, decide whether further audit procedures are necessary:
    - Increasing credit terms of specific customers without regard for risk management processes that are required to be followed.
    - Offering beneficial terms or prices on transactions to specific customers without the necessary approval thereof.
    - Approving deliveries or services to customers and waiving the requirement for standard operating procedures to be followed (e.g. completion of proof of delivery or invoicing documentation).
    - Pre- or back-dating of routine transaction documentation.
    - Interference in supply chain management (SCM) by awarding tenders or bids to specific vendors without following due process, or by providing confidential information to specific vendors that will aid those vendors in obtaining the tender or bid.
    - Intentionally forcing the use of specific suppliers for goods and/or services where no SCM policies or procedures apply to those particular transactions.

[49] ISA 200, paragraph A41.
[50] ISA 240, paragraph 33.

- Forcing the payment of supplier invoices without the necessary proof of delivery for the goods or services (e.g. delivery notes).
- Changing or causing master file changes to be made without the necessary proof or approval of changes required.
- Changing supplier banking details or otherwise altering electronic payment data without approval.
- Instructing the payment of salaries and/or wages to employees outside of the payroll, or in cash, or to connected persons, without complying with payroll standard operating procedures.
- Classifying private expenditure as business expenditure.
- Lack of documented standard operating procedures, procedures and guidelines that results in inconsistent practices being followed in the absence of the aforesaid.
- Insofar as controls that relate to the process for identifying and making accounting estimates, overriding standard operating procedures relating to the use of methodologies, assumptions, data, among others, to manipulate the value of those estimates recognised in the accounting records.
- Insofar as controls that relate to financial reporting, the omission or obscuring of facts, either by under- or over-disclosure, relating to transactions and events, while disclosure of this information would be material to the users of financial reports. Examples may include events after the reporting period, going concern, contingent liabilities or assets and related party transactions. This could also extend to management overriding controls relating to classification or presentation and disclosure to the extent that reported earnings (e.g. EBITDA, earnings per share or headline earnings per share) and/or key ratios are manipulated.

WHEN SELECTING JOURNAL ENTRIES TO TEST, THE AUDITOR SHOULD BE ALERT TO THE FOLLOWING CHARACTERISTICS THAT MAY BE INDICATIVE OF FRAUDULENT TRANSACTIONS OR ADJUSTMENTS:

- Entries made to unrelated, unusual, or seldom-used accounts.
- Entries made by individuals and/or user profiles/user groups within the IT department who typically do not make journal entries.
- Entries recorded at the end of the period or as post-closing entries that have little or no explanation or description.
- Entries made either before or during the preparation of the financial statements that do not have account numbers.
- Abnormal entries made immediately before a reporting period, such as before VAT returns, payroll or employees' tax returns and/or monthly management reports.
- Journal entries that are not sufficiently narrated.

- Entries that contain round numbers or a consistent ending number.
- The characteristics of the accounts affected by the entries:
  - Accounts that contain transactions that are complex or unusual in nature.
  - Accounts that contain significant accounting estimates and period-end adjustments.
  - Accounts that have been prone to errors in the past.
  - Accounts that have not been reconciled or contain unreconciled differences.
  - Accounts that contain intercompany transactions.
  - Accounts that contain related party transactions and/or balances.
  - Accounts that are otherwise associated with identified risks of material misstatement due to fraud.

The auditor's considerations relating to fraud when there is a fraud investigation in progress

61. There may be situations where a forensic investigation into alleged fraud is in progress when an engagement takes place.

62. In those situations, the considerations of the auditor are, for example:
    - To understand the scope of the forensic investigation into alleged fraud and whether it is sufficiently robust to allow the auditor to reach a conclusion thereon for audit purposes upon the completion of the investigation.
    - To understand who is performing the investigation and whether the party is deemed competent, independent, objective and appropriately qualified.
    - Based on the outcome of the investigation, to determine whether management of the entity has discharged its reporting responsibilities in terms of legislation such as the Financial Intelligence Centre Act, 2001 (Act No 38 of 2001) and the Prevention and Combating of Corrupt Activities Act, 2004 (Act 12 of 2004); and whether there is a need for the auditor to report a reportable irregularity[51] or non-compliance with laws and regulations[52] (refer to paragraphs 66-72).
    - Understanding the timing of the investigation as well as the impact on the audit approach and the audit reporting process.
    - Understanding the nature of the matters under investigation and whether they are deemed pervasive to the financial records and the impact on the planned audit approach.
    - To develop additional audit procedures to address the auditor's concerns, based on the auditor's evaluation of the sufficiency of the investigation.

