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# Considering fraud in a financial statement audit : practical guidance for applying SAS no. 82;

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# Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82

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Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82

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*Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* presents the views of the author and others who helped in its development. This publication has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants. Therefore, the contents of this publication, including recommendations and suggestions, have no official or authoritative status.

# **Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82**

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## PREFACE

This practice guide has been published to provide guidance in implementing Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*. This practice guide has been issued by the Accounting and Auditing Publications group of the American Institute of Certified Public Accountants and is intended to provide practitioners with *nonauthoritative* practical guidance on considering fraud in financial statement audits.

The contents of this publication, its focus, and the way it has been presented, have been shaped by the feedback received from practitioners during the development of SAS No. 82. Through comment letters and question and answer sessions conducted at national seminars and on the Accountants Forum, practicing auditors provided suggestions and recommendations for making the guidance in the statement easier to understand and implement.

By its very nature, a statement on auditing standards can establish only a base point from which you conduct your audits. How you apply the standard to the specific facts and circumstances of your clients depends on professional judgment. *The purpose of this book is to help you make informed professional judgments when you consider fraud in a financial statement audit.*

## ACKNOWLEDGMENTS

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# CONSIDERING FRAUD IN A FINANCIAL STATEMENT AUDIT

## Practical Guidance for Applying SAS No. 82

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*IMPLEMENTATION  
GUIDANCE*

*Part* **One**

## CHAPTER ONE:

# INTRODUCTION AND OVERVIEW OF SAS No. 82

**Organization of This Practice Guide** This practice guide is divided into three parts:

- **Part One: Implementation Guidance.** This section provides you with an in-depth understanding of SAS No. 82 by answering questions you may face in implementing the statement. It also includes a case study that illustrates many of the concepts discussed in this section.
- **Part Two: Industry-Specific Fraud Risk Factors and Guidance.** This section provides example risk factors for several specialized industries and (for some industries) suggested audit responses to fraud risk. It also includes example risk factors for small, privately owned businesses.
- **Part Three: Practice Aids.** This section provides several practice aids and examples, including: common fraud schemes and expanded audit procedures, sample workpaper documentation, and sample engagement and client representation letters.

This book is a *companion to but not a substitute for* reading the standard. The suggestions offered in this book are best understood when they've been read after reading SAS No. 82 and identifying the implementation issues unique to your engagements. With that in mind, the best way to use this book is:

*If you're implementing SAS No. 82 for the first time —*

- Read SAS No. 82 and highlight those areas that require further clarification or that pose implementation issues for your clients.
- Read Part One, which summarizes the requirements of the statement and provides answers to the most frequently-asked implementation questions.

*If you're using this book as an on-going reference source —*

- Use the questions and answers in Part One to respond to implementation issues as they arise.
- Use the list of specialized industry fraud risk factors in Part Two to help you tailor the fraud risk factors listed in SAS No. 82 to your clients in these particular industries.
- Use the list of typical fraud schemes and expanded audit procedures in Part Three to tailor your audit

programs in response to assessed risk of material misstatement due to fraud.

- Use the sample workpaper documentation and sample engagement and client representation letters in Part Three as ongoing reference tools.

## Background and Overview of SAS No. 82

In October 1987, the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission) recognized that fraud and its effects are the concern and responsibility of many parties, including management, boards of directors, internal auditors, and independent auditors. The Treadway Commission acknowledged that independent auditors cannot guarantee the accuracy or reliability of financial statements, but they also recognized that the role of the independent auditor can be enhanced — particularly with respect to fraudulent financial reporting. This challenge is ongoing.

In 1988 the Auditing Standards Board issued SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*. Since its issuance, the subject of fraud has continued to draw the interest of ever-growing constituencies. Independent auditors have been the target of litigation and criticism, some of which has emanated from the profession's process of self-examination. SAS No. 82 was issued to respond to these questions and criticism and to clarify that your role and responsibility in the detection of material misstatement in financial statements — whether caused by error or fraud — is central to an audit. The statement supersedes SAS No. 53 and it is effective for audits of financial statements for periods ending on or after December 15, 1997.

Basically, SAS No. 82 does two things. It:

- describes your responsibilities relating to fraud in a financial statement audit, and
- provides guidance on what you should do to meet those responsibilities.

***What are my responsibilities to detect fraud under SAS No. 82? How do these responsibilities differ from those under SAS No. 53?***

SAS No. 82 clearly states that you are responsible for planning and performing your audits to obtain reasonable

assurance about whether the financial statements are free of material misstatement. It makes no difference whether those misstatements are unintentional or intentional. You are responsible for planning and performing your audit to provide reasonable assurance about whether the financial statements are free of both types of material misstatement.

Your responsibilities relating to fraud are stated within the context of materiality to the financial statements taken as a whole. You are not responsible for detecting fraud per se, but for detecting material misstatements caused by fraud. You are not responsible for detecting immaterial misstatements caused by fraud.

You have always had the responsibility to detect material misstatement caused by fraud. These responsibilities have not changed with the issuance of SAS No. 82. What does change is performance — what's required of you to fulfill those responsibilities.

***How do I carry out my responsibilities under SAS No. 82? How do these performance requirements differ from those under SAS No. 53?***

SAS No. 82 requires you to perform the following:

- **Consider the presence of fraud risk factors.** Certain conditions (for example, a lack of an appropriate system of authorization and approval of transactions) often have been observed in circumstances where frauds have occurred. As an auditor, you should become familiar with these risk factors and be alert for their presence at your clients. SAS No. 82 provides examples of risk factors you may consider.
- **Assess the risk of material misstatement of the financial statements due to fraud.** SAS No. 82 requires you to make an assessment as to the risk of material misstatement due to fraud. This assessment is separate from but may be performed in conjunction with other risk assessments (for example, control or inherent risk) you make during the audit. The SAS also requires you to reevaluate your assessment if other conditions are identified during fieldwork.
- **Develop a response.** Based on your assessment of risk, SAS No. 82 requires you to develop an appropriate audit response. In some circumstances, your response may be that your existing audit procedures are

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sufficient to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud. In other circumstances, you may decide to extend your planned audit procedures.

- **Document certain items in the workpapers.** SAS No. 82 requires you to document evidence of the performance of your assessment of risk of material misstatement due to fraud. Your documentation should include risk factors identified as being present as well as your response to those risk factors.
- **Communicate to management.** If you determine that there is evidence that a fraud may exist you should apprise the appropriate level of management, even if the matter may be considered inconsequential. SAS No. 82 also requires you to communicate directly with the audit committee (or equivalent) if the matter involves fraud that would materially misstate the financial statements or fraud committed by senior management.

SAS No. 82 provides guidance on your communication about fraud to management, the audit committee (if applicable) and others, including those outside the entity.

The following example illustrates SAS No. 82's approach to considering the presence of risk factors, assessing the risk of material misstatement due to fraud, and developing a response.

*A Practitioner Speaks*

*When I was a supervisor we audited an electrical wholesaler with about \$1.8 million in sales. They had two locations — one here in town and a new one across the state. I stayed in town to do the audit at the main store, and we sent a staffer across state.*

*He came back after a week and I asked him if he found anything. He hadn't, which was good because we were under time pressure to finish the job. The cross-state store wasn't very big, and I didn't think there'd be any problems with it.*

*One of the first things I did was look at the general journal entries selected by the staff for testing and I noticed a big one — over \$100,000 debit to sales and a credit to accounts receivable. "To adjust the general ledger to the accounts receivable trial balance at the cross-state store" is how the description read. I asked the staff how an adjustment that significant would be necessary and he told me the store manager said they'd had some problems installing the accounting system at the new store.*

*Fine, I thought, since I was pretty sure that the receivables they still had on the books were valid. A little while later I was looking at the analytical procedures and noticed that the gross margin percentages at the cross-state store were quite a bit lower than the margins at the main store. The workpapers included the explanation, "Per store manager, prices were reduced at cross-town store in order to attract customers in a new location."*

*It wasn't until the next day that I started to figure out something was wrong. I was talking to the controller at the main store and I mentioned how it looked like there were a few problems at the cross-state store but they were working out. "I guess those price reductions you had earlier in the year really worked to attract new customers," I said. "Price reductions?" she said. "What price reductions."*

*They're a wholesale distributor — they don't have sales like you find in a retail store. Then we got to talking about the problems they had installing the accounts receivable system at the cross-state store. Turns out that was a lie, too.*

*That was enough to convince me something wasn't right, so we beat up those receivables, tracing payments back and forth from the subledger to the general ledger. One thing led to another, and to make a long story short, the manager at the cross-state store was stealing payments their customers made on account.<sup>1</sup> That's why the subledger was out of balance with the general ledger. To cover it up, he parked the debit in the sales account, which was why the gross margins didn't make sense. That \$100,000 misstatement was definitely material to the financial statements.*

In this example, the auditor (whether he realized it or not) detected the material misstatement due to fraud by following the approach described in SAS No. 82. First, during the course of the audit, certain information came to his attention that he identified as fraud risk factors or other conditions impacting his risk assessment. That information included: inadequate record keeping relating to accounts receivable at the remote location, unexplained reconciling items between the subledger and the general ledger, anomalies in expected financial statement relationships, and perhaps most importantly, inconsistencies in the explanations provided by management.

Once identified, the presence of these risk factors and other conditions caused the auditor to make an assessment that

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<sup>1</sup> See Part Three, Common Frauds and Extended Audit Procedures for examples of some typical schemes used to misappropriate customer payments.



“something wasn’t right.” The planned audit procedures were determined to be insufficient, so he extended his audit procedures until he was able to detect the material misstatement. To complete the procedures required by the SAS, he would need to document certain items in the workpapers and make sure he complied with the communication requirements of the SAS. These documentation and communication requirements are discussed in Part One, Chapter Two.

The example of the electrical wholesaler may leave you with the impression that an assessment of fraud risk occurs at a given point in time during the audit. This is *not* the case. The assessment of the risk of material misstatement due to fraud is a cumulative process. The first three steps in the process (identify risk factors, assess risk, develop a response) are repeated over and over again throughout the course of the audit, as relevant audit information comes to your attention.

In the example provided it was the accumulation of risk factors and other conditions, considered individually and in combination, that determined the auditor’s ultimate assessment of risk. Your assessment of the risk of material misstatement due to fraud is not a static assessment made at a given point in time. It is an evolving assessment that should be revisited repeatedly during your audit.

It’s worth noting that the electrical wholesaler example is based on an audit that occurred before the issuance of SAS No. 82. In this example, the auditor knew “something was wrong” and pursued that question until he had a satisfactory answer. In some respects, SAS No. 82 provides a structure or a more formal process for what “good” auditors do instinctively.

In addition, the above story illustrates some of the reasons why auditors may fail to detect material misstatements due to fraud. These reasons include:

- An over-reliance on inquiry as the only means of audit evidence. The staff accountant performed no procedures to corroborate the store manager’s explanations.
- A lack of awareness that some observed conditions may indicate a material fraud. The staff accountant was concerned only with adjusting the general ledger

to make it agree with the accounts receivable. He never considered that the discrepancy may indicate fraud.

- A tendency to look at current numbers in isolation from the past or other relevant information. The staff accountant failed to compare gross margin percentages and notice the fluctuation from the main store.
- Allowing time and budget pressures to influence audit procedures. In order to extend audit procedures and ferret out the misstatement, the audit team had to ignore time and budget pressures and do whatever was necessary to gather sufficient audit evidence.
- A lack of skepticism. Many auditors do not encounter material misstatements caused by fraud during the course of their career in public accounting, and it's possible that one's sensitivity to the existence of fraud can be dulled over time.

SAS No. 82 provides guidance to help you overcome these obstacles and meet your responsibilities relating to material misstatements due to fraud.

So how do the performance requirements of SAS No. 82 differ from those under SAS No. 53? Before the application of SAS No. 82 you were required to consider the presence of risk of material misstatement due to errors or irregularities and assess that risk as part of overall audit risk. You were also required to design and perform audit procedures appropriate for the assessed risk. The difference under SAS No. 82 is that you must specifically assess and respond to the risk of material misstatement due to fraud and you must assess that risk from the perspective of the broad categories listed in the SAS or different categories with the same substance. Additionally, under SAS No. 82, you must meet new documentation and communication requirements.

***What are management's responsibilities to prevent and detect fraud?***

The Treadway Commission noted the following:

"The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management — starting with the chief executive officer — sets the tone and establishes the financial reporting environment. . . To set the right tone, top management must identify and assess the factors that could lead to fraudulent financial reporting; all public companies should maintain internal controls that provide reasonable

assurance that fraudulent financial reporting will be prevented or subject to early detection — this is a broader concept than internal accounting controls.”

SAS No. 82 reiterates this concept by simply stating that “management is responsible for the prevention and detection of fraud.”

As part of your assessment of the risk of material misstatement due to fraud, SAS No. 82 requires you to make inquiries of your clients to obtain their understanding regarding the risk of fraud in the entity. The author suggests that you include with these inquiries a general discussion of management’s responsibilities for the detection and prevention of fraud. One of the benefits of emphasizing management’s role in preventing and detecting fraud may be your ability to make your clients aware of the business benefits of management oversight throughout the year versus reliance on the independent auditor at year-end. You may also make them aware that deficiencies in their efforts or attitudes relating to fraud may affect the nature, timing and extent of audit procedures and, ultimately, the audit cost. See Part One, Identifying Fraud Risk Factors for more information.

## **Managing the Expectation Gap**

As an auditor, one of your ongoing challenges is to manage the “expectation gap” between your responsibilities relating to fraud established by professional standards and what your clients and the users of financial statements perceive those responsibilities to be. One of the reasons SAS No. 82 was issued was to help auditors narrow this expectation gap. By articulating performance guidelines, the statement helps to assure that auditors more consistently implement, and are more sensitive to the need to exercise the professional skepticism required by, the SAS.

### ***Should I modify my engagement letters?***

When it comes to your responsibilities relating to fraud, you can best manage the expectation gap by educating your clients on the limits of your responsibilities for the detection of fraud. One way to accomplish this is to describe in your engagement letter (1) the fact that your audit is designed to provide reasonable assurance of detecting misstatements that would have a material effect

on the financial statements and that it's not designed to detect all fraud, and (2) that it is management's responsibility to prevent and detect fraud. See Part Three, Sample Engagement Letter for sample wording.<sup>2</sup>

## Characteristics of Fraud

SAS No. 82 contains several paragraphs (numbers 3 through 10) that describe the characteristics of fraud. Although they impose no requirements, they are important paragraphs because the more you know about the nature of fraud, the better equipped you will be to identify risk factors, assess the risk of material misstatement due to fraud, and develop an appropriate audit response.

Paragraph 6 of SAS No. 82 notes that fraud frequently involves the following: (a) a pressure or an incentive to commit fraud and (b) a perceived opportunity to do so. The statement stops short of saying what many fraud experts believe, namely that *both elements must be present for a fraud to be committed*.

SAS No. 82 draws a distinction between misstatements arising from fraudulent financial reporting and those arising from misappropriation of assets. The following example illustrates fraudulent financial reporting perpetrated by management. After presenting the example, the framework described in paragraph 6 will be used to analyze the fraud.

*FastTrack Savings & Loan was a rapidly growing, publicly traded financial institution. In the early 1980s, the institution doubled its assets and earnings for three consecutive years by acquiring smaller financial institutions and by instituting aggressive lending policies. Because of this rapid growth, the institution's stock price soared. In order to attract and retain the best available personnel, senior management compensation consisted principally of stock options, and base salary was tied to stock price.*

*The aggressive lending policies inevitably led to a large number of foreclosures, and after several years, the institution held a significant portfolio of foreclosed real estate assets on its books. These high levels of foreclosed real estate proved problematic.*

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<sup>2</sup> As this publication went to print, the AICPA Auditing Standards Board has approved an exposure draft of a proposed amendment to SAS No. 1, section 310, *Relationship Between the Auditor's Appointment and Planning*. The exposure draft, titled *Establishing an Understanding with the Client*, states that the auditor should establish an understanding with the client regarding services to be performed and this understanding should be documented in the working papers, preferably through a written communication with the client.

Stock analysts became concerned about the quality of the entity's assets and the institution's regulatory capital was eroded, pushing the entity close to violating their regulatory capital requirements.

The vice president in charge of real estate knew of a commercial real estate developer who was looking to finance a project. The vice president approached the developer with a proposition: If the developer agreed to buy foreclosed property from FastTrack, FastTrack would provide financing on the construction project and the foreclosed property at below-market terms. All other principal on the foreclosed property financing would be due when the developer sold the property. In addition, the vice president promised to take the property back if the developer could not sell it within three years. The developer agreed to the deal.

Under generally accepted accounting principles, the transaction should not have been accounted for as a sale.

The vice president recorded these transactions as sales. Although he was not familiar with the complex generally accepted accounting principles for real estate transactions, he did recognize that under FastTrack's normal accounting policies such a loan would not be approved because of the deferral of principal payments and the promise to take back the property. He realized his immediate goal of reducing the amount of foreclosed real estate reported on the institution's balance sheet. He also recognized a profit from the sale of the real estate and fee and interest income from the construction loan, which improved profitability.

Within a short period of time, these types of transactions became commonplace at FastTrack. Loans that were originated by the real estate department received special consideration and were not subject to the normal underwriting policies and procedures required of other loans. The institution's board of directors never questioned how the vice president was able to sell foreclosed properties so quickly. They merely congratulated him on a job well done.

The vice president took certain precautions to conceal the true nature of the transactions. All side agreements linking the loan approval to the sale of the real estate were made orally and never written down. The vice president required the developers to form two separate entities (usually partnerships), one to receive the loan funds and another to buy the property.

In this way, FastTrack was able to fraudulently and materially misstate its financial statements by misstating and overstating the composition of its assets and overstating its income and regulatory capital.

SAS No. 82 describes several characteristics of fraudulent financial reporting, two of which were present in the FastTrack example:

- The financial statements misrepresented certain transactions and intentionally omitted certain events and significant information.

- The entity intentionally misapplied accounting principles.

In the above example, the vice president had ample motivation to perpetrate his scheme. He had been directed to reduce the amount of foreclosed real estate assets, his compensation was linked to the entity's stock price, and the institution needed regulatory capital and profits to maintain its stock price levels. The vice president also perceived an opportunity to commit his fraud. He was at a high enough level in the organization that he was able to bypass established underwriting controls. The people to whom he reported exercised little if any oversight of his activities.

Note that both elements were necessary for the vice president to commit his fraud. Absent a motivation to commit the fraud — for example, continued high levels of profitability and regulatory capital, no pressure to increase sales of foreclosed property — he would have had no reason to devise and carry out such a scheme. If he didn't perceive he had the opportunity to commit the fraud (and get away with it) he never would have tried.

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***Key Point.*** *When assessing the risk of material misstatement due to fraud, some practitioners find it helpful to consider this framework of motivation and opportunity. Although not required by SAS No. 82, you might want to focus your audit attention on the areas where both a motivation and a perceived opportunity to commit fraud exists. Where both factors are present is usually where the greatest risk lies. (See Part One, Assessing the Risk of Material Misstatement Due to Fraud.)*

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***What level of assurance should I obtain that the financial statements are free of material misstatement due to fraud?***

SAS No. 82 very clearly states that you can obtain only reasonable assurance that material misstatements in the financial statements, including misstatements resulting from fraud, are detected. "Reasonable assurance" is a high threshold. But it is not absolute assurance.

When discussing your responsibilities for considering fraud, you may wish to discuss the difference between "reasonable" and "absolute" assurance with your client.

## CHAPTER TWO: APPLYING SAS No. 82

As an auditor, you have a responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, including material misstatements caused by fraud. In order to fulfill that responsibility SAS No. 82 requires you to:

- Consider the presence of fraud risk factors during all stages of the audit process.
- Based on the risk factors present, make an assessment of the risk of material misstatement due to fraud.
- Based on that assessment, develop an appropriate response.

SAS No. 82 also contains certain workpaper documentation and client communication requirements.

The purpose of this chapter is to provide you with suggestions and recommendations for implementing the guidance contained in SAS No. 82. It is organized according to the process described above.

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*Key Point.* Included as an appendix to this chapter is a comprehensive case study of a material fraud that was detected by independent auditors. This case study will be referred to frequently in this chapter to illustrate certain points so you may want to read it before continuing on with this chapter. Refer to Appendix A, *Internet Solutions Case Study*.

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### Identifying Fraud Risk Factors

To fulfill your responsibilities relating to fraud, begin by identifying the presence of fraud risk factors in your audit. As noted in SAS No. 82, risk factors do not necessarily indicate the existence of fraud, but they often have been observed in circumstances in which fraud has occurred.

*Am I required to consider all fraud risk factors listed in the SAS? How much flexibility do I have to develop fraud risk factors tailored to my clients?*

You are not required to consider all of the risk factors listed in the SAS as not all of these examples are relevant in all circumstances. You should use your professional

judgment in determining which example risk factors are relevant to your client. You *are required*, however, to consider fraud risk factor categories that embody the substance of the categories listed in paragraphs 16 and 18 of SAS No. 82. These categories are:

***Misstatements Arising From Fraudulent Financial Reporting***

- **Management's Characteristics and Influence over the Control Environment.** These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
- **Industry Conditions.** These involve the economic and regulatory environment in which the entity operates.
- **Operating Characteristics and Financial Stability.** These pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

***Misstatements Arising From Misappropriation of Assets***

- **Susceptibility of Assets to Misappropriation.** These pertain to the nature of an entity's assets and the degree to which they are subject to theft.
- **Controls.** These involve lack of controls designed to prevent or detect misappropriations of assets.

The detailed example risk factors listed in paragraphs 17 and 19 of SAS No. 82 are just that, a list of examples. They are meant to be generic or, in other words, they are geared to apply to many enterprises. Some of these may not apply to your client. For example, if your client is not a publicly held company, risk factors related to stock price would not apply. You are allowed flexibility in determining the specific risk factors that should be considered within each category. SAS No. 82 allows you to tailor the example fraud risk factors to your particular clients, as long as they encompass the substance of the broad categories described in paragraphs 16 and 18 of the statement.

***A Practitioner Speaks***

*In implementing SAS No. 82, we consider risk factors only in the broad sense listed in paragraphs 16 and 18. We're not getting bogged down in the details but instead, ask ourselves some general questions, like these below, that capture the substance of the SAS's fraudulent financial reporting risk factor categories:*

- *Are there pressures on management that might motivate them to commit fraudulent financial reporting?*



- Does management have the type of attitude or style that would allow them to commit and rationalize a fraud? What kind of culture do they create for their employees?
- Does the client operate in a rapidly changing, highly regulated, or deteriorating industry?
- Do the client's financial results contain anomalies that point to the possibility of fraud?
- Does the client engage in transactions conducive to fraud?

*We think these questions capture the essence of paragraph 16, and it's more meaningful for us and our staff to think in terms of the big picture. If we need further clarification — like what do we mean by “anomalies that point to fraud?” — we look to paragraph 17 of the SAS for examples.*

*That's how we consider the risk of fraudulent financial reporting, and we approach the risk of misappropriation of assets in the same way.*

While the implementation example noted above satisfies the requirements of SAS No. 82, it is the minimum allowed and may not be appropriate in all circumstances. Some circumstances may dictate the need to consider all or most of the risk factors in the SAS.

You may wish to tailor the example risk factors to smaller entities (see discussion below) or to clients in specific industries. For example, if you're auditing a real estate entity, you might include “aggressive or unrealistic real estate appraisal assumptions” as an indication that management has the attitude or style that might lead to fraudulent financial reporting. See Part Two for examples of risk factors tailored to specific industries and small, privately owned businesses.

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**Key Point.** *Even though you are allowed flexibility in determining which risk factors to consider, use caution when deciding that some of the risk factors listed in the SAS do not apply. Expect questions to be raised if a material misstatement due to fraud is discovered in your client's financial statements and several of the example fraud risk factors listed in SAS No. 82 were identified during the course of your audit, but you decided not to consider them as possible indicators of fraud.*

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**Application to Smaller Entities.** If you audit primarily smaller, privately held companies, it may be beneficial for

you to develop a list of risk factors tailored to those types of clients. Here are some suggestions for creating such a list.

