Court File No.: CV-11-431153-00CP

ONTARIO
SUPERIOR COURT OF JUSTICE

BETWEEN:

THE TRUSTEES OF THE LABOURERS' PENSION FUND OF CENTRAL AND EASTERN CANADA, THE TRUSTEES OF THE INTERNATIONAL UNION OF OPERATING ENGINEERS LOCAL 793 PENSION PLAN FOR OPERATING ENGINEERS IN ONTARIO, SJUNDE AP-FONDEN, DAVID GRANT and ROBERT WONG

Plaintiffs

- and -

SINO-FOREST CORPORATION, ERNST & YOUNG LLP, BDO LIMITED (formerly known as BDO McCabe Lo Limited), ALLEN T.Y. CHAN, W. JUDSON MARTIN, KAI KIT POON, DAVID J. HORSLEY, WILLIAM E. ARDELL, JAMES P. BOWLAND, JAMES M.E. HYDE, EDMUND MAK, SIMON MURRAY, PETER WANG, GARRY J. WEST, PÖYRY (BEIJING) CONSULTING COMPANY LIMITED, CREDIT SUISSE SECURITIES (CANADA) INC., TD SECURITIES INC., DUNDEE SECURITIES CORPORATION, RBC DOMINION SECURITIES INC., SCOTIA CAPITAL INC., CIBC WORLD MARKETS INC., MERRILL LYNCH CANADA INC., CANACCORD FINANCIAL LTD., MAISON PLACEMENTS CANADA INC., CREDIT SUISSE SECURITIES (USA) LLC and BANC OF AMERICA SECURITIES LLC

Defendants

Proceeding under the *Class Proceedings Act, 1992*

SUPPLEMENTAL MOTION RECORD OF THE PLAINTIFFS
(Motion For Leave – Part XXIII.1 of the *Securities Act*)

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Defendants

Proceeding under the *Class Proceedings Act, 1992*

SUPPLEMENTAL AFFIDAVIT OF ALAN MAK

I, Alan Mak, of the City of Toronto, in the Province of Ontario, MAKE OATH AND SAY:

1. I am a chartered accountant with Rosen & Associates Limited. I have knowledge of the matters set out below. Where that knowledge is based on information obtained from others, I have so indicated and believe that information to be true.

2. Rosen & Associates was asked by Siskinds LLP and Koskie Minsky LLP, counsel for the plaintiffs, to prepare a report regarding the financial reporting of Sino-Forest and the role of its auditors for the purpose of the motion for leave to assert the cause of action set out in part XXIII.1 of the *Ontario Securities Act.* That report was filed with the Court on March 2, 2012.

3. We have now been asked to provide an opinion on the contents of a presentation prepared in May 2011 by Josephine Man, a partner with Ernst & Young LLP. Attached and marked as **Exhibit "A"** is a copy of the report of Rosen & Associates dated May 4, 2012, which attaches that presentation.

4. I acknowledge that it is my duty to provide evidence in relation to this proceeding as follows:

   (a) To provide opinion evidence that is fair, objective, and non-partisan;

   (b) To provided opinion evidence that is related only to matters that are within my area of expertise; and,

   (c) To provide such additional assistance as the court may reasonably require to determine a matter in issue.

5. I acknowledge that the duty referred to above prevails over any obligation which I may owe to any party by whom or on whose behalf I am engaged.

6. I swear this affidavit in support of the Plaintiffs' motion for leave to amend the statement of claim in this action to assert the cause of action set out in part XXIII.1 of the *Ontario Securities Act*, and for no other or improper purpose.

SWORN before me at the City of Toronto, in the Province of Ontario, this 4th day of May, 2012.	)	
A Commissioner, etc. Serge Kalloghlian (LSUC #55557F)	)	Alan Mak

This is Exhibit "A" mentioned and referred to in the Affidavit of Alan Mak, sworn before me at the City of Toronto, in the Province of Ontario, this 4th day of May, 2012.

A Commissioner, etc.
Serge Kalloghlian
(LSUC#55557F)

Rosen & Associates Limited
Litigation and Investigative Accountants

Forensic Accounting
Business Valuation
Quantification of Damages
Public Accountants' Negligence

May 4, 2012

Privileged & Confidential

Siskinds LLP
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Attention: Messrs. A. Dimitri Lascaris, Michael G. Robb and Daniel Bach

Re: The Trustees of the Labourers' Pension Fund of Central and Eastern Canada et al v. Sino-Forest Corporation et al

I. INTRODUCTION

You have asked for our comments on a presentation that was prepared by Ernst & Young ("E&Y"), entitled "Audit challenges – Chinese companies", dated May 2011 (the "Presentation") and presented to the Canadian Chinese Professional Accountants Association ("CCPAA"). The Presentation, which is available on-line from the CCPAA's website[1], is attributed to Josephine Man, CA, a partner in E&Y's "China Market Group" and a member of the Sino-Forest engagement team.[2] A copy of the Presentation is attached to this report at **Appendix A**.

In particular, you have asked us to comment on whether and how the Presentation impacts the opinions that were expressed in our earlier report in this matter, dated March 2, 2012 (the "March 2012 Report"). The comments herein should be read in conjunction with the March 2012 Report.

[1] http://www.ccpaa.ca/Audit_Challenges-_English_May_2011.pdf
[2] See the September 28, 2010 E&Y engagement letter for Offering Memorandum services, sent to Mr. David Horsley, CFO of Sino-Forest.

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II. SUMMARY OF OUR COMMENTS

In our March 2012 Report, we raised concerns about E&Y's (and BDO McCabe Lo Limited) audits. We suspected deficiencies in planning the audits, particularly with respect to addressing internal control risks and the unusual manner in which timber transactions were conducted. We now know from the Presentation that E&Y was aware of the significant misstatement risks that were commonly encountered in auditing China-based companies.[3] Importantly, the Presentation virtually mirrors the risk factors that existed in Sino-Forest, such as extensive related party transactions, inappropriate revenue recognition and inventory control weaknesses. Being Sino-Forest's external auditor for several years, E&Y was obligated under Canadian generally accepted auditing standards ("GAAS") to plan and perform its 2007 through 2010 audits to reduce the risk of material misstatements flowing from these concerns.

Based upon currently available information, we believe that E&Y failed to modify its audits to take known audit risks into account. In the alternative, E&Y attempted to collect sufficient and appropriate evidence to mitigate its audit risks but was not able to do so. (Evidence regarding ownership, sales and purchases was not collected by the Independent Committee in its own investigation, likely because the necessary evidence does not exist.) In either case, E&Y failed to meet minimum Canadian GAAS requirements and should not have issued its unmodified ("clean") audit reports on Sino-Forest's financial statements for at least the years 2007 through 2010, inclusive.

III. EXCERPTS FROM THE PRESENTATION

The Presentation purports to outline "common challenges encountered [in] performing audits for China based companies listed in North America".[4] Issues noted in the Presentation include:

[3] As listed at page 4 of the Presentation and elaborated upon throughout.
[4] Page 4 of the Presentation.

A. Tone at the top: "weak internal control system", "intention to mislead and misdirect auditors."[5]

B. Audit implications: "Difficult to gather audit evidence", "off-book transactions."[6]

C. Related Party Transactions: "Audit risks/challenges...Fictitious transactions, Measurement of related party transactions, Completeness of related party transactions, Reliability of accounting records as a whole, Possibility of VIEs [variable interest entities] which is [sic] subject to consolidation."[7]

   "Possibility of related party transactions with no cash changing hands...high volume and value of transactions with individuals, Sales to related parties at very low prices or sales to unlisted companies at highly inflated prices, unusual transactions with related parties that have difficulty to understand commercial substance", "Failure to disclose...material transactions entered into with related parties."[8]

D. Inventory count and rollback: "inventory held at different locations throughout China with different inventory tracking systems."[9]

E. Revenue recognition: "Recognize revenue from sales before the related risk and rewards have been transferred to the buyers", "Special agreements where inventory and sales to suppliers are netted against one another", "Material revenue transactions with intercompany or related parties."[10]

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[5] Page 6 of the Presentation.
[6] Page 7 of the Presentation.
[7] Page 8 of the Presentation.
[8] Page 9 of the Presentation.
[9] Page 10 of the Presentation.
[10] Page 12 of the Presentation.

IV. ANALYSIS

We understand that Ms. Man is a partner in E&Y's Vancouver office, and she was a member of the firm's Sino-Forest engagement team. Hence, Ms. Man's comments are especially relevant in evaluating E&Y's performance of its Sino-Forest audits. Being a senior member of the firm and of the Sino-Forest audit team, Ms. Man's experience and knowledge ought to have been incorporated into the planning of the Sino-Forest audits.[11]

The comments in the Presentation also reflect the experience and knowledge of E&Y as a firm of auditors, and particularly those in its "China Market Group". Consequently, the Presentation reveals E&Y's understanding and awareness of the context in which audits of Chinese companies are conducted.