[51] Section 45 of the Auditing Profession Act, 2005 (Act 26 of 2005).

[52] ISA 250, *Considerations of Laws and Regulations in an Audit of Financial Statements*, paragraphs 19-29.

- To report on the matter in the auditor's report, as appropriate. For example, this may result in the auditor communicating a key audit matter in accordance with ISA 701[53], reporting an Emphasis of Matter in accordance with ISA 706 (Revised)[54] or reporting a modified opinion in accordance with ISA 705 (Revised)[55].

WHAT THE AUDITOR SHOULD CONSIDER WHEN THERE IS AN ONGOING FORENSIC INVESTIGATION INTO ALLEGED FRAUD IN PROGRESS DURING THE AUDIT

- Making use of the internal forensic department.
- The significance of the matter, other than only the financial materiality. Considerations may include, among others:
  - Is the matter relevant to the audit?
  - If it is in respect of allegations made by a whistle-blower, do the allegations appear to be credible?
  - Does the matter cause the auditor to raise concerns about management's integrity?
- Evaluate the sufficiency of the investigation being conducted. The auditor may consider, among others:
  - Whether the client's response to the matter was sufficient such that the auditor can rely upon the response in connection with the audit.
  - Who the investigation sponsor is.
  - Whether there were any limitations placed on the investigation.
  - Whether there is any interference by management in the investigation.
  - Whether the investigation scope is sufficient to address audit concerns.
  - The procedures performed and related findings that affect the audit.
  - The basis for the investigative conclusions, and whether the conclusions are based on facts supported by relevant evidence.
  - Whether there was a request by management to change any of the findings and conclusions in the report.
- Whether the statutory audit team needs to be withdrawn from the audit engagement while the forensic fraud investigation is in progress.
- The impact of the ongoing forensic fraud investigation on the timing of completion of the audit engagement and the issuing of the auditor's report.

[53] ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

[54] ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

[55] ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

The auditor's responsibilities relating to fraud in engagements other than in an audit of financial statements

63. ISA 240 only applies to the auditor's responsibilities relating to fraud in an audit of financial statements.

64. However, the auditor's responsibilities relating to fraud may also need to be considered when performing a review or other assurance engagements in accordance with the International Standards on Review Engagements (ISREs) or the International Standards on Assurance Engagements (ISAEs), respectively, and in non-assurance engagements such as when performing an agreed-upon procedures engagement in accordance with the International Standard on Related Engagements (ISRS) 4400, *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*[56]. An example of such engagements includes the review and other assurance engagements performed in terms of Regulation 46 of the Banks Act, 1990 (Act No. 94 of 1990).

65. The auditor should refer to the relevant ISRE, ISAE or ISRS to understand the auditor's responsibilities relating to fraud under these engagements. However, the requirements and application material contained in ISA 240 may be useful when considering fraud under these engagements.

The auditor's reporting responsibilities when a fraud is discovered

66. The auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, including fraud, which may differ from or go beyond ISA 240 and other ISAs, such as:

    (a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed;

    (b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g. in an audit of group financial statements); and

    (c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

    Complying with any additional responsibilities may provide further information that is relevant to the auditor's work, in accordance with ISA 240 and other ISAs (e.g. regarding the integrity of management or, where appropriate, those charged with governance)[57].

67. Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the IRBA Code of Professional Conduct (Revised November 2018) requires the auditor to take steps to

[56] ISRS 4400 (Revised), *Agreed-Upon Procedures Engagements*, was issued in April 2020 and is effective for agreed-upon procedures engagements for which the terms of engagement are agreed on or after 1 January 2022.

[57] ISA 240, paragraph 9.

respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed[58, 59].

68. The auditor is referred to paragraphs 19-22 and paragraphs 23-29, respectively, as well as the respective related application material of ISA 250 (Revised) that deals with *Audit Procedures When Non-Compliance Is Identified or Suspected* and *Communicating and Reporting Identified or Suspected Non-Compliance* for further guidance in this regard.

69. In South Africa, the auditor is further required to report on reportable irregularities in terms of Section 45 of the Auditing Profession Act. The auditor is referred to the IRBA Revised Guide for Registered Auditors: *Reportable Irregularities in Terms of the Auditing Profession Act* (Revised May 2015) that provides guidance to auditors on their responsibility to report reportable irregularities.