**Internal Controls.** Small business entities often are characterized by internal control conditions that in larger entities would be considered fraud risk factors. For example, in a larger entity, the domination of management by a single individual is unusual and may be considered an indication of a higher risk of material misstatement due to fraud; in a smaller entity, this condition is normal and is much less useful as a barometer for measuring risk.

For that reason, when assessing the risk related to fraudulent financial reporting, auditors of small businesses typically focus on the *motivation* of management to fraudulently misstate their financial statements and other attitudes and characteristics that indicate a willingness to do so. Internal controls are considered in this context — as an indication of management’s attitude. When considering controls in your assessment of risk of material misstatement due to fraud, try to distinguish between control weaknesses that are understandable given the entity’s size and nature and those weaknesses that display an inappropriate attitude regarding internal control and the financial reporting process.

**Operating Characteristics.** In a small business entity, the financial performance of the company has a direct impact on the owner-manager. For that reason, risk factors described in SAS No. 82 as relating to the operating characteristics and financial stability of the entity may be considered as factors that affect management’s motivation to engage in fraudulent financial reporting. Specific examples of operating characteristics indicating that management may be motivated to fraudulently misstate their financial statements include:

- Threat of imminent bankruptcy or foreclosure
- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity
- Adverse consequences on significant matters if poor financial results are reported

**Motivation to Under-Report Income or Assets.** Be aware of situations in which management of a small business

entity may have the motivation to under-report income or assets. For instance, management may be motivated to inappropriately reduce income taxes. Also, you may become aware that the financial statements are to be used in situations in which the owner-manager may be motivated to misstate (under- or overstate) income or assets. For example, an owner-manager may be motivated to under-report income or assets to defraud a divorced spouse or a partner of his or her share of the profits or assets of the business or to convince a judge or arbitrator that the business has inadequate cash flow. You are not required to plan your audit to discover personal information (i.e., marital status) of the owner-manager. However, if you become aware of such information, you should consider it in your assessment of risk of material misstatement due to fraud.

**Risk Factors that Clearly Do Not Apply.** SAS No. 82 includes several risk factors that clearly do not apply to a non-public company. For example, risk factors relating to stock price or hostile takeovers need not be considered.

Part Two includes a list of example fraud risk factors tailored to small, privately held companies. If you decide to tailor such a list for your audit practice, you may want to —

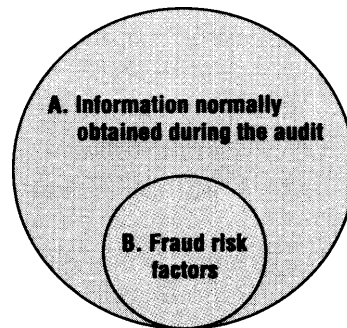
- Review and update the list regularly — don't let it become stale.
- Consider the example specialized industry risk factors listed in Part Two when making the list.
- Circulate the list among the staff and educate them as to its use.

***How actively should I seek out the presence of fraud risk factors? Do I need to change my existing audit approach just to seek out the risk factors listed in SAS No. 82?***

SAS No. 82 requires you to actively seek out the presence of fraud risk factor categories in paragraphs 16 and 18, or different categories with the same substance. To the extent that your existing audit process does not identify the existence of these categories of fraud risk factors, that process should be changed. As a practical matter, the application of SAS No. 22, *Planning and Supervision* and SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (as amended by SAS No. 78,

*Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*) should allow you to identify the broad categories of fraud risk factors listed in paragraphs 16 and 18 of SAS No. 82.

Paragraphs 17 and 19 of SAS No. 82 provide certain detailed examples of fraud risk factors you might consider. You probably already actively consider these items — they are merely a subset of all the information you should gather as part of performing an effective and efficient audit. The following diagram describes this relationship.



By highlighting the items in the smaller circle and labeling them “fraud risk factors,” SAS No. 82 serves to remind you that some of the information you consider during the course of the audit may indicate the presence of fraud. Use the list of fraud risk factors in the SAS (or your own tailored list) as a “memory jogger”, a reminder to be alert for and assess the risk of the possibility of material misstatement due to fraud.

In the Internet Solutions case study included as an appendix to this chapter, the auditor understood that the company was having cash flow problems (in spite of reported profits) and they were operating in a declining industry. Initially, this information was used to identify the auditor’s high risk audit areas. But the auditor also was aware that these items often are observed in circumstances involving fraud (that is, they were fraud risk factors). Because of this, he considered this

information from a second perspective, namely, as an indicator of possible fraud.

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**Key Point.** *In the Internet Solutions case study, the auditor initially could not draw any conclusions about the risk of material misstatement due to fraud based on the information known to him during planning. But assessments of risk relating to fraud are cumulative. Some of the information gathered during the planning phase of the audit should have been “flagged” by the auditor, stored in his mind as an indicator of possible fraud, and re-evaluated continually throughout the audit as other information became known.*

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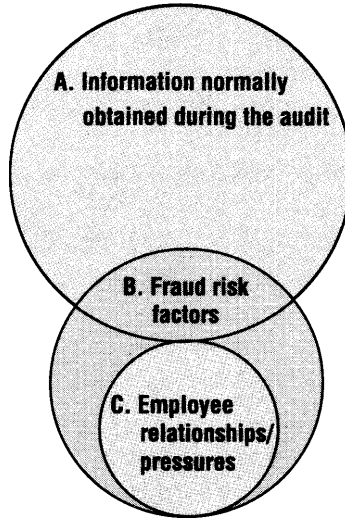
**Key Point.** *Fraud risk factors can be identified by any audit team member at any stage of the audit. For that reason, it’s important that all engagement members be properly trained to identify fraud risk factors when they’re present. Once identified, it’s also important for team members to communicate with each other to ensure these risk factors are considered when assessing risk.*

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**What about information related to financial stress of employees or adverse relationships between the entity and its employees? Are the items listed in paragraph 20 of SAS No. 82 fraud risk factors that I should actively consider?**

The examples listed in paragraph 20 of SAS No. 82 are important because they often have been observed in circumstances in which employees have misappropriated assets. However, you are *not required* to plan and perform your audit to discover this information. If you “stumble upon” this kind of information during the course of your audit, you should note it, consider its significance, and respond accordingly. However, you are not required to develop audit program steps specifically to obtain this information.

Expanding on the diagram presented previously, Area C represents the examples listed in paragraph 20. Note that it falls outside of the information normally gathered in an audit.



The following table summarizes the fraud risk factors listed in SAS No. 82 and your responsibilities as an auditor.

**TABLE 1**

<i>Paragraph(s)</i>	<i>Description</i>	<i>Auditor's Responsibilities</i>
16 and 18	Broad categories of risk factors	You must design your audit to assess risk within these risk factor categories or similar categories that embody the substance of those listed in SAS No. 82. If identified, they should be considered in your assessment of the risk of material misstatement due to fraud.

<i>Paragraph(s)</i>	<i>Description</i>	<i>Auditor's Responsibilities</i>
17 and 19	Detailed listing of example fraud risk factors	<p>These are examples to illustrate the broad categories of risk factors described in paragraphs 16 and 18. You may wish to tailor these examples for your particular client.</p> <p>They usually are a subset of information normally gathered to perform an effective and efficient audit.</p>
20	Information relating to employee relationships or pressures	<p>You are not required to plan your audit to detect these fraud risk factors.</p> <p>If you become aware of the presence of these risk factors during your audit, you must consider them when making your assessment of the risk of material misstatement due to fraud.</p>

***How can computers be used to fraudulently create material misstatements in the financial statements?***

Computerized frauds can be categorized as follows:

- **Input frauds.** Phony transactions are altered or added to the stream of data being processed. For example, input documents such as invoices are altered, forged, or falsified.
- **Throughput frauds.** These are the types of computer frauds that tend to be reported in the press. A computer “wizard” alters the programming to achieve some desired result. For example, a program that calculates interest earned on savings accounts at a bank is changed so that rounded amounts (fractions of pennies) are deposited into an account controlled by the computer programmer.
- **Output frauds.** Output reports, documents, or files are altered, suppressed or stolen. For example, an

exception report used for internal control purposes may be altered to conceal a defalcation.

In terms of the number of frauds committed (as opposed to their dollar amount) most computer frauds can be categorized as input frauds.

Believe it or not, computer technology has not significantly changed the *types* of frauds committed. For example, in the past, management may have overstated inventory by altering a manual record. Now, they may overstate inventory by entering false information into the electronic data processing system.

One thing that computer technology has changed is that the fraud perpetrator no longer needs physical access to certain documents and information. For example, in order to misstate the physical inventory count in a manual environment the perpetrator needs physical access to the count tags. In a computerized environment, he or she needs only *logical* access to the inventory information.

***Which of the risk factors in SAS No. 82 relate to the electronic data processing (EDP) system?***

SAS No. 82 does not contain a separate discussion on how computers are used to perpetrate fraud.

Technological considerations are an integral, not separate, part of the example fraud risk factors and the guidance on assessing and responding to the risk of material misstatement due to fraud. However, the following example risk factors most closely relate to EDP considerations:

- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process, including inadequate monitoring of significant controls. (This includes significant controls over computer processing activities.)
- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process, including management continuing to employ an ineffective information technology staff.
- Risk factors relating to controls, including a lack of appropriate segregation of duties or independent checks (which includes the computer processing functions).



The scope of this publication does not allow a detailed discussion of all the controls that should be present relating to your client's computer system. For a discussion of audit issues relating to EDP environments, you may wish to refer to the Auditing Procedure Study *Auditing in Common Computer Environments*, published by the AICPA (product no. 021059). This study focuses on the computer environments found in most companies today and describes the audit ramifications relating to microcomputers, end-user computing, local area networks, data bases and telecommunications.

The author's survey of reported computer frauds indicates the following conditions as being most prevalent in instances in which fraud has occurred:

- **Lack of adequate logical access control.** Many material frauds are committed because unauthorized people gain access to important data or programs. For this reason, companies should take steps, such as program password control, to limit logical access. Often, companies obtain access control software, but fail to install it or improperly install it so that it is easily bypassed.
- **Lack of independent checks over input and output.** Most computer fraud schemes involve altering input data to alter transactions or enter fraudulent transactions. Therefore, controls to verify the validity of input data can reduce this risk of fraud. Independent checks and follow-up also should be made of computer output, including exception listings, error reports, and evidence of other controls performed automatically by the computer system.
- **Lack of proper segregation of duties.** Incompatible computer functions should be segregated. In some instances this may not be possible, particularly in an environment in which microcomputers are used by individuals who develop and execute the computer program (for example, a spreadsheet application) that generates the information used by that same individual. In those situations, other controls should be in place to reduce the risk of material misstatement due to fraud.

See Part Three, Common Frauds and Extended Audit Procedures for a discussion of common computer frauds and expanded audit procedures that may be performed

in response to assessed risk of material misstatement due to these types of frauds.

***What kinds of inquiries relating to fraud should I make of management?***

As part of your assessment of the risk of material misstatement due to fraud, paragraph 13 of SAS No. 82 requires you to make inquiries of your client to obtain *your client's* understanding regarding the risk of fraud in the entity.

The author suggests that you include with these inquiries a general discussion of management's responsibilities for the detection and prevention of fraud. Part Three, Sample Client Representation Letter provides an example written representation you may wish to obtain from your client relating to responsibility for fraud detection and prevention. If you choose to include this in your client representation letter, you should first discuss this with your client.

Paragraph 13 of SAS No. 82 also requires you to ask if management has any knowledge of fraud that has been perpetrated on or within the entity. The statement also provides examples of other matters that might be discussed, including:

- Whether there are particular subsidiary locations, business segments, types of transactions, account balances, or financial statement categories where fraud risk factors exist or may be more likely to exist, and
- How management may be addressing such risks.

The example inquiries provided in the statement presuppose that the client has an understanding of fraud risk factors and how to determine where the risk of fraud exists. This may not be true with your clients, in which case you may need to "educate" them on the importance of fraud risk factors and the characteristics of fraud.

Although not required by SAS No. 82, you may wish to present your discussion of fraud within the context of motivation and opportunity, as discussed in Part One, Characteristics of Fraud.

People who commit fraud tend to deliberate on their acts. Their first instance of fraud may be an impulsive action, but continual, material fraudulent acts require considerable thought by the perpetrator. They must think about how to commit the scheme and how to cover it up, and usually they have to develop a rationalization to justify their actions.

In the Internet Solutions case study presented in the Appendix to this chapter, Norman Wilder's first instance of fraudulent financial reporting is not completely premeditated — he decides to recognize revenue before the sale is completed. However, on some level he must have deliberated this action and concluded that his chances of getting caught were small. Later, he exploits this weakness in the system, designing an even bigger scheme and identifying the person most likely to help him commit fraud. He devises elaborate measures to conceal the fraud.

In making inquiries of clients regarding their understanding of the risk of fraud in their entity, you might invite them to think through the reasoning process of someone who wishes to commit fraud. Consider asking the following questions (which are not required by SAS No. 82 but are presented here merely as suggestions):

- If someone wanted to misstate the financial statements or misappropriate company assets, what would be the easiest way for them to do that without getting caught?
- What deviations from generally accepted accounting principles are most common in your industry? are most likely at your company?
- What are the weakest links in your company's internal controls?
- If segregation of duties is not always possible, what other controls are in place to reduce the risk that one person can perpetrate and conceal a fraud?
- How are non-routine transactions initiated, approved and processed by your accounting system?
- Which controls can be bypassed or overridden? Do you know of instances in which these controls were bypassed or overridden in the past?
- Which source documents are the easiest to access and forge?
- How could someone introduce a fake entry into the accounting system to conceal a defalcation?

As indicated in SAS No. 82, the information you gather will be more useful if you can focus your inquiries on particular types of transactions or account balances.

In addition to helping you assess the risk of material misstatement due to fraud, inquiries of management will help remind them of their responsibilities to prevent and detect fraud.

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**Key Point.** *“Management” is not just one person. Although not required by SAS No. 82, you should consider extending your inquiries to include personnel outside of the accounting department. In the Internet Solutions case study, inquiries made of the Director of Sales would have provided auditors with important information regarding the risk of material fraud at the company or perhaps disclosed the actual fraud.*

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**Application to Smaller Entities.** The smaller entity usually is more susceptible to misappropriation of assets than to fraudulent financial reporting. If this is true for your clients, focus your inquiries on defalcations. In doing so, try to avoid discussions of the personal traits and characteristics of individuals (like “I’d trust Helen with my life”) and focus instead on the duties and responsibilities of a specific job description. (For instance, “The store managers have responsibility for depositing and writing checks and reconciling the bank accounts for their stores.”) If your client describes a fraud committed against the entity, gather information about how the fraud was committed and concealed, what controls were bypassed, what controls the client might implement to ensure it doesn’t occur again, and how the fraud was eventually detected. Personal details about the individual who committed the fraud, though interesting, usually are less relevant for prevention and detection of further fraud.

***Should management’s responses to inquiries relating to fraud be documented in the client representation letter?***

Client representation letters confirm oral representations made to you during the audit and reduce the possibility of misunderstanding between you and your client. Representation letters are part of the evidential matter you obtain during the audit, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for your opinion on the financial statements.

SAS No. 82 does *not* require you to obtain written representation from management in response to inquiries relating to fraud. However, you may wish to do so, and Part Three, Sample Client Representation Letter contains example language you may choose to add to your representation letter.

### Assessing the Risk of Material Misstatement Due to Fraud

Before making your assessment of material misstatement due to fraud, remember that, as an independent auditor, you consider fraud within the context of materiality to the financial statements. You are concerned primarily with detecting material misstatements; your objective is not to detect fraud *per se*, but to detect material misstatement caused by fraud. Be sure to consider the question, “What is the risk that the fraud risk factor(s) observed indicates a *material* financial statement misstatement?” If you judge the risk of material misstatement to be minimal and the planned audit procedures sufficient to obtain reasonable assurance about the absence of a material fraud, then there’s no reason to consider the matter further.

The following example illustrates an auditor’s consideration of an identified risk factor.

#### *A Practitioner Speaks*

*We had a client — a medium-sized manufacturer — who sold a warehouse to an affiliated company on December 31. The terms of the sale included an agreement to buy back the property in ten years. This is a fraud risk factor right out of SAS No. 82 — a significant related party transaction not in the ordinary course of business. Not only that, but by the time we came out to do the audit, the client still hadn’t gotten signed originals of all the documents.*

*To tell you the truth, we didn’t really spend a lot of time pondering the risk due to fraud. This was a big transaction. We needed to make sure we got the right answer.*

*The first thing I told the client was that we had to have signed original documentation. That was the easy part. I decided to also confirm the key terms of the agreement directly with the other company. If the sale had been an arms-length transaction, I probably wouldn’t have bothered with the confirmation, but in this case, I thought it would be a good idea.*

In this example the auditor considered whether the situation could lead to a *material* misstatement and decided that it could. He then considered and elected to perform additional audit procedures in response to the risk of material misstatement due to fraud.

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***Is the fraud risk assessment the same as the inherent and control risk assessment?***

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***Key Point.*** No. Your assessment of the risk of material misstatement due to fraud is a separate risk assessment, distinct from your assessment of inherent and control risk. It's true that many of the example fraud risk factors listed in SAS No. 82 are similar to the factors you consider when you assess inherent and control risk, and your assessment of risk of material misstatement due to fraud may be performed in conjunction with your inherent and control risk assessment. But it's a separate thought process. Thus, even if you assess inherent and control risk at the maximum, you still must consider fraud risk factors and assess the risk of material misstatement due to fraud. (This concept is articulated in footnote 6 of SAS No. 82.)

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In the Internet Solutions case study, the auditor became aware of industry conditions (declining market for the product) and client characteristics (cash flow problems and increasing receivables) and used this information to plan the audit. SAS No. 82 requires him to go one step further, to consider the presence of these fraud risk factors and ask himself the question, "Does the presence of these risk factors indicate the risk of a material misstatement due to fraud?"

***How should I evaluate the presence of risk factors to make an assessment of the risk of material misstatement due to fraud?***

SAS No. 82 gives you a lot of flexibility in evaluating the presence of risk factors to make an assessment of the risk of material misstatement due to fraud. Your thought process is a function of your experience, your knowledge of the client, and your professional judgment.

In making those judgments, keep in mind the following:

- There is not necessarily a one-to-one relationship between risk factors, an assessment, and a response. The presence of risk factors usually is not considered in isolation but rather in combination with other risk factors or mitigating circumstances at the client. For example, the presence of easily convertible assets, such as bearer bonds, represents a risk factor that may be mitigated by controls such as physical safeguards, adequate record keeping, and detailed independent review of such records.

- There is no requirement to label your assessment (as “high,” “medium,” or “low”, for instance). Rather, you assess whether certain circumstances, or risk factors, result in risk of material misstatement of the financial statements due to fraud. This assessment is *cumulative* (risk factors can be considered individually and in combination) and *continuous* (risk factors can be identified at any stage of the audit).

Although not required by SAS No. 82, you might consider the following approach when evaluating the presence of fraud risk factors.

#### *Look for Both Opportunity and Motivation*

Part One, Characteristics of Fraud points out that many fraud experts believe that in order for a fraud to occur, the perpetrator must have *both* the motivation to commit fraud and the perceived opportunity to do so. Absent one or the other, it’s much less likely a material fraud will be committed.

As an auditor, you might evaluate the risk factors you identify as providing either motivation or opportunity. (Note: SAS No. 82 does *not* categorize the risk factors in this way.) Focus your audit attention where you perceive both motivation and opportunity.

For example, in the Internet Solutions case study, the article indicated a number of risk factors that provided Norman Wilder with the *perceived opportunity* to commit a material fraud and get away with it, including:

- Mr. Wilder’s domination of management without effective compensating controls
- His excessive participation in the application of accounting principles for revenue recognition
- The retention of an ineffective accounting staff

Other risk factors pertain to Mr. Wilder’s *motivation* for committing a material fraud:

- An obsession with taking the company public, which was contingent upon the company meeting revenue and earnings growth projections
- A practice of committing to the outside board of directors to achieve unduly aggressive sales or revenue projections
- Significant pressure to obtain additional capital necessary to finance research and development

- Unrealistically aggressive (given the declining market for the company's product) sales programs

Analyzing these two categories of fraud risk factors side-by-side, you can see that they converge around the issue of revenue recognition. It's in the area of sales (more so than profitability) where Wilder had both the motivation and opportunity to commit a material fraud. For example, he might have misclassified long-term assets as current assets in order to improve the company's current ratio, or he might have intentionally understated the allowance for obsolete inventory. However, he had no motivation to commit these frauds, and they didn't happen.

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**Key Point.** *When considering the presence of fraud risk factors for the purpose of assessing risk, consider these risk factors independent of the person involved. Auditors sometimes let their personal relationship with the client or the client's personality influence their assessment of the risk of material misstatement due to fraud. "My client isn't the type of person who'd commit fraud," is not a sufficient reason for concluding that the risk of material misstatement due to fraud does not exist. When considering the fraud risk factors present at the client, try to be as objective as possible; consider the position (controller, president, owner) and not the person (my golfing buddy Harry).*

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The assessment of the risk of material misstatement due to fraud is more of an art than a science, and for that reason, the process of making that assessment is difficult to describe. One auditor offers the following:

*[When considering the risk of material misstatement due to fraud] the auditor absorbs information, organizes it in some meaningful way, and then sees what the pattern looks like. The patterns to look for are the exceptions and oddities, the things that do not seem to fit in an organized scheme of things because they seem too large, too small, too frequent, too rare, too high, too low, too good to be true, too extraordinary, too many, too few; they involve odd times, odd places, odd hours, odd people, and odd combinations. In a word, the auditor looks for the unusual rather than the usual.<sup>3</sup>*

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<sup>3</sup> Jack Bologna, *Handbook on Corporate Fraud* (Stoneham, MA: Butterworth-Heinemann, 1993).



Several of the example fraud risk factors listed in SAS No. 82 are included to help you identify the unusual. In the case of Internet Solutions, the auditor noted:

- The company's inability to generate cash flows from operations while reporting earnings and earnings growth
- Unusually rapid growth or profitability when compared with that of other companies in the same [in this case declining] industry

**Application to Smaller Entities.** When assessing the risk of material misstatement due to fraud at a smaller entity, it is important to pay particular attention to the motivation of the owner-manager to commit fraudulent financial reporting. In many instances, management of small, privately held companies has little motivation to intentionally and materially misstate the entity's financial statements. However, notable exceptions to this general rule include:

- An interest by management to pursue inappropriate means to minimize reported earnings for tax-motivated reasons
- Debt covenants that are difficult to maintain
- Adverse consequences on significant pending transactions (for example, a contract award, the loss of bonding, or the sale of the business) if poor financial results are reported.

You should also be alert for adverse consequences on significant pending transactions if *good* financial results are reported. For example, if the financial statements of the entity will be used in a divorce proceeding, the owner-manager may be motivated to under-report the earnings, cash flow or assets of the company in order to reduce the amount awarded to the spouse.

Absent these or other risk factors that would motivate an owner-manager to fraudulently misstate the financial statements, the risk of a material misstatement due to fraudulent financial reporting in a small entity usually is addressed adequately by typical audit procedures.

When considering internal controls for a small business entity, try to distinguish between control weaknesses that are understandable given the entity's size and

nature and those weaknesses that display an inappropriate attitude regarding internal control and the financial reporting process.

A lack of controls due to management's improper attitude may indicate a willingness to commit fraudulent financial reporting. For example, if your client exhibits a total disdain for internal controls, you may consider this a risk factor for fraudulent financial reporting.

On the other hand, a lack of controls due mainly to the nature of the client (for example, too few employees to have a sufficient segregation of duties) does not usually increase the risk of fraudulent financial reporting. It does, however, leave the company vulnerable to misappropriation of assets.

***When assessing the risk of material misstatement due to fraud, how should I determine materiality?***

Fraudulent financial statements are intended to deceive financial statement users. Therefore, such fraud is almost always material. Otherwise it wouldn't have the desired effect.

