

LEARNING UNIT 3 – THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT

DURATION: 5 MINUTES



3.1 INTRODUCTION

Fraud represents one of the most significant threats to the credibility of financial reporting and to public confidence in the audit profession. High-profile corporate failures and persistent corruption in both the private and public sectors have resulted in increased regulatory and societal expectations that auditors do more than merely comply with prescribed audit procedures.

ISA 240 (Revised) responds directly to these expectations by reframing the auditor's responsibilities around **mindset, ethical judgement and continuous vigilance**, rather than a checklist-driven approach. The standard emphasises that fraud risk is dynamic and must be evaluated throughout the audit, requiring the auditor to exercise **professional scepticism**, challenge management explanations, and remain alert to indicators of management override and concealment.

In the IAC examination context, ISA 240 (Revised) is seldom examined in isolation. It is typically integrated with **ethics (SAICA Code), corporate governance (King V)**, risk assessment and reporting requirements. Students are therefore expected not only to know the requirements of the standard, but to **apply them using professional judgement in complex, real-world scenarios**.

Please note: ISA 240 (Revised) is new and it is your responsibility to review it



3.2 LEARNING OUTCOME AND ASSESSMENT CRITERIA

The content of this learning unit is based on the following learning assessment criteria:

Learning outcome	Assessment criteria
Exercise ethical judgments, corporate governance principles, and statutory requirements in practical situations.	<ul style="list-style-type: none">• Carry out evaluations of non-adherence practices and make recommendations.• Carry out quality controls for firms that perform audits, review of historical information and other assurance and related service engagements.



3.3 LEARNING ASSUMED TO BE IN PLACE

Students are assumed to:

- Understand the overall audit process and risk-based auditing.
- Be familiar with ethical principles in the SAICA Code of Professional Conduct.
- Have prior knowledge of ISA 240 (old version) at undergraduate level.

Students are now expected to **apply** ISA 240 (Revised) using professional judgment rather than merely recall its requirements.



3.4 BACKGROUND

3.4.1 Fraud versus error

Misstatements in financial statements may arise from either error or fraud. The distinguishing feature is **intent**. Fraud involves an intentional act using deception to obtain an unjust or illegal advantage.

Two broad categories of fraud are relevant to the auditor:

- Fraudulent financial reporting
- Misappropriation of assets

Fraud often involves **management override of controls**, collusion, and deliberate concealment, which increases the risk that it may not be detected.

The distinction between fraud and error is fundamental because it determines the **nature of the auditor's response**. Errors arise unintentionally, often due to oversight or misinterpretation, whereas fraud involves **intentional deception** designed to mislead users of the financial statements.

From an audit perspective, this distinction is critical because fraud is more difficult to detect. Fraud often involves **collusion, falsified documentation and management override of controls**, which limits the effectiveness of traditional audit procedures. As a result, ISA 240 (Revised) acknowledges the inherent limitations of an audit and places greater emphasis on professional scepticism rather than reliance on controls alone.

In an IAC exam, students are expected to explicitly identify **intent** when distinguishing fraud from error and to explain why fraud increases detection risk, particularly when senior management is involved

3.4.2 Fraud and non-compliance with laws and regulations

Fraud ordinarily constitutes non-compliance with laws and regulations and therefore triggers additional responsibilities under ISA 250 (Revised). When fraud or suspected fraud is identified, the auditor must consider not only its impact on the financial statements, but also whether there are **legal or regulatory reporting obligations**.

This interaction between ISA 240 (Revised) and ISA 250 is frequently examined in integrated questions where candidates must demonstrate an understanding of **ethical responsibilities, statutory duties and professional conduct**, particularly where management integrity is called into question.

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, taking into account fraud risk factors and information obtained

throughout the audit (ISA 240 (Revised), paras 39–41).

When identifying and assessing the risks of material misstatement due to fraud, the auditor shall presume that there are risks of fraud in revenue recognition and determine which types of revenue, revenue transactions or relevant assertions give rise to such risks (ISA 240 (Revised), para 41).

