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Fraud detection in a GAAS audit; Fraud detection in a GAAS audit: SAS no. 99 implementation guide;

Michael J. Ramos

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**AICPA Audit and Accounting
Practice Aid Series**

Fraud Detection in a GAAS Audit

Revised Edition

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

**AICPA Audit and Accounting
Practice Aid Series**

Fraud Detection in a GAAS Audit

Revised Edition

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This publication, *Fraud Detection in a GAAS Audit*, is a Practice Aid intended to provide CPAs with the most recent information related to the implementation of Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

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Preface

The accounting profession was under fire. Throughout the long, hot summer, newspapers were filled with new details of a corporate accounting scandal. One of the largest, most respected companies in the United States had been caught inflating earnings and assets through blatant manipulation of the accounting rules. Thousands of investors and employees had suffered. Congressional hearings were called to examine and understand the fraud, and everyone asked, “Where were the auditors?” The accounting profession was under immense political pressure from reform-minded lawmakers, and the negative publicity surrounding the perceived audit failure cast all CPAs in the most unfavorable light.

Sound familiar? The year was 1938.

The corporate accounting scandal was McKesson-Robbins, in which the company inflated assets and earnings by \$19 million through the reporting of nonexistent inventory and fictitious sales. In the wake of the scandal, the auditing profession responded by setting the first formal standards for auditing procedures, including guidance on the auditor’s responsibilities for material misstatements due to fraud.

In the years since McKesson-Robbins, the business world has been rocked by even bigger corporate frauds, and each time the profession has come under criticism—some of which is justified and some of which is not. Once again, but in a new century, we have witnessed the quick, spectacular failure of some of this country’s largest companies, amid a series of indictments, arrests, and allegations of financial fraud. As CPAs, we find ourselves in the uncomfortable position of having to defend our work and our credibility. We are now at the beginning of the post-Enron world.

In the summer of ’02, the Sarbanes-Oxley bill was signed into law, and by all accounts, it has the potential to dramatically change the auditing profession. I was attending a conference on the day the bill passed. The next morning I attended an audit update session. Ignoring his prepared remarks, the presenter took questions from the audience on the future of the profession in the wake of the just-passed legislation. One of the questions was, “How will we be able to earn back our reputation and the trust of the public?”

The answer he gave rang true and helped calm the sense of unease that had permeated the conference. As a profession, he said, the way to regain our reputation is the same way we earned it in the first place—one auditor, one engagement at a time.

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the first major audit standard to be released since the passage of Sarbanes-Oxley. No one ever intended these events to converge like this, but they have: a new fraud standard delivered in the midst of endless

revelations of corporate malfeasance. The timing is fortuitous because this new standard provides us with an excellent opportunity to repair some of the recent damage to our reputation—one auditor, one engagement at a time.

SAS No. 99 has the potential to significantly improve audit quality, not just in detecting fraud, but in detecting *all* material misstatements and improving the quality of the financial reporting process. This is why.

Integrity of the Standard-Setting Process

I have always believed that a high-quality process leads to a high-quality result. Suppose you are building a house, and you want it to be beautiful and functional, and stand the test of time. Everything, you do—from the drafting of the plans, to the selection of materials, and on through the actual construction itself—must be designed to produce that type of quality. Because of that direct relationship between process and product, we can judge the quality of a finished product before it is in use by looking at the quality of the process. Thinking of buying a home but have questions about its quality? Examine the quality of the building process.

As an auditor, I would be skeptical if SAS No. 99 was the product of a hasty process designed solely as a response to the criticism the profession has received in the wake of high profile business failures.

For that reason, it is important to recognize that SAS No. 99 is *not* a knee-jerk reaction to recent events. This new standard was four years in the making. It is the product of a thoughtful, thorough, and open standard-setting process that constantly seeks to improve audit quality. The new standard incorporates:

- Results of academic research on how auditors implemented previous standards on fraud and how those standards might be improved.
- Recommendations of the Public Oversight Board’s Panel on Audit Effectiveness, who conducted their own detailed study on audit effectiveness.
- Comments from more than 50 groups and individuals representing a wide variety of stakeholders in the financial reporting process.

Only a handful of engagement teams have adopted the new standard in advance of its effective date, and it is far too early to determine whether the effective implementation of the new standard will achieve the desired effect on audit practice. However, because of the care exercised in the development of the standard, I feel confident that it is a high-quality standard that will improve the ability of auditors to respond effectively to the potential for fraud.

Audit Smarter

If you are familiar with the previous audit standard on fraud, you know that a cornerstone of that standard was a list of “fraud risk factors,” which, though they do not necessarily indicate the existence of fraud, often have been observed when frauds have occurred. This list of fraud risk factors was intended to help auditors discover indicia of fraud while performing their engagements. In practice, this list usually was reduced to a checklist that auditors completed and included in their working papers.

The academic research that examined the implementation of the previous standard resulted in two key findings:

- Auditors did a good job of identifying indicia of fraud. However, once those indicia were identified, they did a relatively poor job of responding appropriately to the perceived risk of fraud.
- Auditors who rely exclusively on checklists to identify fraud risk factors are less effective than those who supplement checklists with other procedures.

SAS No. 99 is extremely comprehensive and touches on many elements of the audit process. It can not be reduced to a checklist or form. The effective implementation of SAS No. 99 will require auditors to *audit smarter* and think more creatively when they audit. Engagement teams who plan to implement the new standard by obtaining an updated version of a generic audit program will be doing themselves and their clients an injustice. The effective implementation of SAS No. 99 will force you to rethink how you plan and perform your audits.

The New Standard Will Result in Better Audits and Better Client Service, Not Just in Fraud Detection

Over the years I’ve attended a number of audit training sessions on analytical procedures. One sure-fire way for the instructor to get a laugh (and make an important point) is to describe some of the analytical review comments he or she has read on working papers over the years. “Revenues increased because the client sold more.” Or, “Change in account balance from prior year is reasonable per discussion with controller.”

What makes these types of comments scary is that they illustrate how an otherwise effective audit procedure can be rendered ineffective. And analytical procedures are just one of several areas in which the performance of audit procedures is less than optimal. To reduce audit risk to an acceptable level, others on the engagement team must revisit the audit area and do additional work, which makes the engagement less efficient.

The prescription for improving these procedures (and the quality of the audit) is always the same:

- Understand the client’s business.
- Maintain a healthy professional skepticism and corroborate management’s verbal representations.

- Have the more experienced team members share their knowledge with everyone else.
- Do a more thorough job of audit planning.

You would be hard-pressed to find an auditor to argue that this list will *not* result in a more effective and efficient audit.

Recognize that SAS No. 99 *emphasizes all of the above*. To successfully implement the SAS, you will have to address each of the bullet points, which in turn will result in a better audit. For example, the new SAS emphasizes the need for professional skepticism throughout the engagement. Not only will that attitude help you detect material misstatements caused by fraud, it will help you detect those that are not caused by fraud.

Paying More Attention to Fraud Can Improve Client Service

Several years ago I was doing some contract work for a small local firm, and two things happened during the audit season that have stayed with me. At the time, I had just finished working on an implementation guide for the previous fraud standard, and so I was quite sensitive to issues relating to fraud.

The first thing that happened was the firm's largest client discovered an embezzlement. The client called the firm's engagement partner and read him the riot act. The client was furious—where was their CPA while all this was going on! Forget the fact that two years earlier the firm had performed a consulting engagement on internal control that had identified several key weaknesses, which had been exploited to conceal the theft. The irony is that the firm had never conducted an audit of the client. In fact, it had never done a review or a compilation. The client was primarily a *tax* client. And yet the business owners still had the expectation that their CPA was a frontline defense against employee theft.

Right or wrong, many clients have the expectation that CPAs in general—and auditors in particular—help guard against and detect fraud.

The second thing that happened during that busy season was on an audit engagement that I was performing. It was the first time I had done work on that particular client. During the course of the engagement I discovered that the client's bookkeeper had the ability to make adjustments and write off accounts receivable without leaving an audit trail. No credit memo, nothing—the accounting software just allowed it to happen. Not only did she have that ability, she used it, too, writing off thousands of dollars of receivables balances right before the end of the period without the knowledge or approval of the business owner.

Before I had done so much work on the topic of fraud, I probably never would have recognized these circumstances as indicative of a potential fraud. Because I was sensitized to the fact that fraud could occur, however, and because I had read case studies of embezzlements that were concealed through the write-off of receivables, I expanded the scope of our procedures in accounts receivable. I also adopted a different mindset toward the client and asked more pointed questions in an effort to discover other indicators of possible fraud.

In the end, we did not uncover a fraud. We prepared a list of all the adjustments to accounts receivable and presented this to the business owner. We had a frank discussion about the weaknesses in his internal control and how that left him vulnerable to fraud.

A week or so later, at the conclusion of the engagement, we presented him with a bill. It was about 30 percent higher than the previous year. I wouldn't say he was overjoyed, but he did say that he had no problem paying the higher amount. He had heard from his staff how thoroughly we had conducted our engagement, and he had appreciated the comments we made to him during our exit interview. Perhaps he sensed a different mindset and felt that we were really digging hard to find something. I don't know what he was thinking when he told me that paying the bill was no problem and that "this was the best audit we've ever gotten."

Take SAS No. 99 to heart. Use it to change the way you approach the audit, and engage with your clients. They'll notice the difference, and I'm betting that they'll appreciate it.

Looking Ahead

The implementation of SAS No. 99, although important, is only part of a broader initiative to address fraudulent financial reporting. Efforts also are required to focus not only on the auditor's role for fraud *detection*, but that of management, the audit committee, regulators and others in fraud *prevention* and *deterrence*.

SAS No. 99 is a well-conceived, well-executed document. It is something that all those involved in its creation—indeed, our entire profession—should be proud of. But it is only an audit standard and cannot, by itself, achieve its objective of improving the likelihood that auditors will detect material misstatements caused by fraud. That part is up to us, as we understand and implement the requirements of this new standard, one auditor, one engagement at a time.

Michael Ramos
October 2002

Postscript: Update to the 2004 Edition

For the last half of 2003 I spent a good portion of my time helping firms implement SAS No. 99 and the ideas contained in this book. The lessons I learned during this process served as the basis for the updates made to the 2004 edition.

The true test is yet to come. In the next several months, as firms complete their year-end 2003 audits, we will at last find out how SAS No. 99 truly affected our profession. And those lessons will serve as the basis for the next edition.

Michael Ramos
January 2004

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INTRODUCTION: THE PURPOSE AND ORGANIZATION OF THIS PUBLICATION

Purpose

In its summary of the exposure draft of what would become Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), the Auditing Standards Board (ASB) stated that the new SAS will “improve the likelihood that auditors will detect material misstatements due to fraud in a financial statement audit.” This publication shares that objective. It complements the SAS, providing interpretive observations, suggestions, and tools to help you effectively understand and implement the authoritative standard.

The guidance in this book works on three levels:

1. *Explanation.* This publication attempts to explain and provide context for the requirements of the SAS. For example, the standard requires “brainstorming” among audit team members about how a material fraud might be perpetrated and concealed at the client. This publication explains in more detail the purpose of that brainstorming session as well as the intent for the other requirements listed in the standard for the brainstorming session.
2. *Implementation.* Once you have a good understanding of what the standard requires, questions will arise about whether your audit practice appropriately considers these requirements. Before SAS No. 99, your firm probably never had a brainstorming session of the type required by SAS No. 99. Undoubtedly questions will arise when the time comes to adopt the new SAS, for example, “What is the best way to conduct a brainstorming session?” and “What special skills are needed to make this session effective?” This publication addresses those kinds of questions.
3. *Practice Aids.* Finally, knowing what it will take to implement the standard, you will need tools to help you do so effectively and efficiently. For example, many firms have developed practice niches devoted to specialized industries such as governmental entities, not-for-profit organizations, or construction contractors. Included in this publication is an appendix to help you adapt the guidance contained in SAS No. 99 to the needs of specialized industries.

How to Use This Publication

First, this publication should be used by auditors to understand the requirements of SAS No. 99 and whether your current audit practices effectively incorporate these requirements.

Also, this publication should be used to supplement the firm's audit manual. Auditors in the field will find the suggestions helpful as a means to:

- Understand the reason for performing certain audit procedures relating to fraud.
- Communicate more effectively with management and with each other about fraud-related matters.
- Identify and assess the risk of material misstatement due to fraud.
- Design audit procedures that effectively address the risks of material misstatement due to fraud.

Organization of the Publication

This publication is divided into three parts.

Part 1: Understanding SAS No. 99 and Its Implications

The two chapters in Part One provide you with a detailed understanding of the requirements of SAS No. 99. Also included in this section is a discussion of the issues you are likely to face as you continue to incorporate the standard into your audit practice and firm culture.

Part 2: Detailed Implementation Guidance

The chapters in this section provide in-depth implementation guidance in those areas that practitioners might find most troublesome, including:

- Applying professional skepticism in planning and performing the audit, including the evaluation of audit evidence
- Conducting meaningful brainstorming sessions
- Improving the effectiveness of client inquiry
- Linking audit procedures to identified risks
- Performing new audit procedures mandated by the SAS
- Using computer assisted audit techniques to identify indicators of possible material misstatements due to fraud.

Appendixes

This section contains an appendix that will help you identify risks of material misstatement due to fraud related to specialized industries (Appendix A). Also included is guidance to help you design audit procedures for the physical observation of inventory and review journal entries and other adjustments for signs of possible management override of internal control (Appendixes B and C).

PART 1

UNDERSTANDING SAS NO. 99 AND ITS IMPLICATIONS

The first two chapters of this book provide a basic understanding of the requirements of Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Chapter 1 highlights how the standard differs from previous guidance and changes audit practice. Chapter 2 offers an in-depth analysis of each major section of the standard and what it requires.

CHAPTER 1: HOW SAS NO. 99 CHANGED AUDIT PRACTICE

Your Responsibilities for Detecting Fraud

In a generally accepted auditing standards (GAAS) audit you must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, including material misstatements caused by fraud. You have *always* had that responsibility. Unfortunately, many auditors remain confused about this issue.

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), did not change your overall responsibility. SAS No. 99 superceded previous guidance, and the reason it was issued was to substantially improve the likelihood that you will detect material misstatements in the financial statements caused by fraud.

The Fraud Triangle

As the previous fraud standard did, SAS No. 99 provides a brief discussion of the characteristics of fraud. Included in that discussion is a framework that is useful for understanding and evaluating indicators of fraud that you may discover during your audit.



Practice Pointer. The fraud triangle framework is an important conceptual underpinning for a great deal of SAS No. 99. When you apply the standard on your engagements, you should find yourself continually returning to this framework. For example, the framework is particularly helpful when:

- Gathering information to assess the risk of material misstatement due to fraud
- Analyzing and assessing fraud risk
- Having discussions with engagement team members or the entity’s management about the risk of fraud at the audited entity

The “fraud triangle” depicts three conditions that generally are present when fraud occurs.

1. *Incentive or pressure.* Management or other employees may have an incentive or pressure that provides them with a reason to commit fraud.
2. *Opportunity.* Circumstances may exist at the entity (for example, weak internal controls or ineffective board of director oversight) that provide an opportunity for a fraud to be perpetrated.
3. *Rationalization or attitude.* Some individuals possess an attitude, character, or set of ethical values that allow them to rationalize committing a dishonest act.

This overview of the fraud triangle framework was a necessary preliminary to a discussion of the changes described in this chapter. A more complete discussion of the fraud triangle and how it is used together with some of the other characteristics of fraud is contained in Chapter 2 .

Professional Skepticism

SAS No. 99 places renewed emphasis on professional skepticism. Arguably, maintaining the appropriate questioning mindset is the single most important critical success factor for the effective adoption of the SAS. All the audit procedures in the world will be less than optimally effective if the auditor does not maintain the proper mindset. A skeptical mind can ask the right questions and analyze audit evidence in a way that detects material misstatement due to fraud even in the absence of specifically required procedures.

SAS No. 99:

- Requires the audit team to set the proper tone for the audit by having a discussion of the importance of professional skepticism in planning the audit.
- Reminds you to maintain a questioning mind during the gathering and evaluation of audit evidence throughout the audit.

Chapter 3 provides detailed suggestions to help you understand more thoroughly what is meant by professional skepticism and how you can instill this attitude in engagement teams.