Issues relating to materiality judgments usually are more problematic when they relate to misappropriation of assets. Consider the following example:

*XYZ is a retail department store. At year-end, the inventory records are adjusted to the physical count. Invariably, a certain amount of "shrinkage" is present, which flows through cost of goods sold. In the client's industry, 1.5% to 2.0% shrinkage is considered normal.*

In the above example, suppose the physical count revealed a discrepancy significantly in excess of normal amounts and cost of goods sold was adjusted to reflect the significant shrinkage. Is the auditor required to extend procedures to determine how much of the shrinkage was caused by theft?

SAS No. 82 provides no specific guidance on this question. Your response will be based on judgment and on the specific facts and circumstances of each situation.

Many practitioners argue that, in the above example, the theft of inventory truly is a cost of goods sold. One could argue that if the balance sheet and net income for the period are fairly stated, then it would be rare that a defalcation, "buried" inside another income statement line item, would be material to the financial statements taken as a whole.

Using this logic, some practitioners would choose *not* to extend their audit procedures in the above example.

However, don't be too quick in dismissing the possibility of extending your procedures. In the above example, the author believes an auditor should make a reasonable effort to determine the true cause of the shrinkage. That effort will be constrained by the time you have to devote to the issue and the quality of the available information, but as a client service matter, the issue is worth pursuing. If a good faith effort fails to provide a definitive answer, then consider the question, are the financial statements materially correct if a theft is "buried" in cost of goods sold? But don't answer this question until you first make an effort to identify the possible fraud.

***What advice can you give me for assessing the risk of material defalcations?***

The previous discussion on motivation and opportunity works well for the risk assessment related to fraudulent financial reporting. It may not be quite as practical for assessing the risk related to defalcation, mainly because (1) defalcation often is committed by employees, which makes it difficult to consider fraud risk factors for all possible perpetrators, and (2) the motivation for defalcation (for example, stealing cash) applies to almost everyone (who wouldn't want some extra cash?), which makes the methodology ineffective for pinpointing areas of increased risk.

Based on the author's experience (again, this is *not* required by SAS No. 82), you might want to consider the following approach.

***Look for Evidence of Concealment***

In Part One, Background and Overview of SAS No. 82 an auditor provided a description of a material defalcation he detected at an electrical wholesale distribution company with two stores, the main store and the cross-state store. In this situation, the manager of the cross-state store stole payments from customers made on their account.

Think of a defalcation as a three step process:

- The fraud is committed. (The store manager stole the money.)
- The benefits to the fraud are realized. (The store manager converts the money to his personal use,

by depositing it into a checking account he controls and then spending the money.)

- The fraud is concealed. (In this case, the store manager tried to conceal his actions by lying to the auditors. Alternatively, he might have tried to conceal it by adjusting the accounting records, for example recording credit memos for the money taken.)

As an auditor, it is unlikely that you will observe someone committing a fraud. In the example provided, the chances are slim that an auditor would ever observe an employee actually taking the money. It is also unlikely that you will recognize the benefits of the fraud that he or she realizes.

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*Key Point. When financial statements are materially misstated as a result of a misappropriation of assets, what you are most likely to observe are attempts to conceal the fraud.*

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Paragraph 25 of SAS No. 82 provides examples of conditions you may identify during field work that change or support your judgment regarding the assessment of risk of material fraud. Many of those items listed (particularly those regarding discrepancies in the accounting records and conflicting or missing evidential matter) often are present when a fraud is being concealed. In the electrical wholesaler example, the following were present:

- Significant unexplained reconciling items between the accounts receivable subledger and the general ledger
- Inconsistent, vague, and implausible responses from management arising from inquiries

The misappropriation of assets usually is concealed by entering a fake debit into the accounting system. When someone steals an asset, cash for example, the credit is obvious — cash no longer exists and the cash account must be credited. To conceal this theft, a corresponding debit must be entered into the system. Usually, this debit is to cost of sales or another expense account because these accounts are closed out at year-end and, unlike revenues, a debit to an expense account is less likely to draw attention.

False debits often are entered into the accounting system using a fictitious journal entry. In addition to the items listed in paragraph 25 of SAS No. 82, the following have been observed in situations involving fraudulent journal entries.

- Entries made by individuals who normally would not make such entries
- Entries that lack support
- Entries made to adjust receivables, payables, revenues or expenses without explanation
- Entries that don't balance

**Application to Smaller Entities.** Small companies usually are more susceptible to material misstatements caused by defalcations. Part Three, Common Frauds and Extended Audit Procedures provides a discussion of the common types of frauds for several audit areas as well as alternative audit procedures for these areas. Becoming familiar with these schemes will help you to better recognize a material misstatement caused by a defalcation of assets.

## Responding to The Assessed Fraud Risk

SAS No. 82 requires you to develop a response based on your assessment of the risk of material misstatement due to fraud. As with other risk assessments, the greater the risk, the more extensive your audit procedures need to be in order to obtain reasonable assurance that the financial statements are free of material misstatement. In some situations, your planned audit procedures may be sufficient, as in the following example:

*The ABC Partnership owns a mid-rise office building in Anytown. The primary asset of the partnership is the building, and the primary liability is the related mortgage. Revenues consist of rent income, and most of the expenses relate to building operations.*

*During the course of planning and performing the audit, the auditor concludes that there is not much risk of material misstatement due to fraud relating to the building. It is not susceptible to misappropriation, nor is it easy to fraudulently misstate the asset on the balance sheet or in the related notes. The audit fieldwork related to the mortgage (confirmation with the lender) is considered sufficient to detect any material misstatement.*

*A slightly higher risk is assessed for rental income receipts. However, as part of the planned audit procedures, the auditor performs analytical procedures of rental income, including a comparison of income recognized and cash deposits by month. The auditor also performs detailed tests of the rent roll, by*

*comparing the lease terms listed on the rent roll to original executed leases.*

*Based on the assessed risk of material misstatement due to fraud, the auditor believes that these procedures are sufficient to detect a material misstatement caused by fraud.*

In other situations, your planned audit procedures may not be sufficient, and you will need to extend them. For example, in the Internet Solutions case study, the auditor decided that his original sample size for reviewing shipping documents should be expanded, and that he should receive original documents for all accounts receivable confirmations received via fax.

***What are some specific responses I can take as a result of my assessment of risk of material misstatement due to fraud?***

Paragraphs 26 through 32 of SAS No. 82 provide guidance on how you might respond to your assessment of the risk of material misstatement due to fraud. These paragraphs impose no *requirements* on how to respond — they can't, because circumstances vary from audit to audit and you will need to develop a response that is most appropriate to your situation. Instead, these paragraphs of the statement provide examples for you to consider.

Your response to a risk assessment can fall into one of two categories: an overall response directed at the engagement level, or specific response directed to an account balance, class of transaction or assertion, or to a particular type of fraud (that is, fraudulent financial reporting or misappropriation of assets).

Part Three, Common Frauds and Extended Audit Procedures provides a description of typical frauds (both fraudulent financial reporting and misappropriation of assets) broken down by audit area. Also described are audit procedures that might be performed to specifically detect material misstatements caused by these frauds. If you identify fraud risk factors on your audits, consider whether they fit a pattern that might describe the typical frauds listed in Part Three. If they do, you might want to perform some of the suggested procedures to determine whether the financial statements are free of material misstatement due to fraud.

Much of the guidance provided in SAS No. 82 was followed by the auditor in the Internet Solutions case study in

response to his assessment of the risk of material misstatement due to fraud. For example:

- *Overall considerations* (paragraph 27 of SAS No. 82). During the planning of the audit, the auditor identified this engagement as one of high overall risk. In addition to the factors mentioned in the article, the fact that the company was preparing to go public also increased the audit risk in this engagement. Although not stated in the article, certainly under these situations the auditor would have carefully considered the assignment of personnel. CPA firms with a large pool of staff members would be apt to assign their best staff members to an engagement of this sort. In a smaller CPA firm where staffing options are limited, an engagement of this type probably would call for more active involvement of the partner.

During the course of the engagement, as other considerations came to the attention of the auditor and he began to revisit his assessment of the risk relating to fraud, he would have developed a more skeptical attitude in the assessment of audit evidence. His application of professional skepticism included: (1) re-thinking the nature and extent of documentation required to be examined to support sales and accounts receivable (Are faxed confirmation responses adequate? Did we look at enough shipping documents?); and (2) the decision to corroborate management's explanations with additional evidence (for example, the attempt to verify explanation that the shipping document discrepancy was an isolated mistake by examining a larger selection of documents).

- *Nature, timing and extent of procedures* (paragraph 28 of SAS No. 82). During the course of the audit, the auditor modified the nature and extent of planned audit procedures. These modifications were in response to the identification of fraud risk factors and other considerations that increased the assessed risk of material misstatement due to fraud.

It's also possible that many of the decisions regarding the nature, timing and extent of audit procedures were made during the planning phase of the audit. For example, at another, less risky client, the auditor

may have been inclined to perform substantive tests in advance of year end. In the Internet Solutions case study, because of the risk factors identified during planning, the auditor decided to perform the substantive audit procedures as of the balance sheet date rather than at an interim date.

- *Consideration at the Account Balance, Class of Transactions, and Assertion Level* (paragraph 29 of SAS No. 82). As fraud risk factors and other conditions were identified during the course of the audit, the auditor developed a response directed specifically toward accounts receivable. This included contacting major customers by phone to verify reported sales, including the presence of any side agreements with the client. Additionally, the auditor might have conducted interviews with sales personnel, who in this case would have informed the auditor of the material fraud.
- *Specific Responses — Misstatements Arising From Fraudulent Financial Reporting* (paragraph 30 of SAS No. 82). Once the auditor identified revenue recognition as an area that required a specific response, he applied the suggestions listed in paragraph 30 of SAS No. 82.

***How should the results of audit procedures be considered in assessing the risk of fraud? What should I do to assess the clearly inconsequential audit differences that are passed by the staff in the individual workpapers?***

SAS No. 82 requires you to consider, at the completion of the audit, whether the accumulated results of audit procedures and other observations affect your assessment of the risk of material misstatement due to fraud.

Audit differences (both booked and not booked by the client) are a source of information that can help you identify fraud risk factors. When reviewing audit differences use your list of fraud risk factors as a “memory jogger” to see if any are present that weren’t identified previously. (Remember, you’re not required to consider each adjustment individually — they may be, and in many cases are most effective when, considered in combination). If you do uncover the presence of fraud risk factors that were unnoticed before, you should reconsider your assessment of risk of material misstatement due to fraud and whether



your audit procedures were sufficient in light of that risk. If you believe your audit procedures were insufficient, additional tests should be performed.

On many engagements, the audit staff “passes” clearly inconsequential differences in the individual workpapers and never carries these forward to a proposed adjustments schedule or other workpaper where they can be reviewed by the engagement partner. These types of passed adjustments should be considered by someone on the audit team in the same way that proposed adjustments are considered. Keep in mind, however, that your focus is still on items that could lead to material misstatement.

### Detection of Fraud or Misstatements That May Be the Result of Fraud

#### *How should I respond when I detect errors that may be the result of fraud?*

Paragraph 35 of SAS No. 82 provides guidance on what to do when you determine that a misstatement is, or may be, the result of fraud. Note the key threshold of *is or may be*. You do not have to know for certain the misstatement is caused by fraud or even be able to say the misstatement is *probably* the result of fraud. The threshold established by this paragraph is considerably lower than “probable.”

In those instances in which a misstatement is or may be the result of fraud, and the effect is either material or can’t be determined, you are required to take the following steps.

- *Consider the implications for other aspects of the audit* (as described in paragraph 34 of SAS No. 82). One of the important points made in paragraph 34 is that you should evaluate the implications of the possible fraud, “especially those dealing with the organizational position of the person(s) involved.” In the Internet Solutions case study, the possible fraud involved the highest levels of management in the company, which increases the risk the fraud could be widespread and material. On the other hand, as pointed out in the statement, a fraud involving a lower level employee usually is restricted, based on the functions performed by that employee. The person responsible for the petty cash fund could not commit a fraud the nature and magnitude of that committed by Norman Wilder of Internet Solutions. In some instances, determining that a misstatement is or may be the result of fraud may require you to

reconsider audit procedures previously performed and revisit a particular audit area (i.e., inventory) to perform additional procedures. You may need to reassign testing of this audit area to a more experienced staff or to a specialist.

- *Discuss the matter and your approach with the client.* SAS No. 82 states that these discussions should be conducted at a level that is at least one level above those involved. Again, if senior management is involved in a fraud, then you may have to consider the guidance contained in paragraph 36 of the statement relating to possible withdrawal from the engagement.
- *Attempt to obtain additional evidential matter.* If additional procedures are expected to be costly and time consuming, you probably should first discuss this with your client before proceeding.
- *If appropriate, suggest the client consult with legal counsel.* In the Internet Solutions case study, the auditor reached a point in which the indications of fraud were so strong, he had no choice but to recommend to the board of directors that they seek legal advice.

You may encounter situations in which you've identified an audit difference and proposed an adjustment but you are unable to determine whether the misstatement is caused by fraud and the client asks you to expand your procedures to try to come to a more definitive answer about whether fraud was involved. Or, once you've performed some procedures, you discover that a possible misstatement due to fraud would be immaterial to the financial statements yet your client expects you to "get to the bottom of it" anyway. In situations like these, you should take care to distinguish between procedures that are a part of a financial statement audit in accordance with generally accepted auditing standards (GAAS) and those that constitute a fraud examination. To help you distinguish between the two, the following table highlights some of the key characteristics of each type of engagement.

## Differences Between a GAAS Audit and a Fraud Examination

**TABLE 2**

	<i>GAAS Audit</i>	<i>Fraud Examination</i>
<b>Objective</b>	To obtain sufficient competent evidential matter to provide a reasonable basis for forming an opinion about the financial statements. Performed regularly.	To determine whether a fraud has or is occurring, and to determine who is responsible for the fraud. Performed only with sufficient basis that a fraud may have occurred.
<b>Reason for conducting the engagement</b>	Usually required by third party users of the financial statements.	Performed only with sufficient <i>predication</i> , that is, the totality of circumstances leads a reasonable, professionally trained, and prudent individual to believe a fraud has occurred, is occurring, and/or will occur.
<b>Value to management</b>	An auditor's opinion provides credibility to financial information reported by management to third parties.	The fraud examination is conducted to resolve specific allegations of fraud and to assign blame.
<b>Sources of evidential matter</b>	Primarily the underlying accounting data supporting the financial statements.	Evidential matter including financial and nonfinancial data. Techniques include: document examination, review of public records, and interviews.
<b>Sufficiency of evidential matter</b>	In the majority of cases, the auditor relies on evidence that is persuasive rather than convincing.	Fraud examiners attempt to establish proof to support or refute an allegation of fraud.

## ***Under what circumstances should I withdraw from an engagement?***

### *A Practitioner Speaks*

*I had one situation in which the outcome of our audit would determine whether the client received a significant amount of funding from a third party. During the audit, we came across a document that I was fairly certain was forged by the client. I was pretty sure the client had lied to us.*

*My first reaction was to withdraw immediately. But it wasn't that simple. It was the "eleventh" hour of this funding plan, and our lawyer told us that if we withdrew and the client lost the funding, they would probably sue us. We were really stuck between a rock and a hard place on that one — work with a client we suspected was lying or withdraw and invite a lawsuit.*

*I'd hesitate to draw any general conclusions from that experience except that you should always proceed with caution and get as much legal advice as you can.*

The above story illustrates some of the complications that can arise when you consider withdrawing from an engagement. In this case the practitioner's initial impulse was to withdraw immediately from the engagement. Other practitioners may be predisposed the other way, to continue with the engagement and "get to the bottom of things." Still others may not even consider withdrawal as an option.

The practitioner's advice noted above is sound. It is impossible to provide general guidance on when to withdraw from an engagement, as each situation will have its own unique considerations. Paragraph 36 of SAS No. 82 says that you "may wish to consult with your legal counsel when considering withdrawal from an engagement." From a practical standpoint, to do otherwise would not be advisable.

## **Documentation Requirements**

The documentation requirements relating to your consideration of fraud in a financial statement audit are described in paragraph 37 of SAS No. 82. These requirements are somewhat broad, and you have considerable flexibility in choosing how to meet them.

### ***What is required to be documented in the workpapers to comply with SAS No. 82?***

SAS No. 82 requires you to document *evidence of the performance* of the assessment of the risk of material misstatement due to fraud. You are *not* required to

label your assessment (“high”, “medium”, or “low”, for instance) nor are you required to describe your thought process or rationale used to make the assessment. You are only required to document that you performed an assessment of the risk of material misstatement due to fraud. As discussed in Part One, Assessing the Risk of Material Misstatement Due to Fraud, this assessment is a separate risk assessment, distinct from your assessment of inherent and control risk. Although the assessment may be performed in conjunction with your inherent and control risk assessment, it’s a separate thought process and should be documented as such.

To document evidence of your performance of this risk assessment you should document:

- The risk factors identified as present
- Your response to those risk factors
- Fraud risk factors or other conditions, if any, identified during the performance of field work that caused you to believe that an additional audit response is required

If, as a result of your assessment, you conclude that a further response is appropriate, that response should also be documented.

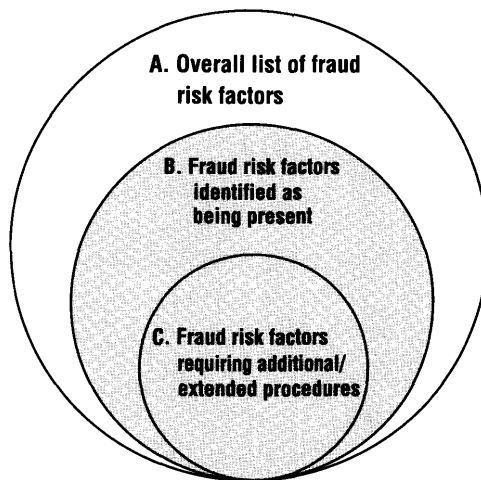
Going into your audit you will be using a list of fraud risk factors to serve as a “memory jogger” to remind you that some of the information gathered during your audit may indicate the presence of fraud. This list may represent the examples listed in paragraphs 17 and 19 of SAS No. 82, or the examples provided may be tailored to your clients (say, for small, privately owned businesses or entities within a particular industry) provided that they embody the substance of the five broad risk factor categories in paragraphs 16 and 18 of the SAS. Documentation of this overall list of fraud risk factors you use is *not* required.

During the planning and performance of the audit, you may identify some of the fraud risk factors from your list as being present at your client. Of these risk factors present, some will be addressed sufficiently by your planned audit procedures; others may require you to extend your audit procedures. SAS No. 82 requires you to document *all risk factors identified as present* (and your response) regardless of whether the presence of those risk factors requires extended audit procedures.

The diagram below illustrates what is required. Circle A represents the overall “memory jogger” list you use and Circle B represents the risk factors on that list you identify as being present at your client. Circle C represents those identified risk factors that require additional, extended audit procedures (above and beyond your planned procedures).

The shaded area depicts your required documentation. You are required to document the risk factors identified as present and your response.

### **SAS No. 82 Documentation Requirements**



In a rare event in which *no* risk factors are identified as being present at your client, keep in mind that you must document evidence of the performance of the assessment of material misstatement due to fraud. At a minimum, you’d document that no risk factors were identified.

#### ***What format should the documentation take?***

SAS No. 82 does not require any specific format (for example, a checklist or a memo) or standard language to comply with these documentation requirements. You are allowed a great deal of flexibility.

Some practitioners prefer to document items and judgments that go beyond the requirements of SAS No. 82 because they find this information useful in the event that others may ask how certain decisions were reached. Other practitioners prefer to limit their documentation to the minimum required. Refer to Part Three, Sample

Documentation for examples of documentation (including documentation relating to the Internet Solutions case study) that demonstrate this range of possibility.

## Communication Requirements

***What information am I required to communicate to my clients, and what threshold needs to be crossed for that communication to be required?***

The answer to that question is provided in paragraph 38 of SAS No. 82, which says, in part:

*Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization.*

Thus, the threshold for communication is “evidence that a fraud may exist.” The mere presence of a fraud risk factor generally does not meet this threshold.

For example, a single employee may have the authority to write checks and the responsibility to reconcile the bank account(s). Absent other controls, this lack of segregation of duties may be a fraud risk factor that leaves the company vulnerable to the theft of cash. The identification of this risk factor, by itself, is not required to be communicated to your client (although you may wish to do so as a client service matter.)

But suppose there is a delay of several weeks before the employee is able to provide you with a year-end bank reconciliation. When testing the reconciliation, you discover that certain canceled checks are missing. The employee is unable to offer an explanation other than the possibility that the bank made a mistake.

At this point you probably have evidence that a fraud may exist (namely, that the employee has stolen cash and attempted to conceal it by destroying the canceled check). Even though the theft may not be material to the financial statements, you should still bring the matter to the attention of management. Although not stated in SAS No. 82, the matter is usually brought to the attention of management in the context of, “Do you want us to pursue this further?” (Again, keep in mind that if the possible misstatement is immaterial and you perform additional procedures at your client's request, these procedures fall outside of the GAAS financial statement audit.)

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**Key Point.** *The communication threshold described in SAS No. 82 is different from the threshold previously established under SAS No. 53. The requirements under that previous statement were —*

*. . .the auditor should assure himself that the audit committee is adequately informed about any irregularities of which the auditor becomes aware during the audit unless those irregularities are clearly inconsequential.*

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The threshold for communication established by SAS No. 82 is “evidence that a fraud may exist. . .even if the matter is considered inconsequential.” This is a lower threshold than that established by the previous statement, and therefore you should expect to communicate more and different matters to management concerning fraud than you did in the past.

Also keep in mind that you are required to communicate *reportable conditions*, as defined in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, to the entity’s audit committee or its equivalent. The existence of a fraud risk factor or several risk factors may lead to the identification of a reportable condition(s).

***For clients with no audit committees, to whom should I address my communication?***

Paragraph 38 of SAS No. 82 describes two situations in which an auditor should communicate directly with the audit committee:

- A fraud causes a material misstatement of the financial statements
- A fraud involves the senior management of the company

The SAS does not provide guidance in situations in which one of the above two conditions exists but the client does not have an audit committee.

In the author’s opinion, if you become aware of a fraud that causes a material misstatement of the financial statements and there is no audit committee, you should consider reporting that to senior management of the company.

The second situation is a bit more problematic. As a practical matter, if you become aware that an owner manager of a privately held company has committed fraud, you



should consider the guidance contained in paragraph 36 of SAS No. 82, which includes consideration of withdrawing from the engagement. See Part One, Detection of Fraud or Misstatements That May Be the Result of Fraud.

### Analysis of Internet Solutions Case Study

Before continuing with this section, read the Internet Solutions Case Study in Appendix A.

Understandably, the auditor in the Internet Solutions case study chose not to be interviewed for the magazine article. The following is an interpretation, based on his testimony at Mr. Wilder's trial, of how Internet's auditor, Dan White, CPA, might have applied the guidance contained in SAS No. 82.

*Audit Planning.* By virtue of the consulting work performed during the year, the auditor was able to gain an understanding of the nature of the client and the industry in which it operated. Referring to the example risk factors listed in paragraph 17a of SAS No. 82, Mr. White knew that the company planned to go public and that in order to do so it would need to report solid earnings. He knew that Mr. Wilder reported earnings projections to the board of directors. He was aware that the company had reported a steadily increasing earnings trend.

All of this information came to Mr. White during the normal course of audit planning, and it was used by him to draw some conclusions about overall engagement risk. To apply SAS No. 82, Mr. White also recognizes that this information indicates the possible presence of fraud risk factors.

At this point, it is impossible for him to determine whether the targeted operating results are "unduly aggressive" or whether Mr. Wilder has "an excessive interest to increase the company's earnings trend." But remember, the assessment of material misstatement due to fraud is a *cumulative process*, and over the course of the audit, Mr. White will gather additional information to help him judge whether the situation is "unduly aggressive" or "excessive."