70. The Auditor-General of South Africa (AGSA) performs its audits in terms of the Public Audit Act, 2004 (Act No. 25 of 2004) (PAA). The 2018 amendments to the PAA[60] introduces the term material irregularity. A material irregularity is similar to a reportable irregularity in terms of the Auditing Profession Act. In terms of the PAA, a material irregularity is defined as any non-compliance with, or contravention of, legislation, fraud, theft or breach of a fiduciary duty identified during an audit performed under the Act that resulted in or is likely to result in a material financial loss, the misuse or loss of a material public resource or substantial harm to a public sector institution or the general public.

71. The AGSA may refer any suspected material irregularity identified during an audit to a relevant public body for investigation; and the relevant public body is required to keep the AGSA informed of the progress and inform the AGSA on the final outcome of the investigation. The PAA also empowers the AGSA to take any appropriate remedial action against an accounting officer or accounting authority who fails to implement recommendation(s) by the AGSA to address a material irregularity and to furthermore issue a certificate of debt if the remedial action related to a financial loss is not implemented.

72. The auditor is further referred to the South African Institute of Chartered Accountants (SAICA) Guide on Regulatory Reporting Duties that provides guidance on regulatory reporting duties.

Public sector perspective

73. The public sector auditor's responsibilities relating to fraud may be a result of law, regulation or other authority applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not

[58] ISA 240, paragraph A8.

[59] See, for example, paragraphs R360.16–360.18 A1 of the IRBA Code of Professional Conduct (Revised November 2018).

[60] Published in Government Gazette No. 42045 of 20 November 2018, with a commencement date of 1 April 2019 that was proclaimed on 11 March 2019.

be limited to consideration of risks of material misstatement of the financial statements but may also include a broader responsibility to consider risks of fraud[61].

74. The AGSA's responsibility relating to fraud in the audit of financial statements is in accordance with ISA 240 and the International Standard of Supreme Audit Institutions (ISSAI) 1240, *Practice Note to ISA 240*, as well as ISAE 3000 (Revised) for fraud relating to the audit of compliance and the audit of predetermined objectives. The AGSA's methodology and approach relating to the risk of material misstatement due to fraud are therefore in accordance with these relevant Standards, which require the auditor to identify the risk of material misstatement due to fraud in the audit of financial statements, compliance with laws and regulations as well as the audit of the predetermined objectives.
75. In accordance with ISSAI 1240, it is recognised that revenue recognition may not always be the most relevant area for the presumption that there is a risk of material misstatement due to fraud, as required by ISA 240. Revenue recognition may be relevant for tax authorities or other agencies that collect revenues, such as universities, colleges and regulatory agencies that charge fees for services rendered or are recipients of donor funds. However, in many public sector entities, the auditor may focus on expenditure and areas such as procurement and payment of grants. Therefore, in addition to revenue recognition, where relevant, the public sector auditor may consider expenditure and areas such as procurement and payment of grants when making the presumption of the risk of material misstatement due to fraud.

[61] ISA 240, paragraph A7.

NOTES

Relevant Guidance on a South African perspective on the auditor's considerations relating to fraud

- The IRBA website contains a list of relevant guidance on a South African perspective on the auditor's considerations relating to fraud. It also has related topics that have been developed internationally and locally that were known to the Fraud Task Group at the date of the issue of this document. This list of relevant guidance is not meant to be exhaustive.

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Appendix A

The Evolving Environment around the Auditor's Considerations relating to Fraud

IRBA

> **"It could be time for us to strengthen auditor competencies in the areas of testing for the existence of fraud and corruption," said Bernard Agulhas, the CEO of South Africa's Independent Regulatory Board for Auditors. "That's the expectation from the public."**
>
> **Bloomberg: Steinhoff, Tongaat Woes Raise South African Auditor Scrutiny – By Janice Kew, 9 June 2019**