The Fraud Risk-Assessment Process

SAS No. 99 requires you to gather and consider a great deal of information to assess fraud risks. The previous auditing standards assumed that traditional audit planning and internal control procedures would be sufficient to identify all the information you needed to assess fraud risks. This is *not* true under SAS No. 99, which significantly expands the information gathering phase beyond the work the auditor traditionally performed.

Significant requirements include:

- A required brainstorming session among the audit team members to discuss the potential for material misstatement due to fraud.
- An increased emphasis on inquiry as an audit procedure that increases the likelihood of fraud detection.
- Expanded use of analytical procedures to gather information used to identify risks of the material misstatement due to fraud.
- The consideration of other information, such as client acceptance and continuance procedures, during the information-gathering phase.

The standard provides extensive guidance on evaluating this information and identifying the risks that may result in a material misstatement due to fraud. Included in this guidance is the presumption that improper revenue recognition is a fraud risk in all entities.

The standard also requires you to take into account an evaluation of the entity's programs and controls that address the identified fraud risks.

Finally, SAS No. 99 mandates certain audit responses on every engagement. These responses are designed to specifically address the ever-present risk of management override over internal controls. Even though you may have performed some or all of these procedures on past audits, you typically have not performed them in the context of responding to a risk of management override.

Information-Gathering Phase

Audit Team Communications

SAS No. 99 introduces an entirely new audit procedure that must be performed on every engagement. As part of planning, members of the engagement team are required to discuss the potential for material misstatement of the entity's financial statements due to fraud.

The SAS requires certain audit team communications that include the following:

- An exchange of ideas, or “brainstorming,” among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud. More specifically, the discussion should include:
 - How and where the entity's financial statements might be susceptible to material misstatement due to fraud.
 - How management could perpetrate and conceal fraudulent financial reporting.
 - How assets of the entity could be misappropriated by management or employees.
- An emphasis on the importance of maintaining the proper state of mind throughout the audit—that is, professional skepticism.

Chapter 2 in this book provide further guidance on the overall objective of the brainstorming session as well as suggestions for making these sessions as effective as possible.

Inquiries of Entity Personnel

Fraud specialists report that often, when a fraud is committed, people with knowledge or suspicion of the fraud would have “blown the whistle,” if only someone would have asked. Also, the commitment and concealment of fraud may be anywhere within the entity, and any employee may have knowledge that can help detect the fraud.

For these reasons, SAS No. 99 requires you to make expanded inquiries of management *and others within the entity* regarding their knowledge of actual or alleged fraud at the entity. SAS No. 99 also requires auditors to make inquiries outside the accounting department and the management group. If the entity has an audit committee or internal audit department, the standard mandates certain inquiries of each of those groups.

Analytical Procedures

SAS No. 99 reminds you that the results of analytical procedures performed as part of planning the audit may identify unusual transactions or events, and unexpected amounts, ratios, and trends. You should consider these results in identifying the risks of material misstatement due to fraud.

You are required to perform analytical procedures related to revenue with the objective of identifying unusual or unexpected relationships that may indicate a material misstatement due to fraud.

Considering Fraud Risk Factors

During the planning and performance of your audit, you may identify conditions or events that may indicate the presence of fraud. These conditions or events are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often have been present in circumstances where fraud exists.

SAS No. 99 provides examples of fraud risk factors, and these examples are organized along the three fraud triangle categories (incentive/pressure, opportunity, and attitude/realization).

For example, management that is struggling to maintain debt covenants has an *incentive* to misstate the financial statements to comply with the covenants. A weakness in internal control provides an *opportunity* for an employee to embezzle funds and then conceal the action.

SAS No. 99 categorizes the risk factors according to whether they provide opportunity, incentive/pressure, or attitude/rationalization to perpetrate fraudulent financial reporting or theft of assets. It is hoped that this reorganization will help you understand and analyze the risk factors when assessing fraud risks.

Other Information

SAS No. 99 requires you to consider other information that may be helpful in identifying risks of material misstatement due to fraud. Information from the following sources should be considered:

- Procedures relating to the acceptance and continuance of clients and engagements
- Reviews or compilation of interim financial statements

Consider Programs and Controls and Assess Fraud Risks

Because fraud prevention, detection, and deterrence are management’s responsibility, SAS No. 99 requires you to determine whether management has designed programs and controls that address identified risks of material misstatement due to fraud and whether those programs and controls have been placed in operation.

To help you make this evaluation, a document titled “Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud,” which is an exhibit to the SAS, discusses and provides examples of programs and controls that management can implement to help deter, prevent, and detect fraud. Auditors may be able to provide valuable client service by discussing many of these best practices programs and controls with management and the audit committees of their audit clients.

Developing an Audit Response

One of the biggest challenges in detecting fraud on an audit is developing appropriate audit responses to identified risks. SAS No. 99 provides a great deal of detailed guidance in this area that may require you to perform significant additional audit procedures on most, if not all, of your engagements.

Responding to the Risk of Management Override

In its conducting its research on audit effectiveness, the Public Oversight Board (POB) analyzed Securities and Exchange Commission (SEC) enforcement actions related to fraud to determine some of the common characteristics of fraudulent financial reporting. In its analysis, the POB discovered that management override of controls was a characteristic of many fraudulent financial reporting schemes. As the POB report noted, “opportunity is a necessary feature of fraud, and it explains why management is in a unique position to perpetrate it. As the stewards of the entity, management possesses the power to manipulate the accounting records and prepare fraudulent financial reports.”

To address the risk of management override, SAS No. 99 provides guidance on how you should respond and mandates procedures related to:

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.
- Performing a “retrospective review” of accounting estimates for biases that could result in material misstatement due to fraud.
- Understanding the business rationale for unusual transactions.

The standard requires that these procedures be performed on *every audit*.

Documenting the Auditor's Consideration of Fraud

Audit documentation should include documentation supporting compliance with substantially all the major requirements of the Statement.

How Should SAS No. 99 Change Audit Practice?

SAS No. 99 is a comprehensive, far-reaching audit standard. It has the potential to significantly change the way we think about and perform audits.

As an analogy, consider the business environment in the 1980s, when the personal computer was first introduced and then widely adopted. At that time, it was predicted that with the new technology, huge investment companies would reap significant benefits in the form of increased productivity. In fact, increases in productivity were quite slow to develop, and by the end of the decade business owners were asking, Where's the benefit?

Through formal and informal study of the situation, analysts concluded that the anticipated benefits of the new technology were slow to surface because companies had simply used the technology to automate existing processes. The more successful implementations occurred when entities used technology as a basis for *rethinking their existing practices* and designing new ones.

That same dynamic could be said of the introduction of SAS No. 99. Many firms will undoubtedly adopt the new standard the same way they have previous ones—by obtaining an updated audit manual and using the most current checklists. For this standard, there is considerable question whether that approach will suffice.

The standard's requirements and their implications for the conduct of audits raise the following issues, some of which may take several years to resolve.

Firm Culture and Auditors' Mindset

Some of the requirements of the SAS will require auditors to change their mindset or perspective on the audit. These changes may affect firm culture and the relationships firms have with their audit clients. The standard reminds auditors that in planning and performing the audit, they must set aside their beliefs that management is honest, even though they may have many years of experience with management.

With its emphasis on professional skepticism, the standard places the onus on audit professionals to maintain a questioning mind throughout the engagement. Firm leaders will be required to model this behavior by setting a proper "tone at the top or engagement culture for the audit team." All firm members must be aware of both the direct and indirect signals they send to each other and to the clients, to ensure that these messages convey the proper attitude. In adopting a more skeptical attitude toward clients, the relationship between the audit firm and management of the audited entity will undoubtedly change. As with any other relationship, this change must be carefully managed.

The SAS also requires auditors to bring a new perspective to understanding an entity's business and its internal control. In addition to the traditional ways in which auditors understand internal control, they now must view it in the context of fraud prevention and detection. Similarly, auditors have always been required to gain an understanding of the entity's business and the industry in which it operates in order to plan the audit. Now, that understanding will be broader and deeper. Under SAS No. 99, auditors' understanding of the entity's business should be sufficient to allow them to identify unusual transactions outside the normal course of business.

Finally, the SAS reminds auditors to maintain a questioning mindset and critically evaluate audit evidence.

New Skills

The requirements of SAS No. 99 will most likely demand that audit firms develop or acquire new skills, including:

- *Communication.* The emphasis on inquiry, in addition to the brainstorming session, will require auditors to enhance their communication and interviewing skills in order to make these procedures as effective as possible.
- *Technology.* The new standard includes commentary and examples that recognize the impact of both the client's and the auditor's use of technology on the risks of fraud. Specifically, certain of the required or suggested audit procedures (for example, the identification and review of unusual journal entries) may benefit from the use of computer-assisted audit techniques,¹ such as data extraction. Skills and knowledge of technology matters will be of great benefit to firms applying the requirements of the SAS.
- *Fraud expertise.* Many of the larger accounting firms have formally trained fraud specialists on staff. These individuals are resources for audit engagement teams, who use them as they would any other in-house specialist. Experience in detecting and investigating fraud may be necessary to help auditors:
 - Assess the risk of material misstatement due to fraud
 - Design audit procedures that respond to the assessed risk of fraud
 - Determine when a separate fraud investigation engagement is necessary

Audit Requirements and Their Implication

Table 1-1 summarizes the significant requirements of SAS No. 99 as well as how these changes are likely to affect practice.

¹ You may refer to Chapter 8 for additional guidance on computer assisted audit techniques.

Table 1-1 Changes to Current Guidance

<i>Change</i>	<i>Description</i>	<i>Implication</i>
Professional skepticism	<ul style="list-style-type: none"> • Emphasize maintaining a questioning mind throughout the audit. • Critical evaluation of the audit evidence. 	<ul style="list-style-type: none"> • Engagement leadership, including the individual with the final responsibility for the audit, must set the proper “tone at the top.” • Relationships with audit clients may be altered.
Brainstorming	<ul style="list-style-type: none"> • Brainstorm among audit team members about fraud risks at the entity. 	<ul style="list-style-type: none"> • Communication and facilitation skills need to be enhanced to conduct these sessions effectively. • Importance of engagement leadership buy-in on the brainstorming session.
Information gathering	<ul style="list-style-type: none"> • Expand the sources used to gather information used to identify risks of material misstatement due to fraud. 	<ul style="list-style-type: none"> • A checklist of fraud risk factors (and the “checklist mentality”) will not be sufficient.
Inquiries	<ul style="list-style-type: none"> • Expand the use of inquiries of management and others within the organization. 	<ul style="list-style-type: none"> • Interviewing and other communication skills need to be enhanced.
Revenue recognition	<ul style="list-style-type: none"> • Presume that revenue recognition is a fraud risk. 	<ul style="list-style-type: none"> • Balance sheet audit focus must be supplemented with procedures focused on revenue recognition.
Internal control	<ul style="list-style-type: none"> • Evaluate entity’s programs and controls that address fraud risks. 	<ul style="list-style-type: none"> • Auditors must supplement existing understanding of internal control with new perspective that considers fraud.

<i>Change</i>	<i>Description</i>	<i>Implication</i>
Management override of controls	<ul style="list-style-type: none">• Require new procedures to address management override.	<ul style="list-style-type: none">• New audit techniques may need to be developed to perform procedures.• Computer assisted audit techniques may be necessary.

CHAPTER 2: CONSIDERING FRAUD IN A FINANCIAL STATEMENT AUDIT

The purpose of this chapter is to take you step by step through Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). The main topic headings in this publication mirror those in the standard.

Introduction and Overview

In addition to providing a map of this long and comprehensive standard, the introduction makes several important points.

Auditor's Overall Responsibility for Fraud Detection

As described in Chapter 1, an auditor's overall responsibility in a GAAS audit is to 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*. As pointed out earlier, your responsibility is *not* to detect fraud, per se, but rather to detect material misstatements in the financial statements caused by fraud, within the context of reasonable assurance.

Within this definition of responsibility are two key terms.

1. *Reasonable assurance*. Reasonable assurance is a high threshold for performance; however, it stops short of *absolute* assurance, which is unattainable. SAS No. 99 (AU sec. 316.12) discusses reasonable assurance and why this is an appropriate threshold for detecting material misstatements caused by fraud.
2. *Materiality*. Remember that materiality is *not* solely a quantitative measure. When planning and performing your audit to detect material misstatements in the financial statements, you should consider the *qualitative aspects* of materiality, including the potential effect of the misstatement on:
 - Financial trends
 - Debt covenants
 - Other contractual agreements
 - Regulatory provisions

A thorough consideration of the qualitative aspects of materiality will require engagement teams to have a good understanding of the client's business early in the audit process. For example, to determine the magnitude and type of misstatements that might be material, the team should have an understanding of the entity's debt covenants and how close they are to violating those covenants. Interpretation No. 4, "Considering the Qualitative Characteristics of Misstatements,"

of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15–.17), provides definitive guidance on the qualitative aspects of materiality.



Practice Pointer. It is important for you to reach an understanding with the client regarding your responsibilities for fraud detection. Key issues to discuss are:

- Detection of material misstatements in the financial statements caused by fraud versus the detection of fraud, per se.
- Reasonable versus absolute assurance.
- Financial statement materiality and what that term means. You also want to discuss with the client their expectations about what should be considered material. For an owner-managed business this threshold varies from materiality to the owner personally.
- The primary responsibility for fraud prevention and detection rests with management and not the auditor.

An Integrated Approach

SAS No. 99 (AU sec. 316.03) describes the auditor’s consideration of fraud as something that should be integrated into the overall audit process. It is not something that is somehow added to your existing audit process as a separate checklist component. Rather, the guidance provided in SAS No. 99 should be blended in seamlessly with your current process because assessing fraud risks is an ongoing process that is continually updated throughout the completion of the audit.

By Way of Analogy...

If you are familiar with the game of basketball, you know that some shots count for two points and others—those that are launched a good distance from the basket—are worth three points. What you may not realize is that the three-point shot was not always a part of the game. It wasn’t until 1980 that the shot was used in both National Basketball Association and college games.

Today, when you watch a game, the three-point shot is an organic part of all aspects of the game. Players take three pointers in the normal course of action. Offensive strategies have been developed to take advantage of the three-pointer shot; players practice it.

In the early years, this was not the case. The three pointer was used mostly as a comeback tool, something you used only at the end of the game when you needed points in a hurry. Teams played their “normal” game and, if they had to, fired off long three pointers.

The objective of SAS No. 99 is to create an environment in which the consideration of fraud is an organic part of all elements of the audit process, in the same way the three-point shot has evolved in the game of basketball.

An Iterative Process

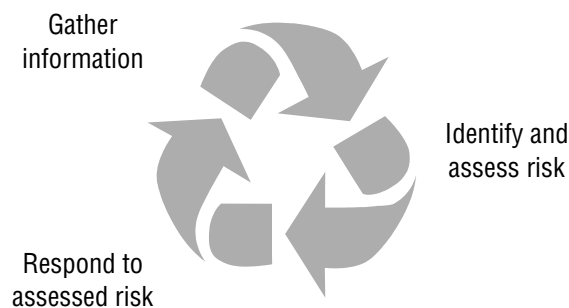
SAS No. 99 describes a process in which the auditor:

- Gathers information needed to identify risks of material misstatement due to fraud
- Identifies risks
- Assesses risks after taking into account an evaluation of the entity’s programs and controls
- Responds to the results of the assessment

Because of the way the information has been presented (and because of the way we have been trained to think), the tendency is to assume that these steps are performed sequentially and that once the final step has been performed, you are done.

In fact, as SAS No. 99 (AU sec. 316.03) points out, the audit process is nonlinear and iterative. That is, the standard is not meant to imply that you should perform the steps in the process in any particular order—the sequence of the requirements of the standard and its guidance may be implemented differently among audit engagements. Further, the process of gathering, updating, and analyzing information does not end when you complete the last step. It continues in a circular fashion—the results of audit procedures become information needed to identify risks, and the process begins anew (see Illustration 2-1). You do not break out of the cycle until you have gathered sufficient evidence to reach your conclusion.

Illustration 2-1 The Fraud Risks Assessment Process



Description and Characteristics of Fraud

SAS No. 99 (AU sec. 316.05–.12) describes certain characteristics of fraud. This section of the standard imposes no requirements on the auditor. Still, it is an important section because the more you know about the nature of fraud, the better equipped you will be to identify risks, assess the risks of material misstatement in the financial statements due to fraud, and develop an appropriate audit response. Additionally, the concepts contained in this section will allow auditors to conduct effective brainstorming sessions about fraud risks among themselves and to make meaningful inquiries of entity personnel.