With regard to internal controls, Mr. White recognizes that management is dominated by a small group of individuals who probably could override any controls. He recognizes other control weaknesses and assesses control risk at the maximum, planning to perform a purely substantive audit. SAS No. 82 requires Mr. White also to consider controls within the context of an assessment of risk of material misstatement due to fraud.

At the planning stage of the audit, Mr. White decides that, no, these conditions do not represent a fraud risk factor but are merely a fact of life in a small, growing company. Again, he makes this initial decision knowing that it may change over the course of the audit as other information becomes known.

Many of the risk factors relating to industry conditions (SAS No. 82, paragraph 17b) are identified during audit planning, including a declining industry and high vulnerability to rapidly changing technology. Mr. White's first response is to identify inventory valuation as a high risk audit area. He also notes that these items are fraud risk factors to be considered in his initial assessment of the risk of material misstatement due to fraud.

During the planning phase of the audit, Mr. White does not identify any additional fraud risk factors. For the fraud risk factors identified, he must now make an assessment of the risk of material misstatement due to fraud and develop an appropriate response. He considers the fraud risk factors in combination and he identifies accounts receivable and inventory valuation to be the areas of primary audit concern. He further determines that the planned audit procedures in these areas are sufficient to provide reasonable assurance that a material misstatement — whether caused unintentionally by error, or intentionally by fraud — will be detected.

However, based on this initial risk assessment, Mr. White plans two overall audit responses for this engagement. First, he plans to be more involved in the review and supervision of this audit than he would be on other audits. Second, he instructs the staff to be sure to obtain corroborating evidence for management's explanations regarding the valuation of receivables and inventory. Both of these responses are in line with those described in SAS No. 82, paragraph 27.

*Early Fieldwork.* Mr. White visits the client early in the audit fieldwork to review workpapers and discuss the audit with Mr. Wilder. He reviews the preliminary analytical procedures performed by the staff. The first thing he notices is that the company has shown a healthy profit for the current year. Margins have held steady over the previous year, but volume has increased approximately 15%. Inventory turnover is reasonable, but accounts receivable turnover has slowed considerably — receivable

balances have increased significantly over the prior year. He also notices that the company has received a significant amount of short-term financing.

It strikes him as unusual that a company that shows such an increase in profits would have to borrow so much money. He then reads an article about the company included in the planning workpapers. The article is highly favorable and notes that "Internet Solutions continued to post record profits while others in the industry struggle to compete."

Mr. White discusses the progress of the audit with Mr. Wilder. Mr. White comments that the company has had a good year, and Mr. Wilder responds enthusiastically about the company's product. Mr. White refines his question. He's really curious about how the company was able to expand its volume while maintaining margins in a deteriorating industry. Mr. Wilder discusses how the company's product is superior to the competition and he uses a lot of technical jargon to explain why. It occurs to Mr. White that the response wasn't exactly what he was looking for, but he declines to pursue the matter further.

He asks about the short term borrowing, which sobers Mr. Wilder considerably. "There are times," he says, "when growing businesses run short of cash." He enlists Mr. White's help in designing a cash management strategy. "We really have to generate some positive cash flow around here," says Mr. Wilder.

Mr. White ends the conversation with general talk of the plans for the public offering. Mr. Wilder is convinced the offering will happen soon based on the company's outstanding track record of revenue and earnings growth.

At the end of the day, Mr. White reflects on his experience at the client. Using the list of fraud risk factors in SAS No. 82 as a memory jogger, he realizes that he has identified two more. The company has an inability to generate cash flows from operations in spite of reporting earnings and earnings growth. Also, compared with other companies in the same industry, Internet Solutions has experienced unusual profitability and growth. He considers that Mr. Wilder's response to inquiries about these two anomalies was vague and unsatisfying.

He returns to his earlier questions as to whether the budgets and forecasts made by the company early in the year were "unduly aggressive." It seems odd that the company would

forecast such growth in an industry widely recognized as in decline. For the first time he draws a link between Mr. Wilder's desire to take the company public and the need for a positive earnings trend. He's not sure Mr. Wilder's interest is "excessive," but clearly there's an interest.

Though puzzling and somewhat troublesome, the identification of additional risk factors is not enough to change Mr. White's assessment of the risk of material misstatement due to fraud. At this point, he believes the existing audit approach and planned procedures are sufficient.

*Later Fieldwork.* Mr. White returns to the client to review the accounts receivable fieldwork. He reviews the work performed on nonresponding confirmation replies, which consists of examining invoices and shipping documents supporting reported sales. He is struck by the following comment in the workpapers:

*"While reviewing this shipping document, we noticed that the date of the shipment (10/2/XX) was different from the invoice date of 3/31/XX. We inquired of the controller, Mr. Stern, who indicated that the shipping date reported by the outside warehouse was in error. He said he planned to seek a reimbursement from the warehouse company for the six months of storage charged on this item, and so the following audit adjustment is proposed. . . ."*

The workpapers included an audit adjustment to debit receivable from supplier and credit storage expense for six months of storage.

Previous identification of fraud risk factors had resulted in Mr. White displaying a high degree of professional skepticism when evaluating explanations made by management. He was skeptical of Mr. Stern's explanation for the discrepancy in dates. If the dates were right and Mr. Stern was wrong, then the company had recognized revenue six months in advance of an actual sale.

Mr. White reviewed the scope of the audit team's sales cut-off fieldwork. They looked at shipping documents five days before and five days after year-end to be sure the transactions were recorded as sales in the proper period. The procedures required the auditor to trace the shipping document to a numerical listing of sales invoices.

"On this sales cut-off fieldwork," he asks the senior auditor, "did we ever tie down the date of the shipping report to the date of the invoice?"

Chagrined, the senior says no, because that's not what they did in last year's audit.

"Do me a favor," says Mr. White. "Trace these shipping documents to the actual invoices and compare dates. Look for large time lags between invoice dates and shipping dates."

From these actions we can see that the situation identified in the workpapers and Mr. Stern's explanation has effectively pushed Mr. White "over the edge." He has evidence a fraud *may* exist. He is no longer convinced that his planned audit procedures are sufficient to provide reasonable assurance that the financial statements are free of material misstatement due to fraud. Consequently, he extends his audit procedures.

He then reviews the confirmation replies. He notices that one reply (sent via fax) contains the first page only, but not the second page with the customer's signature. "What happened here," he asks the senior auditor.

She explains how the second page was sent during a time when the fax machine was out of paper, but that she called the customer and asked them to send another. She says that the customer indicated they never got the first confirmation request.

Mr. White goes on to review the other confirm replies and notices that a large number of them were faxed. "Have we considered getting originals of these faxed responses?" he asks.<sup>4</sup>

"We can."


"Let's do it."

Mr. White understands that his previously identified fraud risk factors centered on the issues of profitability, sales, and accounts receivable. The faxed confirmation replies raise concerns about these same issues — enough of a concern for him to change his assessment of the risk of material misstatement due to fraud. His planned audit procedures (accept a faxed confirmation reply) are insufficient to respond to this risk, so he decides to expand the procedures.

In analyzing this case study it is clear that, throughout the course of the audit, Mr. White identified fraud risk factors

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<sup>4</sup> Paragraph 29 of SAS No. 67, *The Confirmation Process*, provides guidance on the procedures an auditor should consider when confirmation replies are faxed to the auditor.



and made an assessment of the risk of material misstatement due to fraud. That assessment was continually revisited throughout the course of the audit, and consideration was given as to whether the planned audit procedures were sufficient to reduce the risk to an acceptable level. Mr. White's approach meets the requirements of SAS No. 82. For an illustration of how Mr. White complies with the documentation requirements of the SAS, refer to Part Three, Sample Documentation, Example #3.

## APPENDIX A:

### INTERNET SOLUTIONS CASE STUDY

The article that follows is something you might find in a general business magazine. This case study illustrates many of the key issues identified in Part One of this publication. The events in this case study are based on a combination of several actual frauds. The magazine article, including names and places, is a work of fiction.

#### **F R A U D HAPPENS**

—Former Wheatfield  
Hero to Serve  
Jail Time

Later this month, Norman Wilder, a former Wheatfield High Alumnus of the Year, will be sentenced to jail in Denver.

The 52 year-old former president and founder of Internet Solutions, Inc. was convicted last fall of committing a blatant accounting fraud at his company, a small leading edge computer manufacturer located in the "High Tech Corridor" just outside of Denver.

Under Mr. Wilder's direction, Internet Solutions recorded millions of dollars in phony sales during the period leading up to their planned initial public stock offering. Once the fraud was discovered by the outside auditing firm of White and

White, the investment firms who planned to underwrite the financing quickly backed out of the deal.

#### **Oldest Fraud in the Book**

Testifying at the trial, Lance N. Cassandra, a forensic accounting specialist described the scheme as "a classic revenue recognition accounting fraud."

As Mr. Cassandra described it, Internet Solutions recorded \$5 million of revenue on products it supposedly shipped to customers. In truth, the goods were stored in a warehouse, becoming more obsolete with each passing day.

To conceal the fraud from outside auditors and directors, Wilder and his chief accountant forged customer signatures, altered and withheld critical documents, and took a hard line position with the auditors in an effort to discourage them from pursuing leads.

These tactics worked for a while, but in the end the fraud was discovered. "In hindsight," said Cassandra, "there were telltale signs of fraud all over the place. You had a guy [Wilder] obsessed with showing increased profits in a sagging industry, increasing profits but no cash flow, and a very passive board of directors."

When asked if he felt the auditors should have detected the fraud sooner, Cassandra responded, "It's hard to find fraud perpetrated by top management, especially when they're forging documents and lying to the auditors. On the contrary, I give the auditing firm a lot of credit for figuring things out as soon as they did."

#### **Local Hero Gone Bad**

It is hard for anyone who knows Mr. Wilder to imagine him committing such a crime. A self-described "former science geek," he graduated

from Wheatfield High 35 years ago and received a full scholarship to the prestigious Zurich Technological Institute, where he earned his Ph.D. in Applied Electro-magnetism. Dr. Wolfgang Horstmann, dean of the physics department at ZTI recalls, "As a scientist there was a tremendous amount of integrity to his work. He was one of the few young people who really valued and respected the ethical norms of the profession."

Five years ago, Mr. Wilder returned to Wheatfield where he was honored as the Wheatfield High "Alumni of the Year". "He never forgot where his roots were. He was really a humble person. When I found out that he cheated people out of their money like that, I was in shock. Why did he do it?" said school principal, Rebecca Freeman.

#### **Pressure for Profits**

One possible motivation may have been that Mr. Wilder believed his company had to show significant revenue and profitability growth before he could sell stock to the public.

Debra MacDonald, Director of Sales for the company, was the one who finally divulged the scheme to the auditors and later became the star witness for the prosecution. She recalls Mr. Wilder being "obsessed with meeting his sales projections."

She saw another side to Mr. Wilder, one kept carefully hidden from his friends in Wheatfield. "Norman was extremely driven," says Ms. MacDonald. I think he really wanted to prove to people that he was successful."

Mr. Cassandra agrees. Based on interviews he conducted with company staff, he concluded that, "Norman could be very unreasonable at times. Taking that company public was a mission for him. Not only would it have given him a lot of self-esteem — let's face it, it would have also made him extremely rich."

#### **Zero to Hero**

Mr. Wilder never imagined himself as an entrepreneur. After graduating from ZTI, he took a job teaching physics at State University. It was there that he first became

interested in the Internet, programming a website for the physics department just for fun over Christmas break.

An engineer at the local phone company stumbled across the site one day and was so impressed, she convinced her boss to hire Mr. Wilder to improve the phone company's website. He was more than up to the challenge.

Not content with merely programming a website, Mr. Wilder built an entire computer to serve as the company's host. "It was the only way," he said in an interview with the Science Business Times. "They had so many different kinds of computer systems, so much software, it was easier for me to build a custom computer for them rather than do some half-baked patch job with some equipment I can buy at a discount retailer."

He sold his computer to the phone company for the princely sum of \$20,000.

A friend suggested that he quit his job as a university professor and start his own business.



“Those early years were fun,” recalls Ms. MacDonald. “But there was also a lot of pressure just to pay the bills and keep the doors open. There were a couple of times Norman had to put the payroll on his credit card. Then we got the Post Office contract, and things really took off.”

Internet Solutions received a \$2.5 million contract to design and install custom website servers for regional offices of the U.S. Post Office.

The problem was that technology was changing so quickly, even the large contract wasn't enough for Mr. Wilder to spend all he needed to on additional research and development. But the contract with the Post Office gave the company a vital shot in the arm and established their credibility with outside investors. Soon Mr. Wilder was able to convince wealthy individuals and small venture capitalists to back the company.

The days of meeting payroll with a credit card were over, but other troubles loomed ahead.

### **The Slippery Slope to Fraud**

“All that money made Norman feel incredibly responsible to those investors. I don't think he was a greedy person at all, but he felt a true responsibility to make sure those people's faith in him was justified.”

Mr. Wilder began down the slippery slope of fraud in a fairly innocuous way. All of his company's products were custom built. Under the terms of the contract with the Post Office, the machines had to be tested and approved by the customer before they would be accepted. Once accepted, they were physically moved to a secure spot in the company warehouse until the Post Office was ready to accept actual delivery.

At first, production of the machines and acceptance by the customers occurred at approximately the same time. But slowdowns at the Post Office and improvements in Internet Solutions' production process gradually increased the time between the completion of the units and their acceptance.

One quarter, the company was behind its sales goals previously reported to the investors. Mr. Wilder told his chief accountant, Oscar Stern, to record as sales the completed products that had not yet been accepted by the Post Office.

At the trial last fall Mr. Stern testified that under generally accepted accounting principles, the sales revenue should not have been reported until the goods were actually accepted by the customer.

“Norman is a very intelligent person,” says Ms. MacDonald. “But sometimes he's too smart for his own good. He thinks he can tell accountants how to do their jobs even if he doesn't have the slightest idea of what he's talking about.”

In rationalizing his actions Mr. Wilder reportedly told Mr. Stern, “Accounting is not science, you know. It is completely arbitrary. So what difference does a couple of days make. By next week they will approve the products.”

### **Business Worsens**

Even though unit sales appeared to be increasing, the company was

having trouble generating cash. The research and development costs continued to climb, just at a time when the market for Internet websites was beginning to soften.

Additionally, off-the-shelf website products had become more sophisticated and flexible, making it harder for potential customers to justify spending large amounts on Internet Solutions' custom machines. Plans to take the company public were delayed a year.

For some time, a group of outside investors had served as the company's board of directors. In anticipation of eventually selling shares to the public, the board hired the accounting firm of White and White to provide consulting advice in the areas of cash management and internal controls.

Dan White was the engagement partner assigned to Internet Solutions. At the trial of Mr. Wilder he testified, "We were brought in during the spring to do some consulting work with the understanding that we would perform the year-end audit. It was a good opportunity for us because doing the

consulting work would allow us time to learn about the company and the industry in which it operates."

Mr. White declined to be interviewed further for this article.

Unknown to Mr. White, while he and his staff were making recommendations on bookkeeping software packages, the company was fabricating sales in its quarterly reports to the investors.

What began as a slight "cut-off" problem of only a few days had deteriorated into forgery and blatant fraud. Production on new machines continued even in the absence of commitments from customers.

At the end of one quarter, with \$400,000 of equipment sitting complete on the shop floor, the potential buyer hadn't even committed to purchase the product. Frantic, Mr. Wilder approached Ms. MacDonald and pleaded with her to get the customer to sign a contract. "I told him that was impossible," she said. "I'd already been pressuring the client to sign, and I was afraid if I put on too much of a hard sell, he'd back out completely."

"I'll talk to Oscar," said Mr. Wilder, and he left her office. A few days later Ms. MacDonald received a purchase order on her desk, allegedly signed by her client, but the handwriting looked like Mr. Stern's.

Ms. MacDonald decided not to say anything, and two weeks later the client called to say that he was ready to sign a contract and would like immediate delivery of the units.

To close another large sale, Mr. Wilder drafted a letter to the client saying that a \$300,000 sale would be "contingent on our mutual agreement of the final contract." In other words, the customer had not agreed to anything. Under the accounting rules, no sales transaction had occurred, but Internet Solutions reported the income anyway.

On another occasion Ms. MacDonald wandered into Mr. Stern's office and discovered several invoices to customers she had never heard of, for sales she had never made. "Norman made these sales," Mr. Stern told her.

When asked about his recent sales calls, Mr. Wilder told her that in order to meet the

quarterly projections, he'd been forced to "hit the road and do some calling on friends of mine from the university days."

Looking back on it, MacDonald admits that she should have realized Mr. Wilder was not telling the truth. "I'd been working with him for five years to make this business a success. I just wanted to believe him."

Later, when she looked at a quarterly report to shareholders, she realized that much of the sales figures had been fabricated. But she didn't say anything.

At the trial she defended her actions. "Who could I go to?" she asks. "Everyone else wanted to believe the numbers just as much as Norman did."

Now she admits, "I was wrong. But we play these little games with our own integrity, rationalizing things away. I thought I would be disloyal if I confronted Norman with what I knew, but I knew what he was doing was wrong. I knew Dan White would be coming out soon to do the audit, so I made a compromise with myself. I couldn't be the one to make the first contact, but if they came to

me and asked, I wasn't going to lie."

#### **House of Cards**

Dan White testified about the audit performed by White and White. "During the planning phase of our audit, we identified certain areas as posing a high risk. We noted that accounts receivable balances had increased significantly during the year, and we knew the market for Internet websites had declined considerably since the previous year."

"Our workpapers also indicate that we noted a lack of cash flow from operations in spite of reported accrual-based profits."

Initially, Mr. White was concerned about the adequacy of the company's reserves for bad debts and obsolete inventory. In the early stages of the audit Mr. White believed "the client posed a high overall engagement risk, but no, we did not suspect fraud at first."

To prepare for the audit, Mr. Stern and Mr. Wilder prepared fake invoices and contracts. They doctored a shipping logbook, even using different colored pens to make it appear as if entries had

been made on different days.

The White and White auditors prepared confirmation letters to send to Internet Solutions' customers, and these letters were signed by Mr. Wilder. Noting that the confirmations asked if there were "any side agreements, written or oral with regard to purchases from Internet Solutions" Mr. Wilder pulled the confirmations addressed to customers with whom he'd struck side deals. He also pulled the confirmations addressed to customers for whom he'd prepared fictitious invoices.

"It wasn't that difficult," said Mr. Cassandra. "The auditors put their confirmations in the company's outgoing mail basket, and during lunch time, Norm Wilder just removed the ones he didn't want sent out."

Several days later, Mr. Wilder forged a signature on the confirmation and faxed his response to the auditors directly at their office.

Two things happened to finally tip the auditors off to the massive fraud. The first was simply the result of good fortune. One of the doctored confirmation

forms prepared by Mr. Wilder was sent to the White and White office after hours, a ploy to make it appear as if it had come from the west coast. The fax machine ran out of paper, and with no one to replace it, the second page of the confirmation, which contained the forged signature, never arrived.

The next day, realizing what had happened, a staff person on the engagement called the customer to ask them to send a copy of their reply. The customer was confused. She stated that she had never received the request in the first place.

The second instance was an example of "good auditing" according to testimony by Mr. White.

One of the firm's staff people was performing routine audit work, checking shipping documents. On one shipping report, she noticed a charge for six months storage on an order that had been recorded as a

sale during the first quarter of the year. When asked about this, Mr. Stern replied that it must have been some kind of mistake.

"There were several things that didn't quite add up for me," said Mr. White. "We decided to expand our fieldwork at that point and look at more shipping documents than we normally would have. I also instructed the staff to call all customers for whom we had received faxed confirmation replies."

When those additional procedures yielded more questions than answers, Mr. Cassandra was called in to investigate further.

#### **Saddened and Stunned**

Mr. Cassandra specializes in fraud investigations. "Usually by the time I'm called in everyone's pretty sure a fraud has been committed."

He didn't have to look very far to confirm his suspicions. His first task was to question Ms. MacDonald, who kept the bargain she had made

earlier with herself and told Mr. Cassandra all she knew.

"I was so relieved when someone finally asked me those questions." She had saved copies of the questionable documents prepared by Stern and Wilder, and she gave these to Mr. Cassandra.

They were all he needed to bring the house of cards crashing to the ground.

Ms. MacDonald is still saddened by what happened. "I worked so many years for Norman and that company. Now what am I supposed to do?"

In Wheatfield, civic leaders still express shock over what happened. "It's just a very sad situation," says Ms. Freeman. "Norman was a role model for our kids — I can't tell you how popular he was — and now they're so ashamed. He really let us down."

Sentencing guidelines call for Mr. Wilder to receive up to ten years; Mr. Stern could get six.

*INDUSTRY-SPECIFIC  
FRAUD RISK FACTORS  
AND GUIDANCE*

*Part* **TWO**

## Background

SAS No. 82 requires you to consider risk factors and other conditions in assessing the risk of material misstatement due to fraud and it provides examples of risk factors and other conditions. The SAS defines broad risk factor categories in paragraphs 16 and 18 and it lists detailed examples of risk factors within these categories in paragraphs 17 and 19. The detailed example risk factors are just that — examples. They are meant to be generic or, in other words, geared to apply to most enterprises. However, there's certainly no "one size fits all" approach to assessing risk of material misstatement due to fraud. For that reason, you are allowed flexibility in tailoring the risk factors to your particular clients, as long as they embody the substance of the broad risk factor categories described in paragraphs 16 and 18 of the statement.

## What is Part Two About?

This Part of the practice guide includes example industry-specific fraud risk factors and other conditions that have been developed by AICPA Accounting and Auditing Publications staff in consultation with members of the AICPA industry committees. Industry-specific fraud risk factors may be identified throughout the entire engagement process (e.g., during client acceptance/continuance procedures, planning, field work, or review). Other conditions, which may support or alter your judgement about the risk of material misstatement due to fraud, may be identified during audit field work. The fraud risk factors and conditions presented in Part Two are intended to help you tailor the five broad risk factor categories defined in SAS No. 82 for your clients in various industries. The guidance in Part Two *supplements* the risk factors, other conditions, and related guidance found in the SAS. It is a *companion to but not a substitute for* the guidance in the SAS.

## A Caveat

The illustrative listings of industry-specific fraud risk factors and other conditions should not be used exclusively in considering and identifying fraud risk factors and other conditions that may be identified in an audit. Rather, your identification of the presence of such factors and conditions should be based on sound and careful consideration of the circumstances that are particular to every engagement. These industry-specific fraud risk factors and other conditions are only examples. They are not an

all-encompassing inventory of fraud risk factors and other conditions that may be encountered in every industry. *Furthermore, the presence of these example risk factors and other conditions identified during the engagement does not necessarily indicate the existence of fraud.*

## **I Found a Risk Factor!**

When fraud risk factors or other conditions are found to be present during the engagement, professional judgment should be exercised when assessing their significance and relevance. As you assess the risk of material misstatement, keep in mind that the presence of a risk factor or condition should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances. For instance, the presence of easily convertible assets, such as bearer bonds, represents a risk factor that may be mitigated by controls such as physical safeguards, adequate record keeping, and independent review of such records.

Please refer to Part One for a more detailed discussion of the SAS's requirements. Part One includes guidance on considering fraud risk factors and other conditions, assessing the risk of material misstatement due to fraud, and developing a response to the assessed risk. It also guides you through documentation and communication requirements of the SAS.

## **Organization of Part Two**

### ***Risk Factors and Other Conditions***

The industry-specific sections that follow include interpretations of some of the SAS's example risk factors tailored to particular industries. Also included are additional risk factors and other conditions that fall within the broad risk factor categories of the SAS. Other than the "Small, Privately Owned Businesses" section, the fraud risk factors reprinted from the SAS appear in italics. Interpretations of these risk factors and additional risk factors and other conditions appear in Roman type. The "Small, Privately Owned Businesses" section presents those SAS No. 82 example risk factors most relevant to small, privately owned businesses, as well as additional example risk factors.

Every industry-specific section should be used in conjunction with SAS No. 82 because example risk factors in paragraphs 17 and 19 of SAS No. 82 not interpreted or tailored for a specific industry have not been reprinted in

this section. However, the example risk factors not reprinted may be applicable to your client.