1. In the long-term, the IRBA CEO would like to see an IRBA-wide project on fraud that incorporates:
    a. Standard-setting – ISA Plus (a requirement to detect fraud that is linked to professional scepticism and ethics).
    b. Education:
        i. Incorporation of auditor competencies for the detection of fraud (accredited body, e.g. SAICA).
        ii. Incorporation of auditor competencies for the detection of fraud in the Auditor Development Programme.
    c. Internal controls – Establishment of a:
        i. Financial Reporting Internal Control Framework for entities to implement and maintain, with management and the financial director taking responsibility for their system of internal control and certification on the system.
        ii. Requirement for auditors to provide assurance over their clients' systems of internal controls (similar to what is required in the United States of America – Section 302 of the Sarbanes-Oxley Act of 2002).
2. Standard-setting (as envisaged in paragraph 1(a)) will be dependent on revised auditor competencies and their incorporation into university curricula. ISA Plus (related to additional responsibilities related to fraud) will need to be considered alongside auditor competencies.
3. It is envisaged that the following standards could be affected and may need to be revised in the South African environment:
    a. ISA 240;
    b. ISA 315 (Revised);

c. ISA 620[62]; and

d. The IRBA Code of Professional Conduct (Revised November 2018).

4. This long-term vision would also require the engagement and participation of other stakeholders, such as investors, the Companies and Intellectual Properties Commission, the JSE and SAICA.

IAASB

5. One of the IAASB's strategic actions[63] is that it will challenge and enhance the fundamentals of its International Standards by considering further topics to maintain public confidence in audits, in light of the changing public interest, such as those relating to the auditor's consideration of fraud.

6. The IAASB further anticipates that it will perform more focused information gathering and research activities with regard to the topic of fraud[64] to understand and evidence identified issues and challenges that fall into the IAASB's remit, and that are globally relevant, and then to perform activities focusing on analysing the topic of fraud to determine recommendations for Board action (including the scoping of such work and the development of a project proposal as needed). The outcome(s) from these activities may include new projects or workstreams on the IAASB's work plan.

Other international developments

7. There are a number of national standard setters around the world that are exploring developing guidance and/or strengthening requirements on the auditor's considerations relating to fraud.

[62] ISA 620, *Using the Work of an Auditor's Expert*.

[63] IAASB Strategy for 2020-2023.

[64] IAASB Work Plan 2020-2021. The initial objective of this workstream is to further consider the issues and challenges related to applying ISA 240 in light of the changing environment, jurisdictional developments and changing public expectations.

Appendix B

Forensic Interview Techniques

The purpose of this appendix is to provide an auditor with guidelines on how to approach interviews with executives, managers and other relevant employees at a client, with a view to clarify or uncover the root causes of irregularities (including fraud) uncovered during an engagement.

These guidelines are not exhaustive and therefore cannot replace the knowledge, skills and experience obtained through the practical honing of interviewing skills.

General principles relating to interviews

1. Two principles should always be observed when interviewing individuals.
    a. The first is the "*audi*" principle (derived from the Latin phrases "*audi alteram partem*" or "*audiatur et altera pars*"). This principle decrees that no person should be judged without a fair hearing in which each party is given the opportunity to respond to the evidence against them.
    b. The second is the "*nemo iudex in causa sua*" principle, which translates to "one should not be a judge in his own cause". This principle relates to the open-mindedness of the interviewer and the fact that they should not make up their mind before hearing the versions of everyone involved.
2. Latin aside, these principles dictate that a person conducting an interview should be impartial, should listen with an open mind and consider other possibilities and probabilities other than the ones already raised.
3. An interviewee, especially one suspected of wrong-doing, whether their acts were reckless, negligent or intentional, should be afforded the opportunity to state their case, tender their version of events and have their version of events (including exculpatory evidence) considered by the interviewer.
4. Often, it's a casual conversation with someone that leads to the auditor becoming suspicious; so, it's important to always be alert to signs of deception and not just during an interview.

What is interviewing?

5. An interview is a conversation aimed at obtaining desired information from a respondent.
6. Interviews differ from normal conversations. For example:
    a. Interviews take place in a controlled environment.
    b. Parties to an interview have established roles – one person (the interviewer) questions the respondent (the interviewee), who is expected, in turn, to answer or attempt to answer the inquiries.

Preparation for an interview

7. Proper and diligent preparation for an interview is of utmost importance to ensure that the interviewer asks direct, pertinent and relevant questions.