Misappropriation of Assets Versus Fraudulent Financial Reporting

SAS No. 99 distinguishes between misappropriation of assets (employee theft) and fraudulent financial reporting. Table 2-1 summarizes the differences between these two types of frauds.

Table 2-1 Misappropriation of Assets Versus Fraudulent Financial Reporting

<i>Misappropriation of Assets</i>	<i>Fraudulent Financial Reporting</i>
<ul style="list-style-type: none"> • Involves the theft of an entity’s assets where the effect of the theft causes the financial statements to be materially misstated. • Usually perpetrated by employees but can involve management. • Typically driven by opportunity. • Often a major concern for the owner-manager of a privately held business entity. 	<ul style="list-style-type: none"> • Intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive users. • Usually perpetrated by management. • Typically driven by incentives or pressures. • A concern for both public and privately held entities, including governmental and not-for-profit organizations.



Practice Pointer. The scope of SAS No. 99 includes only those misappropriations of assets for which the effect of the misappropriation causes the financial statements to be materially misstated. You should take steps to ensure that owners of privately held businesses understand that the materiality of a defalcation will be considered in relation to the fairness of the financial statements, not the personal net worth of the owner.

The Fraud Triangle

As described briefly in Chapter 1, three conditions are present when fraud occurs.

- *Incentive/pressure.* Management or other employees may have an incentive or be under pressure, which provides a motivation to commit fraud.
- *Opportunity.* Circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for fraud to be perpetrated.
- *Rationalization/attitude.* Those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

Example 2-1 Sound Machine

Sound Machine is a retailer of high-end consumer electronics. The new owner of the company accumulated personal wealth as a salesman in another industry. He used a significant portion of his personal assets to buy the company and then borrowed heavily to embark on an ambitious

expansion plan. The debt agreement contained a number of loan covenants, and the owner provided the creditor with a personal guarantee.

On several occasions, the owner was known to give sales personnel “credit” for a sales transaction before some of the accounting “technicalities” had been completed (for example, delivery of the product and, signed sales agreement). Because his sales force was paid on a commission basis, the occasional early recording of revenue allowed the salesperson to be paid his or her commissions earlier. As a former salesperson, the owner was sympathetic to the argument that “the deal was essentially done,” and he wanted to help a salesperson who was in a temporary cash flow crunch and needed the commission check. In the owner’s mind, what he was doing was granting the employee an “advance,” which was “paid back” when the sales paperwork was finalized.

Over the course of several years, the owner made about a dozen such advances and each one was repaid—that is, the sale eventually was finalized. These “advances” were always made known to the auditor, who would prepare year-end adjustments to make any corrections to the financial statements. The procedure for authorizing such an advance was simple: The owner presented unsigned contracts to the bookkeeper and told her to recognize a sale before all the paperwork was final and to prepare a commission check for the salesperson.

Meanwhile, the company’s expansion plans were not proceeding as expected. The cash flow generated from the new stores was insufficient to meet the debt payments, and the company was in danger of violating its loan covenants.

At the end of one reporting period, the owner had a number of sales transactions that he himself had been working on. None of them was completed, technically speaking, but based on his experience, he was certain that they would close soon, after the end of the reporting period. The transactions’ status was similar to what he had used to justify employee advances over the years. Fearing that the company’s lack of sufficient profitability would put it in default on its loan, the owner went to the bookkeeper, gave her the unsigned contracts, and told her—as he had on several previous occasions—to record the sales in advance of receiving the final paperwork even though he knew the sales should not be recorded under GAAP. He further lead the bookkeeper to believe that he had already told the auditor of these “advances” and therefore, she should not say anything to them.

In Example 2-1, the small business owner has committed a financial reporting fraud. All three elements of the fraud triangle were present.

- *Incentive/pressure.* The company was in danger of defaulting on its loan agreement, which the owner had personally guaranteed.
- *Opportunity.* The company had certain controls in place to prevent the advance recording of revenues. The owner was able to override these controls by simply telling the bookkeeper to record the sales in the absence of all required documentation.
- *Rationalization/attitude.* The owner had done similar things in the past, as a way to help his employees. In his mind, he was receiving an “advance” from the lender in the same way his salespeople received advances from him.

Eliminate one of these three characteristics, and the risk of material misstatement in the financial statements due to fraud diminishes. Conversely, you may *add* a third side to make a triangle where one

did not exist previously. For example, the owner of Sound Machine *always* had the opportunity to override controls, book revenues in advance, and rationalize the act. It was not until the company was in danger of defaulting on its loan—providing an incentive—that the fraud occurred. Part of your fraud risk assessment process should be to consider whether the changes at the client since the last audit have, in effect, added a “third side” to complete a fraud triangle.

Other Characteristics of Fraud

SAS No. 99 (AU sec. 316.05–.12) describes two other characteristics of fraud that are helpful during your audit.

- *Commitment-conversion-concealment.* Frauds can be thought of as a three-step process.
 - The fraud is committed. In Example 2-1, the company records revenue prematurely.
 - The benefits to the fraud are realized. In the example, the company avoids defaulting on its loan, and the owner is not required to perform on his personal guarantee.
 - The fraud is concealed. In the example, the documentation for the sale is unsigned or incomplete. Under scrutiny of an audit, the owner or other company personnel may attempt to conceal the fraud by altering documents in a way to make it appear that the sale was finalized during the reporting period.

As an auditor, it is unlikely that you will observe someone committing a fraud or recognize that management or employees have realized a benefit of the fraud. 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*.

- *A simple plan.* SAS No. 99 (AU sec. 316.06) states that “fraudulent financial reporting need not be the result of a grand plan or conspiracy.” In Example 2-1, the owner was able to rationalize the appropriateness of the misstatement as a temporary condition that would correct itself shortly. The standard goes on to describe other ways in which a fraud starts out as something relatively simple.

Although not stated in the standard, frauds due to theft have similar characteristics. They typically do not start as a grand plan, but rather something innocuous that grows bigger over time.

Professional Skepticism

There are several reasons why auditors fail to detect material misstatements in the financial statements caused by fraud. Some of the more commonly observed include:

- An overreliance on client representations (both oral and written) or a failure to collaborate those representations with other audit evidence
- A lack of awareness or a failure to recognize that an observed condition may indicate a material fraud

- A lack of experience in understanding why frauds occur or what behavior patterns to look for. This lack of experience can result in a complacent attitude about fraud.
- Personal relationships with clients and a belief that they are honest and conduct themselves with integrity

SAS No. 99 (AU sec. 316.13) reminds auditors that they need to overcome these natural tendencies and biases and approach the audit with an attitude that includes a questioning mind and a critical assessment of the audit evidence. Also critical is the need for the auditor to set aside past relationships with the client and to view every audit as an opportunity for management to perpetrate a fraud. Chapter 3 provides suggestions on how auditors can learn to adopt a more critical, skeptical mindset on their engagements.

Discussion Among Engagement Personnel

As described in Chapter 1, SAS No. 99 requires the audit team to discuss the potential for a material misstatement in the financial statements due to fraud before or during the information-gathering process. This required “brainstorming” session is a *required* procedure and should be applied with the same degree of due care as any other audit procedure, such as inventory observation or confirmation of accounts receivable.

Most businesspeople treat brainstorming as a check box, a threshold variable, such as “Can you ride a bicycle?” or “Do you know how to tie your shoes?” They overlook the possibility that brainstorming can be a skill or an art, more like playing the piano than tying your shoes.¹



Practice Pointer. For reasons discussed elsewhere in this publication (for example, Chapter 3), the brainstorming requirement has the potential to significantly improve the auditor’s ability to detect material misstatements caused by fraud. The ultimate effectiveness of brainstorming in achieving this goal hinges on the emphasis and importance placed on it by the engagement team leaders.

Objective of the Brainstorming Session

There are two primary objectives of the brainstorming session. The first one is strategic in nature.

¹ From Tom Kelley, *The Art of Innovation* (New York: Doubleday, 2001), p. 55.

By Way of Analogy²...

To the uninitiated, the art of fishing may seem a mysterious and random act. A fisherman casts his line into the sea in what seems to be an act of pure faith that fish exists below the inscrutable surface of the sea. And the line hangs for minutes, hours, even days (in the case of Hemingway's *The Old Man and the Sea*, 84 days). To the nonfisherman, it seems to be pure luck when a fish finally takes the bait, and the pole begins to shimmy and bend.

The experienced fisherman knows the amount of skill and planning that goes into the exercise. Before setting out on his excursion, the fisherman determines what kind of fish he is trying to catch. He chooses the equipment he needs. He reviews the habits of the target fish—where they swim, when they are active, the type of motion that they are attracted to and what will prompt them to strike. Armed with this information, he then is prepared to cast his line, into the spot where the fish are likely to be, at the time of day they are hungry, and with a retrieval technique that is likely to induce a strike.

Detecting a material misstatement in the financial statements caused by fraud should not be viewed as a random and mysterious act, something the auditor “stumbles upon” while conducting the audit. Rather, like the experienced fisherman, the auditor should determine what kinds of frauds (fish) are likely to be present and which tools and techniques are best equipped to find them.

As a result of the brainstorming session, the engagement team should have a good understanding of:

- Information that experienced team members have about their experiences with the client.
- How a fraud might be perpetrated and concealed at the entity.
- The procedures the team might perform to detect any material misstatement that results.

The second objective of the brainstorming is to set the proper “tone at the top” for conducting the engagement. Within the context of assessing an entity’s internal control, auditors have long recognized the importance of the control environment and the proper tone at the top set by management. Intuitively, we recognize that a proper corporate culture can permeate an entity’s internal control, making individual controls much more effective in identifying misstatements, whether due to error or fraud.

SAS No. 99 takes that same approach and applies it to the audit itself. The requirement that the brainstorming session is to be conducted with an attitude that “includes a questioning mind” is an attempt to model the proper degree of professional skepticism and set the culture for the engagement.

² This is not the first publication to use a fishing analogy to describe the search for fraud. Defense attorneys are fond of using the term *fishing expedition* to describe an investigation into their client’s activities that seems to lack a well-defined purpose. Fraud and other crime investigators use similar metaphors, for example, describing how their investigations “cast a wide net.” Experts in fraud and forensic accounting also use fishing analogies to describe the process of conducting a fraud investigation. Howard R. Davia, CPA, used a fishing analogy in two of his books, *Accountant’s Guide to Fraud Detection and Control* (New York: John Wiley & Sons, 2000) and *Fraud 101: Techniques and Strategies for Detection* (New York: John Wiley & Sons, 2000). This is our version of the fishing analogy.

As in a client's control environment, the belief is that this audit engagement culture will infuse the entire engagement, making *all* audit procedures that much more effective.

As a practical matter, many auditors do not encounter material misstatements in the financial statements caused by fraud during the course of their career in public accounting, and the auditor's sensitivity to the existence of fraud possibly could be dulled over time. The mere fact that the engagement team engages in a serious discussion about the entity's susceptibility to fraud also serves to remind the team members that the possibility does exist in every engagement—in spite of any history or preconceived biases about the honesty and integrity of management.

By Way of Analogy...

In his short story "On the Zatterre," William Trevor tells the tale of Verity, a 38-year-old woman who moves back into her father's house after the death of her mother. In the opening paragraph we learn that after she moved back home, she "became as her mother had been, her father's chief companion and was in time exposed to traits in his nature she had not known existed. Preserving within the family the exterior of a bluff and genial man, good-hearted, knowledgeable and wise, her father had successfully disguised the worst of himself."

In the story the father and daughter go on vacation together to Venice, and during that time, Verity notices the worst of her father at every turn. He is mean about spending small sums of money. He tells petty, unimportant lies. He can be boorish beneath his urbane exterior. It is apparent that now that she has acknowledged the worst of her father, she recognizes it all the time.

As auditors, we may have created certain images of our clients in our mind. One of the objectives of the brainstorming session is to remove these images and to acknowledge the possibility that fraud may exist at any entity. Once we become sensitized to that possibility, we will be more likely to recognize the indicators of fraud when they present themselves.



Practice Pointer. SAS No. 99 does not provide any requirements on who should attend the brainstorming session other than stating that it ordinarily should involve key members of the audit team. That would require the participation of those planning, performing, or supervising key aspects of the audit. In rare situations, if it is not possible for a key member to be present, important messages and items discussed during the session should be communicated to that person. SAS No. 99 does *not* require the discussion to be conducted face-to-face; however, in-person sessions typically are more effective than those conducted over the phone or via e-mail.

Continuous Communication

SAS No. 99 does *not* restrict brainstorming to the planning phase of the audit process. Brainstorming can be used in conjunction with any part of the information-gathering process. Auditors gather information continuously throughout the engagement, so look for opportunities to brainstorm *throughout* the engagement. Some auditors may choose to conduct a brainstorming session near the conclusion of the audit in order to consider the findings and experiences of all team members during

the audit and whether the team's assessment about and responses to the risk of material misstatement due to fraud were appropriate.

In addition to brainstorming, SAS No. 99 requires audit team members to communicate with each other throughout the engagement about the risks of material misstatement due to fraud. In fact, SAS No. 99 (AU sec. 316.74) requires the auditor with final responsibility for the audit to determine that there has been appropriate communication among team members—not just during the brainstorming, but throughout the engagement.

Suggestions for an Effective Brainstorming Session

Structuring the Session

First, split the session into two parts. The main objective of brainstorming is to generate ideas about how fraud might be committed and concealed at the entity. That is all that is required by SAS No. 99. As a practical matter, some engagement teams may choose to discuss how the engagement team may respond to the identified risks. If you choose to discuss audit responses as part of a brainstorming meeting, it is important to recognize that the two activities require two very different processes and mindsets. Generating ideas is a right-brain, intuitive exercise. Developing an audit plan is just the opposite. One sure way to kill the generation of new ideas is to critique and analyze them as soon as they are brought up.

For that reason, if you choose to discuss audit responses at your brainstorming meeting, you should consider dividing the session into two distinct segments. First, get *all* the ideas out, without analyzing or commenting on their merit. Take a break, make sure that group members understand that they are switching gears, and then discuss an audit response.

Then, determine a reasonable time limit. Consultants and business owners who participate regularly in business brainstorming sessions suggest that a good session lasts about an hour. After that, the energy begins to fade, and the law of diminishing returns sets in. Plan on spending about an hour brainstorming ideas on how the entity might be vulnerable to fraud.

The Brainstorming Process

First, consider assigning "homework." The actual brainstorming session will be much more productive if all members have a similar level of understanding about the client, the nature of its business, and its current level of financial performance. In his book *The Art of Innovation*, Tom Kelley describes an experiment he performed at his company regarding brainstorming homework. One group did no homework, a second performed detailed quantitative analysis of the situation, and the third did research that was more intuitive and impressionistic in nature, such as visiting stores of the client's competitors. The group that performed analytical homework outperformed the group that did no preparation, but the group that performed less structured research performed best of all.

For auditors brainstorming about fraud matters, it may certainly be beneficial to perform analytical, fact-based research before the brainstorming session. Examples might include:

- Analytical procedures of the most current financial information
- Review of prior year's or interim financial statements
- Review of previously issued management letters
- Review of selected working papers from the previous engagement that may provide ideas for possible areas of vulnerability to fraud. Examples of these working papers include: internal control documentation, summary of audit differences, and summaries of key legal agreements.
- Review of client acceptance and continuance documentation
- Review of press releases, current marketing literature, and other information released by the entity
- Review information about the industry

In structuring your session it will help to consider the characteristics of the fraud triangle.

For example, you might discuss the incentives/pressures that may exist at the entity or the opportunities management or employees have to commit fraud. You also may discuss observations about attitudes or rationalizations that may indicate the presence of a risk of material misstatement caused by fraud.

If the circumstances of the client permit, engagement teams also may consider preparing for the brainstorming session by engaging in non-fact-based research. Example 2-1 describes a fraud committed by a consumer electronics retailer. In a similar situation, it may be instructive for the auditors to visit a client location and observe the entity's operating procedures and methods.