**Suggested Responses**

For some industries, the guidance includes some suggested alternative procedures to consider when fraud risk factors and other conditions are present. Like the fraud risk factors and conditions in this Part, these suggestions supplement the responses described in SAS No. 82. (For additional suggestions on alternative audit procedures, see Part Three, *Common Frauds and Extended Audit Procedures*, of this book.)

**How to Use Part Two in Identifying the Presence of Risk Factors and Other Conditions**

- 1) Read SAS No. 82 in its entirety and carefully review the risk factor categories and example risk factors found in paragraphs 16 through 19.
- 2) Read Part One of this book, "*Identifying Fraud Risk Factors*."
- 3) Consider the example risk factors and other conditions described in this section for your client's industry.
- 4) Consider other conditions identified throughout the audit engagement that may alert you to the possibility that material misstatements due to fraud may exist.



## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in institutions where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management's Characteristics and Influence Over the Control Environment

- *An excessive interest by management in maintaining or increasing the institution's stock price or earnings trend through the use of unusually aggressive accounting practices.*
  - Unusually aggressive recognition of income related to complex lending arrangements or capital markets transactions.
  - Unusually aggressive interpretation of authoritative guidance related to hedge accounting.
- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - Lack of Board/management oversight of critical processes, such as:
    - ▶ Intercompany/Interbranch Cash/Suspense ("I/O") Accounts and "Internal" demand deposit accounts ("DDAs") — monitoring of activity and resolution of aged items.
    - ▶ Lending — ineffective risk review function or one that lacks independence.

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<sup>5</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

- ▶ Treasury — securities/derivatives valuation (selection of models, methodologies and assumptions)<sup>6</sup>.
  - ▶ Regulatory Compliance — serious lack of knowledge of pertinent regulations.
  - ▶ Deposits — lack of monitoring unusual and significant activity.
  - ▶ Customer Acceptance — failure to establish sound and effective due diligence procedures on potential new customers.
- Management's failure to establish independent reporting lines for key assurance functions (e.g., internal audit, risk review, appraisal group, etc.).
  - Lack of Board approved credit (underwriting and administration) policies.
  - Substantially weak CAMEL (BOPEC for bank holding companies) ratings.
- *Management displaying a significant disregard for regulatory authorities.*
    - Existence of a regulatory cease and desist order, memorandum of understanding or other regulatory agreements (whether formal or informal), that concern management competence or internal control.
  - *Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.*
    - Excessive consideration of "business issues" (e.g., shareholder expectations) in determining the allowance for loan losses methodology and related significant assumptions.
    - Unusual propensity to enter into complex collateral disposition agreements.
  - *Strained relationship between management and the current or predecessor auditor.*
    - Frequent disputes with current or predecessor auditors regarding the reasonableness of sensitive

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<sup>6</sup> For more information on derivatives refer to *Derivatives — Current Accounting and Auditing Literature* (AIPCA Product #014888) and *Internal Control Issues in Derivatives Usage: An Information Tool for Considering the COSO Internal Control Integrated Framework in Derivatives Applications*.

estimates (allowance for loan losses, recourse liabilities, deferred loan origination costs, prepayment assumptions on mortgage-related assets, etc.).

**B. Industry  
Conditions**

- *High degree of competition or market saturation, accompanied by declining margins.*
  - A very large increase in the returns on investment products offered by competitors, that are close alternatives for the institution's deposit products (e.g., mutual funds, insurance annuities, etc.), accompanied by declining margins.
- *Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.*
  - A failure or inability to keep pace with the rapid growth in electronic banking, if the financial stability or profitability of the particular institution is placed at risk due to that failure or inability.
  - Deteriorating economic conditions (declining corporate earnings, adverse exchange movements, real estate prices, etc.) within industries or geographic regions where the institution has significant credit concentrations.
  - Significant volatility (interest rates, foreign exchange rates, commodity prices, etc.) in financial markets where the institution has a significant capital markets presence.
  - For credit unions, losing a very substantial portion of the membership base which places considerable pressure on management, insofar as financial projections are often based upon gaining new members.

**C. Operating  
Characteristics  
and Financial  
Stability**

- *Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*
  - Concentrations of substantial loans and other transactions with directors, significant shareholders, affiliates, and other related parties, particularly those involving favorable terms.
  - Significant purchases of assets by directors and significant shareholders, particularly foreclosed real estate.

- *Unrealistically aggressive sales or profitability incentive programs.*
  - Unrealistically aggressive loan goals and highly lucrative incentive programs for loan originations.
  - A very large decrease in lending rates that are unaccompanied by decreases in the general level of interest rates.
  - Unusually high increase in deposit rates, unattributable to a general interest rate increase.

#### **D. Auditor Response**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following response.

##### *Allowance for Loan Losses*

If an auditor concludes that the allowance for loan losses is a significant estimate that is based on unusually subjective judgments and further concludes that a risk of material misstatement due to fraud exists, it may be necessary to modify the procedures used to audit the allowance for loan losses. Such an approach might involve more detailed analytical procedures (such as analyzing specific credit lines rather than the portfolio taken as a whole), increasing the sample size of loans sufficiently to reach a conclusion as to the accuracy of credit risk ratings and the adequacy of specific loan loss allowances. Consideration should also be given to increasing confirmation coverage when existence is questioned.

## **MISAPPROPRIATION OF ASSETS**

**An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in institutions where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.**

**A. Controls**

- *Lack of appropriate management oversight.*
  - Vacant branch manager positions or branch managers away on leave without replacement for an inordinate amount of time, causing a considerable lack of management oversight.
- *Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.*
  - FBI background checks, credit reports, and bondability screening not incorporated into the hiring process for employees with access to significant assets susceptible to misappropriation.
- *Lack of appropriate segregation of duties or independent checks.*
  - Lack of independent monitoring of activity in internal demand deposit accounts (“DDAs”).
  - No independent monitoring and resolution of customer exceptions/inquiries related to EFT transactions, loan disbursements/payments, customer deposit accounts, securities/derivatives transactions, and trust/fiduciary accounts.
  - Lack of key periodic independent reconciliations (in addition to reconciliations of subledgers to the G/L) between:
    - ▶ EFT — daily transaction batch totals and the EFT system
    - ▶ Treasury — daily trading logs and the treasury system
    - ▶ Treasury — treasury system securities/derivatives positions and custodian records
    - ▶ Trust/Fiduciary — assets recorded on the trust/fiduciary system and sub-custodians and sub-agent records
    - ▶ Vault — vault asset register and both pre-numbered asset receipts and customer/bank asset records
    - ▶ Retail Branch — teller/branch counts of cash/negotiable instruments and the related balancing reports

- Lack of segregation of duties in the following areas:
  - ▶ EFT — origination, processing, confirmation and record keeping.
  - ▶ Lending — relationship management, underwriting (including approval), processing, cash collection/disbursement and record keeping.
  - ▶ Treasury — trading, processing, settlement and record keeping.
  - ▶ Trust — relationship management, transaction authorization, transaction execution, settlement, custody, and account record keeping.
  - ▶ Fiduciary — issuance, registration, transfer, cancellation and record keeping.
- Independent or objective internal appraisals not performed on collateral related to real estate loans as part of the underwriting process.
- Cash payments to securities/derivatives counter parties are not executed through an independent settlement/operations area.
- No periodic independent validation of derivatives pricing models.
- The derivatives/securities positions on the Treasury system are not priced by an independent operations area.
- The capital markets risk management process is not independent from the trading function or the independent risk management function does not have the appropriate level of sophistication or the capability to effectively monitor and measure the risks related to capital markets activities.
- No periodic confirmation of customer loan information or indebtedness by personnel independent of the relationship officer.
- Significant teller/branch cash shortages/overages are not aged and independently resolved.
- No annual review of the activity in trust accounts by an investment committee to ensure compliance with the terms of the trust agreement and bank investment guidelines.
- Employees (who have access to assets susceptible to misappropriation) that are known to have bounced

checks or have difficulty maintaining minimum balances within their personal accounts (This type of activity within employee personal accounts is typically identified through an institution's internal audit testing).

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*Case in Point. An employee working in the check clearing function processes transactions and encodes them to individual accounts. This same employee also has responsibility over the general ledger suspense account related to check clearing. Taking advantage of the situation, this employee ensured that his personal account and his family's accounts were never debited for any transactions; imbalances were fixed through the general ledger suspense account. A material misstatement of the financial statements occurred due to these fraudulent acts.*

*Had the institution maintained a better process of reviewing employee accounts, this fraud may have been detected. Based on his risk assessment, an auditor may want to determine the adequacy of the process an institution has established for reviewing employee, Board and "associated" accounts. Many fraudulent activities are run through an employee's own account or the account of a relative or friend.*

*Also, periodic tests to identify accounts with duplicate addresses might uncover fictitious accounts used by employees to cover fraudulent activities.*

*Such fraud is unlikely to be detected if such accounts are not reviewed by the institution.*

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**Remember**

SAS No. 82 does not require an auditor to plan the audit to discover information that is indicative of financial stress of employees or adverse relationships between the institution and its employees. If the auditor becomes aware of the existence of such information, he should consider it in addressing the risk of material misstatement arising from misappropriation of assets.

- *Lack of appropriate system of authorization and approval of transactions.*
  - No verification of EFT transaction initiation and authorization, including those instances where

bank employees initiate a transaction on a customer's behalf.

- Frequent underwriting exceptions to Board established credit authorization limits.
  - Frequent instances of cash disbursements on loans that have not yet received all approvals or met all preconditions for funding.
  - Lack of Board approval for significant loans or unusually high loan officer approval limits. (Be alert to the existence of multiple loans being funded just below a loan officer's limit.)
- *Poor physical safeguards over cash, investments, inventory or fixed assets.*
    - Lack of adequate physical security over the EFT operations area and customer records.
    - Access to the vault is not appropriately limited to authorized employees acting within the scope of their job.
  - Lack of accountability over negotiable instruments and inadequate training of tellers regarding controls over those instruments.

## **B. Auditor Response**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following response.

### *“Internal” DDA Accounts*

The auditor may have concluded that a risk of material misstatement due to fraud exists with regard to the lack of independent monitoring over the activity in “internal” DDAs (those bank DDA accounts where bank employees have authority to write checks). In this instance, the auditor might modify his audit procedures by stratifying the population of checks written by dollar amount and selecting a sample of checks from the highest stratum. The auditor would test each check for proper authorization, noting whether the purpose for the disbursement appeared to be within the scope of the employee's responsibility and supported by appropriate evidential matter.



## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management's Characteristics and Influence Over the Control Environment

- *A motivation for management to engage in fraudulent financial reporting.*
  - The structure of incentive plans induces traders to take unusually greater risks.
  - Unusually high level of internal competition for capital allocation among product types/trading desks.
- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - A failure by management and the Board of Directors to set parameters (i.e., trading limits, credit limits, aggregate market risk limits) and continuously monitor trading activities against those parameters.
  - A failure by management to ensure that the brokers are properly trained, appropriately licensed and adequately supervised.
  - Lack of policies and training on derivatives, retail sales and other sales practices.
  - Lack of sufficient access controls for front-office and back-office systems.

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<sup>7</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

- Lack of adequate “Chinese Wall” between investment banking and trading (i.e., insider trading).
  - Failure to monitor the filling of customer orders from the firm’s inventory (i.e., front-running, and excessive mark-up).
  - Lack of review of customer lists and insufficient controls surrounding the customer account approval and maintenance process for both cash and margin accounts.
  - Lack of Board approval and a specialist’s independent evaluation of in-house developed valuation models.
  - A failure by management to assess the quality and breadth of the company’s internal audit department, to ensure that the department receives adequate training and resources to match the sophistication and progression of the company.
- *An excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend through the use of unusually aggressive accounting practices.*
    - Unusually aggressive interpretation of regulatory rules (i.e., Net Capital Rules and Weekly Reserve Formula) when the company is reaching minimum Net Capital required by the SEC.
  - A failure by management to have an adequate understanding of the entity’s trading and investment strategies as conducted by the entity’s traders, including the types, characteristics, and risks associated with the financial products purchased and sold by the entity.

**B. Industry Conditions**

- *High degree of competition or market saturation, accompanied by declining margins.*
  - High degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities, registered investment companies/mutual funds, accompanied by declining margins.
- *Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.*

- A failure or inability to keep pace with the rapid growth in electronic trading, if the financial stability or profitability of the particular entity is placed at risk, due to that failure or inability.

- Unusually high level of “soft dollar” brokerage activities.

**C. Operating Characteristics and Financial Stability**

- *Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult “substance over form” questions.*

- Unusually significant increase in unsettled trades at year end.

**D. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses.

- Extend confirmation procedures concerning agreements with counterparties (e.g., leases, clearing, custody, margin, subordinated debt).

- Extend confirmation procedures concerning the terms of selected transactions (e.g., swaps, financing transactions, fails) with counterparties.

- Review the results of valuation testing performed by departments of the company (i.e., controllers, internal audit and middle office).

- Review background information about the board of directors and management to determine if they have the capacity to understand trading and investment strategies. Conversations with appropriate people and review of the board’s and management’s experience and credentials may be necessary.

- Review management summary reports on performance and meet with management to discuss trading and business direction.

- Perform periodic reviews of valuation methodologies by independent specialists throughout the year.

- Meet with middle office personnel to gain an understanding of the company’s policies concerning managing risk (e.g., stress testing, valuations, etc.).

- Extend testing on regulatory computations for companies barely meeting the minimum net capital requirements.

- Extend testing of the entity’s “soft dollar” arrangements to ensure compliance with SEC rules and regulations.

## MISAPPROPRIATION OF ASSETS

An auditor’s interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

- A. **Susceptibility of Assets to Misappropriation**
  - Large amounts of securities (e.g., bearer instruments) held in the company’s vault.
  - Commingling of customer securities with the entity’s securities at a custodian bank.
  
- B. **Controls**
  - *Lack of appropriate management oversight.*
    - Lack of management oversight of extensive retail branches, or overseas branches and subsidiaries.
    - Inadequate supervision of traders’ trading practices and limits, especially for those generating a large proportion of the entity’s total revenue.
  - *Lack of appropriate segregation of duties or independent checks.*
    - Lack of segregation of duties between the front-office (i.e., execution of trades) and the back-office (i.e., settlement and accounting for trades).
    - Lack of independent review of periodic reconciliations (e.g., settlement accounts, cash accounts, stock record, etc.).
    - Failure to confirm failed transactions on a timely basis.

- Failure to periodically review items in suspense accounts.
- Failure to review the aging of items, including failed transactions and receivables.
- Lack of or infrequent independent pricing of inventory performed by middle-office or back-office (i.e., Risk Management and Controller's group).
- *Poor physical safeguards over cash, investments, inventory or fixed assets.*
  - Lack of safeguarding and insuring securities in transfer.
  - Lack of sufficient access controls for cash wiring systems.
- *Lack of timely and appropriate documentation for transactions.*
  - Lack of documentation related to "soft dollar" brokerage activities.
  - Lack of documentation related to derivative transactions with counter parties, such as ISDA Master Agreements.

**C. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses.

- Review exception/break reports for settlement activities.
- Ensure that the compliance function reviews the personal account statements of the company's brokers and traders.
- Review registration statements of individual traders, account representatives and principals.
- Extend testing of access controls of on-line fund wiring system terminals.
- Review revenue trend of an individual trader over a period of time.
- Review level of errors and broker charge backs of commissions.

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *A motivation for management to engage in fraudulent financial reporting.*
  - Senior management of the plan sponsor appoints itself trustee of the plan and uses that position to benefit the plan sponsor, for example uses the plan's money to do speculative investing or to support the company through buying employer assets, or supporting a supplier.
- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - Failure by management to have adequate valuations performed, including actuarial valuations.
  - The plan administrator lacks an understanding of the major regulations that govern the plans (i.e., ERISA, IRS Code, etc.).
- *Management displaying a significant disregard for regulatory authorities.*
  - Management displaying a significant disregard toward compliance with ERISA and Internal Revenue Code and Department of Labor regulations.

<sup>s</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

— The plan administrator or trustees have been investigated by the Department of Labor or IRS for fiduciary violations in operating the plan.

- Lack of management candor in dealing with plan participants, claimants, actuaries, and auditors regarding decisions that could have an impact on plan assets including restructuring or downsizing arrangements.
- The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL (Such participation could be an indication of ineffective management of the plan or controls over the plan.).

**B. Industry Conditions**

- *Declining industry with increasing business failures and significant declines in customer demand.*

— The plan sponsor is in an industry that is declining in stability and which could lead to difficulties in meeting financial commitments to the plan including contributions.

- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable.
- The plan has limited investment options or the plan has invested significantly in employer securities or other employer assets (e.g., owning franchise stores).

**C. Operating Characteristics and Financial Stability**

- *Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*

— Indications of significant or unusual parties-in-interest transactions not in the ordinary course of operations.

— Excessive or unusual transactions with the plan sponsor/administrator.

**D. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor in an employee benefit plan audit engagement may want to consider the following responses.

- Investment Results. Obtain the requisite investment information directly from the plan trustee, and obtain

the same information from the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor (the directing party) and review and reconcile the directing party's reports (investment position and activity) with those of the trustee.

- **Claim Reserves.** Confirm, with third parties, the historical and statistical information that is being used to prepare the reserves. Review the qualifications of the individuals preparing the reserves.
- Apply the following procedures to fully understand a party in interest transaction:<sup>9</sup>
  - Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
  - Inspect evidence in possession of the other party or parties to the transaction.
  - Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
  - Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
  - With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

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<sup>9</sup> See Chapter 11 of the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, for further audit guidance.



- For single employer plans, obtain the most recent financial statements of the plan sponsor and review for indicators of financial difficulties. For multi-employer plans obtain an understanding of the industry.

## MISAPPROPRIATION OF ASSETS

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Controls

- *Lack of appropriate management oversight.*
  - Lack of review of investment transactions by trustees, sponsor, or investment committee.
  - Lack of appropriate segregation of duties or independent checks.
  - Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan.
- *Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans.*
  - No independent records of the plan are maintained to enable the plan administrator to periodically check the information to the custodian.
- *Lack of appropriate system of authorization and approval of transactions.*
  - Insufficient approval over transactions with parties-in-interest that could lead to prohibited transactions.

- *Lack of timely and appropriate documentation for transactions.*
  - Trustee does not prepare required supplemental information (e.g., historical cost records not maintained).
- Lack of controls surrounding benefit payments including the termination of payments in accordance with plan provisions.
- Lack of appropriate segregation of plan assets from the sponsor's assets or inappropriate access to plan assets by plan sponsor.
- SAS No. 70 report indicates a lack of adequate controls at an outside service provider.
- Use of a service provider that does not provide a SAS No. 70 report.
- Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recordkeeping amounts for a defined contribution plan (unallocated assets or liabilities).

**B. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor in an employee benefit plan audit engagement may want to consider the following responses.

- Review reconciliations of the assets held by the trust with participant records throughout the year. Review any reconciling adjustments for propriety.
- Review the account activity for participants who have access to plan assets or assist in administering the plan.
- The auditor may have concluded that a risk of material misstatement exists with regard to a lack of a qualified outside service provider acting as trustee and/or custodian for plan assets. In these instances, the auditor should physically inspect assets and examine other evidence relating to ownership. In addition, the fair value of investments should be tested by reference to market quotations or other evidence of fair value in accordance with SAS No. 57, *Auditing Accounting Estimates*.
- The auditor may have concluded that a risk of material misstatement exists with regard to unreconciled differences between net assets available for benefits per the

trustee/custodian records and the record keeping amounts for a defined contribution plan. If the trustee/custodian records are higher than the record keeping totals (excluding accrual adjustments) an unallocated asset exists that should be allocated to participant accounts. If the trustee/custodian records are lower than the record keeping totals (excluding accrual adjustments), plan assets may have been misappropriated requiring further investigation by the auditor (e.g., reconciliation of monthly trustee/custodian activity to the record keeper).


- The auditor may have concluded that a risk of material misstatement exists with regard to remittance of employee contributions for a defined contribution plan with a sponsor experiencing cash flow problems. In this instance, the auditor may perform a reconciliation of total employee contributions per the payroll register to the record keeping report for the year. In addition, the auditor may select certain months to test for the timely remittance of employee contributions in accordance with regulations.
- The auditor may have concluded that a risk of material misstatement exists with regard to expenses being paid by an overfunded defined benefit plan on behalf of an underfunded plan. In this instance, the auditor might select expense amounts paid by the overfunded plan and trace them to specific invoices noting that the expense pertained to the proper plan. Alternatively, the auditor could also ask to review expense invoices pertaining to the underfunded plan paid by the company to make sure the overfunded plan did not pay them.
- Review the timeliness of contributions from the plan sponsor throughout the year.
- Compare canceled checks to disbursement records. Where benefits are paid by check disbursements, compare the signature on the canceled check to participant signatures on other employee documents.
- Confirm benefit payments with participants or beneficiaries.
- Confirm medical bills directly with service providers.

## **Fraud Examples**

Listed below are actual instances of fraudulent activity on employee benefit plan engagements. They are presented to help auditors become better acquainted with fraudulent

activities. Although none of these particular examples resulted in a material misstatement of the financial statements, similar fraudulent activity at other benefit plans may cause a material misstatement of the financial statements, depending upon the circumstances.

- A pension plan notifies participants who have reached the age of 70 1/2 that they must under law take their distributions from the plan. An employee of the company is responsible for notifying the participants and providing distribution forms. Once the forms are completed, they are provided to a supervisor for approval and submitted to the insurance company (custodian) for payment. For all participants reaching the age of 70 1/2, the employee decides to forge the distribution forms and not notify the participants of the distributions. The forged forms are provided to the supervisor who approves them and the insurance company is directed to make lump sum distributions via wire transfers into an account set up with the employee's name as a relative for the beneficiary. The fraud continues for several months until a participant notifies the supervisor that they would like to receive their distribution, and the supervisor notices that a lump sum was already distributed.
- A long time employee at a company is responsible for reporting loan repayments (for loans not paid off by automatic payroll deduction) to the recordkeeper by providing copies of the face of the repayment checks to the recordkeeper. The employee is also a participant in the plan and currently has a \$20,000 loan from her account. The employee decides to take a second loan but under plan provisions cannot do it until her first loan is paid off. The employee makes out a check to pay off the \$20,000 loan from her personal account and provides a copy of the check to the recordkeeper. A second loan for \$25,000 is taken out for the employee. However, the first loan is never paid off because the employee never deposits the \$20,000 check into the plan. Cash reconciliations continually show immaterial unreconciled items that are not followed up timely and the fraud is not discovered for months.
- A company has two defined benefit plans; one is overfunded and one is underfunded. In past years, administrative expenses were paid from each plan's



assets; however, this year the company decides it will pay the expenses for the underfunded plan. The overfunded plan continues to pay its own expenses. Due to an administrative error, the overfunded plan ends up paying the expenses for both plans. When management discovers this fact, a decision is made not to reimburse the plan which paid the expenses because it is fully funded.

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *A motivation for management to engage in fraudulent financial reporting.*
  - Substantial political pressure on management creates an undue concern about reporting positive financial accomplishments.
- *A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.*
  - A significant portion of entity-wide, department, or fund management's compensation or performance appraisals linked to budgetary or program accomplishments or other incentives, the value or results of which are contingent upon the entity achieving unduly aggressive targets for budgetary or operating results.
- *An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.*
  - An excessive interest in meeting or exceeding the entity's budgetary targets or maintaining fund

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<sup>10</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

balance or debt coverage requirements through the use of unusually aggressive accounting practices.

- *A failure by management (either executive management, financial management, or the entity's governing body) to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - A governing body that lacks appropriate background knowledge or experience regarding the function and responsibilities of government.
  - Lack of established policies or controls related to investment risk levels.
- *An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.*
  - An ineffective or nonexistent means of communicating and supporting the entity's accountability for public resources and ethics, especially regarding such matters as acceptable business practices, conflicts of interests, and codes of conduct.
- An individual or individuals with no apparent executive position(s) with the entity appear to exercise substantial influence over its affairs or over individual departments or funds (for example, a major political donor or fundraiser, or a major employer in the community).