A. Understanding of the Audited Entity and Assessment of Misstatement Risks

According to the Canadian Institute of Chartered Accountants' ("CICA") Handbook at the relevant date, an auditor is obligated to become informed of the environment and internal control systems of an entity as part of conducting a GAAS audit:

> .002 *The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.* AUDIT EVIDENCE, Section 5300, requires the auditor to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. This Section requires the auditor to make risk assessments at the financial statement and assertion levels based on an appropriate understanding of the entity and its environment, including its internal control. THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, Section 5143, discusses the auditor's responsibility to determine overall

[11] See Section 5140.03 of the CICA Handbook – "Planning involves the engagement partner 1 (see paragraphs 5150.12 and 5150.21) and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process."

> responses and to design and perform further audit procedures whose nature, timing and extent are responsive to the risk assessments. The requirements and guidance of this Section are to be applied in conjunction with the requirements and guidance provided in other Sections. In particular, further guidance in relation to the auditor's responsibility to assess the risks of material misstatement due to fraud is discussed in THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, Section 5135. [JAN. 2006][12]

Acquiring such knowledge would include taking into account an auditor's general awareness of the client's industry as well as specific information about the client's business. The Presentation sets forth Ms. Man's, on behalf of E&Y, general knowledge about auditing China-based businesses. Presumably, the Presentation represents E&Y's accumulated knowledge and experience with China-based companies over an extended period of time.

Based upon the contents of the Presentation, Ms. Man's experience was directly relevant to the Sino-Forest situation. As set out in our March 2012 Report, common audit concerns included:

1. Extensive related party transactions, including challenges in identifying related parties and valuing transactions with Authorized Intermediaries and Suppliers[13];
2. Weak internal controls systems (including management intention to misdirect or mislead auditors)[14];
3. Inappropriate revenue recognition[15];
4. Netting purchases and sales (such as those involving Authorized Intermediaries and Suppliers to Sino-Forest)[16]; and,

[12] CICA Handbook Section 5141.002.
[13] See pages 24 - 29, and page 56 of the March 2012 Report
[14] See pages 32-43 and 51-52 of the March 2012 Report.
[15] See pages 54-56 of the March 2012 Report.
[16] See pages 21-23 and 54-56 of the March 2012 Report.

5. Difficulties verifying or tracking inventory assets.[17]

Each of the foregoing risks existed in Sino-Forest for the 2007 through 2010 fiscal years. Our March 2012 Report explains the related financial reporting concerns, and includes the overstatement of revenues, profits, operating cash flows and assets by Sino-Forest during the relevant period. The circular nature of Sino-Forest's timber transactions, the lack of external, third-party verifications and absence of cash flows are striking hallmarks for the "audit challenges" that are identified in the Presentation.

The significance of E&Y's awareness of these risks is that an auditor is obligated to plan and perform the audit to address those risks:

> .03 *In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level.* The overall responses and the nature, timing, and extent of the further audit procedures are matters for the professional judgment of the auditor. In addition to the requirements of this Section, the auditor also complies with the requirements and guidance in THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, Section 5135, in responding to assessed risks of material misstatement due to fraud. [JAN. 2006][18]

As set out in Section 5135 of the CICA Handbook, not only is an auditor required to obtain knowledge of the client's business and environment, according to Canadian GAAS, he (or she) is specifically obligated to act on such knowledge. Audit procedures must be planned and performed to address those risks of material misstatement. Sufficient and appropriate audit evidence must be collected and evaluated to form the audit opinion.

According to the Presentation, E&Y were aware of specific misstatement risks involved in auditing China-based companies, like Sino-Forest. Given the

[17] See pages 19-21 and 52-54 of the March 2012 Report.
[18] CICA Handbook Section 5143.03

concerns and risks, audit procedures ought to have been planned and performed to address those risks to dispel any concern that the annual financial statements could have been materially misstated.

The Independent Committee's investigation has not obtained objective evidence of Sino-Forest's inventory transactions. Hence, it is highly unlikely that crucial, corroborative evidence to address the known risks would have been available to E&Y even if it had attempted to collect such evidence.

Based upon the available information, we strongly suspect that E&Y did not plan and perform its audit to mitigate known environmental and corporate risks. In the alternative, E&Y attempted to modify its audit procedures and was frustrated in its effort to collect necessary evidence (because such evidence does not exist, as apparently determined by the Independent Committee's own investigation). In either case, E&Y fell short of minimum GAAS requirements and should not have issued its unmodified (clean) audit reports for the relevant years.

B. Auditor's Responsibilities With Respect to Detecting Fraud

In the slide entitled "Audit objective to keep in mind", E&Y states that audits "[d]o not aim to detect fraud, error, non-compliance with laws or regulations and other irregularities."[19] To the contrary, a GAAS-compliant audit is required to consider material misstatements due to fraud.

> ".021 An auditor conducting an audit in accordance with generally accepted auditing standards obtains reasonable assurance that the financial statements taken as a whole are free of material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and

[19] See page 5 of the Presentation.

> the fact that much of the audit evidence available to the auditor is persuasive rather than conclusive in nature."[20]

Fraud risk factors are supposed to be considered by auditors in planning and conducting GAAS audits. Examples of fraud risk factors, possible audit procedures to address the risk of material misstatement due to fraud and examples of circumstances that indicate the possibility of fraud are listed in the Appendices to CICA Handbook Section 5135 (attached at **Appendix B**).

The detection of misstatements as a result of fraud, and especially fraud perpetrated at the management level, may be more difficult. However, contrary to E&Y's view expressed in the Presentation that audits "do not aim to detect fraud", many audit procedures require that the possibility of fraud be considered. An auditor is required to obtain reasonable assurance that financial statements are free of material misstatement, whether caused by fraud or error. E&Y may suffer from a fundamental misunderstanding of its professional obligations.

[20] CICA Handbook Section 5135.021

V. RESTRICTIONS

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Respectfully submitted,

ROSEN & ASSOCIATES LIMITED

A.T. Mak

L.S. Rosen

Audit challenges – Chinese companies

May 2011

ERNST & YOUNG
Quality In Everything We Do

Presented by

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Ernst & Young Vancouver

- Ernst & Young, China Market Group in Vancouver is focused on providing professional services to China based companies public in North America.
- We are the auditors of the two largest China based listed companies by market capitalization on TSX.
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- Forestry and Wood Products
- Pharmaceutical
- Bio-Chemical
- Manufacturing
- Energy
- Agriculture
- Aquaculture

Seminar outline

Common challenges encountered performing audits for China based companies listed in North America:

- Two sets of accounting books and reliability of financial records
- Related party transactions
- Inventory count and rollback
- Revenue recognition
- Tremendous cash transactions

Audit objective to keep in mind

- Perform audit procedures to obtain reasonable assurance about whether the financial statements are free from material misstatement
  - Examine on a test basis
  - Do not aim to detect fraud, error, non-compliance with laws or regulations and other irregularities

Two sets of accounting records

- Mostly seen in privately-owned enterprises
  - Tone at the top: owner-manager situation
    - simple management structure, weak internal control system
    - intention to mislead and misdirect auditors
    - financial reporting vs. tax reporting
    - intend to understate sales and profit to avoid paying corporate income tax
  - Usually official sales/purchase invoices are not issued
    - Official VAT sales/purchase invoices have to be purchased from and registered with the PRC tax bureaus

Two sets of accounting records (cont'd)

- Audit implication
  - Difficult to gather audit evidence
  - Completeness concern
  - Off-book transactions
  - Assessment of tax penalty and interest
    - Possible to negotiate tax penalty but it depends on whether the circumstance involve tax evasion or solely miscalculation of taxable profit
- How to put proper tax filings back on track?