Next, during the session, focus on the energy of the group. The energy in a brainstorming session is like popping popcorn in the microwave. At first there is little activity. This is followed by a quickly accelerating burst of energy in which a great many ideas are "popped." Eventually, the energy plateaus and peters out. In a brainstorming session, this "popping" process will repeat itself several times.

During the early stages of the session, the facilitator should be patient and encourage the group to share ideas. Avoid the temptation to have the most senior person in the group express his or her views to "get the ball rolling," as this will tend to stifle creativity. No one likes to challenge the boss.

As the energy rises, keep building the momentum. Introduce variations on the main idea being discussed as a way to push the limits of the idea. For example, if the group is discussing ways to prematurely record revenue, a question that builds momentum would be, "Side agreements with customers is one way the entity might improperly recognize revenues. What are some others?"

As the energy begins to plateau, "jump" the discussion to another topic or back to one that was discussed previously. For example, "We can always come back to revenue recognition. What are some ways the entity might underreport expenses?"

Finally, describe the objective of the session in language people can relate to. SAS No. 99 describes the objective of brainstorming to identify “how and where the team believes the entity’s financial statements might be susceptible to material misstatement due to fraud.” This is wonderful language for an audit standard but not for generating creative ideas. To help generate creative, practical ideas, pose questions that people can more easily understand:

- If you were the bookkeeper for the entity, how could you embezzle funds and not get caught?
- If you worked on the loading dock, how could you steal inventory?
- If you owned this company, what impression would you want to make on third parties, such as banks or the IRS? How might you manipulate the financial statements to create this impression?



Practice Pointer. SAS No. 99 does not indicate how a sole practitioner who has no staff should conduct a brainstorming session. This lack of guidance should *not* be construed to mean that a sole practitioner is exempt from the spirit of what the standard requires. The purpose of the brainstorming session is to cultivate a questioning mindset during the engagement and to consider how a fraud might be perpetrated at the entity. Introspection and reflection upon the guidance contained in this Practice Aid and the standard itself would be one way in which the sole practitioner could comply with the spirit of the requirement even in the absence of other individuals necessary to conduct a brainstorming session.



Practice Pointer. Some firms have implemented the brainstorming requirements of SAS No. 99 by conducting brainstorming sessions at two levels. The first, higher level brainstorming is performed at the industry or specialized practice area. For example, the firm might conduct a brainstorming session to discuss fraud in the high-tech or not-for-profit industry. Significant audit efficiencies may be realized by performing brainstorming at this high level. However, by itself, an industry-wide brainstorming session does not comply with the requirements of SAS No. 99. To meet the requirements, these general brainstorming sessions must be followed up with sessions focused exclusively on individual clients.

Rules of Engagement

You might consider developing and posting brainstorming rules to help you achieve your objective. Here are some examples.

- *There are no dumb ideas or questions.* Prejudging questions by labeling them “dumb” is one sure way to stifle the contribution of ideas. Similarly, you should try to explore even the most seemingly basic questions. You never know where a “dumb” idea or question might lead.
- *Ideas are a work in process.* The most effective brainstorming sessions are those in which the group contributes to the communal building of an idea, similar to the way the members of a traditional farming community would all participate in a “barn raising.” One of the mistakes made by a group involved in brainstorming is to inadvertently assume that an idea presented

by a group member is fully formed and needs only to be “memorialized” by adding it to a list on a flipchart. This type of approach will result in less effective brainstorming. Group members should assume that all ideas are a work in process and, once presented, it is their collective responsibility to add to it, change it, and ultimately “raise” it to a more complete state.

- *No hierarchy.* The world of ideas does not recognize rank, experience, or compensation level. Work to create an environment in which senior members of the team share information without dominating the discussion, and junior members feel “safe” contributing their own ideas.
- *No excessive note-taking.* A brainstorming session is an intuitive, spontaneous process. *Excessive* note-taking is a barrier to this process. Those individuals who take notes as if it were the last class period before a biology exam will not be effective contributors to the session.³

Obtaining Information to Identify the Risks of Material Misstatement Due to Fraud

As described earlier, the audit is an iterative process that includes gathering information, identifying and assessing risks, and responding to the risk of material misstatement due to fraud. SAS No. 99 (AU sec. 316.09–.34) provides guidance on obtaining information for the purpose of identifying and assessing risks from the following sources.

- Inquiries of management and others within the organization
- Analytical procedures
- Consideration of fraud risk factors
- Other information

Inquiries

The SAS requires you to make the following inquiries.

- *Management.* The SAS lists several items that you should ask management relating to their awareness and understanding of fraud, fraud risks, and the steps taken to mitigate this risk at the entity.
- *Others.* SAS No. 99 requires you to make inquiries of the audit committee, internal audit personnel (if applicable), and others within the entity about the existence or suspicion of fraud and to make possible inquiry about the individual’s views about the risks of fraud within the

³ Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires you to document how and when the brainstorming occurred, who participated, and the subject matter discussed. It does not require you to document in great detail the specific risks discussed. As a practical matter, the *over* documentation of risk factors discussed may provide unnecessary litigation exposure to the firm.

entity. Even if the entity's audit committee is not active (which is common in smaller public companies and many not-for-profit organizations), you are still required to ask the chairperson about fraud. As discussed later in this section, "others" also includes those individuals who are outside the financial reporting process.

Inquiries of Management

SAS No. 99 (AU sec. 316.20) lists the inquiries you should make of management. The required inquiries are:

- Whether management has knowledge of any fraud or suspected fraud affecting the entity.
- Whether management is aware of allegations of fraud or suspected fraud affecting the entity, for example, because of communications from employees, former employees, analysts, regulators, short sellers, or other investors.
- Management's understanding about the risks of fraud in the entity, including any specific fraud risks the entity has identified or account balances or classes of transactions for which the risk of fraud may be likely to exist.
- Programs and controls⁴ the entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud, and how management monitors those programs and controls. Exhibit I of SAS No. 99 discusses examples of programs and controls an entity may implement to prevent, deter, and detect fraud.
- For an entity with multiple locations, (a) the nature and extent of monitoring of operating locations or business segments, and (b) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist.
- Whether and how management communicates to employees its views on business practices and ethical behavior.

Some of these inquiries will need little or no explanation. For example, asking whether management has knowledge of fraud affecting the entity is relatively straightforward.

Other inquiries may require you to "educate" the entity's management about the characteristics of fraud (for example, the fraud triangle), the nature of fraud risks, and the types of programs and controls that will deter and detect fraud. The guidance contained in SAS No. 99 and this publication provide you with the background necessary to discuss these matters with most clients.


SAS No. 99 does not define *management*. As a practical matter, your inquiries of management about fraud should be directed to those individuals within the entity who sign the management


⁴ SAS No. 55 (AU sec. 319.06 and .07) defines internal control and its five interrelated components (the control environment, risk assessment, control activities, information and communication, and monitoring). Entity programs and controls intended to address the risks of fraud may be part of any of the five components discussed in SAS No. 55.


representation letter. SAS No. 85 (AU sec. 333.09) states that the management representation letter should be signed:

...by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity.

You also should consider making inquiries of the controller and, in an owner-managed business, the owner.

 **Practice Pointer.** The discussions you have with client management about fraud are tangible benefits to your clients of the adoption of SAS No. 99. If you make the effort to have a thoughtful, comprehensive discussion with them, they will ascribe more value to your services. Some firms are planning to conduct more formal fraud awareness “training” sessions for their audit clients, which business owners may receive even more favorably.

 **Practice Pointer.** Thorough advance preparation will increase the effectiveness of your inquiries. Chapter 4 of this Practice Aid provides further suggestions on how to prepare for and conduct inquiries of entity personnel regarding fraud matters.

 **Practice Pointer.** Inquiries about fraud may involve the discussion of relatively sensitive matters that will require auditors to exercise discretion and judgment in balancing their need to obtain information with a desire to maintain a relationship of mutual trust with the client. Audit teams should carefully consider which team member is most qualified to conduct these inquiries.

Inquiries of Others Within the Entity

For the most part, auditors tend to restrict their inquiries of the client to personnel directly involved in the financial reporting process. This approach is appropriate for matters that accounting personnel have direct knowledge of, such as how transactions are processed or controlled. However, it is less effective to ask accounting personnel about matters for which they do not have first-hand knowledge (for example, the procedures used to examine, count, and receive items into inventory, or the terms of certain contracts). Critics of the audit process frequently cite the auditor’s reluctance to make inquiries outside of the accounting department as a reason for the lack of in-depth understanding necessary to plan and perform an effective and efficient audit.

SAS No. 99 is the first standard that requires auditors to make inquiries of “others within the entity” (for example, nonaccounting personnel). The SAS suggests making inquiries of:

- Operating personnel not directly involved in the financial reporting process
- Individuals with knowledge of complex or unusual transactions
- In-house legal counsel

Further, you should not restrict your inquiries to senior management. The standard suggests making inquiries of personnel at various levels within the organization.

There are two primary objectives in making inquiries of others within the organization.

- *To obtain first-hand knowledge of fraud.* Fraud can happen in any department, at any level within the organization. Anyone in the entity may have observed first-hand someone committing or concealing a fraud. Oftentimes, those with knowledge of a fraud have stated, after the fact, that they would have told someone, “but nobody asked.” SAS No. 99 increases the likelihood that the auditor will now be that “someone” who asks.
- *To corroborate or lend perspective to representations of others.* Operating personnel can corroborate representations made by others or provide a different perspective on how things “really work.” For example, accounting department personnel may be able to provide you with the recommended control procedures relating to the safeguarding of inventory. Operational personnel, in this case, those who work in the warehouse, can tell you how the control procedures are applied in practice and when, if ever, those controls are overridden or circumvented.

The standard allows you to use considerable judgment in determining to which individuals within the organization you should direct your inquiries and what you should ask.

By Way of Analogy...

Drop a rock into a still, glassy pool and watch the water ripple in an ever-widening circle.

In an audit, the focus of activity is the accounting department and entity management. You start there, asking questions to gain a preliminary understanding of the entity. To improve that understanding and corroborate what you have learned, you must expand the reach of your inquiries to those outside the first group. The tight, initial circle widens, until you have gathered enough reliable, persuasive evidence to form an opinion.

Other Inquiries

SAS No. 99 lists certain specific inquiries that you are required to make of management and others in the entity. However, the statement does not restrict you to making only those required inquiries. In fact, inquiry can be an effective procedure to help you gather or corroborate a wide variety of information that can help you identify or assess risks of material misstatement due to fraud. For example, you may wish to use inquiries to:

- Identify incentives/pressures, opportunities, or attitudes/rationalizations that can lead to material misstatements caused by fraud.
- Understand the policies, procedures, and controls at the entity for recording journal entries or other adjustments directly to the financial statements.
- Identify circumstances under which management has or may override internal control.

- Understand policies and procedures related to revenue recognition.
- Understand the business rationale for significant unusual transactions.

Many of the inquiries related to these matters should be asked of personnel outside of management or the accounting department. Asking the same question of different people can increase the effectiveness of your inquiries, as you can compare answers to identify consistencies or anomalies in the responses. The following table provides examples of inquiries you might consider making of entity personnel. These inquiries are *not* required by SAS No. 99.

<i>Objective of Inquiry</i>	<i>Example Inquiries</i>	<i>Direct Inquiries to</i>
Identify incentives/pressures that can lead to material misstatements caused by fraud.	<ul style="list-style-type: none"> • Describe the current threats affecting the financial stability or profitability of the entity. • How do these threats create pressure on the entity to report improved financial results? 	<ul style="list-style-type: none"> • Management • Sales personnel • Production personnel
	<ul style="list-style-type: none"> • What expectations do third parties have regarding entity performance and reported financial results? 	<ul style="list-style-type: none"> • Management • Investor relations
	<ul style="list-style-type: none"> • Describe significant provisions of management and/or board compensation. 	<ul style="list-style-type: none"> • Management • Human resources
	<ul style="list-style-type: none"> • Has management made any personal guarantees on behalf of the company? 	
	<ul style="list-style-type: none"> • Describe the nature of any significant investment management has made in the company. 	
	<ul style="list-style-type: none"> • Describe the way in which financial targets are used to motivate employee performance. 	<ul style="list-style-type: none"> • Management • Human resources
	<ul style="list-style-type: none"> • What is the nature and magnitude of the pressure felt by employees to achieve these targets? 	<ul style="list-style-type: none"> • Employees affected by the financial target incentives

(continued)

<i>Objective of Inquiry</i>	<i>Example Inquiries</i>	<i>Direct Inquiries to</i>
Identify <i>opportunities</i> that can lead to material misstatements caused by fraud.	<ul style="list-style-type: none"> • Describe any industry conditions that allow the entity to dictate terms or conditions to suppliers or customers. • Describe any significant turnover of personnel in accounting, information technology, or internal audit. • How does the entity's turnover experience compare with others of its size in the same industry? With companies of a different size or different industry? • How active is management in the oversight of the financial reporting process? • Is this involvement effective? 	<ul style="list-style-type: none"> • Sales personnel • Purchasing personnel • Human resources • Accounting • Information technology • Internal audit • Accounting • Management
Identify <i>attitude/rationalization</i> that can lead to material misstatements caused by fraud.	<ul style="list-style-type: none"> • Describe the entity's values and ethical standards. • How are these communicated, supported and enforced? • To what extent does nonfinancial management participate in the selection of accounting principles or determination of significant estimates? 	<ul style="list-style-type: none"> • Management • Employees • Accounting • Sales personnel • Other nonfinancial management

<i>Objective of Inquiry</i>	<i>Example Inquiries</i>	<i>Direct Inquiries to</i>
	<ul style="list-style-type: none"> • Do any accounting policies seem overly aggressive or inappropriate? • To what extent is “materiality” used to justify marginal or inappropriate accounting policies? 	<ul style="list-style-type: none"> • Accounting
Identify fraud risk factors relating to the misappropriation of assets.	<ul style="list-style-type: none"> • Are there any adverse or strained relationships between employees and the company? • Are there any recent or planned layoffs or changes to employee compensation or benefit plans that could create resentment among the employees? • Are there any recent or planned bonuses, promotions, or other actions that were/will be inconsistent with expectations and could create resentment among the employees? • How involved is management in overseeing employees with access to cash and other assets susceptible to misappropriation? • What is the attitude of management and employees toward internal control and established policies and procedures? • Have you observed any unusual or unexplained changes in behavior or lifestyle of management or employees? 	<ul style="list-style-type: none"> • Management • Human resources • Employees • Management • Human resources • Management • Employees • Management • Employees

(continued)

<i>Objective of Inquiry</i>	<i>Example Inquiries</i>	<i>Direct Inquiries to</i>
Understand policies, procedures, and controls related to journal entries and other adjustments to the financial statements.	<ul style="list-style-type: none"> • What is the process for recording nonstandard journal entries or other adjustments directly to the financial statements, including: <ul style="list-style-type: none"> — Description and purpose — Individuals responsible — Timing — Review and approval process 	<ul style="list-style-type: none"> • Accounting
Identify instances of management override of internal control.	<ul style="list-style-type: none"> • Under what circumstances will members of management waive or bypass established policies or procedures? • Describe the policies or procedures that management has waived or bypassed during the past year. 	<ul style="list-style-type: none"> • Management • Accounting
Understand policies and procedures related to revenue recognition	<ul style="list-style-type: none"> • See Chapter 5 of this Practice Aid 	<ul style="list-style-type: none"> • Management • Accounting • Sales and marketing personnel • Shipping personnel
Understand business rationale for significant, unusual transactions.	<ul style="list-style-type: none"> • Has management discussed the nature and accounting for these transactions with the audit committee or board of directors? • Have transactions involving unconsolidated related parties been reviewed and approved by the board? • Does management seem to place an unusual emphasis on the need for a particular accounting treatment rather than on the underlying economics of the transaction? 	<ul style="list-style-type: none"> • Management • Audit committee • Board of directors • Audit committee • Board of directors • Accounting



Practice Pointer. For further guidance on formulating follow-up questions, please refer to the following.

- Questions relating to incentives/pressures, opportunities, or attitudes/ rationalizations, see the Appendix to SAS No. 99, which provides example fraud risk factors.
- Questions relating to nonstandard entries and other adjustments to the financial statements, see SAS No. 99 (AU sec. 316.58–.62) and PITF Practice Alert 03-2, *Journal Entries and Other Adjustments* (included as Appendix C to this book).
- Questions relating to the business rationale of significant unusual transactions, see SAS No. 99 (AU sec. 316.67).