## **B. Industry Conditions**

- *New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.*
  - Imminent or anticipated adverse changes in major program legislation or regulations that could impair the financial stability or profitability of the entity.
- *Declining industry with increasing business failures and significant declines in customer demand.*
  - Major taxpayers in declining industries or tenuous financial condition.
  - Declining property values or tax base or other restrictions on revenue recognition or realization.

**C. Operating Characteristics and Financial Stability**

- The entity is experiencing a stagnant tax base or revenue base, declining enrollments, or declining demand or use.
- *Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.*
  - Rapid changes in major taxpayers' industries such as significant technology changes, customer bases, or product obsolescence.
- *Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity — including need for funds to finance major research and development or capital expenditures.*
  - Significant pressure to obtain additional funding necessary to stay viable and maintain levels of service considering the financial or budgetary position of the entity or of a specific fund or program, including need for funds to finance major infrastructure improvements or other capital expenditures.
- *Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent programmatic or governmental purpose.*
  - Significant subrecipient or subcontract relationships for which there appears to be no clear programmatic or business justification (for example, a subrecipient providing services it does not appear qualified to provide, or a vendor geographically distant from the entity when nearby vendors are available).
- *Unrealistically aggressive sales or profitability incentive programs.*
  - Unrealistically aggressive budget or program goals.
- *Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain.*
  - Threat of imminent third-party funding termination or significant reduction in third-party funding levels,



the effect of which would be financially material to the entity.

- A mix of fixed price and cost reimbursable program types funded by third parties that create incentives to shift costs or otherwise manipulate accounting transactions.
- Significant investments in high risk financial instruments or high risk ventures.

#### **D. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses to fraud risk factors.

- Additional or more focused analytical procedures concerning actual to budget variances and their underlying causes.
- Testing of larger samples of transactions of expenditures for conformity with allowable cost principles.
- Consultation with the funding agency's inspector general or other oversight organization regarding specific risks and responses for particular programs.
- More focused testing of programs or cost categories for which the entity has a history of prior findings and questioned costs.
- More detailed testing of transactions made by or potentially affected by entity or FFA program managers who have motives to produce particular budgetary, programmatic, or financial results.
- Confirm transaction details with other governments (e.g., grants, tax collections, receivable/payable balances), pertaining to year-end cutoffs.
- Additional inquiry and tests on collectibility of inter-fund receivables, particularly those reporting large continuing balances.
- More focused review of documentation of write-offs of uncollectible taxes and other receivables.
- Confirm with revenue sources to determine if revenue recognized was for services performed prior to year-end, and vouch revenue to bank statements to assure that the revenue was received in the availability period.

- Conduct a more rigorous search for unrecorded liabilities by more closely examining disbursements made after year-end.
- More detailed analysis of investment portfolios and investment policies; and use of investment risk specialists to better assess the riskiness of the entity's investments.

## **MISAPPROPRIATION OF ASSETS**

**An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances do not present a risk of material misstatement. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.**


### **A. Controls**

- *Lack of appropriate segregation of duties or independent checks, especially in areas such as purchasing and force account labor supervision.*

### **B. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses to fraud risk factors.

- Additional participant eligibility testing, including unannounced visits to intake centers, work sites, and other sites where the existence and identity of participants can be verified.
- Observation of benefit payment distribution to identify "ghost" program participants.
- Use of confirmation letters to assure the existence of program participants.
- Review of the governmental entity's purchasing practices to make sure that prices are reasonable for the products purchased. (Inflated prices could indicate



and disclose purchasing agent acceptance of bribes, gratuities, or kickbacks.)

- Examine outstanding encumbrances and encumbrances that were released in the first part of the next year to determine if the encumbering of funds was appropriate and legal.

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *A motivation for management to engage in fraudulent financial reporting.*
  - Substantial political pressure on management creates an undue concern about FFA program accomplishments.
- *A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.*
  - A significant portion of entity-wide or FFA program management's compensation or performance appraisals linked to FFA budgetary or program accomplishments or other incentives, the value or results of which are contingent upon the entity achieving unduly aggressive targets for budgetary or operating results.
- *An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.*
  - An excessive interest by management or employees in meeting or exceeding the entity's budgetary

<sup>11</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

targets through the use of unusually aggressive accounting practices.

- *An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.*
  - An ineffective or nonexistent means of communicating and supporting the entity's values or ethics, especially regarding such matters as acceptable business practices, conflicts of interests, and codes of conduct.
- *Management displaying a significant disregard for regulatory authorities.*
  - Management displaying or conveying an attitude of disinterest regarding strict adherence to FFA rules and regulations such as those related to participant eligibility, benefit determinations, or eligibility.
- An individual or individuals with no apparent executive position(s) with the entity appear to exercise substantial influence over its affairs or over individual FFA programs (for example, a major donor or fundraiser, or a politician).

## **B. Industry Conditions**

- *New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.*
  - Imminent or anticipated adverse changes in program legislation or regulations that could impair the financial stability or profitability of the entity.
- *High degree of competition or market saturation, accompanied by declining margins.*
  - High degree of competition for FFA funding, especially when accompanied by declining availability of FFA funding nation-wide or region-wide.
- *Declining industry with increasing business failures and significant declines in customer demand.*
  - The entity is experiencing a stagnant tax base, revenue base or declining enrollments or eligible participants.

**C. Operating Characteristics and Financial Stability**

- Declining FFA program funding, declining program participant populations, or declining benefit amounts.
- *Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.*
  - Rapid changes in FFA programs, such as significant centralization or decentralization initiatives, funding shifts from federal to state or local levels, increases or decreases in participant populations, high vulnerability to significant changes in compliance requirements, or pending program elimination.
- Threat of imminent program termination or significant reduction in scope, the effect of which could have a material financial impact on the entity.
- *Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity — including need for funds to finance major research and development or capital expenditures.*
  - Significant pressure to obtain additional funding necessary to stay viable and maintain levels of service considering the financial or budgetary position of the entity or of specific FFA programs, including need for funds to finance major research and development or capital expenditures.
- *Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent programmatic or business purpose.*
  - Significant subrecipient or subcontract relationships for which there appears to be no clear programmatic or business justification (for example, a subrecipient providing services it does not appear qualified to provide, or a vendor geographically distant from the entity when nearby vendors are available).
- *Unrealistically aggressive sales or profitability incentive programs.*
  - Unrealistically aggressive budget or program goals.

- A mix of fixed price and cost reimbursable program types that create incentives to shift costs or otherwise manipulate accounting transactions.

#### **D. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses.

- Additional or more focused analytical procedures concerning actual to budget variances and their underlying causes.
- Testing of larger samples of transactions of expenditures for conformity with allowable cost principles.
- Consultation with the funding agency's inspector general or other oversight organization regarding specific risks and responses for particular programs.
- More focused testing of programs or cost categories for which the entity has a history of prior findings and questioned costs.
- More detailed testing of transactions made by or potentially affected by entity or FFA program managers who have motives to produce particular budgetary, programmatic, or financial results.
- Confirm transaction details with other governments (e.g., grants, tax collections, receivable/payable balances), pertaining to year-end cutoffs.
- Additional inquiry and tests on collectibility of inter-fund receivables, particularly those reporting large continuing balances.
- More focused review of documentation of write-offs of uncollectible taxes and other receivables.
- Confirm with revenue sources to determine if revenue recognized was for services performed prior to year-end, and vouch revenue to bank statements to assure that the revenue was received in the availability period.
- Conduct a more rigorous search for unrecorded liabilities by more closely examining disbursements made after year-end.
- More detailed analysis of investment portfolios and investment policies; and use of investment risk specialists to better assess the riskiness of the entity's investments.

## **MISAPPROPRIATION OF ASSETS**

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### **A. Controls**


- *Lack of appropriate segregation of duties or independent checks*, especially in areas such as outreach, intake, eligibility determination, and benefits awards.
- *Lack of appropriate system of authorization and approval of transactions*, such as purchasing, benefit determinations, and eligibility.
- *Lack of timely and appropriate documentation for transactions*, such as eligibility and benefit determinations.

### **B. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses.

- Additional participant eligibility testing, including unannounced visits to intake centers, work sites, and other sites where the existence and identity of participants can be verified.
- Observation of benefit payment distribution to identify "ghost" program participants.
- Use of confirmation letters to assure the existence of program participants.
- Review of the governmental entity's purchasing practices to make sure that prices are reasonable for the products purchased. (Inflated prices could indicate and disclose purchasing agent acceptance of bribes, gratuities, or kickbacks.)



- 
- **Examine outstanding encumbrances and encumbrances that were released in the first part of the next year to determine if the encumbering of funds was appropriate and legal.**

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *An ineffective means of communicating and supporting the organization's values or ethics, or communication of inappropriate values or ethics.*
  - Lack of an effective corporate compliance program.
- *Inadequate monitoring of significant controls.*
  - Lack of oversight or control of various affiliations in an integrated health delivery system.
  - Lack of management review of dispersed locations.
  - Insufficient Board/senior management oversight of critical processes, such as:
    - ▶ Establishment of allowance for uncollectible accounts and contractual adjustments, buildup of unallocated reserve.
    - ▶ Incident monitoring, follow-up, and settlement.
    - ▶ Business affiliations and combinations.
    - ▶ Regulatory compliance.
- *Management displaying a significant disregard for regulatory authorities.*
  - Failure to respond to recent regulatory reviews.

<sup>12</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

## B. Industry Conditions

- A board of directors mainly comprised of local business people and doctors. A board comprised of such people combined with large available financial resources, creates the potential for insider business deals.
- A board of directors comprised of people who lack the necessary experience and skills to properly oversee a health care organization.

- *Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.*

— A failure or inability to keep pace with the rapid growth in medical technology, if the financial stability or profitability of the particular entity is placed at risk due to that failure or inability.

- Intense scrutiny by governmental bodies, watchdog groups, and other interested parties of the organization, placing unusual pressure on management.

Situations targeted for investigation might include:

- ▶ Improper billing of services performed by residents.
- ▶ Inappropriate transfers or discharges.
- ▶ Illegal arrangements involving physicians.
- ▶ Improper referrals.
- ▶ Billing for non-approved medical devices.

(Auditors should be aware of the existence of these types of situations in the health care industry. If these situations are identified on an engagement, they should be considered in the auditor's assessment of material misstatement due to fraud.)

- Intense pressure from governmental bodies and health maintenance organizations to embrace cost containment and efficiency enhancement programs.

## C. Operating Characteristics and Financial Stability

- The existence of many complex third-party payor contracts.

**D. Auditor Response**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following response.

*Allowance for Uncollectible Accounts and Contractual Adjustments.*

If there is the risk of material misstatement concerning the allowance for uncollectible accounts and contractual adjustments, the auditor should consider taking a more substantive approach to testing the factors used to determine such allowances. Such steps might include more detailed analytical procedures such as analyses of historical contractual adjustments by specific payors to the recorded allowance or the testing/analysis of the collectibility of a sufficient number of accounts to arrive at an independent conclusion as to the adequacy of the allowance.

## MISAPPROPRIATION OF ASSETS

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

**A. Susceptibility of Assets to Misappropriation**


- Pharmaceutical inventory with high street values.
- Large amounts of cash payments received for medical care.

**B. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor may want to consider the following responses.

*Cash Receipts*

The auditor may have identified a risk of material misstatement relating to the potential embezzlement of cash receipts. The lack of internal accounting controls provides the opportunity for the embezzlement to be covered up



through bad debt, contractual or other write-offs. In this situation, the auditor might expand the review of cash receipts to compare remittance advises to accounts posted as received or might review specific accounts which have been written-off for appropriateness.

*Kickbacks From Suppliers*

The auditor may have identified a risk of material misstatement relating to potential kickbacks from suppliers. Such kickbacks might result in the entity paying excessive amounts for goods. The auditor might have concluded that the lack of adequate internal accounting control over the purchasing process provides the opportunity for this to occur. The auditor might consider, in these circumstances, a more detailed analytical review of expenses and a review of a sample of invoices to compare amounts paid for specific items to amounts per purchase contracts or with independent prices obtained from other vendors.

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *An excessive interest by management in maintaining or increasing the company's stock price or earnings trend through the use of unusually aggressive accounting practices.*
  - Risk transfer criteria for reinsurance transactions rarely met.
  - Use of discretionary reserves to manipulate earnings.
- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - Lack of Board/management oversight of critical processes:
    - ▶ Underwriting — control risk, price risk.
    - ▶ Reinsurance Activity — monitoring stability of reinsurers.
    - ▶ Suspense account clearance.
    - ▶ Treasury — securities/derivatives valuation (selection of models, methodologies and assumptions).<sup>14</sup>

<sup>13</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

<sup>14</sup> For more information on derivatives refer to *Derivatives — Current Accounting and Auditing Literature* (AICPA Product #014888) and *Internal Control Issues in Derivatives Usage: An Information Tool for Considering the COSO Internal Control Integrated Framework in Derivatives Applications*

- ▶ Establishment of loss and loss adjustment expense reserves.
- ▶ Investment decisions.
- No business risk management responsibility or function.
- Management's inattention to establishing independent reporting lines for key assurance functions (e.g., internal audit, quality control reviews of claims and underwriting, etc.)
- *Management displaying a significant disregard for regulatory authorities.*
  - Existence of a regulatory enforcement action.
  - Prior examination findings not addressed or inadequately addressed.
  - Mandated restatements of regulatory financial reports due to inappropriate accounting treatment.
  - Company assessed market conduct fines.
- *Strained relationship between management and the current or predecessor auditor.*
  - Disputes with current or predecessor auditors regarding the reasonableness of sensitive estimates (e.g., loss and loss adjustment expense reserves, allowances for uncollectible reinsurance and other amounts).

## **B. Industry Conditions**

- *New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.* Possible situations may include:
  - New criteria used by rating agencies to assign ratings to insurers.
  - Impact of codification of statutory accounting principles.
  - Applicability of GAAP for mutual insurers.
  - Demutualization.
  - Changes in risk-based capital requirements.
- *Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.*

**C. Operating  
Characteristics  
and Financial  
Stability**

- Rapidly changing distribution network results in different sales vehicles without adequate controls (e.g., possible use of the Internet).
- *Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the company.*
  - Estimates for loss and loss adjustment expenses, reinsurance recoverables, DAC, and others based on unusually subjective judgments.
  - *Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*
    - Numerous intercompany reinsurance transactions.
  - *Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult “substance over form” questions.*
    - High yields on investments that appear to be low-risk.
    - Transactions that “convert” nonadmitted assets to admitted assets.
    - Numerous and complex off-balance sheet financing transactions.
  - *Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.*
    - Unusual and considerable increases in the number of policyholders over a short period of time.
- The company sells and buys an unusual and substantial amount of securities that do not have an active market which could indicate “parking losses.”
- Volatility of earnings due to CATs could cause the company to manipulate earnings.
- Loans requested on life policies occurring soon after large deposits on the policy are made. The loan could be issued before the deposit check clears and then the check is returned for insufficient funds.



## MISAPPROPRIATION OF ASSETS

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Susceptibility of Assets to Misappropriation

- Significant activity and/or balances present in suspense accounts.
- Large volume of duplicate claims processed.
- Large volume of claims paid to post office boxes.
- Large volume of claims paid to persons other than the applicable insured.
- Large volume of claims paid to employees.

### B. Controls

- *Lack of appropriate management oversight.*
  - Lack of adequate monitoring of underwriting policies and procedures.
  - Significant amount of year-end or month-end transactions which precludes normal review procedures.
  - Extensive use of MGAs with little or no supervision by management.
- *Lack of appropriate segregation of duties or independent checks.*
  - Lack of rotation or review of claim adjusters on long-term claims.
  - Custodial reconciliations performed by individual who records the amounts to the ledger.
- Large volume of system overrides (e.g., claim payments, commissions, etc.)

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - Lack of a clearly defined policy with respect to personal investing activities.
  - Unusual and considerable influence of portfolio manager over pricing sources used to value securities.
  - Inadequate controls around the calculation of the net asset value.
  - Reconciliation of security holdings with the custodian are infrequent or incomplete.
  - The monitoring of the Fund's tax status as a regulated investment company is not adequate.
  - The monitoring of the Fund's compliance with its prospectus requirements is inadequate.
  - Transfer agency controls are ineffective or implementation of user controls in a service center environment are ineffective.
  - Lack of an appropriate policy regarding corrections of net asset value errors, or failure to comply with policy.
  - Lack of Board members' understanding of how portfolio management intends to implement the Fund's investment objectives.

<sup>15</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

— Lack of Board members' understanding of derivatives utilized by portfolio managers and involvement in approving or disapproving use of specific strategies such as embedded leverage.

• *Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.*

— An excessive focus on maintaining a high rate of dividend payments regardless of the Fund's actual earnings.

• *A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.*

— Commitment to achieving a low targeted expense ratio based on unreasonable expectations of asset growth.

• *Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.*

— Past suspensions of ability to act as an investment adviser or requirement that the adviser be supervised by others.

**B. Operating  
Characteristics  
and Financial  
Stability**

• *Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*

— Significant transactions with affiliates which are not approved by the board of directors in accordance with Section 17 of the Investment Company Act.

• Undocumented or ill-defined soft-dollar arrangements.

• Significant investments for which readily available market quotes are not available and procedures for estimating these values are not adequate.

• Significant investment in derivative financial instruments for which value is very difficult to estimate.

• Significant investments are held which are being restructured due to default or bankruptcy and the restructuring transaction is initiated near year end.

## **MISAPPROPRIATION OF ASSETS**

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### **A. Controls**

- Securities, not under the control of the custodian, fail to comply with self-custody rules.
- Lack of any periodic review of a transfer agency's control design and operation by an independent auditor knowledgeable in the area (such as a SAS 70 report).

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *A significant portion of management's compensation represented by bonuses, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.*
  - A significant portion of management's compensation is linked to unduly aggressive program accomplishments or unduly aggressive fund-raising targets.
- *Domination of management by one person or a small group without compensating controls such as effective oversight by the board of directors or audit committee.*
  - Executive director possesses significant power and latitude to manage programs, activities, and transactions and to override controls.
- Board members or management, charged with oversight responsibilities, lack the necessary background experience in NPO management and NPO program activities or lack a commitment to fulfilling their duties.
- A major donor or fundraiser exercises substantial influence over the affairs of the organization.

<sup>16</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

**B. Industry  
Conditions**

- *High degree of competition or market saturation, accompanied by declining margins.*
  - Unusually intense competition for the limited pool of contributions and government grants exists, thereby pressuring management to present a favorable financial picture in the hope of attracting those contributions and grants.
  - Political and economic events occur, causing dramatic decreases in government grants and contributions.
- An unusual focus by external financial statement users on the amounts reported as program, management and general, and fund raising expenses.
- The threat of imminent third-party funding termination or significant reductions in third-party funding.

**C. Operating  
Characteristics  
and Financial  
Stability**

- *Significant, unusual, or highly complex transactions, especially those close to year-end that pose difficult “substance over form” questions.*
  - The existence of numerous split-interest agreements containing complex provisions.
- *Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.*
  - Significant subrecipient or subcontract relationships, without a clear program purpose or business justification.
- A mix of fixed price, units of service, and cost reimbursement program types funded by third parties that creates incentives to shift costs or manipulate accounting transactions.
- Diverse programs funded by multiple sources involving many complex requirements that must be complied with. The organization may also have to comply with federal requirements.

**D. Auditor Responses**

In addition to the sample responses presented in SAS No. 82, an auditor of a not-for-profit organization may want to consider the following responses.


- Send confirmations to donors to confirm, not only the amount of promises to give in the future, but to clarify the nature of any restrictions.
- Obtain information from comparable organizations with respect to the collectibility of contributions receivable.
- Perform more focused analytical procedures related to program-specific budgets.
- Test larger samples of expenditures for conformity with allowable cost principles.
- Extend confirmation procedures with donors to determine that all contribution revenue was recorded.
- Thoroughly analyze the allocation of costs to various programs.

## **MISAPPROPRIATION OF ASSETS**

**An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.**

**A. Controls**

- *Lack of appropriate management oversight.*
  - Failure to develop adequate controls over contributions and grants, resulting from the assignment of scarce resources more to program activities and less to internal control.
- *Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.*

- 
- The presence of volunteers working in the organization, who have access to assets susceptible to misappropriation and who have not been adequately screened.
  - *Lack of timely and appropriate documentation for transactions.*
    - Promises to give in the future are not adequately documented.



## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.


### A. Management Characteristics and Influence Over the Control Environment

- *Management displaying a significant disregard for regulatory authorities.*
  - Failure to appropriately respond to findings from the latest commission-mandated management audit.
  - Significant disallowances of allowable cost in latest rate proceeding.
- *An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.*
  - Inappropriate deferral of incurred cost or failure to write-off previously deferred cost pursuant to the provisions of SFAS No. 71.
  - Failure to recognize a regulatory liability pursuant to the provisions of SFAS No. 71.
  - Unusually aggressive accrual of performance awards and incentives.

### B. Industry Conditions

- Proposed changes in the federal and state regulatory environment introducing a high level of competition into the market that may create pressure on profitability and potential losses related to "stranded investments."

<sup>17</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.



**C. Operating  
Characteristics  
and Financial  
Stability**

- Considerable pressure to maintain or reduce rates that may create pressure on earnings.
  - *Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity.*
- Consideration should be given to:
- ▶ Significant regulatory deferrals.
  - ▶ Embedded regulatory assets.
  - ▶ The recognition of regulatory liabilities.

## FRAUDULENT FINANCIAL REPORTING

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Management Characteristics and Influence Over the Control Environment

- *An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.*
  - An excessive interest by management in maintaining or increasing the reported amount of real estate assets through the use of unusually aggressive appraisal assumptions.
  - The use by management of unusually aggressive accounting practices in recognizing revenue from real estate sales.
- Inadequate responses or an unwillingness to respond to inquiries about known regulatory or legal issues (e.g., the presence of environmental contamination on an entity-owned site).

### B. Operating Characteristics and Financial Stability

- *Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*
  - Interdependent, multiple transactions between the same parties or their affiliates.

<sup>18</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

- *Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult “substance over form” questions.*
  - Complicated criteria for recognizing sales transactions, making it difficult to assess the completeness of the earnings process.
  - Significant “side agreements” or transaction terms not previously disclosed.
- Key contracts awarded without a competitive bidding process.

## MISAPPROPRIATION OF ASSETS

An auditor’s interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

### A. Susceptibility of Assets to Misappropriation

- Significant unencumbered real estate that could be used as collateral for an unauthorized loan, the proceeds of which are distributed to an individual or outside entity.

The following listing of example risk factors for small, privately owned businesses includes SAS No. 82 example risk factors most relevant to these entities as well as additional example risk factors. This section should be used in conjunction with the discussion on considering fraud risk factors for small businesses in Part One, *Identifying Fraud Risk Factors — Application to Smaller Entities*.

## FRAUDULENT FINANCIAL REPORTING

### A. Management Characteristics and Influence Over the Control Environment

- A motivation for management to engage in fraudulent financial reporting.
  - An interest by management to pursue inappropriate means to minimize reported earnings for tax-motivated reasons.
  - Adverse consequences on significant matters if poor financial results are reported, for example a violation of debt covenants.
  - Adverse consequences on significant matters if *good* financial results are reported. Specific examples include management's motivation to inappropriately reduce income taxes, to defraud a divorced spouse or a partner of his or her share of the profits or assets of a business, or to convince a judge or arbitrator that the business in dispute is not capable of providing adequate cash flow. Keep in mind that you are not required to plan your audit to discover personal information (i.e., marital status) of the owner-manager. However, if you become aware of such information, you should consider it in your assessment of risk of material misstatement due to fraud.
  - Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.
  - Significant pressure to obtain additional capital necessary to stay competitive.
  - Threat of imminent bankruptcy or foreclosure.

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<sup>19</sup> Refer to the "Introduction" of this Part for guidance on how to use this section.

— A practice by management of committing to creditors and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts.

- Known history of claims against the entity or its senior management alleging fraud.
- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
- Strained relationship between management and the current or predecessor auditor.