ISA 240 (Revised) requires the auditor to design and perform responses to the assessed risks of material misstatement due to fraud at both the financial statement level and the assertion level. These responses include overall audit responses as well as specific procedures addressing management override of controls, journal entries, accounting estimates and significant unusual transactions (ISA 240 (Revised), paras 42–53).

Aspects of fraud may be included into many topics, for example in questions on the CPC, reportable irregularities and risk assessment.



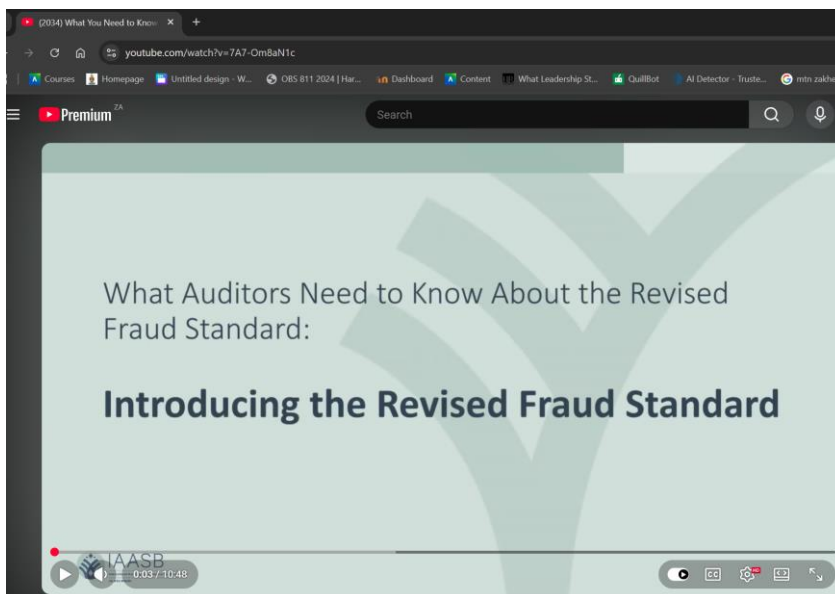
IMPORTANT PRINCIPLE – LEARNING ASSUMED TO BE IN PLACE

You need to be familiar with the entire of ISA 240 (Revised), including all the appendices. Appendices provide guidance on how fraud could impact on different areas of the audit process by making it practical with the examples provided in this auditing standard. It also highlights areas where there could be a possibility of fraud.

ACTIVITY 3.1 Watch the following video on ISA 240 (Revised)



<https://www.youtube.com/watch?v=7A7-Om8aN1c>



Refer to the **following appendices of ISA 240 (Revised)** for examples of **fraud risk factors and possible audit procedures** to deal with these.

Appendix 1:	Examples of fraud risk factors
Appendix 2:	Examples of possible audit procedures to address the assessed risk of material misstatement due to fraud
Appendix 3:	Examples of circumstances that may be indicative of Fraud
Appendix 4:	Additional considerations that may inform the auditor when selecting journal entries and other adjustments for testing
Appendix 5:	Other ISAs addressing specific topics that reference fraud or suspected fraud



3.5. PROFESSIONAL SKEPTICISM AND ETHICAL JUDGMENT

Professional scepticism under ISA 240 (Revised) is not a passive attitude, but an **active and continuous questioning mindset**. The auditor is required to critically assess audit evidence, remain alert to contradictory information and challenge explanations that appear implausible or inconsistent.

ISA 240 (Revised) explicitly requires the auditor to investigate inconsistencies in management responses and to question the authenticity of documents where there are indicators of possible manipulation. This reflects a shift away from assuming management honesty toward a more balanced and alert approach.

In the IAC examination, professional scepticism is commonly tested through scenarios involving:

- inconsistent or vague explanations by management;
- pressure to reduce audit work or ignore anomalies;
- unusual journal entries processed late in the reporting period; and
- resistance to audit procedures.

These scenarios often give rise to ethical threats such as **self-interest, intimidation and familiarity threats**, which must be identified and addressed in accordance with the SAICA Code.