Planning Analytical Procedures

Example 2-2

XYZ Investment Partnership owned several commercial office buildings. One of these buildings was managed by an onsite property manager, who managed to embezzle several rent payments received from tenants. To conceal the fraud, the property manager credited rental income, knowing that the XYZ asset manager focused solely on the property's income statement and would not notice any difference in rental income. To balance the credit to income, the property manager debited accounts receivable.

The fraud was detected when the audit engagement senior reviewed interim financial statements and noticed an odd relationship between receivables and rental income. The balance in rental income receivable represented approximately four months of rental income. Given the nature of the property—a commercial office building where tenants paid on a monthly basis—it did not make sense that four months of income would go uncollected. That observation prompted a series of questions and extended procedures that quickly discovered the fraud.

One of the reasons auditors fail to detect material misstatements caused by fraud is a tendency to look at current numbers in isolation from the past or other relevant information. For that reason, SAS No. 99 states that the auditor should consider the results of analytical procedures in identifying the risks of material misstatement caused by fraud. Example 2-2 illustrates how the result of an analytical procedure performed during planning was effective at identifying a fraud. The example analytical procedure was performed during the overall review stage of the audit process, but it could just as easily have been performed during the planning phase of the engagement.

SAS No. 99 (AU sec. 316.72) provides a good list of example analytical procedures that may indicate a risk of material misstatement due to fraud.⁵ This paragraph also notes that some analytical relationships are more effective than others at identifying fraud risks because management or employees generally are unable to manipulate certain information to create seemingly normal or expected relationships. For example, management may be able to

⁵ These examples are provided within the context of the overall review stage of the audit; however, they can just as easily be performed during the information gathering phase to help identify and assess fraud risks.

manipulate earnings, but it cannot manipulate cash flow. Thus an unusual relationship between reported earnings and cash flow may indicate a risk of material misstatement due to fraud. The standard also provides limited examples of analytical procedures related to revenue that may be helpful in identifying material misstatements caused by fraud. Here are some other analytical relationships you might use.

*The CPA's Handbook of Fraud and Commercial Crime Prevention*⁶ describes the results of an academic study based on companies identified by the Securities and Exchange Commission (SEC) as earnings manipulators during a 10-year period. The purpose of the study was to develop quantitative fraud warning signs by analyzing a series of ratios that might be used as predictors of material misstatements caused by fraud.⁷

The research identified a group of financial statement variables that may be helpful in identifying material misstatements caused by fraud. These variables are:

- *Day's sales in receivables index.* Calculate day's sales in receivables for the current period. Compare that to the same calculation for the immediate prior period. A ratio of 1:1 indicates that the day's sales in receivables has held steady between the two periods. Receivables that are beginning to become large in relation to sales may be a sign of fraudulent revenue recognition.
- *Gross margin index.* Compare gross margin for the current period to that for the immediate prior period. In this instance, look for a ratio that is *less than* 1:1, which indicates gross margins are deteriorating for the entity. As indicated in the list of fraud risk factors included as the Appendix to SAS No. 99, declining margins may indicate a lack of financial stability or profitability, providing management with an incentive to fraudulently misstate the financial statements.
- *Asset quality index.* Asset quality is the ratio of noncurrent assets exclusive of property, plant, and equipment to total assets in any given year. The asset quality ratio measures the ability of the company to produce reliable earnings in the future. The higher the proportion of noncurrent assets to total assets, the greater the risk to the company of future earnings growth. A ratio of current year asset quality to prior year asset quality that is greater than 1:1 means more costs are being capitalized and deferred, which could be a sign of fraudulent earnings manipulation.
- *Sales growth index.* This is the ratio of current year sales to prior year sales.

⁶ *The CPA's Handbook of Fraud and Commercial Crime Prevention*, Avey et al. (New York: AICPA, 2002).

⁷ The study was conducted by Messod D. Beneish, an associate professor at the Kelley School of Business, Indiana University. The results were published in "The Detection of Earnings Manipulation," *Financial Analysts Journal* 24 (1999): 24–36.

- *Total accruals to total assets.* This is a measure of changes in noncash working capital to total assets at the end of the current period. Start with working capital excluding cash. Determine year-to-year change in this amount. Divide this amount into total assets at the end of the period. A large result indicates that a growing percentage of the entity's working capital is composed of *noncash* items, which is a sign of possible fraudulent financial reporting.

The following table summarizes the results of the research. The findings indicate that financial statement “manipulators” exhibit certain financial statement characteristics that are detectable and different from “nonmanipulators.”

<i>Characteristic Measures</i>	<i>Manipulators Mean</i>	<i>Nonmanipulators Mean</i>	<i>Difference</i>	<i>Difference (%)</i>
DSRI	1.460	1.030	0.430	42
GMI	1.190	1.010	0.180	18
AQI	1.250	1.040	0.210	21
SGI	1.610	1.130	0.480	42
TATA	0.031	0.018	0.013	72

Of course, you should not automatically assume that entities that exhibit unusual, unexplained ratios have engaged in fraudulent financial reporting. The information presented here is intended only to alert you to the possibility of fraud under certain circumstances.

Fraud Risk Factors

A fraud risk factor is an event or condition that indicates:

- An incentive or pressure to perpetrate fraud
- Opportunities to carry out the fraud
- Attitudes or rationalizations to justify a fraudulent action

Note that this definition of fraud risk factors tracks with the three conditions of the fraud risk triangle. Although fraud risk factors do not necessarily indicate the existence of fraud, they often are present in circumstances where fraud exists.

The Appendix to SAS No. 99 lists examples of fraud risk factors. Although these examples cover a broad range of situations, they are only examples. You may wish to consider additional or different risk factors, especially those that are unique to specialized industries. Appendix A to this publication provides examples of fraud risk factors for a number of specialized industries.



Practice Pointer. Even though you are allowed some flexibility in determining which risk factors to consider, use caution when deciding that some of the risk factors listed do not apply. Expect questions to be raised if a material misstatement due to fraud is discovered in the entity's financial statements or several of the example fraud risk factors listed in SAS No. 99 were identified during the course of your audit, but you decided *not* to consider them as possible indicators of fraud.



Practice Pointer, redux. On the flip side, you should consider the presence of risk factors that are *not* listed as examples in SAS No. 99. As indicated earlier in this publication, research found that auditors who used checklists that also required them to consider other risk factors outperformed those who just relied on a checklist.

Designing Audit Procedures to Identify Fraud Risk Factors

SAS No. 99 states:

When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present.

As a practical matter, the application of SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), relating to audit planning; SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, relating to internal controls; and the other sections of SAS No. 99 should allow you to identify the broad categories of fraud risk factors related to incentive/pressure and opportunity.

Regarding fraud risk factors relating to attitude/rationalization, the Appendix to the standard acknowledges that these risk factors may not be susceptible to observation by the auditor related to the attitude/rationalization condition. In other words, you cannot possibly know with certainty an individual's ethical standards and beliefs. However, during the course of your engagement, you may become aware of some of the circumstances described in Appendix A and should consider the possible presence of a fraud risk factor.

Other Information

SAS No. 99 requires you to consider other information that may be helpful in identifying the risks of material misstatement due to fraud. This other information includes that obtained during:

- The engagement team brainstorming session.
- Client acceptance and continuance procedures.
- Reviews of interim financial information.
- Consideration of inherent risks at the account or transaction level.



Practice Pointer. Looking back on their implementation of the previous fraud standard, some firms reported that it was common for engagement teams to document the existence of very few, if any, fraud risk factors on their engagements, even though several factors were present. The most common explanation for this lack of documentation was that auditors tended to collapse the three distinct steps of the fraud risk assessment process into one. The thinking went something like this: “Yes, fraud risk factor XYZ is present, but it is not a big risk, and besides we already do audit procedures to look for it, so I’ll just check ‘n/a’ on the form.”

Combining the three risk assessment steps into one decision can lead to a loss of audit effectiveness. Try to keep the three steps separate and distinct from each other. During the first phase of the process, focus only on gathering information and documenting your observations. Later, once you have obtained sufficient information, you will assess risk and then plan your audit response.

Identify and Assess Fraud Risks

By Way of Analogy...

All the President's Men is a true account of how Washington Post reporters Bob Woodward and Carl Bernstein investigated and reported the Watergate scandal. At one point early in the investigation the two are frustrated, for their work is not leading anywhere productive. Woodward meets with a secret source high up in the Nixon administration. During that meeting he explains that he and Bernstein have collected various bits and pieces of data. They are like pieces of a puzzle, but the two of them cannot even begin to determine how they might fit together or what the picture looks like.

Woodward’s source tells him, “Follow the money.” The source is unwilling to tell him any of the details he knows of the crime and its cover-up. The best he can do is give Woodward an overall guiding principle on how to analyze the pieces of the puzzle to develop clues on how they might fit together.

As an auditor, you gather information that may be relevant to detecting a material misstatement caused by fraud. These are the pieces of the puzzle. Like Woodward, you will become stuck, unsure how the pieces might begin to fit together and how you are to proceed. What you need is advice that can get you back on track, a device that allows you to organize and understand the bits and pieces you have assembled.

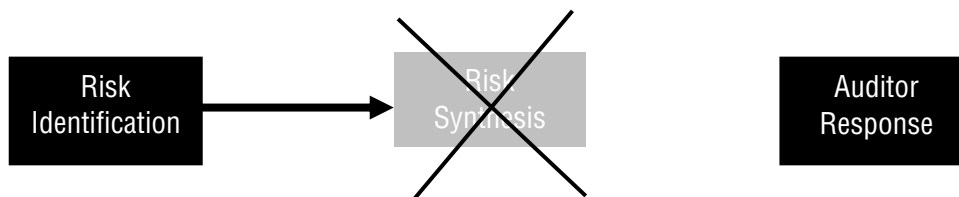
SAS No. 99 provides that advice.

After the release of the previous SAS on fraud, the AICPA sponsored academic research to determine the effectiveness of that guidance. One of the most significant findings was that auditors were very good at identifying the presence of fraud risk factors. However, they were not very good at designing audit tests that responded to those identified risk factors.

The key to designing effective audit tests is to *perform an effective synthesis* of the identified risks. The following illustration maps the audit process from risk identification to audit test design. “Synthesis” is the element that links the two ends of the process.



Eliminate risk synthesis from the process step, and the chain is broken—there is no link to risk identification.



Once that link between risk identification and audit test design is eliminated, it is not surprising that the design of audit tests does not respond effectively to identified risks.

The example describes the process as one of *synthesis*, which can be defined as “the assembling of a complex whole from originally separate parts.” That is what you must do after you identify risks. Previous auditing standards (and to a lesser degree, the current one) use the term *assessment*, which caused some confusion in practice. As auditors, we have ascribed a certain specific meaning to *assessing risk*—we typically take this to mean that we should describe it as high, medium, or low. That is *not* how the term is meant to be interpreted in SAS No. 99. Auditors are not required to, nor should they, “assess” fraud risks as high, medium, or low.

Instead, what is intended is for you to synthesize the identified risks as a way to determine where the entity is most vulnerable to material misstatement due to fraud, the types of frauds that are most likely, and how those material misstatements are likely to be concealed.

To help you do a more effective job synthesizing identified risks and providing that necessary link, SAS No. 99 (AU sec. 316.35–.42) provides the following guidance.

Build a Fraud Triangle

Remember the three elements of the fraud triangle: incentive/pressure, opportunity, and attitude/rationalization. The risk of material misstatement due to fraud generally is greater when all three are present.

Example 2-3 Sound Machine, Continued

An earlier example described a fraud at Sound Machine, a retailer of high-end consumer electronics. The owner-manager of the business always had the ability to override controls, which gave him an opportunity to commit fraud. Within his personality were the seeds of rationalization.

Without an incentive, no fraud was committed. However, once the company overextended itself and was in danger of defaulting on its debt, the owner felt a great deal of pressure—the missing third element of the triangle—and he committed fraud.

As an auditor, use your intuition, judgment, and experience to look for patterns in the identified fraud risks.

Using the fraud triangle framework is not foolproof. SAS No. 99 (AU sec. 316.35–.36) reminds you that the failure to observe one of the elements of the triangle does not guarantee that no fraud has been committed. For example, it usually is difficult to identify attitude/rationalization. For that reason, you should *not* conclude that the risk of material misstatement due to fraud is absent simply because you did not observe the necessary attitude/rationalization. Stated another way, it has been observed that auditors have a tendency to identify incentive and opportunity but mistakenly decided not to pursue the issue because they have not observed an attitude/rationalization that is conducive to fraud.

You also should be aware that some elements of the triangle may weigh more heavily than others in certain situations. Nevertheless, the fraud triangle framework can be helpful in synthesizing identified fraud risks.

Pervasive or Specific

It also helps to consider whether the identified risks are related to either:

- Specific accounts or transactions, or
- To the financial statements as a whole.

Example 2-4

Suppose that a company manufactures semiconductors, which are small, easy to transport, and extremely valuable. For these reasons, the company is vulnerable to theft. Now suppose that recent layoffs and budget cuts at the company have left the employees extremely angry (rationalization), and that you discover that the company does not have very effective physical control over its inventory (opportunity). Under these circumstances, finished goods inventory would be the specific account that is the most directly related to the identified fraud risks.

Once you can link the identified risks to a specific account (or the financial statements taken as a whole) you can then design and perform more effective procedures. In Example 2-4, the auditors would want to modify the nature, timing, or extent of procedures relating to inventory shrinkage. Chapter 7 provides detailed examples of audit procedures you may consider that address risks of fraud for specific accounts or groups of transactions.

Accounting Estimates and Soft Information

SAS No. 99 (AU sec. 316.39) reminds us that estimates and other “soft” accounting information may present risks of material misstatement due to fraud because of the high degree of management judgment involved. Chapter 6 provides guidance on auditing techniques for accounting estimates.

Attributes of Risk

When assessing information about potential fraud risks, consider:

- The *type* of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets.
- The *significance* of the risk, that is, whether it is of a magnitude that could lead to a possible material misstatement of the financial statements.
- The *likelihood* of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements.
- The *pervasiveness* of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions.

Required Risk Assessments

When synthesizing risks, SAS No. 99 has *two additional requirements*. You should:

- Presume that improper revenue recognition is a fraud risk. In its report, the Public Oversight Board observed that the vast majority of fraudulent financial reporting schemes involved improper revenue recognition. This observation was consistent with the findings of other groups and individuals who examined fraudulent financial reporting. Because of these problems, SAS No. 99 states that you *should ordinarily* presume that there is a risk of material misstatement due to fraud relating to revenue recognition. The key threshold is “should ordinarily,” which stops just short of requiring the presumption on *every* audit engagement. If you do not identify improper revenue recognition as a risk of material misstatement due to fraud, you should document the reasons supporting this conclusion (see SAS No. 99 [AU sec. 316.83]).
- Identify the risks of management override of controls. Those who have studied fraudulent financial reporting have noted that the risk of management override is unpredictable, and therefore it is difficult for auditors to design procedures to identify and assess it. Therefore, the risk of management override of controls should be considered a fraud risk on every audit. For that reason, auditors should perform tests in response to the risk of management override in every audit.

Evaluating the Entity's Programs and Controls

Once you have identified specific risks of fraud, you should consider the entity's programs and controls that mitigate or exacerbate identified risks of material misstatement due to fraud.

A document titled "Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud" is included as an exhibit to SAS No. 99. This document, which was issued by the AICPA and other distinguished organizations, discusses and provides examples of programs and controls that management can implement to help deter, prevent, and detect fraud. The following is a brief summary of the guidance contained in that document.⁸

The guidance in the document is based on the presumption that entity management has both the responsibility and the means to take action to reduce the occurrence of fraud at the entity. To fulfill this responsibility, management should:

- Create and maintain a culture of honesty and high ethics.
- Evaluate the risks of fraud and implement the processes, procedures, and controls needed to mitigate the risks and reduce the opportunities for fraud.
- Develop an appropriate oversight process.

In many ways, the guidance offered in "Management Antifraud Programs and Controls" echoes the concepts and detailed guidance contained in the COSO report. The primary difference is that the antifraud document reminds management that it must be aware of and design the entity's internal control to specifically address material misstatements caused by fraud and *not* limit its efforts to the detection and prevention of unintentional errors.