Related party transactions

- Can be either individuals or corporations
- Can be customers, suppliers, service providers, contractors
- Rely to a large extent on management in identifying related parties
- Audit risks/challenge:
  - Fictitious transactions
  - Measurement of related party transactions
  - Completeness of related party transactions
  - Reliability of accounting records as a whole
  - Possibility of VIEs which is subject to consolidation

Related party transactions (cont'd)

- Possibility of related party transactions
  - transactions with no cash changing hands
  - high volume and value of transactions with individuals
  - Sales to related parties at very low prices or sales to unlisted companies at highly inflated prices
  - unusual transactions with related parties that have difficulty to understand commercial substance
- Failure to disclose
  - material contingencies involving related parties
  - material transactions entered into with related parties

Inventory count and rollback

- Inventory held at different locations throughout China with different inventory tracking systems
- Unsophisticated inventory count by management
- Incomplete historical inventory records
- Incomplete record of GRNs and GDNs or GRNs and GDNs not in sequential order
- Warehouse record does not reconcile with accounting record
- Third party inventories
- Inventory stored at third party locations
- Obsolete inventory

Inventory count and rollback (cont'd)

- Inventory rollback procedures for companies require 3 year audited financial statements for listing requirements
  - time consuming
  - good internal control required
  - lack of audit evidence
  - management's effort in keeping accounting or other related records

Revenue recognition

- Recognize revenue from sales before the related risk and rewards have been transferred to the buyers
- Sales by region/location is more than what's allowed by the annual quota/limit set out by the government for some regulated industries
- Exceptional high gross profit margin as compared to peers
- Domestic sales vs. export sales
- Record sales in other payables to avoid payment of tax
- Special agreements where inventory and sales to supplier are netted against one another
- Material revenue transactions with intercompany or related parties

Revenue recognition (cont'd)

- Red-flags
  - cash flow do not match with the increase in sales and purchases
  - e.g. recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
  - unusual increase in accounts receivable and sales ratio
  - rapid growth or unusual profitability, especially compared to that of other companies in the same industry
  - high turnover of customers
  - capacity of the company to meet the production and sales volume

Tremendous cash transactions (cont'd)

- Mostly seen situations
  - owner-manager enterprises - where all cash being kept on the owner's personal bank accounts
  - sales were conducted by way of cash transactions purposely by management
  - cash transactions to avoid paying tax
  - huge amount of petty cash
  - lack of approval / segregation of duties on cash management

Tremendous cash transactions (cont'd)

- Audit implication
  - transactions done in cash have no paper trail
  - lack of bank confirmations and anticipated difficulties in obtaining audit evidence
  - completeness of accounting record when cash transactions are going through personal accounts
  - misappropriation of assets

Case studies

China Forestry Case

- Background
- Case facts and audit related issues
- Risk indicators and fraudulent activities
- Audit implications
- Potential solutions

Case studies (cont'd)

Background of the Company

- Financed by large equity funds (Carlyle Group US$55M, January 2008; Switzerland-based Partners Group US$30M, June 2009)
- Raised US$216 million in a December 2009 listing on the Hong Kong stock exchange
- Auditors KPMG informed China Forestry's board of irregularities in the books in December 2010
- CEO and senior management team was replaced as a result
- Reported a loss for 2010 of 2.71 billion Yuan after drastically lowering the value of its plantation holdings, which is the company's chief asset
- Applied for suspension in trading shares on January 26, 2011

Case studies (cont'd)

Case facts and audit related issues

- Weak corporate governance
  - private-equity and other investors in emerging markets
  - regulatory and other standards often don't match those of developed markets
- Management always under pressure to deploy funds
- Inadequate/falsified audit evidences were provided to auditors
  - bank statements
  - inconsistent insurance-policy documentation
  - logging permits
  - forest ownership certificates

Case studies (cont'd)

Risk indicators and fraudulent activities

- Tremendous cash transactions
  - under management pressure, almost all of the sales were conducted by way of cash transactions
  - sales proceeds of such transactions have not been deposited into the Company's bank account
  - actual cash movement was concealed from the board

- Two sets of accounting records
  - more than one set of books were kept by the former CEO

Case studies (cont'd)

How to face such audit challenges?

- Cash and bank
  - auditors control the sending and receiving procedures for bank confirmations
  - suggest stronger internal control to management (i.e. appropriate authorized signatories for all transfer of funds; maintain funds with larger financial institutions)
  - physical site visit and if possible, conduct interviews, with major banks
- Obtain direct audit evidences from third party
  - government authorities
  - insurance companies re detail insurance policies
- Company background search

Case studies (cont'd)

Other cases in the U.S.

- China Century Dragon Media, Inc.
  - Discrepancies noted on customer confirmations and the auditors were unable to directly verify the company's bank records
- China Education Alliance, Inc.
  - consolidated revenue was $25 million while the financial statements of the company's main operating subsidiary filed with the Chinese authorities reported less than a million of revenue

Final words

- Due diligence on legal and accounting matters
- Evaluating the ability of the accounting and financial reporting team
- Potential business risk exposures include:
  - possible litigation
  - damage of reputation

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GENERAL ASSURANCE AND AUDITING
SECTION 5135
the auditor's responsibility to consider fraud

Additional Resources

This Section is harmonized with International Standard on Auditing (ISA) 240, issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC), entitled "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

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INTRODUCTION

.001 The purpose of this Section is to establish standards and provide guidance on the auditor's responsibility to consider fraud and misstatements arising therefrom, in an audit of financial statements and other financial information. [1] This Section also expands on how the standards and guidance in the following Sections are to be applied in relation to the risks of material misstatement due to fraud:

(a) MATERIALITY, Section 5142;

(b) PLANNING, Section 5150;

(c) UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, Section 5141; and

(d) THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, Section 5143;

The standards and guidance in this Section are intended to be integrated into the overall audit process. Additional guidance on material misstatements arising from the consequences of illegal acts is provided in MISSTATEMENTS — ILLEGAL ACTS, Section 5136. When performing procedures set out in this Section, the auditor is alert for indications that illegal acts may have occurred.

.002 This Section:

(a) distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor:

  (i) misstatements resulting from misappropriation of assets; and

  (ii) misstatements resulting from fraudulent financial reporting;

(b) describes the respective responsibilities of those charged with governance and the management of the entity for the prevention and detection of fraud; [2]

(c) describes the inherent limitations of an audit in the context of fraud and sets out the responsibilities of the auditor for detecting material misstatements due to fraud;

(d) requires the auditor to:

  (i) maintain an attitude of professional scepticism, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance;

  (ii) perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud;

(iii) assess for the financial statements as a whole, and for relevant assertions relating to significant account balances or classes of transactions, the risks of material misstatement due to fraud; and, for those assessed risks that could result in a material misstatement due to fraud, to consider the design of the entity's related controls, including relevant control activities, and whether they have been implemented;

(iv) design and perform audit procedures to respond to the risk of management override of controls;

(v) determine overall responses to address the risks of material misstatement due to fraud at the financial statement level, consider the assignment and supervision of personnel, consider the accounting policies used by the entity and incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed;

(vi) determine responses to address the assessed risks of material misstatement due to fraud;

(vii) consider whether an identified misstatement may be indicative of fraud;

(viii) obtain written representations from management relating to fraud; and

(ix) communicate with management and the audit committee or equivalent and provide guidance on communications with regulatory and enforcement authorities;

(e) requires members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud, and requires the engagement partner to consider which matters are to be communicated to members of the engagement team not involved in the discussion;

(f) provides guidance if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit;

(g) provides guidance when the auditor is responding to an enquiry from a proposed successor auditor; and

(h) establishes documentation requirements.

.003 *In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.* [JAN. 2006]

CHARACTERISTICS OF FRAUD

.004 Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

.005 The term "error" refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:

(a) a mistake in gathering or processing data from which financial statements are prepared;

(b) an incorrect accounting estimate arising from oversight or misinterpretation of facts; and

(c) a mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

.006 The term "fraud" refers to an intentional act by one or more individuals among management, other employees, those charged with governance or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, for the purposes of this Section, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion within the entity or with third parties outside the entity.

.007 Two types of intentional misstatements are relevant to the auditor: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether the misstatement is intentional or not.

.008 Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users. Fraudulent financial reporting may be accomplished by the following:

(a) manipulation, falsification (including forgery) or alteration of accounting records or supporting documentation from which the financial statements are prepared;

(b) misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information; and

(c) intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

.009 Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

(a) recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives;

(b) inappropriately adjusting assumptions and changing judgments used to estimate account balances;

(c) omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period;

(d) concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements;

(e) engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity; and

(f) altering records and terms related to significant and unusual transactions.

.010 Fraudulent financial reporting can be caused by the efforts of management to manipulate the entity's financial position or to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's creditworthiness or solvency, or performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing (see also ASSURANCE AND RELATED SERVICES GUIDELINE AuG-41, Applying the Concept of Materiality, for further guidance with respect to earnings management and misstatements).

.011 Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management, which is usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways, including:

(a) embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts);

(b) stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment);

(c) causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees); and

(d) using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

.012 Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target, particularly since the consequences to management for failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control. Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

RESPONSIBILITIES OF THOSE CHARGED WITH GOVERNANCE AND OF MANAGEMENT

.013 The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. The respective responsibilities of those charged with governance and of management may vary by entity, by jurisdiction, and according to the relevant statute and regulation. In some entities, the governance structure may be more informal, as those charged with governance may be the same individuals as management of the entity.