## **B. Industry Conditions**

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- Declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

## **C. Operating Characteristics and Financial Stability**

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity, such as timing of revenue recognition or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult “substance over form” questions.
- Overly complex organizational structure.
- Unusually rapid growth or profitability compared with that of other similar companies.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements.

## **MISAPPROPRIATION OF ASSETS**

- A. Susceptibility of Assets to Misappropriation**
- Large amounts of cash on hand or processed.
  - Inventory characteristics, such as small size, high value or high demand.
  - Easily convertible assets.
  - Fixed asset characteristics, such as small size, marketability, or lack of ownership identification.
- B. Controls**
- (Keep in mind that the extent of your consideration of risk factors relating to controls is influenced by the degree to which susceptibility risk factors are present.)
- Lack of appropriate management oversight.
  - Lack of appropriate segregation of duties or independent checks — Inadequate segregation of duties is quite often understandable in a small business environment in that it's a function of the entity's size. However, you should consider it in conjunction with other risk factors and with mitigating controls.
  - Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.
  - Inadequate record keeping with respect to assets susceptible to misappropriation.
  - Lack of appropriate system of authorization and approval of transactions (for example, in purchasing).
  - Poor physical safeguards over cash, investments, inventory or fixed assets.
  - Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
  - Lack of a mandatory vacation policy for employees performing key control functions.

*PRACTICE AIDS*

*Part* **Three**



## COMMON FRAUDS AND EXTENDED AUDIT PROCEDURES

The purpose of this section is to help you design extended audit procedures whenever you believe previously planned audit procedures are not sufficient to respond to the assessed risk of material misstatement due to fraud. This chapter is organized according to audit area, and within each area you will find:

- A description of examples of some typical fraud schemes you might discover in that area;
- A listing of some symptoms to look for that may indicate the existence of fraud; and
- A description of some example audit procedures that may help you detect material misstatements resulting from those frauds.

For fraud schemes relating to the misappropriation of assets, a listing of supplemental internal control questions has been included to help you and your clients identify control weaknesses that leave them susceptible to fraud. (Note: Fraudulent financial reporting usually is perpetrated by management, who has the ability to override most internal controls. For this reason, the sections dealing with fraudulent financial reporting do not include a discussion of controls.)

This section, like the entire book, is written for auditors performing an audit in accordance with GAAS. When you extend your audit procedures, you should continually evaluate whether the possible misstatement is material to the financial statements. If, upon obtaining additional information, you find that the possible misstatement would be immaterial to the financial statements, additional audit procedures would be considered part of a fraud examination consulting engagement rather than part of a GAAS audit. Refer to Part One, Detection of Fraud or Misstatements That May Be the Result of Fraud for additional information on the difference between these types of engagements.

The material presented in this section consists of the author's observations and recommendations. The example audit procedures are not required by SAS No. 82.

# CASH

## Misappropriation of Assets

### *Typical Frauds*

The most common way in which a company (particularly a small business) is defrauded of cash is through **fraudulent disbursements**. Under these schemes, the employee uses company checks to either (a) withdraw cash directly for his or her own benefit, or (b) pay personal expenses. For example—

- An employee writes checks payable to cash and posts the debit to various expense accounts. When the bank statement comes back with the canceled checks, she simply discards the ones she had cashed and performs the bank reconciliation.
- An employee uses company checks to pay personal credit card bills. Each month, he has a credit card bill approximately equal to the company's required payroll tax withholding. Instead of making the payroll tax deposit, he writes a check to his credit card company. He discards these checks when they are returned with the bank statements. He also discards the notices received from the IRS stating that the company's payroll withholding deposits have not been made.

There are infinite variations of these types of frauds. People who commit these kinds of frauds are faced with two tasks. First, they must post a debit somewhere in the general ledger to disguise the disbursement. The clever embezzler will post this debit to an expense account (which is closed out at the end of the year, thus eliminating the audit trail), or to inventory (where differences between the books and the physical count flow through cost of sales, thus eliminating the audit trail). Second, the embezzler must have a way to avoid detection during the bank reconciliation process. In a small business, this usually is possible because of a lack of segregation of duties. It might also involve collusion.

Companies that handle large amounts of cash are also susceptible to **theft of cash on hand**. Industries such as retail sales or restaurants are particularly susceptible to these kinds of frauds. It would be rare that the theft of

cash on hand would be material to an entity's financial statements, but as a client service matter, you should be alert to the possibility. Common schemes include:

- **Skimming.** Cash is "skimmed" before it enters the accounting system. For example, the employee accepts cash but never prepares a receipt, or prepares a receipt for less than the amount taken.
- **Substituting personal checks for cash.** The employee takes money from the cash register and substitutes a personal check. In that way, the cash drawer is always "in balance," but the employee never submits the personal check for deposit to the company's bank account. Consequently, the employee receives free use of the cash.
- **Fictitious refunds and discount.** The employee records a refund and removes cash as if a refund had occurred. But no merchandise was returned or discount given.
- **Altered credit card receipts.** This is a problem in the restaurant business where the waitperson may increase the tip written on a credit card receipt.

#### ***What to Look For***

In addition to the items listed in paragraphs 19, 20, and 25 of SAS No. 82, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Missing checks or checks out of sequence
- Employee personal checks found in cash drawers
- Large, unexplained reconciling items in the bank reconciliations
- Unusual endorsements on checks
- Bank statements that do not include canceled checks
- Some canceled checks are missing
- Disbursements are unsupported by invoices or other documentation
- Customer complaints
- Altered or missing cash register tapes
- Unusual or unexpected voids or sales returns

### ***Example Audit Procedures***

The following audit procedures should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of the risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Examine bank reconciliations. A thorough review of bank reconciliations is one of the best ways to detect fraud relating to cash.
- Review bank statements and canceled checks. Look for checks made out to cash, employees, or unusual vendors. Compare endorsement to payee. Make sure all canceled checks are accounted for.
- Obtain a bank cut-off statement. Cut-off statements are requested from the bank and delivered directly to the auditor, who reconciles it.
- Perform analytical procedures (at high precision levels) on expense accounts. Investigate accounts with higher than expected balances.
- Search for and examine unusual expense account activity close to the end of an accounting period. The theft of cash usually is concealed with a debit to an expense account because expenses are closed to retained earnings at the end of the accounting cycle. The clever embezzler will concentrate his or her theft at the end of the cycle to limit the amount of time the theft remains on the books.
- Perform surprise cash counts. These will sometimes turn up embezzlement of petty cash.
- Analyze sales discounts and returns. Compare current period to prior periods or breakdown activity by employee. Look for unusual patterns or trends.
- Review vendor list with management and investigate any payments to unknown or unusual vendors.
- Compare check endorsements to payee information.

***Expanding Your Internal Control Questionnaire***

Your internal control questionnaire should have questions aimed at identifying your client's vulnerability to the misappropriation of cash. If any of the following questions are not included in your questionnaire, consider adding them. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud; however, as a client service matter, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud. Keep in mind that "no" responses may also indicate reportable conditions or material weaknesses to be communicated to the client.

**Cash**  
**Internal Control Questions**  
**Related to Fraud**

	<u>Yes</u>	<u>No</u>
1. Are all bank accounts reconciled on a timely basis?	_____	_____
2. Is there adequate segregation of duties between cash receipt, cash disbursement, and bank reconciliation functions?	_____	_____
3. Does the company receive canceled checks along with its bank statements?	_____	_____
4. Do the bank reconciliation procedures include accounting for all canceled checks?	_____	_____
5. Are employees with cash disbursement and bank reconciliation duties required to take vacations and are other employees cross-trained to perform those functions when an employee is absent?	_____	_____
6. Has the company limited the logical access to computerized cash disbursement records?	_____	_____
7. Does the company limit the physical access to negotiable assets such as blank checks?	_____	_____
8. Does the owner review and sign all checks? If not, do disbursements over a certain dollar amount require dual signature or another control procedure?	_____	_____
9. If employees process a significant amount of cash transactions, does the company adequately control and monitor these transactions?	_____	_____
10. Does the company use an approved vendor list (i.e., vendors are approved by management before used)?	_____	_____

## REVENUE RECOGNITION

### Fraudulent Financial Reporting

#### *Typical Frauds*

There are many frauds related to the improper recognition of revenue, including:

- **Recording fictitious sales.** This may be accomplished by recording sales to nonexistent customers, or recording phony sales to legitimate customers. The latter schemes include: double billing, or billing for items not shipped or ordered. These schemes usually occur near the end of an accounting period and are concealed by issuing credit memos or other credit adjustments to accounts receivable in the period immediately following the balance sheet date.
- **Recognizing revenue on transactions that do not meet the revenue recognition criteria.** These include improper revenue recognition when the right of return exists, “bill and hold” transactions, or other transactions where the earnings process is not complete. Rights of return and other sales terms that would preclude revenue recognition often are concealed through the use of written side agreements or oral agreements not disclosed to the auditors.
- **Sham transactions.** For example, selling assets at inflated prices to an outside entity, while simultaneously buying assets at inflated prices from that same entity. These types of transactions are particularly difficult to detect because they involve collusion with a co-conspirator outside the entity.
- **Recognizing revenue in the improper period.** The most common of these types of frauds is to recognize revenue on future, anticipated sales. This may be accomplished by altering dates on shipping documents or holding the books open until after the shipment has occurred.

#### *What to Look For*

In addition to the items listed in paragraphs 17 and 25 of SAS No. 82, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Excessive credit memo and other credit adjustments to accounts receivable after the end of the accounting period
- Customer complaints and discrepancies in accounts receivable confirmations (for example, disputes over terms, prices, or amounts)
- Unusual entries to the accounts receivable subledger or sales journal
- Missing or altered source documents (for example, invoices or shipping documents) or the inability of the client to produce original documents in a reasonable period of time
- A lack of cash flow from operating activities when income from operating activities has been reported
- Unusual reconciling differences between the sales journal and the general ledger
- Sales to customers in the last month before the end of the accounting period at terms more favorable than previous months
- Sales with affiliates and related parties
- Pre-dated or post-dated transactions
- Journal entries made to the sales or revenue account directly, that is, not posted from the accounts receivable subledger or sales journal
- Large or unusual adjustments to sales accounts made just prior to or just after the end of the period

### ***Example Audit Procedures***

The following audit procedures should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of the risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Perform a thorough review of original source documents (not photocopies) including: invoices, shipping documents, customer purchase orders, cash receipts,



and written correspondence between the client and the customer.

- Analyze and review credit memos and other accounts receivable adjustments for the period subsequent to the balance sheet date.
- As part of the accounts receivable confirmation effort, confirm with customers the terms of sales agreements, including the absence of right of return and terms that might preclude immediate revenue recognition.
- Analyze all large or unusual sales made in the last month prior to the end of the period. Vouch to original source documents. Confirm terms of the transaction directly with the customer.
- Scan the general ledger, accounts receivable subledger and sales journal for unusual activity.
- Compare operating cash flow to sales. Analyze by salesperson, location, or product.

## ACCOUNTS RECEIVABLE

### Misappropriation of Assets

#### *Typical Frauds*

Most frauds relating to the misappropriation of accounts receivable involve the diversion of payments received from customers. The scheme is fairly simple to perform. For example, an employee may open a personal bank account with a name similar to that of the company (Acme Inc. rather than Acme Company). Customer payments can then be taken by the employee and deposited into the employee's bank account.

What varies in accounts receivable frauds is how the frauds are *concealed*. Common techniques include the following:

- **Lapping.** The payment from customer A is diverted by the employee. To keep customer A from complaining, the payment from customer B is applied to customer A's account. Customer C's payment is applied to customer B's account, and so on.
- **Posting improper credits to the account.** To conceal the fraud, the employee posts credit memos or other non-cash reductions (for example, representing a sales return or write-off) to the customer account from which the funds were diverted.
- **Altering internal copies of invoices.** The company's copy of the sales invoice is altered to report an amount lower than that actually billed to the customer. When payment is received, the "excess" amount is diverted by the employee.

Another accounts receivable fraud involves the **diversion of payments from written-off accounts**. Most companies do not monitor the activity on accounts that have been written off, which provides the employee with the opportunity to divert payments from these customers and not be detected. For example, an employee will work with a customer to collect an overdue receivable. As the customer is about to pay, the employee writes off the account, removing it from the books.

Also, the author is aware of one fraud committed by an employee who made an arrangement with customers to "manage" their past due accounts. The employee took

steps to make sure these customers' accounts were always shown as current in the company's books and records. This effectively gave the customers an unlimited amount of time to pay their bills and avoid late fees and interest charges. In exchange for this service, the employee received a **kickback** from the customers.

***What to Look For***

In addition to the items listed in paragraphs 19, 20, and 25 of SAS No. 82, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Unexplained differences noted by customers on their accounts receivable confirmations
- Significant delays between the date the customer states a payment was made and the date payment was recorded as received by the company
- A significant number of credit entries and other adjustments made to the accounts receivable records
- Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger
- Discrepancies between customer names and amounts on deposit slips and subledger accounts and amounts credited

***Example Audit Procedures***

The following audit procedures should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of the risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Confirm account activity (not just the balance) with the customers directly. Be sure to confirm credit memo and sales return activity, as well as the date payments on account were made. Follow up on significant accounts receivable confirmations by contacting customers by telephone.

- Perform analytical reviews of credit memo and write-off activity, for example, by comparing to prior periods. Look for unusual trends or patterns such as large numbers of credit memos pertaining to one customer or sales person, or those processed shortly after the close of an accounting period.
- Vouch credit memos and other write-offs to receiving records for returned goods, correspondence with customers, and other documentation supporting the transactions.
- Investigate all differences between the payment date reported by the customer and the payment date recorded by the company. Do not rely on company-generated activity summaries — review both sides of the original checks or check copies.
- Analyze recoveries of written-off accounts.
- Obtain an understanding of how the accounts receivable aging is prepared and who has access to the data used to prepare the aging.
- Review collections of accounts receivable in subsequent periods to determine validity of sales in prior periods.

### ***Expanding Your Internal Control Questionnaire***

Your internal control questionnaire should have questions aimed at identifying the client's vulnerability to the misappropriation of accounts receivable. If any of the following questions are not included in your questionnaire, consider adding them. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud; however, as a client service matter, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud. Keep in mind that "no" responses may also indicate reportable conditions or material weaknesses to be communicated to the client.

**Accounts Receivable  
Internal Control Questions  
Related to Fraud**

	<u>Yes</u>	<u>No</u>
1. Are different employees responsible for preparing invoices, receiving payment, and maintaining accounts receivable records?	_____	_____
2. Has the company limited the logical access to computerized accounts receivable records and processes?	_____	_____
3. Are employees with accounts receivable responsibilities required to take vacations and are other employees cross-trained to perform those functions when an employee is absent?	_____	_____
4. Are credit memos approved and reviewed by management?	_____	_____
5. Does the entity have a method for tracking and monitoring customer complaints related to billing? Are these complaints periodically reviewed by management?	_____	_____
6. Is the accounts receivable subsidiary ledger reconciled to the general ledger account balance on a regular basis?	_____	_____

# INVENTORY

## Misappropriation of Assets

### *Typical Frauds*

One of the more common inventory frauds is the **theft of inventory for personal use**. This is most likely to happen when inventory items are small and easy to steal, and the items have value to an employee as a consumer. For example, computer chips are small and easy to steal, but they have no value to the employee as a consumer. A laptop computer has the physical characteristics that make it susceptible to theft, *plus* the employee can use it immediately. The computer is more likely than the computer chip to be stolen for personal use.

A more lucrative inventory fraud is the **theft of inventory for sale**. For these frauds, it's not necessary for the inventory to have value to the employee as a consumer, since the goods won't be used for personal use. A common scheme is for the receiving personnel to steal the goods from the receiving dock, before physical custody is established by the warehouse. For example, the employee signs a receiving report stating that 100 units were received, but only 90 are stocked in the warehouse and 10 are placed in the trunk of the employee's car. The missing units may not be discovered until the year-end physical inventory count.

For larger inventory items that are more difficult to transport, the receiving personnel may collude with the vendor's delivery personnel. The delivery personnel diverts 10 units of inventory to another location and delivers the remaining 90 units. The receiving personnel prepares a receiving report indicating that all 100 units were received. The stolen merchandise is then sold and the proceeds split between the two.

**Theft of scrap** is another common fraud. For example, a hospital employee was convicted of stealing used x-rays, then recovering and selling the silver. In most companies, inventory scrap is not recorded or well-controlled, which makes it easy to steal. These thefts can be significant, especially in situations where the embezzler has the ability to inappropriately designate saleable inventory as scrap.

### ***What to Look For***


In addition to the items listed in paragraphs 19, 20, and 25 of SAS No. 82, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Large differences between the physical inventory counts and perpetual inventory records
- Unexpected or unexplained increases in inventory turnover accompanied by decreases in gross profit percentages
- Unexplained entries in the perpetual inventory records
- Key inventory ratios (for example, shrinkage, turnover, or gross profit) that vary significantly from industry norms or between company locations or inventory types
- Shipping documents (indicating that goods were shipped from the company) without corresponding sales documentation

### ***Example Audit Procedures***

The following audit procedures should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of the risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Analyze inventory shortages by location or product type. Compare key inventory ratios to industry norms. Look for unusual concentrations, patterns, or trends as a way to direct more detailed inquiries and investigations.
- Review receiving reports and look for indication of alternative shipping sites.
- Review supporting documentation for reductions to the perpetual inventory records.
- Compare shipping documents to corresponding documentation.



Because of the nature of inventory theft, it may be difficult to detect using traditional audit techniques. If your client has reason to believe inventory is being stolen, a fraud examination may be required. For example, a fraud examiner might perform surveillance of receiving personnel or surprise counts of items received into inventory.

***Expanding Your Internal Control Questionnaire***

Your internal control questionnaire should have questions aimed at identifying your client's vulnerability to the misappropriation of inventory. If any of the following questions are not included in your questionnaire, consider adding them. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud; however, as a client service matter, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud. Keep in mind that "no" responses may also indicate reportable conditions or material weaknesses to be communicated to the client.



**Inventory**  
**Internal Control Questions**  
**Related to Fraud**

	<u>Yes</u>	<u>No</u>
1. Does the client maintain adequate safeguard controls (for example, locked warehouses) over inventory susceptible to misappropriation?	_____	_____
2. Is there proper segregation of duties between employees responsible for inventory record-keeping and those responsible for its physical custody?	_____	_____
3. Are employees with inventory, shipping, and receiving responsibilities required to take vacations and are other employees cross-trained to perform those functions when an employee is absent?	_____	_____
4. Has the company limited the logical access to computerized inventory records?	_____	_____
5. Are physical inventory counts performed regularly? Are the count procedures adequate to ensure an accurate count?	_____	_____
6. Is scrap inventoried and controlled?	_____	_____
7. Is there proper segregation of duties between those with the authority to identify or designate scrap and those with the responsibility for selling it?	_____	_____

# INVENTORY

## Fraudulent Financial Reporting

### *Typical Frauds*

Inventory frauds are perpetrated to manipulate earnings. Inflated ending inventory balances reduce the amount of reported cost of goods sold, which results in improper increases to gross profit and net income. The usual method for inflating ending inventory is to report **fictitious inventory amounts**. This can be done in numerous ways, including:

- Altering quantities reported on inventory count tags or sheets that were not reviewed by the auditors
- Entering inventory count tags or sheets for non-existent inventory
- Shifting the same inventory between several different locations
- Altering or disguising the physical characteristics of inventory items to make it appear as if larger quantities are on hand (for example, hollow stacks of inventory that are made to appear solid, or inventory boxes filled with weights).
- Substituting cheaper, inferior quality inventory for more expensive, high quality inventory

In other instances, management may be predisposed to **understate beginning inventory balances**, which has the same desired effect of increasing current period earnings. For example, this scheme may be perpetrated when there has been a change in management and current management wishes to report improved profitability. The most common method for understating beginning inventory is to overstate the allowance for inventory obsolescence.

### *What to Look For*

In addition to the items listed in paragraphs 17 and 25 of SAS No. 82, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Inability to produce all inventory count tags or sheets
- Lack of control over the population of used count tags or sheets

- Slow inventory turnover; increases in certain types of inventory or in branches or other locations not examined by auditors
- Vendor invoices supporting purchases are unavailable (for example, while performing price fieldwork)
- Significant changes in gross profit percentages
- Large unexplained reconciling differences between the inventory amounts recorded on the books and the physical inventory count
- Large increases in inventory balances without corresponding increases in purchases
- Journal entries made directly to the inventory account rather than through the purchases journal

### ***Example Audit Procedures***

Your primary audit procedure relating to the existence of inventory is the physical inventory count. The following audit procedures, performed during the physical inventory count, should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of the risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Account for all inventory count tags or sheets used during the physical count.
- Expand the number of test counts.
- Thoroughly examine all items counted ( for example, by opening sealed boxes to observe the contents).
- Perform physical inventory counts at all locations simultaneously.
- Use the work of a specialist to help determine the quality (for example, the purity, grade, or concentration) of the inventory items.
- Perform analytical procedures of gross profit. Analyze according to location or inventory type.
- Perform analytical procedures of inventory balances and purchases. Analyze according to location or inventory type.

## PURCHASING AND PAYROLL

### Misappropriation of Assets

#### *Typical Frauds*

The purchasing function is particularly vulnerable to fraud. For many small businesses it represents the largest area of the risk of embezzlement.

The most common fraud scheme is the **payment of invoices to a fictitious company**. To perpetrate this scheme, the embezzler establishes a fake entity (often with a P.O. Box for an address, and a name similar to that of a legitimate company) and gets the fake entity entered into company records as a legitimate vendor. The embezzler then produces invoices for the fake vendor, which are processed by the accounts payable system. Sometimes the embezzler is responsible for authorizing payment but other times not. The scheme may also require collusion between various employees, such as receiving (doctoring a receiving report to indicate something was received) and accounts payable (approving the invoice for payment).

Another common fraud is a **kickback** paid by vendors to the company's purchasing agent. In collusion with suppliers, a purchasing agent may get paid a kickback for any number of activities including:

- Allowing the vendor to submit fraudulent billing and approving the payment. Examples of fraudulent billing practices include: billing for goods or services never performed or received, billing more than once for the same item, substituting lower quality items than the ones billed, or overbilling for the items delivered.
- Excess purchasing of property or services
- Bid rigging

Kickbacks are "off-the-book" frauds, that is, their concealment is not recorded on the books of the company. For that reason, it is often difficult for auditors to detect the presence of kickbacks.

The most common payroll fraud is the use of **ghost employees**, where the embezzler enters fictitious employees into the payroll system and receives the resulting payroll checks. A variation on this scheme is to keep terminated employees on the payroll several pay periods

after they leave their job. The embezzler then receives the paycheck for the terminated employee.

Another payroll fraud is an **overpayment scheme**. These schemes involve higher pay rates, inflated hours or days, or unauthorized bonus pay. Duplicate payroll checks for the exact amount of the legitimate check are also common.

### ***What to Look For***

In addition to the items listed in paragraphs 19, 20, and 25 of SAS No. 82, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

#### **Fictitious vendors**

- Photocopied invoices or invoices that have been tampered (for example, sections have been “whited out” and typed over)
- Invoice numbers from the same vendor that occur in an unbroken consecutive sequence
- Invoices from companies with a P.O. Box address and/or no phone number
- Invoices from companies with the same address or phone number as an employee
- The amount of each invoice from a particular vendor falls just below a threshold for review
- Multiple companies that have the same address and phone number
- Vendor names that appear to be a “knock-off” of well-established businesses (i.e., names spelled very similarly to well-established businesses)

#### **Kickbacks**

- Purchasing agent handles all matters related to a vendor even though it might be outside or below his or her normal duties
- Vendors who receive an inordinate amount of business from the company for no apparent business reason
- Vendor salesmen make frequent, unexplained visits to purchasing personnel
- Prices from a particular vendor are unreasonably high when compared to others
- Quality of goods or services received from a vendor is low

- Tips or complaints from other employees or honest vendors
- Key contracts awarded with no formal bid process
- Purchase of excess goods

### **Ghost Employees**

- Employees with duplicate addresses, checking accounts, or Social Security numbers
- Employees with no withholding taxes, insurance, or other normal deductions

### ***Example Audit Procedures***

The following audit procedures should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Review selected invoices and look for evidence that the invoice has been doctored.
- Perform a computerized search of the vendor list and look for: P.O. Box addresses, duplicate addresses, and vendors with no phone number.
- Determine if vendors are listed in yellow pages of phone book. Call vendors if considered necessary.
- Perform a computerized match of the vendor list with a list of employees and look for matches of addresses or phone numbers.
- Perform a computerized sort of invoices by vendor and look for unusual sequencing or amount (indication of possible fictitious company). Look for unusual pricing and volume trends (indication of possible kickback).
- Review selected invoices and examine supporting documentation indicating goods or services were received.
- Perform a computerized search of payroll records to identify duplicate addresses, Social Security numbers, or bank accounts.