A Culture of Honesty and Ethics

A culture of honesty and ethics includes the following elements:

- A value system founded on integrity
- A positive workplace environment in which employees have positive feelings about the entity
- Human resource policies that minimize the chance of hiring or promoting individuals with low levels of honesty, especially for positions of trust
- Training—both at the time of hire and on an ongoing basis—about the entity's values and its code of conduct
- Confirmation from employees that they understand and have complied with the entity's code of conduct and that they are not aware of any violations of the code
- Appropriate investigation and response to incidents of alleged or suspected fraud

⁸ From *How to Comply with Sarbanes-Oxley Section 404*, by Michael J. Ramos, published by John Wiley & Sons, 2004, pages 104–105.

Evaluating Antifraud Processes and Controls

The entity's risk assessment process should include the consideration of fraud risk. With an aim toward reducing fraud opportunities, the entity should take steps to:

- Identify and measure fraud risk.
- Mitigate fraud risk by making changes to the entity's activities and procedures.
- Implement and monitor an appropriate system of internal control.

Developing an Appropriate Oversight Process

The entity's audit committee or board of directors should take an active role in evaluating management's:

- Creation of an appropriate culture
- Identification of fraud risks
- Implementation of antifraud measures

To fulfill the audit committee's oversight responsibilities, audit committee members should be financially literate and each committee should have at least one financial expert. Additionally, the committee should consider establishing an open line of communication with members of management one or two levels below senior management to assist in identifying fraud at the highest levels of the organization or investigating any fraudulent activity that might occur.

In addition to the guidance provided by the exhibit to SAS No. 99, consider the following.

The Entity's Environment and Culture ("Tone at the Top")

It seems that virtually every organization or individual who has studied the effects of internal control starts the discussion by describing the importance of establishing a proper "tone at the top." Culture and values are a critical element of control because these are the mindset from which all other controls are applied. Culture drives behavior.

By Way of Analogy...

In traditional Hawaiian culture, there was no private ownership of land. The land belonged to the gods—as humans, we were just its caretakers. In the middle of the 19th century the Western concept of private land ownership was introduced, and by-and-large, that system is fully functional in Hawaii today.

Important vestiges of the traditional culture remain, however. Many state laws exist to ensure that beaches remain open to the public and that private citizens cannot block access to those beaches. Hike to a waterfall, and you are likely to see a fellow hiker take a rock from somewhere deep in the pool, wrap that rock in a ti leaf, and place it in a crevice high up on the face of the waterfall. That is a sign of respect for the land, a token of appreciation to its real owner. The official state motto, translated into English, is "The life of the land is perpetuated in righteousness."

And so it goes. The values of the culture drive the behavior of those who are part of it.

Business entities have their own culture and values. Postmortems on famous (or infamous) frauds inevitably describe a corporate culture that had a direct bearing on the fraud that was committed. When assessing the risk of material misstatement due to fraud, auditors that fail to consider an entity's culture do so at their own peril.

The CPA's Handbook of Fraud and Commercial Crime Prevention compares the environment and culture of high fraud potential entities with those of lower potential.⁹

<i>Variable</i>	<i>High Fraud Potential</i>	<i>Lower Fraud Potential</i>
Management style	• Autocratic	• Participative
Management orientation	• Low trust • Power driven	• High trust • Achievement-driven
Distribution of authority	• Centralized; reserved by top management	• Decentralized, dispersed to all levels, and delegated
Planning	• Centralized • Short range	• Decentralized • Long range
Performance	• Measured quantitatively and on a short-term basis	• Measured both quantitatively and qualitatively and on a long-term basis
Business focus	• Profit	• Customer
Management strategy	• Management by crisis	• Management by objectives
Reporting	• Reporting by routine	• Reporting by exception
Policies and rules	• Rigid and inflexible; strongly policed	• Reasonable; fairly enforced
Primary management concern	• Capital assets	• Human, then capital and technological assets
Reward system	• Punitive • Penurious • Politically administered	• Generous • Reinforcing • Fairly administered

(continued)

⁹ From *The CPA's Handbook of Fraud and Commercial Crime Prevention*, 15.

<i>Variable</i>	<i>High Fraud Potential</i>	<i>Lower Fraud Potential</i>
Feedback on performance	<ul style="list-style-type: none"> • Critical • Negative 	<ul style="list-style-type: none"> • Positive • Stroking
Interaction mode	<ul style="list-style-type: none"> • Issues and personal differences are skirted or repressed 	<ul style="list-style-type: none"> • Issues and personal differences are confronted and addressed openly
Payoffs for good behavior	<ul style="list-style-type: none"> • Mainly monetary 	<ul style="list-style-type: none"> • Recognition, promotion, added responsibility, choice assignments, plus money
Business ethics	<ul style="list-style-type: none"> • Ambivalent; rides the tide 	<ul style="list-style-type: none"> • Clearly defined and regularly followed
Internal relationships	<ul style="list-style-type: none"> • Highly competitive; hostile 	<ul style="list-style-type: none"> • Friendly, competitive, and supportive
Values and beliefs	<ul style="list-style-type: none"> • Economic, political, and self-centered 	<ul style="list-style-type: none"> • Social, spiritual, and group-centered
Success formula	<ul style="list-style-type: none"> • Works harder 	<ul style="list-style-type: none"> • Works smarter
Human resources	<ul style="list-style-type: none"> • Burnout • High turnover • Grievances 	<ul style="list-style-type: none"> • Not enough promotional opportunities for all the talent • Low turnover • Job satisfaction
Company loyalty	<ul style="list-style-type: none"> • Low 	<ul style="list-style-type: none"> • High
Major financial concern	<ul style="list-style-type: none"> • Cash flow shortage 	<ul style="list-style-type: none"> • Opportunities for new investment
Growth pattern	<ul style="list-style-type: none"> • Sporadic 	<ul style="list-style-type: none"> • Consistent
Relationship with competitors	<ul style="list-style-type: none"> • Hostile 	<ul style="list-style-type: none"> • Professional
Innovativeness	<ul style="list-style-type: none"> • Copy cat; reactive 	<ul style="list-style-type: none"> • Leader, proactive
CEO characteristics	<ul style="list-style-type: none"> • Swinger, braggart, self-interested, driver, insensitive to people, feared, insecure, gambler, impulsive, tight-fisted, numbers- and things-oriented, profit-seeker, vain, bombastic, highly emotional, 	<ul style="list-style-type: none"> • Professional, decisive, fast-paced, respected by peers, secure risk-taker, thoughtful, generous with personal time and money, people-, products- and market-oriented, builder-helper, self-confident,

<i>Variable</i>	<i>High Fraud Potential</i>	<i>Lower Fraud Potential</i>
	partial, and pretentious	composed, calm, deliberate, even disposition, and fair; know who they are, what they are, and where they are going.
Management structure, systems and controls	<ul style="list-style-type: none"> • Bureaucratic • Regimented • Inflexible • Imposed controls • Many-tiered structure; vertical • Everything documented; a rule for everything 	<ul style="list-style-type: none"> • Collegial • Systematic • Open to change • Self-controlled • Flat structure; horizontal • Documentation is adequate but not burdensome; some discretion is afforded
Internal communication	<ul style="list-style-type: none"> • Formal, written, stiff, pompous, and ambiguous 	<ul style="list-style-type: none"> • Informal, oral, clear, friendly, open, and candid
Peer relationships	<ul style="list-style-type: none"> • Hostile, aggressive, and rivalrous 	<ul style="list-style-type: none"> • Cooperative, friendly, and trusting

Most Common Control Failures at Small Business Entities

The “Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud” exhibit to SAS No. 99 discusses and provides examples of programs and controls, some of which apply only to larger entities. Here are some examples of weak control environments in small business entities that can directly affect the entity’s vulnerability to fraud.¹⁰

- *Poor physical access controls.* Most business owners acknowledge the need to control physical access to assets and information. In practice, these controls may be lax. Many frauds require that the perpetrator come into physical contact with either the asset being misappropriated or the related asset records (or computer terminal to access those records) used to conceal the fraud.
- *Lack of formal job descriptions.* As auditors, we recognize the need to have a proper segregation of duties. We also acknowledge that entity personnel perform important control functions. Yet, when it comes to formally segregating duties or describing how control functions are to be performed, the typical small business owner is loathe to perform this task. It is not the written job description, per se, that is important, but rather the disciplined process

¹⁰ Adapted from *The CPA’s Handbook of Fraud and Commercial Crime Prevention*.

that requires the owner to decide who should perform what and how that can reduce the entity's vulnerability to fraud.

- *Proper supervision.* The approval and review of key information processing procedures are important controls that may be overlooked by small entities that believe they lack necessary resources.

Additional Resources

Chapter 7 describes specific fraud prevention control procedures for individual accounts or classes of transactions.

Responding to the Assessed Risks


You will respond to the risks of material misstatement due to fraud in the following three ways:

- A response that has an overall effect on how the audit is conducted
- A response to identified risks involving the nature, timing, and extent of audit procedures
- A response to address management override of controls

Overall Responses

Judgments about the risks of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways.

Assignment of personnel and supervision. SAS No. 99 provides relatively straightforward guidance on this matter that is easy to understand and implement. Essentially, the guidance says that the greater the risk of material misstatement, the more experienced personnel and the greater amount of supervision required on the engagement.

 **Practice Pointer.** SAS No. 99 acknowledges that engagement teams may want to consider whether the judgments about fraud risks might require the addition of a fraud specialist to the engagement team. Firms should consider setting formal policies or informal guidelines on circumstances that require or encourage teams to add fraud specialists to the audit team.

Accounting principles. The standard audit report expresses an opinion about whether the financial statements “present fairly ... in accordance with GAAP.” Some auditors and others involved in the financial reporting process have questioned whether the “present fairly” criterion has become subordinate to “in accordance with GAAP.” That is, the issue may be whether some entities make a case that “since GAAP does explicitly not prohibit a particular accounting, it must be acceptable,” without considering whether the accounting will result in a “fair presentation” of the financial position, results of operations, and cash flows.

Thus, the *choice* of accounting principles, in addition to their application, becomes crucial for auditors to consider. SAS No. 99 requires you to consider management's selection and application of significant accounting principles as part of your overall response to the risks of material misstatement.

SAS No. 99 (AU sec. 316.50) focuses your attention on accounting principles related to subjective measurements and complex transactions. In addition, given the presumption of revenue recognition as a fraud risk, you should consider the entity's revenue recognition policies and whether these policies are consistent with key revenue recognition concepts, such as:

- Completion of the earnings process
- Realizability of the sales proceeds
- Delivery of the product or service

Chapter 5 provides additional suggestions for performing audit procedures related to revenue recognition.

To help you assess management's selection and application of accounting policies, consider asking the following questions.¹¹

Reserves and Estimates

- How are reserves and estimates determined and subsequently monitored?
- How are previously established reserves disposed of when the events that caused their creation are no longer applicable?
- In those cases where an estimate involves a range of possible outcomes, where does the estimate reported in the financial statements fall within that range?
- What criteria does management use to determine whether there is a continuing need to maintain a reserve when the matters to which the reserve relates (for example, litigation or environmental remediation) are "slow moving"?
- In general, how are changes in the balances of reserves perceived by financial statement users?
- Are the company's disclosures of its reserves adequate, particularly the entity's exposure to losses in excess of recorded amounts?

¹¹ These questions were adapted from PITF Practice Alert 00-2, *Quality of Accounting Principles—Guidance for Discussions with Audit Committees*. PITF Practice Alerts are prepared by the SEC Practice Section of the AICPA. The alerts are intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. The alerts are based on the experiences of the individual members of the SEC Professional Issues Task Force and matters arising from litigation and peer reviews. A complete set of PITF alerts can be downloaded from the AICPA Web site at www.aicpa.org. They are also available electronically as part of the AICPA's reSOURCE collection of literature (either online or on CD) and in print format as part of the Technical Practice Aids.

Asset and Liability Carrying Values

- How does management determine useful lives and salvage values for its assets?
- How does management determine discount rates used to make present value calculations?
- How does management determine carrying values of other assets and liabilities?

Evolving Issues and Unusual Transactions

- What was management's process for evaluating and selecting accounting policies for:
 - Emerging and rapidly evolving accounting issues
 - Special structures, including:
 - Off-balance-sheet financing
 - Research and development activities
 - Special purpose financing structures that affect ownership rights (such as leveraged recapitalization, joint ventures, and preferred stock of subsidiaries)
 - Unusual transactions and arrangements, including:
 - Bill-and-hold transactions
 - Self-insurance
 - Multi-element arrangements contemporaneously negotiated
 - Sales of assets or licensing arrangements with continuing involvement of the enterprise

Predictability of auditing procedures. Successful perpetrators of fraud are familiar with the audit procedures external auditors normally perform on their engagements. With this knowledge, they can then conceal the fraud in accounts where auditors are least likely to look. For that reason, SAS No. 99 *requires* you to incorporate an element of unpredictability into your procedures from year to year. This is important in auditing because these tests are *not performed based on risk or materiality*.

Here are some tips for implementing this requirement:

- Consider tests aimed at the misappropriation of assets, because procedures to detect immaterial defalcations (which may be material to the owner-manager) usually are not performed. Explain to the owner-manager that you have expanded your test work (make sure the owner-manager also understands the limits of your test work), and how the performance of additional procedures benefit him or her directly.
- Use the brainstorming session to identify transactions or accounts that you normally would not examine and that lend themselves to concealing a fraud.
- Use Chapter 7 of this book to identify common frauds and specific procedures that address these frauds.
- If you think of too many tests you want to perform, set a two- or three-year implementation plan and do a different set of procedures each year.
- Use computer assisted audit techniques (as described in Chapter 8) to help you perform these tests more effectively.

Procedures to Address Specific Accounts or Classes of Transactions

SAS No. 99 provides general guidance on modifying the nature, timing, and extent of audit procedures you will perform to address identified risks of material misstatement due to fraud. In addition to the guidance contained in the standard, you also should consider the suggestions provided in Chapter 7, which describes common frauds by audit area and example audit procedures that address them.

Three other audit areas merit special mention in SAS No. 99: revenue recognition, inventory quantities, and accounting estimates. Besides the guidance contained in the standard, you also may want to consider the suggestions included in this Practice Aid.

- *Revenue recognition*, please refer to Chapter 5.
- *Inventory quantities*, please see Appendix B to this Practice Aid for a copy of PITF Practice Alert 94-2, *Auditing Inventories—Physical Observations*.
- *Accounting estimates*, please refer to Chapter 6.

Addressing the Risk of Management Override

SAS No. 99 requires you to perform certain procedures to address the risk of management override of internal controls. Those procedures are explained below.

Examining Journal Entries and Other Adjustments

Management can perpetrate financial reporting frauds by overriding established control procedures and recording unauthorized or inappropriate journal entries or other postclosing adjustments (for example, consolidating adjustments or reclassifications). For example, SEC Accounting and Auditing Enforcement Release No. 1287 (Guilford Mills, Inc.) describes a situation in which the controller entered false journal entries debiting accounts payable and crediting purchases (cost of sales). The effect was to understate payables and significantly increase earnings.

To address situations such as these, SAS No. 99 requires you to test the appropriateness of journal entries recorded in the general ledger and other adjustments.

Understanding the financial reporting process. To effectively implement this required procedure, you will need to obtain a good understanding of the entity's financial reporting process. This understanding is important because it allows you to know what *should* happen in a "normal" situation so you can then identify anomalies. The following table describes example inquiries you may consider making of entity personnel. Adjacent to each inquiry is a description of how the information learned from the answer can help you identify and select journal entries and other adjustments for testing.

<i>Example Inquiry</i>	<i>Identify and Select Items for Testing</i>
What are the sources of significant debits and credits to a given account? For example, is the account posted automatically as a normal part of transaction processing, or is it posted directly through a journal entry?	Look for account activity being posted from unexpected sources (for example, a journal entry where none is expected).
Who has the ability (for example, logical or physical access to the necessary records) to make journal entries or other adjustments?	Look for the information to be an “opportunity” within the fraud triangle framework. Look for incentives and the ability to rationalize related to the same individuals.
Who is responsible for initiating journal entries or other adjustments?	Look for transactions initiated from unexpected sources.
What approvals are required for journal entries or other adjustments?	Look for unapproved transactions.