.014 It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a culture of honesty and ethical behaviour. Such a culture, based on a strong set of core values, is communicated and demonstrated by management and by those charged with governance, and provides the foundation for employees as to how the entity conducts its business. Creating a culture of honesty and ethical behaviour includes:

(a) setting the proper tone;

(b) creating a positive workplace environment;

(c) hiring, training and promoting appropriate employees;

(d) requiring periodic confirmation by employees of their responsibilities; and

(e) taking appropriate action in response to actual, suspected or alleged fraud.

.015 It is the responsibility of those charged with governance of the entity to ensure, through oversight of management, usually by the audit committee or equivalent, [3] that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Active oversight by the audit committee or equivalent can help reinforce management's commitment to create a culture of honesty and ethical behaviour. In exercising oversight responsibility, the audit committee or equivalent considers the potential for management override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

.016 It is the responsibility of management, with oversight from those charged with governance, to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes establishing and maintaining controls pertaining to the entity's objective of preparing financial statements that present fairly, in all material respects, the financial position, results of operations and cash flows in accordance with generally accepted accounting principles except in the circumstances referred to in reporting standard (iv) of GENERALLY ACCEPTED AUDITING STANDARDS, paragraph 5100.02, and managing risks that may give rise to material misstatements in those financial statements. Such controls reduce but do not eliminate the risks of misstatement. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular internal control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

INHERENT LIMITATIONS OF AN AUDIT IN THE CONTEXT OF FRAUD

.017 As described in AUDIT OF FINANCIAL STATEMENTS — AN INTRODUCTION, Section 5090, the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows in accordance with generally accepted accounting principles except in the circumstances referred to in reporting standard (iv) of GENERALLY ACCEPTED AUDITING STANDARDS, paragraph 5100.02. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with generally accepted auditing standards. For the reasons set out in paragraphs 5135.018-.020, the assurance an auditor provides concerning lack of misstatements arising from fraud is necessarily lower than the assurance provided concerning those arising from error. The nature and scope of a public sector audit relating to the detection of fraud may be affected by legislation, regulation, ordinances and ministerial directives. The terms of the mandate may be a factor that the public sector auditor needs to take into account when exercising judgment.

.018 The likelihood of not detecting a material misstatement resulting from fraud is higher than the likelihood of not detecting a material misstatement resulting from error, because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. The auditor may inform the audit committee or equivalent, in an engagement letter, that the audit will be performed in accordance with generally accepted auditing standards and that fraud may not be detected by the application of procedures that comply with these standards.

.019 Furthermore, the likelihood of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist in carrying out a fraud, with or without the employees' knowledge.

.020 The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with generally accepted auditing standards. This is particularly the case for certain kinds of intentional misstatements, since audit procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, the audit committee or equivalent, employees or third parties, or that involves falsified documentation. Whether the auditor has performed an audit in accordance with generally accepted auditing standards is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence.

RESPONSIBILITIES OF THE AUDITOR FOR DETECTING MATERIAL MISSTATEMENTS DUE TO FRAUD

.021 An auditor conducting an audit in accordance with generally accepted auditing standards obtains reasonable assurance that the financial statements taken as a whole are free of material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit evidence available to the auditor is persuasive rather than conclusive in nature.

.022 When obtaining reasonable assurance, an auditor maintains an attitude of professional scepticism throughout the audit, considers the potential for management override of controls and recognizes the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of material misstatement due to fraud. The remainder of this Section provides additional guidance on considering the risks of fraud in an audit and designing procedures to detect material misstatements due to fraud.

PROFESSIONAL SCEPTICISM

.023 The auditor plans and performs an audit with an attitude of professional scepticism in accordance with

AUDIT OF FINANCIAL STATEMENTS — AN INTRODUCTION, paragraph 5090.05, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Due to the characteristics of fraud, the auditor's attitude of professional scepticism is particularly important when considering the risks of material misstatement due to fraud. Professional scepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Professional scepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.

.024 *The auditor should maintain an attitude of professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.* [JAN. 2006]

.025 As discussed in UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, Section 5141, the auditor's previous experience with the entity contributes to an understanding of the entity. However, although the auditor cannot be expected to fully disregard past experience with the entity about the honesty and integrity of management and those charged with governance, the maintenance of an attitude of professional scepticism is important because there may have been changes in circumstances. When making enquiries and performing other audit procedures, the auditor exercises professional scepticism and is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. With respect to those charged with governance, maintaining an attitude of professional scepticism means that the auditor carefully considers the reasonableness of responses to enquiries of those charged with governance, and other information obtained from them, in light of all other evidence obtained during the audit.

.026 An audit performed in accordance with generally accepted auditing standards rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. Furthermore, the auditor may not discover the existence of a modification to the terms contained in a document, for example through a side agreement that management or a third party has not disclosed to the auditor. During the audit, the auditor considers the reliability of the information to be used as audit evidence, including consideration of controls over its preparation and maintenance where relevant. Unless the auditor has reason to believe the contrary, the auditor ordinarily accepts records and documents as genuine. However, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that the terms contained in a document have been modified, the auditor investigates further, for example, confirming with the third party or considering using the work of a specialist to assess the document's authenticity.

DISCUSSION AMONG THE ENGAGEMENT TEAM

.027 *Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.* [4] [JAN. 2006]

.028 UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, Section 5141, requires members of the engagement team to discuss the susceptibility of the entity to material misstatement of the financial statements. This discussion places particular emphasis on the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion includes the engagement partner, who uses professional judgment, prior experience with the entity and knowledge of current developments to determine which other members of the engagement team are included in the discussion. Ordinarily the discussion involves the key members of the engagement team and consideration is given to including specialists in the discussion. The discussion provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.

.029 *The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.* All of the members of the engagement team do not necessarily need to be informed of all of the matters covered in the discussion. For example, a member of the engagement team involved in audit of a component of the entity may not need to know the matters covered regarding another component of the entity. [JAN. 2006]

.030 The discussion occurs with a questioning mind, setting aside any beliefs that the engagement team members may have that management and the audit committee or equivalent are honest and have integrity. The discussion ordinarily includes:

(a) an exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated;

(b) a consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting;

(c) a consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;

(d) a consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation;

(e) a consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team;

(f) an emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud;

(g) a consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud;

(h) a consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed;

(i) a consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statements to material misstatement due to fraud, and whether certain types of audit procedures are more effective than others;

(j) a consideration of any allegations of fraud that have come to the auditor's attention; and

(k) a consideration of the risk of management override of controls.

.031 Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud is an important part of the audit. It enables the auditor to consider an appropriate response to the susceptibility of the entity's financial statements to material misstatement due to fraud and to determine which members of the engagement team will conduct certain audit procedures. It also permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, the engagement partner, having personally conducted the planning of the audit, considers the susceptibility of the entity's financial statements to material misstatement due to fraud.

.032 It is also important that after the initial discussion while planning the audit, and also at intervals throughout the audit, engagement team members continue to communicate and share information obtained that may affect the assessment of risks of material misstatement due to fraud or the audit procedures performed to address these risks. For example, for some entities it may be appropriate to update the discussion when reviewing the entity's interim financial information.

RISK ASSESSMENT PROCEDURES

.033 As required by UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, Section 5141, the auditor performs risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control. As part of this work the auditor performs the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud:

(a) makes enquiries of management, of the audit committee or equivalent, and of others within the entity as appropriate, and obtains an understanding of how the audit committee or equivalent exercises oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks;

(b) considers whether one or more fraud risk factors are present;

(c) considers any unusual or unexpected relationships that have been identified in performing analytical procedures; and

(d) considers other information that may be helpful in identifying the risks of material misstatement due to fraud.

Enquiries, and obtaining an understanding of oversight exercised by the audit committee or equivalent

.034 *When obtaining an understanding of the entity and its environment, including its internal control, the auditor should make enquiries of management regarding:*

(a) management's assessment of the risk that the financial statements may be materially misstated due to fraud;

(b) management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist;

(c) management's communication, if any, to the audit committee or equivalent regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) management's communication, if any, to employees regarding its views on business practices and ethical behaviour. [JAN. 2006]

.035 As management is responsible for the entity's internal control and for the preparation of the financial statements, it is appropriate for the auditor to make enquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls vary from entity to entity. In some public entities, management may make detailed assessments on an annual basis or as part of continuous monitoring, and disclose to the auditor and the audit committee or equivalent any fraud, whether or not material, that involves management or other employees who have a significant role in the entity's internal control. In other entities, management's assessment may be less formal and less frequent. In some entities, particularly smaller entities, the focus of the assessment may be on the risk of employee fraud or misappropriation of assets. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

.036 In a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity, thereby compensating for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because of the informal system of internal control. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

.037 When making enquiries as part of obtaining an understanding of management's process for identifying and responding to the risks of fraud in the entity, the auditor enquires about the process to respond to internal or external allegations of fraud affecting the entity. For example, a public entity may be required to establish procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. For entities with multiple locations, the auditor enquires about the nature and extent of monitoring of operating locations or business segments and whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist.