3.6. RISK ASSESSMENT RELATING TO FRAUD

3.6.1 Ongoing nature of fraud risk assessment

Fraud risk assessment is not limited to the planning stage. The auditor must continuously evaluate whether information obtained throughout the audit indicates the presence of fraud risk factors.

A key enhancement introduced by ISA 240 (Revised) is the recognition that fraud risk assessment is **not confined to the planning stage**. The auditor is required to continuously reassess fraud risks as new information emerges during the audit.

This reflects the reality that fraud indicators often arise only once substantive procedures are underway. Consequently, the audit strategy and audit plan may need to be revised in response to emerging fraud risks, reinforcing the importance of professional judgement throughout the engagement

3.6.2 Fraud risk factors

Fraud risk factors generally relate to:

- Incentives or pressures
- Opportunities

- Attitudes or rationalisations

The presence of fraud risk factors does not necessarily indicate fraud, but it increases the risk of material misstatement due to fraud.

3.6.3 Engagement team discussion

The engagement team must discuss:

- How and where the financial statements may be susceptible to fraud
- Possible management override of controls
- Risks relating to revenue recognition
- Fraud that occurred in prior periods



3.7. UNDERSTANDING THE ENTITY AND INTERNAL CONTROL

The auditor must obtain an understanding of:

- The entity's culture and ethical values
- Oversight by those charged with governance
- Whistleblower mechanisms
- Controls over journal entries and accounting estimates

Deficiencies in internal control relevant to the prevention or detection of fraud must be identified and evaluated.



3.8. IDENTIFYING AND ASSESSING FRAUD RISKS

The auditor must identify and assess risks of material misstatement due to fraud:

- At the financial statement level
- At the assertion level
- All fraud risks are treated as significant risks.

Mandatory presumptions

- There is a presumed risk of fraud in revenue recognition.
- There is always a risk of fraud relating to management override of controls.



3.9 RESPONDING TO FRAUD RISKS

3.9.1 Overall responses

Overall responses may include:

- Assigning more experienced staff
- Increasing supervision
- Incorporating unpredictability in audit procedures

3.9.2 Management override of controls

Management override of controls represents a **pervasive and unavoidable fraud risk**, irrespective of the strength of the control environment. ISA 240 (Revised) therefore requires auditors to perform specific procedures to address this risk in every audit engagement.

These procedures focus on areas where management is able to exercise discretion, including journal entries, accounting estimates and significant unusual transactions. The objective is not merely to detect errors, but to identify **intentional bias or manipulation** designed to misstate the financial statements.

In examinations, candidates are expected to explain **why** these procedures are required and to link them explicitly to the risk of fraudulent financial reporting, rather than listing procedures mechanically

3.9.3 Evaluation of audit evidence

The auditor must reassess fraud risks if new information emerges and consider whether sufficient appropriate audit evidence has been obtained.



3.10. FRAUD OR SUSPECTED FRAUD IDENTIFIED

When fraud or suspected fraud is identified, the auditor must:

- Obtain an understanding of the matter
- Evaluate management's response
- Determine the impact on the audit strategy
- Reconsider the reliability of management representations

Fraud that is quantitatively immaterial may still be **qualitatively material**, particularly if it involves senior management.



3.11. REPORTING AND COMMUNICATION

3.11.1 Communication with management and those charged with governance

Fraud or suspected fraud must be communicated on a timely basis, unless prohibited by law.

3.11.2 Key Audit Matters

Fraud-related matters that required significant auditor attention may give rise to Key Audit Matters and must be clearly described as such in the auditor's report.

3.11.3 Reporting to authorities

The auditor must determine whether there is a legal or ethical duty to report fraud to an external authority.

Effective communication of fraud-related matters is a critical component of the auditor's responsibilities. ISA 240 (Revised) emphasises timely communication with management and those charged with governance, recognising their oversight role in preventing and responding to fraud.

Fraud-related matters that required significant auditor attention may also result in **Key Audit Matters**, reinforcing transparency to users of the financial statements. In certain circumstances, auditors may have a legal or ethical duty to report fraud to external authorities, highlighting the intersection between auditing standards, corporate governance and public interest responsibilities