Your understanding of the financial reporting process also should include knowledge of how journal entries are initiated, recorded, and processed (for example, directly online or in batch mode from physical documents), the design of any controls over journal entries and other adjustments, and whether those controls have been placed in operation. This information will help you design suitable tests.¹²

Brainstorming

As part of your brainstorming session, you should consider discussing how journal entries may be used to perpetrate or conceal a fraud. For example, you might discuss:

- The various ways in which management could originate and post inappropriate journal entries or other adjustments.
- The kinds of unusual combinations of debits and credits that the engagement team should be looking for.
- The types of journal entries or other adjustments that could result in a material misstatement that would not likely be detected by standard audit procedures.

¹² Note that SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, already requires you to obtain an understanding of the entity’s internal control, including journal entries. The requirements of SAS No. 99 place an even greater premium on auditors understanding their clients’ financial reporting process.

Inquiries

As part of your inquiries of management and others about fraud-related matters, you should consider asking accounting, data entry, and IT personnel about whether they have observed any unusual accounting entries during the audit period.

Identifying journal entries and other adjustments for testing. Your assessment of the risk of material misstatement due to fraud, together with your assessment of the effectiveness of controls, will determine the extent of your tests. SAS No. 99 requires that you inspect the general ledger to identify journal entries to be tested and examine the support for those items. This procedure is required even if you determine that controls over journal entries and other adjustments are operating effectively. When testing journal entries and other adjustments, it is vital that you identify and consider the entire population of journal entries and other adjustments. Be aware that some entries and adjustments may be made outside of the general ledger. For that reason, you will need to obtain a complete understanding of how the various general ledgers are combined and the accounts are grouped to create the financial statements.

SAS No. 99 (AU sec. 316.61) provides the following guidance on what to consider when selecting items for testing.

Characteristics of Fraudulent Entries or Adjustments

- Entries made to unrelated, unusual, or seldom-used accounts
- Entries made by individuals who typically do not make journal entries
- Entries recorded at the end of the period or as postclosing entries that have little or no explanation or description
- Entries made either before or during the preparation of the financial statements that do not have account numbers
- Entries that contain round numbers or a consistent ending number

The Nature and Complexity of the Accounts

- Accounts that contain transactions that are complex or unusual in nature
- Accounts that contain significant estimates and period-end adjustments
- Accounts that have been prone to errors in the past
- Accounts that have not been reconciled on a timely basis or contain unreconciled differences
- Accounts that contain intercompany transactions
- Accounts that are otherwise associated with an identified risk of material misstatement due to fraud

In addition to these items, you should consider journal entries and other adjustments that are processed outside the normal course of business (“nonstandard” entries and adjustments).

Considering CAATs

Computer assisted audit techniques may be required to identify entries that only exist electronically.¹³ CAATs may be necessary to identify the complete population of journal entries and other adjustments to be tested. In addition, CAATs may be used to detect:

- Entries made at unusual times of day, for example outside regular business hours
- Entries made by unusual users, blank or nonsensical user names, senior management, or the IT staff
- Electronic entries that, through management manipulation, are not documented in the general ledger
- One-time or otherwise nonrecurring transactions

Testing Journal Entries and Other Adjustments

Once you identify journal entries and other adjustments for testing, you should examine documentary evidence indicating that they were properly supported and approved by management. Because fraudulent journal entries often are made at the end of a reporting period, your testing ordinarily should focus on the journal entries made at that time. However, you should not completely ignore journal entries made throughout the period.

PITF Practice Alert No. 03-2, *Journal Entries and Other Adjustments*, provides additional guidance on the procedures you should consider to review journal entries and other adjustments for signs of management override of internal control. That Practice Alert is included as Appendix C to this book.

Retrospective Review of Accounting Estimates

Accounting estimates are particularly vulnerable to manipulation because they depend so heavily on judgment and the quality of the underlying assumptions. For that reason, SAS No. 99 requires you to perform a retrospective review of prior-year accounting estimates for the purpose of identifying bias in management's assumptions underlying the estimates.

This review is *not* intended to call into question your professional judgments made in prior years that were based on information available at the time. Rather, this retrospective review should be considered within the context of its implications for the current year audit, and the facts and circumstances that currently exist. Although this procedure is included in that section of the standard used to describe responses to management override, it might also have been included as part of the information-gathering phase of the engagement. That is, the information you gain from a retrospective review of management's assumptions underlying key estimates may be used to identify risks of material misstatement due to fraud.

¹³ You may refer to Chapter 8 for additional guidance on computer assisted audit techniques.

Example 2-5

XYZ company designs and manufactures men's casual sportswear. One of the entity's significant estimates is the amount of sales returns. In FY 20X1, the estimated sales returns were \$100,000, which seemed reasonable given the information available at the time. In fact, actual sales returns related to 20X1 sales were \$175,000.

Further, the total sales for 20X1 were \$8 million—\$1 million of which were recorded in the last month of the fiscal year (holiday shopping season), which presumably would be the items most likely to be returned after the balance sheet date.

During 20X2, the company reported an increase to \$9 million in sales, \$1.5 million of which were recorded in the last month. For FY 20X2 the entity has estimated sales returns to be \$60,000 and has provided the auditors with documentation supporting the assumptions underlying the estimate.

Given the relationship between estimated sales returns and actual sales for the past two years, together with the actual sales returns for the prior year, the auditor should question whether management's assumptions are overly biased. Additionally, the auditor will want to perform additional tests to corroborate management's estimate and the key assumptions used to form that estimate.

Business Rationale for Significant Unusual Transactions

Many financial reporting frauds have been perpetrated or concealed by using unusual transactions that are outside the normal course of business. For that reason, SAS No. 99 requires auditors to understand the business rationale for these types of transactions. SAS No. 99 (AU sec. 316.67) provides an excellent list of items you should consider when understanding the business rationale for unusual transactions.

As indicated in SAS No. 99, entities intent on fraudulently reporting financial results may use related party transactions to perpetrate or conceal the fraud. The most common related party transactions used for these purposes include the following.

- Property sales and exchanges
 - Sales of property (including real estate) at prices that differ significantly from their appraised value
 - Exchanges of property for similar property in a nonmonetary transaction
 - Sales without substance, for example when the seller provides funds to the buyer, which allow the buyer to fully remit the sales price
 - Sales with a commitment to repurchase that, if known, would preclude recognition of all or part of the revenue
 - Sales at below-market rates to an unnecessary “middle man” related party, who in turn sells to the ultimate customer at a higher price, with the related party (and ultimately its principals) retaining the difference
 - Purchase of assets at prices in excess of fair market value
 - Sales arrangements in which the seller has a concurrent obligation to the buyer to purchase goods or services or provide other benefits

- Sale of land with arranged financing
- Sales of marketable securities at a significant discount from quoted market prices
- Lending activity
 - Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates
 - Making loans with no scheduled terms for when or how the funds will be repaid
 - Loans to parties that do not possess the ability to repay
 - Advancing company funds that are subsequently transferred to a debtor and used to repay what would otherwise be an uncollectible loan or receivable
 - Loans advanced ostensibly for a valid business purpose and later written off as uncollectible
- Purchase of services
 - Services or goods at little or no cost to the entity
 - Payments for services never rendered or rendered at inflated prices
 - Engaging in other transactions (for example, leases) at more or less than market value
 - Agreements under which one party pays expenses on behalf of another party

As indicated in SAS No. 99, these types of related party transactions, per se, do not constitute fraudulent financial reporting. However, if these transactions were entered into without proper approval, or if entity management did not identify these transactions for you, there may be indications that fraudulent financial reporting is being concealed.



Practice Pointer. The auditing standard requires you to gain an understanding of the business rationale for significant transactions that are “outside the normal course of business for the entity or otherwise unusual.” As a prerequisite for performing this required procedure, the engagement team’s understanding of the entity and its environment must be sufficient to allow it to recognize an unusual transaction. When implementing SAS No. 99, firms may wish to consider whether current audit planning procedures are sufficient for engagement team personnel to obtain this depth of understanding.

Evaluating Audit Evidence

Earlier in this chapter we described the process of fraud as one that involves “commitment-conversion-concealment.” As auditors, we are most likely to observe attempts at concealment or the lack of concealment. Signs of concealment (or lack thereof) include:

- *Discrepancies in the accounting records.* For example, transactions that lack supporting documentation may indicate that a perpetrator failed to adequately conceal a fraud.

- *Conflicting or missing evidential matter.* For example, missing documents may be the attempt to conceal a fraud by destroying incriminating documents.
- *Problematic or unusual relationships between the auditor and client.* For example, unusual delays by the entity in providing requested information may indicate that the information never existed in the first place because the purported transaction did not occur.

SAS No. 99 (AU sec. 316.68) provides comprehensive examples of conditions you may identify during fieldwork that may be indicative of fraud. This paragraph reiterates that the assessment of the risk of material misstatement due to fraud is an iterative process that continues throughout the engagement. In a similar vein, SAS No. 99 (AU sec. 316.69–73) reminds auditors that analytical procedures conducted as substantive procedures or as part of the overall review stage of the audit may also uncover previously unrecognized risks of material misstatement due to fraud. The standard provides several examples of unusual or unexpected analytical relationships that may indicate a risk of material misstatement due to fraud.



Practice Pointer. Brainstorming sessions conducted near the end of the audit can help the audit team evaluate the magnitude and collective significance of conditions that may be indicative of fraud that are identified during the audit. Conditions that may seem inconsequential in isolation may take on added significance when considered within the context of all other observed conditions.

Misstatements That May Be the Result of Fraud

SAS No. 99 (AU sec. 316.75–78) describes how you should respond when you determine that a misstatement is, or may be, the result of fraud. Note the key threshold is “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. This threshold is considerably lower than “probable.”

If you believe that a misstatement is or may be the result of fraud, but the effect of the misstatement is *not* material to the financial statements, you still are required to evaluate the implications of your belief, especially those dealing with the organizational person(s) involved. For example, if you discover that a member of senior management has fraudulently overstated his or her expenses for reimbursement, you will want to reevaluate the integrity of that individual and the impact that a nontrustworthy person in that position could have on the financial statements and your engagement.

In those instances where the misstatement is or may be the result of fraud, and the effect is either material or cannot be determined, you are required to take the following steps.

- Attempt to obtain additional evidential matter.
- Consider the implications for other aspects of the audit.
- Discuss the matter and the approach for further investigation with the client. These discussions should be conducted at a level that is at least one level above those involved and also should include senior management and, if applicable, the audit committee.
- If appropriate, suggest the client consult with legal counsel.

Note that one of the key factors in determining your response is the materiality of the misstatement. As stated earlier in this chapter, an auditor's consideration of materiality should consider the *qualitative* aspects of the misstatement and should *not* be limited to quantitative measures.

SAS No. 99 (AU sec. 316.78) provides guidance on the auditor's course of action when the risk of material misstatement due to fraud is such that he or she is considering withdrawing from the engagement. The circumstances under which you would withdraw may depend on the implications about the integrity of management and their cooperation in investigating the circumstances and taking appropriate action. It is impossible to definitively describe when withdrawal is appropriate, but in any event you probably will want to consult with your legal counsel.

Communication About Fraud Matters

SAS No. 99 (AU sec. 316.79) states that “whenever you have determined that there is evidence that a fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is 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 or some other condition that has been observed when fraud is present generally does *not* meet this threshold.

Example 2-6

Assume that a single employee at a company has the authority to sign checks and also the responsibility to reconcile the bank account(s). Absent other controls, this lack of segregation of duties may provide an opportunity for that employee to commit fraud. However, by itself, the condition is not required to be communicated by the auditor to the entity, except within the context of reportable conditions and internal control weaknesses.

However, suppose that there is a delay of several weeks before the employee is able to provide the auditor with a year-end bank reconciliation. When testing the reconciliation, the auditor discovers that certain canceled checks are missing. The employee is unable to offer an explanation.

At this point, the auditor has 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 be immaterial to the financial statements, you should still bring the matter to the attention of management.

In addition, you also should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud represent *reportable conditions* that should be communicated to senior management and the audit committee.

Documentation

The documentation requirements of SAS No. 99 significantly extend the requirements of the previous standard, requiring documentation supporting compliance with substantially all the major requirements of the standard. SAS No. 99 (AU sec. 316.83) provides a complete, easy-to-understand list of documentation requirements.

According to the standard, you are required to document the following.

- The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed.
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud.
- Specific risks of material misstatement due to fraud that were identified and a description of the auditor's response to those risks.
- If the auditor has not identified, in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor's conclusion.
- The results of the procedures performed to further address the risk of management override of controls.
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions.
- The nature of the communications about fraud made to management, the audit committee, and others.



Practice Pointer. It is not necessary to document the brainstorming session in great detail. The requirement to document "the subject matter discussed" has been interpreted in practice to mean a listing and brief description of the topics discussed, not an exhaustive recap of all that was said during the discussion.



Practice Pointer. For your review of significant unusual transactions, consider documenting the following:

- The nature of the transaction
- The counterparty(ies) to the transaction
- How the transaction was accounted for, presented, and disclosed in the financial statements
- The process followed by the entity to approve the transaction and its accounting treatment
- Management's stated business rationale for the transaction

PART 2

DETAILED IMPLEMENTATION GUIDANCE

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), touches on a great many elements of the audit process. These six chapters explore some of those areas in more detail, providing extended implementation guidance on professional skepticism, inquiries of entity personnel, and revenue recognition. Chapter 7 provides detailed examples of common frauds, organized by financial statement account or transaction type, together with audit procedures and control procedures that directly address the risk.

CHAPTER 3: PROFESSIONAL SKEPTICISM

Professional skepticism is one of the cornerstones of Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). The Statement provides as much guidance as a professional auditing standard possibly can on a topic that essentially is an exploration of human psychology. The standard does a thorough job of highlighting the importance of professional skepticism, defining it, and pointing out those areas of the engagement where a questioning mind is particularly apt.

What exactly is “a questioning mind and a critical assessment of audit evidence?” If we can define it, then how do we instill this mindset in our staff? The purpose of this chapter is to explore the issue of professional skepticism in more depth as a way to implement the spirit of what SAS No. 99 requires.

The Attitude Found It

By Way of Analogy...

In his book *Zen and the Art of Motorcycle Maintenance*, Robert Pirsig tells a story that many of us can relate to. He was having problems with his motorcycle and so he took it to a mechanic. In a series of blunders, the mechanic actually made the situation worse, each time telling Pirsig that the motorcycle was fixed. After taking his bike into the shop three times, Pirsig got fed up and got his bike back, even though it was barely running. “Just don’t touch anything else,” he told them.

He knew nothing about motorcycle maintenance but pulled off the engine cover and poked around to see what he could find. Lo and behold, he soon discovered that a small pin had been sheared and was preventing oil from reaching the engine at high speeds. His “crackerjack” mechanic failed to spot this problem on three tries, and that was why the mechanic was unable to fix the problem.

The question that bothered Pirsig was, Why? Why did a so-called expert miss something so obvious, but a novice catch it? He writes:

And it occurred to me there is no manual that deals with the real business of motorcycle maintenance, the most important aspect of all. Caring about what you are doing is considered either unimportant or taken for granted....[Emphasis in original]

When you want to hurry something, that means you no longer care about it and want to get on to other things. I just want to get at [this story] slowly, but carefully and thoroughly, with the same attitude I remember was present just before I found that sheared pin. It was the attitude that found it, nothing else. [Emphasis added]

Pirsig’s conclusion about his motorcycle is an apt reminder for auditors as it relates to the detection of material misstatements due to fraud. The attitude found it.

SAS No. 99 embraces the idea that an auditor’s attitude can find misstatements, that the mindset one brings to the performance of a task can improve the effectiveness of the task. Some would argue that an appropriate mindset can even make up for a poorly designed procedure. Conversely, it is difficult for even the best procedure to maintain its effectiveness if the person performing it does not really care about how it is performed.

Attitude Is a Filter

By Way of Analogy...

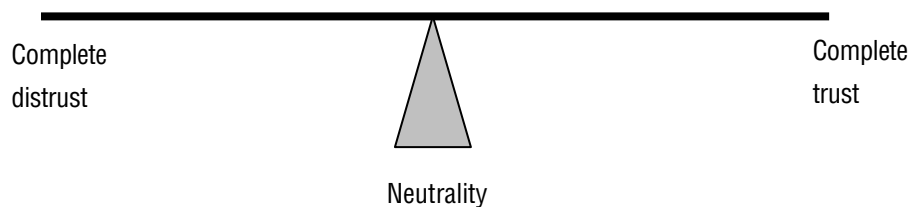
You are snow skiing on a cloudless day. The white, crystalline snow dazzles in the sunlight. Unfortunately, you have lost your sunglasses.