.038 *The auditor should make enquiries of management, internal audit, and others within the entity, as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.* [JAN. 2006]

.039 Although the auditor's enquiries of management may provide useful information concerning the risks of material misstatement in the financial statements resulting from employee fraud, such enquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making enquiries of others within the entity, in addition to management, may be useful in providing the auditor with a perspective that is different from management and those responsible for the financial reporting process. Such enquiries may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated. The auditor uses professional judgment in determining those others within the entity to whom enquiries are directed and the extent of such enquiries. In making this determination, the auditor considers whether others within the entity may be able to provide information that will be helpful to the auditor in identifying the risks of material misstatement due to fraud.

.040 The auditor makes enquiries of internal audit personnel, for those entities that have an internal audit function. The enquiries address the views of the internal auditors regarding the risks of fraud, whether during the year the internal auditors have performed any procedures to detect fraud, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any actual, suspected or alleged fraud.

.041 Examples of others within the entity to whom the auditor may direct enquiries about the existence or suspicion of fraud include:

(a) operating personnel not directly involved in the financial reporting process;

(b) employees with different levels of authority;

(c) employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees;

(d) in-house legal counsel;

(e) chief ethics officer or equivalent person; and

(f) the person or persons charged with dealing with allegations of fraud.

.042 When evaluating management's responses to enquiries, the auditor maintains an attitude of professional scepticism, recognizing that management is often in the best position to perpetrate fraud. Therefore, the auditor ensures that management's representations are not the sole source of evidence on the matters to which the enquiries relate. When responses to enquiries are inconsistent, the auditor seeks to resolve the inconsistencies.

.043 *The auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.* [JAN. 2006]

.044 Those charged with governance of an entity, in particular those with responsibility for oversight of the financial reporting process (usually the audit committee or equivalent), have oversight responsibility for systems for monitoring risk, financial reporting and compliance with the law. The audit committee or equivalent may play an active role in oversight of the entity's assessment of the risks of fraud, and of the internal control the entity has established to mitigate specific risks of fraud that the entity has identified. Since the responsibilities of the audit committee or equivalent and management may vary by entity and by jurisdiction, it is important that the auditor understand their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals. [5] The audit committee or equivalent includes management when management performs such functions, such as may be the case in smaller entities.

.045 Obtaining an understanding of how the audit committee or equivalent exercises oversight of management's processes for identifying and responding to the risks of fraud in the entity, and the internal control that management has established to mitigate these risks, may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of such internal control and the competence and integrity of management. The auditor may obtain this understanding by performing procedures such as attending meetings where such discussions take place, reading the minutes from such meetings or by making enquiries of the audit committee or equivalent.

.046 *The auditor should make enquiries of the audit committee or equivalent to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity.* [JAN. 2006]

.047 The auditor makes enquiries of the audit committee or equivalent in part to corroborate the responses to the enquiries from management. When responses to these enquiries are inconsistent, the auditor obtains additional audit evidence to resolve the inconsistencies. Enquiries of the audit committee or equivalent may also assist the auditor in identifying risks of material misstatement due to fraud.

Consideration of fraud risk factors

.048 *When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present.* [JAN. 2006]

.049 The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, when planning the audit, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Such events or conditions are referred to as "fraud risk factors". For example:

(a) the need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;

(b) the granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and

(c) an ineffective control environment may create an opportunity to commit fraud.

While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of the risks of material misstatement.

.050 Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the auditor exercises professional judgment in determining whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud.

.051 Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix A. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists: an incentive or pressure to commit fraud, a perceived opportunity to commit fraud, and an ability to rationalize the fraudulent action. Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix A cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist. The auditor also has to be alert for risk factors specific to the entity that are not included in Appendix A. The auditor does not assume that all three conditions must be observed or evident before concluding that there are identified risks. Although the risks of material misstatement due to fraud may be greatest when all three fraud conditions are observed or evident, the auditor does not assume that the inability to observe one or two of these conditions means there are no risks of material misstatement due to fraud. Not all of the examples in Appendix A are relevant in all circumstances, and some may be of greater or lesser significance in entities of different sizes, with different ownership characteristics, in different industries or because of other differing characteristics or circumstances.

.052 The size, complexity and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of the audit committee or equivalent, the internal audit function and the existence and enforcement of a formal code of conduct. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.

Consideration of unusual or unexpected relationships

.053 *When performing analytical procedures to obtain an understanding of the entity and its environment, including its internal control, the auditor should consider unusual or unexpected relationships that may indicate risks of material misstatement due to fraud. As part of risk assessment procedures, the auditor should perform analytical procedures relating to revenue.* [JAN. 2006 *]

.054 ANALYSIS, Section 5301, discusses the auditor's use of analytical procedures as risk assessment procedures, in performing substantive procedures and in evaluating the overall financial statement presentation at or near the end of the audit. When performing analytical procedures, the auditor uses his or her understanding of the entity and its environment, including its internal control, to identify meaningful relationships among various types of information. The auditor uses these relationships to form expectations for comparison with recorded amounts. When a comparison of those expectations with recorded amounts or with ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement due to fraud. Analytical procedures include procedures related to revenue accounts with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting. Examples of such indications are fictitious sales or significant returns from customers that might indicate undisclosed side agreements.

Consideration of other information

.055 *When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether other information obtained concerning the entity subject to audit indicates risks of material misstatement due to fraud.* [JAN. 2006]

.056 In addition to information obtained from applying analytical procedures, the auditor considers other information obtained about the entity and its environment that may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members described in paragraphs 5135.027-.032 may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

IDENTIFICATION AND ASSESSMENT OF THE RISKS OF MATERIAL MISSTATEMENT

.057 *When identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor should identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor should evaluate the design of the entity's related control, including relevant control activities, and determine whether they have been implemented.* [JAN. 2006]

.058 To assess the risks of material misstatement due to fraud the auditor uses professional judgment and:

(a) identifies risks by considering the information obtained through performing risk assessment procedures and by considering the classes of transactions, account balances and disclosures in the financial statements;

(b) relates the identified risks to what can go wrong at the assertion level; and

(c) considers the likely magnitude of the potential misstatement, including the possibility that the risk might give rise to multiple misstatements, and the likelihood of the risk occurring.

.059 It is important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud, because in designing and implementing such controls management may make informed judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. The auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties; this may often be the case in small entities where the owner provides day-to-day supervision of operations. Information from obtaining this understanding may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatements due to fraud.

Risks of fraud in revenue recognition

.060 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor ordinarily presumes that there are risks of fraud in revenue recognition and considers which types of revenue, revenue transactions or assertions may give rise to such risks. Those assessed risks of material misstatement due to fraud related to revenue recognition are significant risks to be addressed in accordance with paragraphs 5135.057 and 5135.061. Appendix B includes examples of responses to the auditor's assessment of the risk of material misstatement due to fraudulent financial reporting resulting from revenue recognition. If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor documents the reasons supporting the auditor's conclusion as required by paragraph 5135.113.

RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD

.061 *The auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and should design and perform further audit procedures* *whose nature, timing and extent are responsive to the assessed risks of material misstatement at the assertion level.* [JAN. 2006]

.062 THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, Section 5143, requires the auditor to perform substantive procedures that are specifically responsive to risks that are assessed as significant risks.

.063 The auditor responds to the risks of material misstatement in the following ways:

(a) a response that has an overall effect on how the audit is conducted (that is, increased professional scepticism and a response involving more general considerations apart from the specific procedures otherwise planned);

(b) a response to identified risks at the assertion level involving the nature, timing and extent of audit procedures to be performed; and

(c) a response to identified risks involving the performance of certain audit procedures to address the risks of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

.064 The response to address the assessment of the risks of material misstatement due to fraud may affect the auditor's professional scepticism in the following ways:

(a) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions; and

(b) increased recognition of the need to corroborate management explanations or representations concerning material matters.

.065 The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In such circumstances, the auditor considers the implications for the audit (see paragraphs 5135.089 and 5135.103).