- Verify Social Security numbers by calling the Social Security Administration.
- Review personnel files and look for those that contain little or no evidence of activity (for example, a lack of performance evaluations, requests for changes to withholdings, or retirement plan options).
- Observe a payroll check distribution. Determine why unclaimed checks were not claimed.

Because kickbacks are conducted off-the-books, they may be difficult to detect using traditional audit techniques. If your client has reason to believe a purchasing agent is accepting kickbacks, a fraud examination may be required.

***Expanding Your Internal Control Questionnaire***

Your internal control questionnaire should have questions aimed at identifying your client's vulnerability to the misappropriation of assets in the purchasing and payroll functions. If any of the following questions are not included in your questionnaire, consider adding them. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud; however, as a client service matter, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud. Keep in mind that "no" responses may also indicate reportable conditions or material weaknesses to be communicated to the client.

**Purchasing and Payroll  
Internal Control Questions  
Related to Fraud**

	<u>Yes</u>	<u>No</u>
1. Is there adequate segregation of duties between purchasing, receiving, and the accounts payable functions?	_____	_____
2. Are employees with purchasing and accounts payable responsibilities required to take vacations and are other employees cross-trained to perform those functions when an employee is absent?	_____	_____
3. Has the company limited the logical access to computerized vendor, accounts payable, and payroll records?	_____	_____
4. If the company chooses suppliers based on competitive bids, are all bids date stamped when received and opened at the same time under dual control?	_____	_____
5. Does the accounts payable system include controls to avoid duplicate payments?	_____	_____
6. Are new vendors reviewed by management before being added to the list of qualified vendors?	_____	_____
7. Does the company have a written policy on the amount and the type of gifts an employee can accept from suppliers and customers? Is that policy communicated to employees, customers, and suppliers?	_____	_____
8. Does the company include a "right to audit" clause in its contracts with major suppliers? <sup>20</sup>	_____	_____
9. Are new employees approved by management before being added to the payroll records?	_____	_____
10. Are there controls in place to ensure that terminated employees are removed from records in a timely manner?	_____	_____
11. If the size of the entity permits it, does the owner-manager periodically review the payroll records to determine if every employee listed is personally known to him or her?	_____	_____

<sup>20</sup> Right to audit clauses can be included in contracts or printed on the back of all purchase orders. Under a right to audit clause, the company reserves the right to audit the vendor's books at any time. Vendors who know their records are subject to examination generally are reluctant to make bribery payments.



## COMPUTER SCHEMES

### Misappropriation of Assets

#### *Typical Frauds*

The most common types of computer schemes involve **input tampering**. This can be accomplished by altering, forging, or fabricating computer input documents. In an entity with inadequate logical access control (which is common for small businesses), input tampering is quite easy to accomplish. The more common computer input schemes include:

- **Entering false transactions.** For example, entering invoices for fake vendors into the accounts payable system, or recording false credit memos to accounts receivable.
- **Entering phony file maintenance transactions.** File maintenance activities include transactions such as changing a customer's address or adding a new employee to the payroll. Phony file maintenance transactions can lay the groundwork for any number of frauds, for example the use of ghost employees to embezzle funds.
- **Failure to enter legitimate transactions or file maintenance instructions.** For example, when an employee is terminated, that information should be entered into the computer system to immediately remove that employee from the payroll records. A failure to do so creates a ghost employee.
- **Altering input data.** For example, changing the amounts, dates, or other information contained on the input data.

Other computer frauds involve **program modification** schemes, sometimes referred to as "throughput frauds." To accomplish these schemes requires an understanding of and the ability to modify computer application programs. Typical schemes include:

- **Unauthorized instructions.** A computer programmer may place unauthorized instructions into a computer program so that the computer will perform unauthorized functions (for example, making payments to a vendor not listed on an approved list).

- **Siphoning funds.** Funds can be siphoned in small amounts from a large number of accounts, for example, pennies and portions of pennies (due to rounding) can be shaved from thousands of savings accounts. The money is then accumulated in a single account that is accessed by the embezzler.
- **Direct manipulation of accounts.** Computer programs may be altered to obtain direct access to manipulate files without authorization. For example, file maintenance changes may be accomplished without the input of the normal documentation.

### ***What to Look For***

Computers often are used to accomplish the frauds listed elsewhere in this section of the publication. Observing signs of other frauds may lead you to one of the computer frauds schemes listed above. In addition to the items listed elsewhere, be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Inability to process computer applications in a timely manner
- Unexplained differences in batch or hash totals, or other means to control computer input
- Undocumented or unauthorized account postings, file changes, or modifications to application programs
- Unexplained differences between the general ledger and computerized accounting records (for example, a computer spreadsheet) maintained on a separate computer

Most small businesses use microcomputers, either to process accounting information or to prepare or summarize information for input (for example, through use of a spreadsheet). The use of microcomputers and a highly decentralized computer processing environment can leave a company vulnerable to various fraud schemes due to:

- A lack of segregation of duties. The same person can prepare a source document (for example, an invoice), process the information (prepare a spreadsheet summary for the day or month), and review the output (review the output and input the totals to the general ledger).

- Lack of logical access control. Many off-the-shelf computer programs contain logical access controls such as password protection. Unfortunately, entities often fail to install these controls or they do so ineffectively.
- Lack of adequate computer processing controls. Most microcomputer accounting packages contain controls to ensure the accuracy of processing or to identify conditions that require user follow-up (for example, exception reports). Many entities fail to properly implement these controls.

When gaining an understanding of the entity's internal controls, be alert for weaknesses relating to the entity's use of microcomputers. An excellent source of additional information is an Auditing Procedure Study published by the AICPA, *Auditing in Common Computer Environments* (product no. 021059).


#### ***Example Audit Procedures***

The following audit procedures should help detect the frauds described above. Depending on your assessment of the risk of material misstatement due to fraud, these procedures may be performed as part of an audit conducted in accordance with GAAS. Alternatively, they may be performed outside the scope of a GAAS audit. If your assessment of the risk of material misstatement due to fraud requires you to respond and an example procedure is already part of your planned approach, consider expanding the extent of testing, perhaps by selecting more items.

- Review documentation supporting a selection of financial transactions or file maintenance procedures.
- Review error reports, batch processing totals, and other user controls over the input and processing of financial transactions or file maintenance procedures.
- Reconstruct accounts or files from original source documents.

#### ***Expanding Your Internal Control Questionnaire***

Your internal control questionnaire should have questions aimed at identifying your client's vulnerability to computer fraud. If any of the following questions are not included in your questionnaire, consider adding them. "No" responses may not change your control risk assessment or your



assessment of the risk of material misstatement due to fraud; however, as a client service matter, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud. Keep in mind that “no” responses may also indicate reportable conditions or material weaknesses to be communicated to the client.

**Computer Schemes  
Internal Control Questions  
Related to Fraud**

	<u>Yes</u>	<u>No</u>
1. Is there proper segregation of duties between the authorization of input, the preparation of input, and the reconciliation of output?	_____	_____
2. Are employees with computer input duties required to take vacations and are other employees cross-trained to perform those functions when an employee is absent?	_____	_____
3. Is there proper segregation of duties between computer programmers and computer operators?	_____	_____
4. Has the company implemented effective logical access controls, including access to application programs, master files, and data bases?	_____	_____
5. Does the company have adequate controls to ensure the adequacy and legitimacy of input data?	_____	_____
6. Does the company have adequate controls to ensure that changes to computer applications are authorized and they function as planned?	_____	_____
7. Are exception reports, error listings, and other computer-generated items that require user follow-up investigated and resolved in a timely manner?	_____	_____
8. Are spreadsheets and other microcomputer applications used to process significant accounting information checked for accuracy by someone other than the person who prepared them?	_____	_____

## SAMPLE DOCUMENTATION

Paragraph 37 of SAS No. 82 describes the documentation requirements relating to your consideration of fraud. That paragraph requires you to document *evidence of the performance* of the assessment of the risk of material misstatement due to fraud. Remember, there's no requirement to label your assessment ( "high", "medium", or "low", for instance) as you do for other risk assessments nor is there a requirement to describe your thought process or rationale used to make the assessment. You are only required to document evidence that you performed an assessment of the risk of material misstatement due to fraud. As discussed in Part One, Assessing the Risk of Material Misstatement Due to Fraud, this assessment is a separate risk assessment, distinct from your assessment of inherent and control risk. Although the assessment may be performed in conjunction with your inherent and control risk assessment, it's a separate thought process and should be documented as such.


To document evidence of your performance of this risk assessment you should document:

- The risk factors identified as present
- Your response to those risk factors (either individually or in combination)
- Fraud risk factors or other conditions, if any, identified during the performance of fieldwork that cause you to believe that an additional audit response is required

If, as a result of your assessment, you conclude that a further response is appropriate, that response should also be documented.

See Part One, Documentation Requirements for further discussion of the documentation required by SAS No. 82. There is no prescribed format (for example, a checklist or a memo) or standard language required to comply with these documentation requirements. You are allowed a great deal of flexibility.

Some practitioners prefer to document items and judgments that go beyond the requirements of SAS No. 82



because they find this information useful in the event that others may ask how certain decisions were reached. Other practitioners prefer to limit their documentation to the minimum required. The following examples demonstrate that range of possibility and illustrate some approaches you might take to document your consideration of fraud in a financial statement audit. Each of the three examples includes sample documentation that just meets the requirements of SAS No. 82 and sample documentation that goes beyond that required by the SAS.

## EXAMPLE #1

**CLIENT NAME: LAKE VIEW OFFICE TOWER**

**FRAUD RISK: FRAUDULENT FINANCIAL REPORTING**

**ADDITIONAL AUDIT RESPONSE REQUIRED? NO**

### Description

Lake View Office Tower is a partnership whose primary asset is a four-story office building. The partnership leases space to others under operating leases, in a section of town that has experienced steadily increasing vacancy rates. The related mortgage contains covenants about rent rolls and the partnership financial condition that are becoming difficult to meet. The two partners personally guarantee the debt.

### Sample Documentation

The following memo in the workpapers *goes beyond* the documentation requirements of SAS No. 82 relating to this client.

#### Consideration of Fraud

While planning the audit of Lake View Office Towers, certain items came to our attention that we considered to be fraud risk factors. Those risk factors are:

- Debt covenants that are difficult to maintain
- Deteriorating financial position when management has personally guaranteed significant debts of the entity

These conditions suggest a possible motivation for the partners to overstate the entity's financial results, as a way to fraudulently maintain debt covenants and avoid having to perform under the personal guarantee.

The debt covenants relate to the financial position of the entity and certain items (primarily vacancy and lease rates) related to the rent roll.

The primary asset of the partnership is the office building; the primary liability is the related mortgage. A material overstatement of the financial position of the entity could occur only through an overstatement of the building or an understatement of the mortgage. Changes in these accounts beyond normal betterments and principal reductions would be obvious in the financial statements.

Our audit procedures include a review of supporting documents for significant building additions and confirmation of the debt balance with the lenders. Additionally, we test the rent roll (including significant lease terms) by reviewing a sample of lease agreements and modifications. We believe these audit procedures are sufficient to obtain reasonable assurance that the financial statements are free of material misstatement caused by fraud.



*Author's note: The above memo goes beyond the documentation requirements of SAS No. 82 in that it includes a discussion of the rationale for how the identified risk factors could lead to material misstatement of the financial statements due to fraud. It also includes the auditor's conclusion that the response adequately addresses the assessed risk. Documentation of this conclusion is not required.*

**Sample  
Documentation —  
Minimum Required**

The following memo in the workpapers complies with the documentation requirements of SAS No. 82 relating to this client.

Consideration of Fraud

While planning the audit of Lake View Office Towers, we noted that the Company's financial position is deteriorating and management has personally guaranteed significant debts. Furthermore, we noted that the Company's debt covenants are becoming difficult to maintain. In response, our planned audit procedures include the following steps:

- Test significant building additions
- Confirm debt balance with the lender
- Agree rent roll additions and modifications to supporting documentation

**EXAMPLE #2****CLIENT NAME: GAS-N-GO CONVENIENCE STORES****FRAUD RISK: MISAPPROPRIATION OF ASSETS****ADDITIONAL AUDIT RESPONSE REQUIRED? NO**

<b>Description</b>	Gas-N-Go Convenience Stores is a chain of nine convenience stores operating in the metro area.
<b>Sample Documentation</b>	The following memo in the workpapers goes <i>beyond</i> the documentation requirements of SAS No. 82 relating to this client.

Consideration of Fraud

While planning the audit of Gas-N-Go Convenience Stores, certain items came to our attention that we considered to be fraud risk factors relating to the misappropriation of assets. Those risk factors are:

- Large amounts of cash on hand or processed — Most of the sales are cash sales. Additionally, the stores cash personal and payroll checks as an accommodation to their customers. This service requires the stores to maintain large amounts of cash on hand, particularly on or around the paydays of the large employers located nearby.
- Inventory characteristics that make it susceptible to theft — Each store sells groceries and deli products that are small and easily stolen. The stores also sell beer, wine, cigarettes and lottery tickets, which are easy to steal and convert to cash.

Our discussions with the controller about the risk of misappropriation of assets indicated that the following points mitigate the risk of asset misappropriation:

- Additional control procedures are being implemented as a result of a fraud that occurred at one of the stores during the year. Note that the fraud did not materially impact the financial statements. The fraud required the collusion of three store managers and began with the theft of approximately \$10,000 cash from an unusually large deposit caused by high levels of check cashing activity during the holidays. The store managers concealed the fraud by kiting deposits and submitting false information to the accounting department about cash balances. The controller discovered the fraud by observing that deposits reported by the store managers did not agree with deposits shown on the bank statements and that daily cash balances did not periodically decline as low as expected. All of the loss is covered by insurance. The controller now —
  1. Requires area supervisors to perform surprise cash accounts at all of the stores regularly during the year.

2. Has a courier collect deposits daily from each of the stores and bring them to the office where the deposit tickets are verified.

- Accounting information is maintained (by store) showing sales, cost of sales, and inventories according to major sources and the major categories of expenses. Inventories are counted monthly by an outside counting service. The controller investigates significant differences between the services' counts and the store inventories, as well as significant differences between the actual and expected cost of sales percentages.
- The exposure from lottery tickets is small because the State lottery commission controls tickets with winnings above \$50.

We have corroborated that these procedures are in place through inquiry and observation and we will perform the following previously planned procedures:

- Observe cash and inventory counts at the end of the year for a sample of stores.
- Perform trend analyses using the store information, looking separately at stores open full years and those open partial years.
- Compare store gross profit percentages with percentages used in retail inventory calculations.
- Review fluctuations in daily cash balances of selected stores before and after year-end.

We believe these audit procedures are sufficient to obtain reasonable assurance that the financial statements are free of material misstatement caused by fraud.

*Author's note: The above memo goes beyond the documentation requirements of SAS No. 82 in that it describes the controls in place that mitigate the risk associated with the identified risk factors. The auditor has also documented the inquiries made of management related to fraud. These inquiries are required but the documentation of their performance is not. (See paragraph 13 of SAS No. 82.) Furthermore, the memo includes the auditor's conclusion that the response adequately addresses the assessed risk.*

## Sample Documentation — Minimum Required

The following memo in the workpapers complies with the documentation requirements of SAS No. 82 relating to this client.

### Consideration of Fraud

Each Gas-N-Go store processes large amounts of cash and maintains inventories that can be easily converted into cash. However,

as is typical for convenience store operations, the Company has controls in place to minimize the risk of loss from misappropriation of assets. Misappropriations found have been immaterial to the financial statements and covered by insurance. Industry publications indicate that misappropriations totaling approximately 1% of retail sales are to be expected. Our previously planned audit procedures are designed to appropriately reduce the risk of material misstatement due to errors or fraud.

***Author's note:** This documentation is very similar to the sample documentation (minimum required) for Example #1. However, in Example #2, the auditor makes a general reference to the previously planned audit procedures rather than including a description of the specific procedures relevant to the assessed risk.*

## EXAMPLE #3

**CLIENT NAME: INTERNET SOLUTIONS**

**FRAUD RISK: FRAUDULENT FINANCIAL REPORTING**

**ADDITIONAL AUDIT RESPONSE REQUIRED? YES**

**Description** See Internet Solutions Case Study in Part One, Chapter One, Appendix A for background information.

**Sample Documentation** The following memo in the workpapers goes beyond the documentation requirements of SAS No. 82 relating to this client.

### Consideration of Fraud

While planning the audit of Internet Solutions, we identified the presence of certain fraud risk factors. Those risk factors are:

- The Company operates in a declining industry, both in terms of margins and customer demand.
- The Company's industry is marked by rapidly changing technology.
- The Company reported unusually rapid growth when compared with that of other companies in the same industry.
- The Company will be unable to consummate its initial public offering if revenue and profitability growth are not reported.
- The Company is unable to generate cash flows from operations despite reporting revenue and earnings from operations growth.

We identified these risk factors through the performance of analytical reviews and other planning procedures, including inquiries of the client.

In response to these identified fraud risk factors, we developed an overall engagement response that included an increase in the involvement of the audit partner at all phases of the engagement, including planning, supervision, and review.

The above noted risk factors impact the audit areas of revenue recognition, accounts receivable and inventory valuation. During the planning phase of the audit, we believed that our planned audit procedures in these areas were adequate to obtain reasonable assurance that the financial statements were free of material misstatement due to fraud.

During the performance of fieldwork, the identification of other conditions and the evaluation of audit results caused us to change our judgment regarding the assessment of risk of material misstatement due to fraud. Identified conditions include:

- A discrepancy between the invoice date (3/31/XX) and shipping date (10/2/XX) of a particular sale. Company management was unable to explain this discrepancy, which caused us to expand the scope of our sales cut-off fieldwork.
- Unavailability of other than faxed confirmation replies for an inordinate number of accounts receivable confirmations. In response to this condition, we spoke to all customers who reportedly sent faxed confirmation replies and we received signed, original replies from all those contacted.

As a result of these and other procedures, we discovered misstatements relating to revenue and accounts receivable. See workpaper XX for a calculation of the related audit adjustment.

*Author's note: The above documentation goes beyond the requirements of SAS No. 82 in that the auditor has included a discussion of the thought process and rationale used to evaluate the identified risk factor and other conditions noted. The memo also includes a discussion of the results of the extended audit procedures, which is not required by SAS No. 82.*

**Sample  
Documentation —  
Minimum Required**

The following memo in the workpapers complies with the documentation requirements of SAS No. 82 relating to this client.

Consideration of Fraud

During the planning of this audit, we identified fraud risk factors related to the entity's financial condition and its profitability (particularly when compared to others in the same industry and the declining industry in which the company operates). We also noted that the company is unable to generate cash flows from operations (despite reporting revenue and earnings from operations growth) and that the company will be unable to consummate its initial public offering if revenue and profitability growth are not reported. These were also considered to be fraud risk factors. As a result of the identification of these risk factors we increased the involvement of the audit partner at all phases of the engagement. Initially, the planned nature, timing, and extent of audit procedures was determined to be adequate.

While performing the audit procedures, other conditions came to our attention that caused us to reevaluate our original assessment. These other conditions included unexplained discrepancies between invoices and shipping documents and an unusually high number of faxed confirmation replies. As a result of these identified conditions we expanded the scope of our fieldwork relating to sales cut-off, and we received original, signed replies to all confirmation requests.

[CPA Firm Letterhead]

[Date]

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
[Client's Name and Address]

Dear \_\_\_\_\_:

This will confirm our understanding of the arrangements for our audit of the financial statements of \_\_\_\_\_ [client name] for the year ending \_\_\_\_\_ [balance sheet date].

We will audit the Company's financial statements for the year ending \_\_\_\_\_ [balance sheet date] for the purpose of expressing an opinion on the fairness with which they present, in all material respects, financial position, results of operations and cash flows in conformity with generally accepted accounting principles.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. An audit includes examining, on a test basis, evidence that supports the amounts and disclosures included in the financial statements. It also includes assessing the accounting principles used and estimates made by management, as well as evaluating the overall financial statement presentation. Our audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, our audit will not necessarily detect misstatements less than this materiality level that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described on a separate attachment. Timely completion of this work will facilitate the completion of our audit.

As part of our engagement for the year ending \_\_\_\_\_ [balance sheet date], we will also prepare the federal and state income tax returns for \_\_\_\_\_ [client name].

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility, plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees of \$ \_\_\_\_\_ .

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you.

Sincerely,

[Partner's Signature]  
[Firm Name]

Accepted and agreed to:

\_\_\_\_\_  
[Client Representative's Signature]

\_\_\_\_\_  
[Title]

\_\_\_\_\_  
[Date]



[Client Letterhead]

[Auditor's Report Date]

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

In connection with your audit of the financial statements of \_\_\_\_\_ [client name] as of \_\_\_\_\_ [balance sheet date] and for the \_\_\_\_\_ [period] then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly the financial position, results of operations, and cash flows of \_\_\_\_\_ [client name] in conformity with generally accepted accounting principles, we (I) confirm, to the best of our (my) knowledge and belief, the following representations made to you during your audit:

1. We are (I am) responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. We are (I am) also responsible for adopting sound accounting policies, establishing and maintaining internal control, and preventing and detecting fraud.
2. We (I) have made available to you —
  - a. All financial records and related data.
  - b. All minutes of meetings of shareholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
  - c. Information relating to all statutes, laws, or regulations that have a direct effect on our financial statements.
  - d. All reports from other accountants who have been engaged to make a review of interim financial information of significant components of the reporting entity, its subsidiaries, or its other investees.
  - e. All information relating to contracts with and results of work by specialists.
3. We (I) have apprised you of all (There are no) instances of fraud perpetrated on or within the Company of which we are (I am) aware.
4. We (I) have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
5. The following have been properly recorded or disclosed in the financial statements:
  - a. Related-party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

- b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
  - c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line of credit or similar arrangements.
  - d. Agreements to repurchase assets previously sold.
  - e. Security agreements under the Uniform Commercial Code.
  - f. Contractual obligations for purchases of assets.
  - g. Liens, encumbrances, or subordination of assets pledged as collateral in any way.
  - h. Subordination of any liabilities.
  - i. All leases or rental obligations under long-term leases.
  - j. Information relating to risks and uncertainties regarding nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations in accordance with SOP No. 94-6.
  - k. Environmental liabilities, which must be disclosed in accordance with SFAS 5 criteria as interpreted by SOP No. 96-1, paragraph 5.6.
6. There are no —
- a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
  - b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by SFAS No. 5.
  - c. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with SFAS No. 5.
  - d. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.
  - e. Material transactions that have not been properly recorded in the accounting records underlying the financial statements.
7. Provision, when material, has been made to —
- a. Reduce excess or obsolete inventories to their estimated net realizable value.
  - b. Reduce all investments for permanent declines in value.
  - c. Adjust long-lived assets, certain identifiable intangibles, and related goodwill in accordance with SFAS No. 121.
8. The Company has satisfactory title to owned assets, and there are no such liens or encumbrances on assets nor has any asset been pledged.

*Sample Client Representation Letter for a Small Business Audit*

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9. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.
10. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.
11. We (I) have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
12. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

Very truly yours,

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[Chief Financial Officer]

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