8. In preparation for an interview, an interviewer should, for example:
    a. Determine the name, position, responsibilities and reporting line of the interviewee.
    b. Study all documents relevant to the interview.
    c. Prepare a set of draft questions to serve as a guide. This will keep the interview relevant and prevent distractions from the subject matter at hand. The interview should not be used as a rigid question and answer session. An interviewer should remain flexible in their approach and explore other relevant issues, should those arise.
    d. Prepare a bundle of relevant documents. This becomes useful when asking open and closed questions. It will also negate the necessity to have a follow-up interview to clarify certain issues.
    e. Ensure that specialists working on the matter and those who may ask questions of a technical nature are present during the interview. The best way to obtain information is to have the requisite technical knowledge to ask questions that are relevant to the subject matter.

The interview

9. Practical guidelines to conducting an interview are, for example, as follows:
    a. Arrive early and set up all the necessary tools, e.g. computer, relevant documents and recording equipment (if allowed).
    b. Keep a proper record of the interview. This may include recording the interview (if allowed) and keeping contemporaneous notes. Sometimes an interviewee may express their reluctance to have the interview recorded. In those cases, one should explain the purpose of the recording (accuracy, time saving, etc.) and offerto send the interviewee a copy of the recording. In most cases, this will allay any apprehension by the interviewee.
    c. Ensure that you are accompanied by another team member. This member should be properly briefed and knowledgeable of the issues to be canvassed during the interview. It's also important to have a colleague present for observation of the interviewee's body language. If you are taking notes, it will be difficult to observe the body language, unless you are taking a video of the interview.
    d. Be courteous, professional, attentive to what is being said and meticulous in asking questions.
    e. Explain the reason/s for the interview and what you are trying to achieve.
    f. Try to gain the trust of the interviewee.

g. Manage the interview. It is important that interviewers remain in control of the interview. This is essential in ensuring that the interview objectives are met and achieving a good interview. A good interview is one that meets the purpose of collecting all the relevant evidence the interviewee has, preferably in the shortest amount of time.

Guidance for auditors

10. As an introduction, explain to the interviewee the reason/s for the interview. When looking for deception in answers, it's important to have a baseline. So, this rapport-building introduction phase is crucial as you will be creating a baseline of how the person talks and acts when answering truthfully.
11. Obtain a proper understanding of reporting lines, delegations of authority, standard operating procedures, legislative prescripts and other relevant policies. In other words, determine the standard to which the actions of employees and management should comply.
12. After determining the "should have" part of the interview, you can discuss what happened in practice. This part of the interview is based on, for example, irregularities identified during the audit. For this, your bundle of evidence and the paper trail of events are of utmost importance, especially when dealing with a non-cooperative or recalcitrant interviewee.
13. Focus on specifics during this part of the interview. An example might be saying "I refer you to the transaction dated…" before following that by showing the interviewee the relevant documentation.
14. Ask the interviewee to explain in their own words the process followed preceding, during and after the event in question.
15. Avoid multi-part questions, hypothetical questions and leading questions.
16. Compare what happened to what should have happened and then ask the interviewee for an explanation of the anomaly. Do not frame the question as an accusation, rather frame it as a clarification.
17. Determine the reasons why the interviewee deviated from, for example, the standard operating procedures.
18. Determine whether the deviation was unintentional or intentional. If intentional, determine the motive as to why it was done. The responses can take the form of "I didn't know" or "X instructed me to do so" or "we did not have the capacity to do it". Make a note of the explanations, but do not let them distract you from digging further.
19. If the interviewee refers to documentation and evidence that you do not have, ask the interviewee if he/she would provide you with copies. If possible, ask for copies to be made

and offer to wait for them. Consider going with the person making the copies to make sure they don't fill in missing information or even create the documents while you are waiting.

20. Do not disregard any information and consider both the explanation of the interviewee and any documentation obtained before reaching conclusions.

21. Determine the identity of other individuals who might have been involved and who can shed additional light on the anomalies detected. If possible, obtain their names and contact details.

22. When looking for signs of deception in answers, these are some of the more common indicators:

    a. Answering a closed question that requires a simple "yes" or "no" with an explanation.

    b. Incongruencies between words and the body language.

    c. Micro-expressions. These are facial expressions that last for a hundredth of a second and are revealing of the person's true emotions.

After the interview

23. In some instances, it might be worthwhile to transcribe the interview. Alternatively, type the interview notes and send them to the interviewee for him/her to confirm the correctness of the notes. This can prevent disputes later on.

24. Follow-up on explanations provided by the interviewee and additional information provided.

25. Follow-up on technical issues raised and consult with experts and specialists where necessary. This will enable you to determine whether explanations provided by the interviewee are correct.