Overall responses

.066 *In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should:*

(a) consider the assignment and supervision of personnel;

(b) consider the accounting policies used by the entity; and

(c) incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. [JAN. 2006]

.067 The knowledge, skill and ability of the individuals assigned significant engagement responsibilities are commensurate with the auditor's assessment of the risks of material misstatement due to fraud. For example, the auditor may respond to identified risks of material misstatement due to fraud by assigning additional individuals with specialized skill and knowledge, such as forensic and IT specialists, or by assigning more experienced individuals to the engagement. In addition, the extent of supervision reflects the auditor's assessment of risks of material misstatement and the competencies of the engagement team members performing the work.

.068 The auditor considers management's selection and application of significant accounting policies, particularly those related to subjective measurements and complex transactions. The auditor considers whether the selection and application of accounting policies may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

.069 Individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. Therefore, the auditor incorporates an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed. This can be achieved by, for example:

(a) performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk;

(b) adjusting the timing of audit procedures from that otherwise expected;

(c) using different sampling methods; and

(d) performing audit procedures at different locations or at locations on an unannounced basis.

Audit procedures responsive to risks of material misstatement at the assertion level

.070 The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing and extent of auditing procedures in the following ways:

(a) The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant, or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. Physical observation or inspection of certain assets may become more important, or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files. In addition, the auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by recording sales under sales agreements that include terms that preclude revenue recognition, or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with enquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

(b) The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement (for example, a misstatement involving improper revenue recognition) may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.

(c) The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

.071 If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

.072 The auditor may identify a risk of material misstatement affecting a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through planning the audit may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

.073 Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud are presented in Appendix B. The Appendix includes examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

Audit procedures responsive to risk of management override of controls

.074 As noted in paragraph 5135.019, management is in a unique position to perpetrate fraud because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. While the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and is a significant risk of material misstatement due to fraud. Accordingly, in addition to overall responses to address the risks of material misstatement due to fraud and responses to address the assessed risks of material misstatement due to fraud at the assertion level, the auditor performs audit procedures to respond to the risk of management override of controls.

.075 Paragraphs 5135.076-.082 set out the audit procedures required to respond to risk of management override of controls. However, the auditor also considers whether there are risks of management override of controls for which the auditor needs to perform procedures other than those specifically referred to in these paragraphs.

.076 *To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:*

(a) *test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;*

(b) *review accounting estimates for biases that could result in material misstatement due to fraud; and*

(c) *obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business for the entity or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.* [JAN. 2006]

Journal entries and other adjustments

.077 Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries throughout the year or at period end, or making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments and reclassifications. In designing and performing audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, the auditor:

(a) obtains an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments;

(b) considers the design of the controls over journal entries and other adjustments and determines whether they have been implemented;

(c) makes enquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(d) determines the timing of the testing; and

(e) identifies and selects journal entries and other adjustments for testing.

.078 For the purposes of identifying and selecting journal entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor considers the following:

(a) The assessment of the risks of material misstatement due to fraud
The presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.

(b) Controls that have been implemented over journal entries and other adjustments
Effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.

(c) The entity's financial reporting process and the nature of evidence that can be obtained
For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.

(d) The characteristics of fraudulent journal entries or other adjustments
Inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries:

(i) made to unrelated, unusual or seldom-used accounts;

(ii) made by individuals who typically do not make journal entries;

(iii) recorded at the end of the period or as post-closing entries that have little or no explanation or description;
(iv) made either before or during the preparation of the financial statements that do not have account numbers; or
(v) containing round numbers or consistent ending numbers.

(e) The nature and complexity of the accounts
Inappropriate journal entries or adjustments may be applied to accounts that:
(i) contain transactions that are complex or unusual in nature;
(ii) contain significant estimates and period-end adjustments;
(iii) have been prone to misstatements in the past;
(iv) have not been reconciled on a timely basis or contain unreconciled differences;
(v) contain inter-company transactions; or
(vi) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

(f) Journal entries or other adjustments processed outside the normal course of business
Non-standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

.079 The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. Because fraudulent journal entries and other adjustments are often made at the end of a reporting period, the auditor ordinarily selects the journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, the auditor considers whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting estimates

.080 In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. In reviewing accounting estimates for biases that could result in material misstatement due to fraud, the auditor:

(a) considers whether differences between estimates best supported by audit evidence and the estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor reconsiders the estimates taken as a whole; and

(b) performs a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. The objective of this review is to determine whether there is an indication of a possible bias on the part of management, and it is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

.081 If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor evaluates whether the circumstances producing such a bias represent a risk of material misstatement due to fraud. The auditor considers whether the cumulative effect of bias in management's accounting estimates is designed, for example, to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

Business rationale for significant transactions

.082 The auditor obtains an understanding of the business rationale for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit. The purpose of obtaining this understanding is to consider whether the rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. In gaining such an understanding the auditor considers:

(a) whether the form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties);

(b) whether management has discussed the nature of and accounting for such transactions with the audit committee or equivalent, and whether there is adequate documentation;

(c) whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;

(d) whether transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or equivalent; and

(e) whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

EVALUATION OF AUDIT EVIDENCE

.083 As required by THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, Section 5143, based on the audit procedures performed and the audit evidence obtained, the auditor evaluates whether the assessments of the risks of material misstatement at the assertion level remain appropriate. This is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor considers whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

.084 An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, information may come to the auditor's attention that differs significantly from the information on which the assessment of the risks of material misstatement due to fraud was based. For example, the auditor may become aware of discrepancies in accounting records or conflicting or missing evidence. Also, relationships between the auditor and management may become problematic or unusual. Appendix C contains examples of circumstances that may indicate the possibility of fraud.

.085 *The auditor should consider whether analytical procedures performed at or near the end of the audit* (see ANALYSIS, paragraph 5301.23) *when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud.* Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example, uncharacteristically large amounts of income being reported in the last few weeks of the reporting period from unusual transactions, or income that is inconsistent with trends in cash flow from operations. [JAN. 2006]

.086 *When the auditor identifies a misstatement, the auditor should consider whether such a misstatement is indicative of fraud, and if there is an indication of fraud, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.* [JAN. 2006]

.087 The auditor cannot assume that an instance of fraud is an isolated occurrence. The auditor also considers whether misstatements identified may be indicative of a higher risk of material misstatement due to fraud at a specific location. For example, numerous misstatements at a specific location, even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

.088 If the auditor believes that a misstatement is or may be the result of fraud, but the effect of the misstatement is not material to the financial statements, the auditor evaluates the implications, especially those dealing with the organizational position of the individual(s) involved. For example, fraud involving a misappropriation of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risks of material misstatement due to fraud, because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a non-management employee. Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor re-evaluates the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risk. The auditor also reconsiders the reliability of evidence previously obtained, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence.

.089 *When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should consider the implications for the audit.* MATERIALITY, Section 5142, provides guidance on the evaluation and disposition of misstatements and their effect on the auditor's report. [JAN. 2006]

MANAGEMENT REPRESENTATIONS

.090 *The auditor should obtain written representations from management that:*

- *(a) it acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud;*
- *(b) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;*
- *(c) it has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:*
  - *(i) management;*
  - *(ii) employees who have significant roles in internal control; or*
  - *(iii) others, where the fraud could have a non-trivial effect on the financial statements; and*
- *(d) it has disclosed to the auditor its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.* [JAN. 2006]

.091 It is important that, irrespective of the size of the entity, management acknowledge in writing its responsibility for internal control designed and implemented to prevent and detect fraud.

.092 Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud and its knowledge of actual, suspected or alleged fraud affecting the entity.

COMMUNICATIONS WITH MANAGEMENT AND THE AUDIT COMMITTEE OR EQUIVALENT

.093 *If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters to the appropriate level of management on a timely basis.* [JAN. 2006]

.094 When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management on a timely basis. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

.095 *If the auditor has identified any of the following matters, the auditor should communicate them to the audit committee or equivalent in accordance with COMMUNICATIONS WITH THOSE HAVING OVERSIGHT RESPONSIBILITY FOR THE FINANCIAL REPORTING PROCESS, Section 5751:*

- *(a) questions regarding the honesty and integrity of management;*
- *(b) fraud involving management;*
- *(c) fraud involving employees who have significant roles in internal control;*
- *(d) fraud (whether caused by management or other employees) that results, or may result, in a non-trivial misstatement of the financial statements; and*
- *(e) matters that may cause future financial statements to be materially misstated.* [JAN. 2006]

.096 The auditor's communication with the audit committee or equivalent is preferably in writing. COMMUNICATIONS WITH THOSE HAVING OVERSIGHT RESPONSIBILITY FOR THE FINANCIAL

REPORTING PROCESS, paragraph 5751.37, identifies factors that affect the auditor's decision whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving management and fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and considers whether it is necessary to also report such matters in writing. If the auditor suspects fraud involving management, the auditor communicates these suspicions to the audit committee or equivalent and also discusses with them the nature, timing and extent of audit procedures necessary to complete the audit.

.097 If the integrity or honesty of management is doubted, the auditor considers seeking legal advice when reporting thereon to the audit committee or equivalent.

.098 At an early stage in the audit, the auditor reaches an understanding with the audit committee or equivalent about the nature and extent of the auditor's communications regarding fraud that the auditor becomes aware of involving employees other than management that does not result in a material misstatement.

.099 *When reporting in accordance with INTERNAL CONTROL IN THE CONTEXT OF AN AUDIT — WEAKNESSES IN INTERNAL CONTROL, Section* 5220, *the auditor should make management and the audit committee or equivalent aware, as soon as practicable, and at the appropriate level of responsibility, of significant weaknesses* [6] *in the design or implementation of internal control to prevent and detect fraud that may have come to the auditor's attention.* [JAN. 2006]

.100 If the auditor identifies a risk of material misstatement of the financial statements due to fraud, which management has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgment there is a significant weakness in management's risk assessment process, the auditor includes such significant weaknesses in the communication to the audit committee or equivalent as set out in INTERNAL CONTROL IN THE CONTEXT OF AN AUDIT — WEAKNESSES IN INTERNAL CONTROL, Section 5220.

.101 When communicating other matters arising from the audit that in the judgment of the auditor are important and relevant to the audit committee, as required by COMMUNICATIONS WITH THOSE HAVING OVERSIGHT RESPONSIBILITY FOR THE FINANCIAL REPORTING PROCESS, paragraph 5751.27, the auditor considers, for example:

(a) concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated;

(b) a failure by management to appropriately address identified significant weaknesses in internal control;

(c) a failure by management to appropriately respond to an identified fraud;

(d) the auditor's evaluation of the entity's control environment, including questions regarding competence and integrity of management;

(e) actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability; and

(f) concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

In the public sector, the auditor may have additional communication responsibilities because of specific provisions of the audit mandate or related legislation or regulation.

COMMUNICATIONS TO REGULATORY AND ENFORCEMENT AUTHORITIES

.102 The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor may, in some circumstances, have a statutory duty to communicate certain matters to third parties, such as regulators (for example, in an audit of a federally regulated financial institution). The auditor considers obtaining legal advice if in doubt about his or her responsibility. For public sector auditors, written communications may be placed on the public record.

AUDITOR UNABLE TO CONTINUE THE ENGAGEMENT

.103 *If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor should:*

(a) consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit

appointment or, in some cases, to regulatory authorities;

(b) *consider the possibility of withdrawing from the engagement; and*

(c) *if the auditor withdraws:*

  (i) *discuss with the appropriate level of management and the audit committee or equivalent the auditor's withdrawal from the engagement and the reasons for the withdrawal; and*

  (ii) *consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.* [JAN. 2006]

.104 Such exceptional circumstances can arise, for example, when:

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

(b) the auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud;

(c) the auditor discovers a document that is not authentic; or

(d) the auditor has significant concern about the competence or integrity of management or the audit committee or equivalent.

.105 Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of the audit committee or equivalent (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

.106 Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others. In the public sector, the responsibilities of the auditor are usually set out in legislation and the auditor may not have the option to withdraw from the engagement.

COMMUNICATION WITH A PROPOSED SUCCESSOR AUDITOR

.107 *On receipt of an enquiry from a proposed successor auditor, the existing auditor should advise whether there are any circumstances that should be taken into account that might influence the decision whether or not the proposed successor should accept the appointment. The existing auditor should refer to the relevant rules of professional conduct and any legal or regulatory requirements for guidance on this matter, including when fraud may be a factor in the change in auditors.* [JAN. 2006]

.108 The auditor may be contacted by a proposed successor auditor enquiring whether there are any circumstances that should be taken into account that might influence his or her decision whether or not to accept the appointment. The responsibilities of existing and proposed successor auditors are set out in relevant rules of professional conduct; however, the professional and legal responsibilities of each auditor may vary by jurisdiction.

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

DOCUMENTATION

.110 *The documentation of the auditor's understanding of the entity and its environment and the auditor's assessment of the risks of material misstatement required by UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, paragraph* 5141.123, *should include:*

(a) *the significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and*

(b) *the identified and assessed risks of material misstatement due to fraud at the financial statement* *level and at the assertion level.* [JAN. 2006]

.111 *The documentation of the auditor's responses to the assessed risks of material misstatement required by THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, paragraph* 5143.75, *should include:*

(a) *the overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and*

(b) *the results of the audit procedures, including those designed to address the risk of management override of controls and the risk of a material misstatement due to fraud caused by improper revenue recognition.* [JAN. 2006]

.112 *The auditor should document communications about fraud made to management, the audit committee or equivalent, regulators and others.* [JAN. 2006]

.113 *When 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 should document the reasons supporting his or her conclusion* (see paragraph 5135.060). [JAN. 2006]

.114 The extent to which these matters are documented is for the auditor to determine using professional judgment.

APPENDIX A

EXAMPLES OF FRAUD AND RISK FACTORS

The fraud risk factors identified in this Appendix are examples of such factors typically faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration — that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives / pressures, opportunities, and attitudes / rationalizations. 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. They do not necessarily indicate the existence of fraud. However, they are often present when fraud has occurred. Some of these factors will be present in entities in which specific conditions do not present a risk of material misstatement. Therefore, the auditor uses professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls or circumstances that mitigate or eliminate the risk. Fraud risk factors are discussed in paragraphs 5135.048-.052. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk factors relating to misstatements arising from fraudulent financial reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting:

Incentives / pressures

(a) Financial stability or profitability is threatened by economic, industry or entity operating conditions, such as (or as indicated by):

- (i) high degree of competition or market saturation, accompanied by declining margins;
- (ii) high vulnerability to rapid changes, such as changes in technology, product obsolescence or interest rates;
- (iii) significant declines in customer demand and increasing business failures in either the industry or the overall economy;
- (iv) operating losses making the threat of bankruptcy, foreclosure or hostile takeover imminent;
- (v) recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth;
- (vi) rapid growth or unusual profitability, especially compared to that of other companies in the same industry;
- (vii) new accounting, statutory or regulatory requirements.

(b) Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- (i) profitability or trend level expectations of investment analysts, institutional investors, significant creditors or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages;

(ii) need to obtain additional debt or equity financing to stay competitive (including financing of major research and development or capital expenditures);

(iii) marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements;

(iv) perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

(c) Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

(i) significant financial interests in the entity;

(ii) significant portions of their compensation (for example, bonuses, stock options and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position or cash flow; [1a]

(iii) personal guarantees of debts of the entity.

(d) There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

(a) The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

(i) significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm;

(ii) a strong financial presence, or ability to dominate a certain industry sector, that allows the entity to dictate terms or conditions to suppliers or customers, which may result in inappropriate or non-arm's length transactions;

(iii) assets, liabilities, revenues or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate;

(iv) significant, unusual or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions;

(v) significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist;

(vi) use of business intermediaries for which there appears to be no clear business justification;

(vii) significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

(b) There is ineffective monitoring of management as a result of the following:

(i) domination of management by a single person or small group (in a non-owner-managed business) without compensating controls;

(ii) ineffective oversight by those charged with governance over the financial reporting process and internal control.

(c) There is a complex or unstable organizational structure, as evidenced by the following:

(i) difficulty in determining the organization or individuals that have controlling interest in the entity;

(ii) overly complex organizational structure involving unusual legal entities or managerial lines of authority;

(iii) high turnover of senior management, legal counsel or those charged with governance.

(d) Internal control components are deficient as a result of the following:

(i) inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required);

(ii) high turnover rates or employment of ineffective accounting, internal audit or information technology staff;

(iii) ineffective accounting and information systems, including situations involving significant weaknesses in internal control.

Attitudes / rationalizations

(a) There is ineffective communication, implementation, support or enforcement by management of the entity's values or ethical standards, or communication of inappropriate values or ethical standards.

(b) Non-financial management participates excessively in or is preoccupied with the selection of accounting policies or the determination of significant estimates.

(c) There is a known history of violations of securities laws or other laws and regulations, or there are claims against the entity, its senior management or those charged with governance alleging fraud or violations of laws and regulations.

(d) There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.

(e) There is a practice by management of committing to analysts, creditors and other third parties to achieve aggressive or unrealistic forecasts.

(f) Management fails to correct known significant weaknesses in internal control on a timely basis.

(g) There is an interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.

(h) There is low morale among senior management.

(i) The owner-manager makes no distinction between personal and business transactions.

(j) There is a dispute between shareholders in a closely-held entity.

(k) There are recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.

(l) The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:

  (i) frequent disputes with the current or predecessor auditor on accounting, auditing or reporting matters;

  (ii) unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report;

  (iii) formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance;

  (iv) domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk factors relating to misstatements arising from misappropriation of assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives / pressures, opportunities, and attitudes / rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives / pressures

(a) Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

(b) Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

  (i) known or anticipated future employee layoffs;

  (ii) recent or anticipated changes to employee compensation or benefit plans;

  (iii) promotions, compensation or other rewards inconsistent with expectations.

Opportunities

(a) Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

(i) large amounts of cash on hand or processed;

(ii) inventory items that are small in size, of high value or in high demand;

(iii) easily convertible assets, such as bearer bonds, diamonds or computer chips;

(iv) fixed assets which are small in size, marketable or lacking observable identification of ownership.

(b) Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) inadequate segregation of duties or independent checks;

(ii) inadequate management oversight of employees responsible for assets (for example, inadequate supervision or monitoring of remote locations);

(iii) inadequate oversight of senior management expenditures, such as travel and other reimbursements;

(iv) inadequate job applicant screening of employees with access to assets;

(v) inadequate record keeping with respect to assets;

(vi) an inadequate system of authorization and approval of transactions (for example, in purchasing);

(vii) inadequate physical safeguarding of cash, investments, inventory or fixed assets;

(viii) a lack of complete and timely reconciliations of assets;

(ix) a lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns;

(x) a lack of mandatory vacations for employees performing key control functions;

(xi) inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation;

(xii) inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes / rationalizations

(a) There is a disregard for the need for monitoring or reducing risks related to misappropriation of assets.

(b) There is a disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.

(c) Behaviour indicates displeasure or dissatisfaction with the entity or its treatment of the employee.

(d) There are changes in behaviour or lifestyle that may indicate assets have been misappropriated.

(e) There is tolerance of petty theft.

APPENDIX B

EXAMPLES OF POSSIBLE AUDIT PROCEDURES TO ADDRESS THE ASSESSED RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. When applying this list of example procedures, it is important to consider them in light of the guidance contained in paragraphs 5135.070-.073, which elaborate on the need for judgment in deciding whether, and how, to design specific procedures relating to an assessed risk. The auditor exercises judgment to select the most appropriate procedures in the circumstances. These audit procedures identified may not be the most appropriate nor necessary in each circumstance. Also, the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the assertion level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect.

The following are specific examples of responses:

(a) Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.

(b) Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.

(c) Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization or seeking more or different information.

(d) Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.

(e) For significant and unusual transactions, particularly those occurring at or near year end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.

(f) Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.

(g) Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.

(h) When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.

(i) If the work of a specialist becomes particularly significant with respect to a financial statement item for which the risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the specialist's assumptions, methods or findings to be able to conclude on their reasonableness, or engaging another specialist for that purpose.

(j) Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments (for example, an allowance for sales returns) were resolved with the benefit of hindsight.

(k) Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.

(l) Performing computer-assisted techniques, such as data mining to test for anomalies in a population.

(m) Testing the integrity of computer-produced records and transactions.

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

Specific responses — misstatement resulting from fraudulent financial reporting

Examples of responses to the auditor's assessment of the risk of material misstatement due to fraudulent financial reporting are as follows:

Revenue recognition

(a) Performing substantive analytical procedures relating to revenue using disaggregated data; for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.

(b) Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements, and the basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts and cancellation or refund provisions often are relevant in such circumstances.

(c) Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.

(d) Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing), and performing other appropriate sales and inventory cutoff procedures.

(e) For those situations for which revenue transactions are electronically initiated, processed and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory quantities

(a) Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.

(b) Observing inventory counts at certain locations on an unannounced basis, or conducting inventory counts at all locations on the same date.

(c) Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.

(d) Performing additional procedures during the observation of the count; for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labelled, and the quality (that is, purity, grade or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard.

(e) Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparing quantities counted with perpetual records.

(f) Using computer-assisted audit techniques to further test the compilation of the physical inventory counts; for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management estimates

(a) Using a specialist to develop an independent estimate for comparison to management's estimate.

(b) Extending enquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific responses — misstatements due to misappropriation of assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

(a) counting cash or securities at or near year end;

(b) confirming directly with the customer the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit;

(c) analyzing recoveries of written-off accounts;

(d) analyzing inventory shortages by location or product type;

(e) comparing key inventory ratios to industry norm;

(f) reviewing supporting documentation for reductions to the perpetual inventory records;

(g) performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers;

(h) performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts;

(i) reviewing personnel files for those that contain little or no evidence of activity, for example, a lack of performance evaluations;

(j) analyzing sales discounts and returns for unusual patterns or trends;

(k) confirming specific terms of contracts with third parties;

(l) obtaining evidence that contracts are being carried out in accordance with their terms;

(m) reviewing the propriety of large and unusual expenses;

(n) reviewing the authorization and carrying value of senior management and related party loans;

(o) reviewing the level and propriety of expense reports submitted by senior management.

APPENDIX C

EXAMPLES OF CIRCUMSTANCES THAT INDICATE THE POSSIBILITY OF FRAUD

As described in paragraph 5135.084, the auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud. The circumstances listed below are only examples, and in some cases other factors and circumstances may be present that mitigate or eliminate the possibility of fraud:

Discrepancies in the accounting records, including:

(a) transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification or entity policy;

(b) unsupported or unauthorized balances or transactions;

(c) last-minute adjustments that significantly affect financial results;

(d) evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties;

(e) tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

(a) missing documents;

(b) documents that appear to have been altered;

(c) unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist;

(d) significant unexplained items on reconciliations;

(e) unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues;

(f) inconsistent, vague or implausible responses from management or employees arising from enquiries or analytical procedures;

(g) unusual discrepancies between the entity's records and confirmation replies;

(h) large numbers of credit entries and other adjustments made to accounts receivable records;

(i) unexplained or inadequately explained differences between the accounts receivable records;

(j) missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement;

(k) missing inventory or physical assets of significant magnitude;

(l) unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies;

(m) fewer responses to confirmations than anticipated, or a greater number of responses than anticipated;

(n) inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

(a) denial of access to records, facilities, certain employees, customers, vendors or others from whom audit evidence might be sought;

(b) undue time pressures imposed by management to resolve complex or contentious issues;

(c) complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management;

(d) unusual delays by the entity in providing requested information;

(e) unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques;

(f) denial of access to key IT operations staff and facilities, including security, operations and systems development personnel;

(g) unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable;

(h) unwillingness to address identified weaknesses in internal control on a timely basis.

Other circumstances, including:

(a) unwillingness by management to permit the auditor to meet privately with the audit committee or equivalent;

(b) accounting policies that appear to be at variance with industry norms;

(c) frequent changes in accounting estimates that do not appear to result from changed circumstances;

(d) tolerance of violations of the entity's code of conduct.

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Footnotes

1. In this Section, "financial information" may be used in place of "financial statements".

2. AUDIT OF FINANCIAL STATEMENTS — AN INTRODUCTION, paragraph 5090.03, describes the terms "management" and "those charged with governance".

3. AUDIT OF FINANCIAL STATEMENTS — AN INTRODUCTION, paragraph 5090.03, describes the term "audit committee or equivalent". In this Section, this term is used to refer to those charged with governance who have specific responsibility for the oversight of the financial reporting process.

4. Sole practitioners consider these matters on their own and discuss difficult matters, if necessary, with a professional colleague or their professional association.

5. COMMUNICATIONS WITH THOSE HAVING OVERSIGHT RESPONSIBILITY FOR THE FINANCIAL REPORTING PROCESS, Section 5751, discusses with whom the auditor communicates when the entity's governance structure is not well-defined.

* Editorial change — August 2005.

6. Material weakness and significant weakness are synonymous concepts in the CICA Handbook – Assurance.

1a. Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

The Trustees of the Labourer's Pension Fund of Central and Eastern Canada, et al.
Plaintiffs

and

Sino-Forest Corporation, et al.
Defendants

Court File No: CV-11-431153-00CP

ONTARIO
SUPERIOR COURT OF JUSTICE

Proceedings Under the *Class Proceedings Act, 1992*

Proceeding commenced at **Toronto**

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SUPPLEMENTARY MOTION RECORD OF THE PLAINTIFFS (Motion for Leave – Part XXIII.1 of the *Securities Act*)

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