As you start down the mountain, the fine details of the terrain blend and merge beneath the glare. You squint, trying to anticipate the bumps and imperfections in the snow. But you are moving too fast, the sun is too bright, and you simply cannot see very well. You ski poorly.

Imagine the exact same day, only this time you have your sunglasses. They are polarized to filter out the glare. You put them on, and all the details of the trail now become apparent. As you head down the mountain you are much better prepared to respond; you ski better because now you can see.

Professional skepticism is like a filter. The mindset we bring to an engagement is a filter through which we view audit evidence and other information we gather during the audit. Like a pair of tinted ski goggles, the skeptical mind allows us to “see” what’s before us and react accordingly.

Professional literature requires us to have a neutral position, neither trust nor distrust of an entity’s management. This neutral mindset is described in the following diagram.

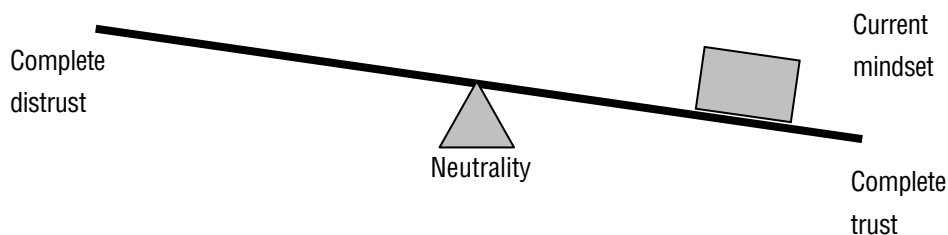


Most auditors tend to rely too much on what management tells them. This was the conclusion of the Public Oversight Board’s report, which stated:

The Panel’s findings suggest that auditors do not always pursue sufficiently conditions discovered during an audit or corroborate adequately management representations made to them.

In other words, we have weighed in on the right-hand side of the diagram and lost our balanced position. As a practical matter, this is understandable because most firms have thorough client

acceptance and continuance procedures to screen out dishonest clients. Nevertheless, the standard reminds us that we should *not assume* management is always honest.



What is clear is that the mindset of the auditors must shift left toward the middle of the spectrum, to bring us back to a position of neutrality.

Lessons From Psychology

The ultimate goal of adding a discussion of professional skepticism to SAS No. 99 is to change auditor behavior. But how do we change an individual’s attitude? We may describe someone’s attitude as cheerful, surly, helpful, abrupt, and self-centered. How do we change that?

Self-awareness is an important early step in modifying any behavior—especially a behavior that is done subconsciously. In that context, the objective of these next few pages is relatively simple—to increase your awareness of how the mind processes information in the belief that self-awareness can ultimately lead to a change in attitude.

In examining the role of professional skepticism on an audit, several questions come to mind, including:

- Auditors reach a conclusion based on information they receive during the engagement—information that is filtered through a particular mindset. How does that mindset affect our conclusions? In short, how do auditors “know” what they think they know?
- What assumptions or biases are embedded in an auditor’s attitudes toward his or her client?
- How can these assumptions or biases be overcome or set aside so we may assume a more neutral position?

To begin exploring the answers to these questions, we need to look to the field of cognitive psychology to gain a basic understanding of how the mind works to process information and reach conclusions about the world we live in.

Assumptions Allow Us to Self-Select What We See

In a well-known experiment, a psychologist asked a group of individuals to look at individual playing cards and describe what they saw. Mixed in with “normal” cards were some “abnormal” cards in

which the colors of the suits were switched. For example, instead of a red ace of hearts, the deck had a black ace of hearts. What the researchers found was that the observers self-corrected the abnormal cards. They reported the black ace of hearts as an ace of clubs. What the researchers concluded was that the observers' assumptions about a situation ("a black suit is for clubs and spades") limit their awareness.¹

This is not to say that assumptions are bad. In fact, they are absolutely essential if we are to function in the real world. We assume that the floor we are standing on is more or less level, that the ceiling runs parallel to it, and the walls rise at a 90 degree angle. Can you imagine how difficult it would be to live in a world where every time we entered a room we challenged that assumption? Assumptions allow us to conserve effort and to gain a measure of stability in our understanding of the world. The trade-off is that we often are resistant to new information that conflicts with our assumptions.

Example 3-1

The controller for a company involved in one of the most infamous financial reporting frauds tells the story of how the auditors almost caught him.

To conceal nonexistent transactions, the controller created fictitious supporting documents. If the auditors asked for support for one of these transactions, the controller would say that it must have been misfiled, would return to his office, and would create the needed document.

One time the auditors told the controller that they had been unable to locate a check supporting a particular transaction. Assuming that the transaction probably had never occurred, the controller excused himself and went to create the required document. He returned sometime later and handed the check to the engagement manager. At that moment, the staff accountant entered with the real check in question—the transaction was valid, and the check truly had been misplaced.

Now the auditor had two checks supposedly in support of the same transaction. In the controller's mind, he had been caught red-handed, and as he tells the story, was ready to confess everything.

Instead of asking the controller to explain how such a thing was possible, however, the auditor provided his own explanation, describing how it was possible for the system to generate two different checks for the same item. The auditor's assumptions about the situation—the client is honest, the accounting system is faulty—prevented him from seeing the true situation.

It is human nature to screen out much of our surroundings because we do not believe that certain events occur. If stimulus reaches us that does not fit our assumptions, we may ignore it, just the way that observers in the card experiment self-corrected the abnormal playing cards. This happens to auditors. Information reaches us, but if it does not fit with what we "know," we find a way to make it fit.

¹ This experiment was conducted by Jerome Bruner and Leo Postman and was first published in the *Journal of Personality* (1949) in their article "On the Perception of Incongruity: A Paradigm."

Where do these assumptions come from? Past history and personal experience play a big role, as do the *culture of the societies or organizations we are part of and our professional training*. Once these assumptions are part of us, we tend to not challenge them. Edward de Bono, author of *Lateral Thinking*, maintains, “It is historical continuity that maintains most assumptions—not a repeated assessment of their validity.”²

We Construct Reality

Many psychologists and philosophers have come to the conclusion that what we know as “reality” is actually something we construct from the information we receive. What we know is not reality per se but a personal approximation of reality. In his book *The Psychology of Consciousness*, the psychologist Robert Ornstein describes the process this way.

Our biological inheritance determines that we *select* the sensory personal consciousness from the mass of information reaching us. This is done by a multilevel process of filtration. From this, we are ultimately able to *construct* a stable consciousness in coordination with the filtered input....

Each of us selects and constructs a personal world in several simultaneous procedures. Sense organs gather information that the brain can modify and sort. This heavily filtered input is compared with memory, expectations, body movements, and preparations for motor output until, finally, our consciousness is constructed as a “best guess” about reality. These “best guesses” are the formations of our assumptive world; they offer stability at the cost of exclusion.³

For auditors, once we accept that what we “know” about our clients (and their integrity, for example) is a construct, we also can accept the idea that what we “know” is just one of several possibilities. For example, we may “know” that our clients are honest, but in reality, there are other dimensions to our clients that we don’t know. We might not be aware of what sort of personal pressures or incentives may motivate them to commit fraud or the nature of their personal ethics that may allow them to rationalize it. As auditors, we should recognize that our perceptions of our clients may be incomplete or biased.

Once we accept that what we “know” about our clients is a *personal* construction, we can adopt a more skeptical mindset by *changing* the way in which we construct this reality. The point is that by understanding how we come to know what we think we know, we have the insight necessary to change.

² From Edward de Bono, *Lateral Thinking* (New York: HarperTrade, 1990), 91.

³ Robert Ornstein, *The Psychology of Consciousness* (New York: Viking Penguin, 1975), 43 and 44.

Habituation and Categories

Up until the mid-1950s, an elevated train ran along Third Avenue in New York City. As you might imagine, late at night, when the street was otherwise quiet, the sound of the train rattling was quite noisy. After the train was torn down, police began receiving calls late at night from citizens close to the old train tracks who noted “something strange” occurring. The police later determined that calls were coming at about the time the old train used to run. What people were reporting as strange was the *absence* of a noisy train.

Psychologists have concluded that we human beings quickly adapt to constancies in our world. As long as the train runs every night at the same time, the noise doesn’t bother us. As soon as that routine is changed, we “hear” it. This phenomenon is known as *habituation*, and it explains why, if we view the same object over and over again, we begin to look at it in the same way each time.

Categories of information are a psychological response we develop to organizing and interpreting information. Over time, we develop certain “buckets” for interpreting information. For example, as an auditor, we may create a bucket called “reliable, virtually unassailable audit evidence,” which tells us that we can accept the evidence at face value and draw a conclusion without further investigation. Through experience, we come to associate certain items as being a part of a particular category. A signed confirmation from a third party may fall into our category of reliable audit evidence.

The system of categorization becomes a shortcut for analysis and interpretation. We are presented with information and perform some quick checks to determine which category to assign it. At that point we no longer experience the original item itself (the confirmation), but its category. We ascribe the in-depth characteristics of the category (convincing audit evidence) to the individual item, even though we only did a quick, superficial test of it (the confirmation was signed) in order to assign it to our category.

Recap

Ornstein summarizes how the mind works.

Our normal personal consciousness is not a complete, passive registration of the external environment; rather it is a highly evolved, selective, personal construction constrained primarily for individual biological survival...

Let us trace this process: The sensory organs discard most of the input information reaching us. The brain further limits input by selectively inhibiting sensory activity... We quickly learn to “habituate” to the constancies of the world. Further, we sort the input into categories that depend on transitory needs, language, our past history, our expectations, and our cultural biases. Finally, we must *construct* a stable consciousness.⁴

⁴ Ornstein, page 69.

As human beings we solve the problem of information overload by selecting what information we pay attention to. We adopt shortcuts to process that information more efficiently. All of these processes are heavily influenced by past experience and cultural expectations. Given that, in the vast majority of cases, client personnel *are* honest and that the firm culture emphasizes client service and audit efficiency, it is little wonder that auditors have drifted away from a position of neutrality.

Implications for Auditors

The preceding brief overview of how the mind processes information has several important implications for auditors.

- *Acknowledge our assumptions.* It is human nature to form assumptions and carry biases into a given situation. The first step toward eliminating these biases and assuming a neutral mindset is to acknowledge their existence. Label assumptions so they can be easily spotted when they arise and start to cloud your judgment. For example, a young staff accountant may work closely with client personnel to understand certain accounting procedures. The client knows these procedures backward and forward—everything he or she says about the way the system works proves to be true. Under those conditions, you would expect the staff accountant to develop an assumption that everything that particular individual said was true—which may not be the case. By becoming aware of this bias, the staff accountant at least has a chance to adopt a questioning mind toward the individual. One thing is certain, if the staff accountant is *not* aware of the bias, he or she stands very little chance of correcting it.
- *Periodically challenge assumptions.* Remember that most assumptions persist out of habit, not because we regularly confirm their validity. Rather than take information and try to determine which category it belongs to, take that same information and ask whether it confirms or contradicts assumptions you have about the entity, its owner, or employees.

For example, a duplicate check may *not* mean that the accounting system is in error because management has high integrity. It may mean that the system has integrity and management is falsifying documentation. SAS No. 99 reminds auditors to challenge your assumptions when evaluating audit evidence. SAS No. 99 (AU sec. 316.68) provides an extensive list of conditions you might identify during fieldwork that could lead you to challenge assumptions about the risk of material misstatement due to fraud at the entity. For example, missing documents may not have been inadvertently lost (assumption). Documents may be “missing” because the transaction selected by the auditor for testing is fraudulent—the documents never existed.

- *Explore alternative categories.* As an expedient, we drop things into preassigned categories. Once an item makes it to a category, we make additional assumptions about patterns that we know to exist within that category. In Example 4-1, the audit manager put “canceled check” into the “reliable audit evidence” category. Once categorized, it never left that original category. Alternative patterns or categories (for example, “multiple checks for the same item” is a pattern for the “possible fraud” category) can lead us to breakthrough insights.

- *Provocative stimulation can be a catalyst for insight.* As de Bono says, “Insight is brought about by alterations in pattern sequence brought about by provocative stimulation.”⁵ By “alterations in patterns” he means the process we have of putting information into preformed categories for analysis. That is, he agrees with the conclusion reached in the previous bullet point, but he takes it one step further by stating that “provocative stimulation” can be a catalyst for considering alternative patterns. How can auditors create “provocative stimulation?” Enter brainstorming.

The Value of Brainstorming

SAS No. 99 requires an engagement team brainstorming session be conducted for every audit. Chapter 2 of this publication provides suggestions for implementing that requirement.

The brainstorming session is the perfect venue for addressing auditor assumptions about the client and for sensitizing the engagement team to alternative realities (for example, that fraud can occur in every entity). For example, in your brainstorming session you might:

- Ask engagement team members to describe the assumptions they have about the entity, its owner, management, and employees, and its financial performance.
- Identify conditions that lead the engagement team to believe that management is honest and has integrity. Set these aside. For the purposes of the brainstorming session, these assumptions are no longer valid.
- Discuss whether all remaining assumptions continue to be true.
- Discuss common frauds in the entity’s industry as a way to sensitize the team to alternative ways to organize audit evidence.

Applied Professional Skepticism

The value in adopting a skeptical attitude is that it can lead to additional or more effective audit procedures. SAS No. 99 requires auditors to apply professional skepticism in *gathering and evaluating audit evidence*, which in turn, can lead to changes in your audit. For example, your skepticism may lead you to:

- Design additional or different auditing procedures to obtain more reliable evidence. Chapter 7 of this publication provides detailed examples of auditing procedures that are designed to respond to specifically identified risks of material misstatements due to fraud.
- Obtain additional corroboration of management’s explanations or representations concerning material matters. Examples include:

⁵ De Bono, page 47.

- Third-party confirmation
- Use of a specialist
- Analytical procedures
- Examination of documentation from independent sources
- Inquiries of others within or outside the entity

Implementation Tips

When asked about his approach to arms control with the Soviets, President Reagan summed up his philosophy by saying that we must “trust but verify” their compliance. That phrase is a good summary of how audit teams should approach their engagements—trust the clients, but verify what they say.

How do we do that? The following table summarizes some of the reasons why we lose our professional skepticism and what we can do to get it back.

<i>How We Lose Skepticism</i>	<i>How We Can Get It Back</i>
<i>Personal relationship.</i> We have a personal relationship with the client, who has never lied to us before. To question the client’s integrity seems like a violation of the friendship.	Make it clear that investigation and corroboration is part of your engagement. It is nothing personal—professional audit standards require you to gather evidence.
<i>Past history.</i> We rationalize. No one at this client has tried to commit fraud before, why should things be different now?	Things change. Management or employees might have a change in personal circumstances that provide an incentive for fraud. Changes in controls may provide opportunities. What happened in the past is not audit evidence for the current period.
<i>Lack of experience in detecting fraud.</i> It is rare that independent auditors experience a fraud at one of their clients. For this reason, we can “let our guard down” and fail to see the warning signs.	Become familiar with the most common frauds in your client’s industry, how they are concealed, and the signs that they have occurred. When brainstorming, think from the “fraudster’s” point of view. If you wanted to commit and conceal a fraud, how would you do it?
<i>We only talk to the accountants.</i> Most of our inquiries are made of the accounting personnel, who only reinforce our assumptions and “categories.”	Get outside of the accounting department. Talk to operational personnel to corroborate management’s responses to your questions. Get a different point of view that challenges your assumptions.

CHAPTER 4: INQUIRIES OF ENTITY PERSONNEL

Note: Chapter 2 of this publication provides an understanding of the requirements of Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), relating to inquiries of management relating to fraud. That chapter also offers suggestions for implementing those requirements of the SAS. This chapter provides additional suggestions for making inquiries of entity personnel about fraud matters, and these suggestions are intended to supplement what SAS No. 99 requires.

Introduction

The Canadian Institute of Chartered Accountants (CICA) has conducted research on improving the effectiveness of audit inquiry.¹ In its research report, the CICA notes that traditional evidence-gathering techniques, such as confirmation, observation, or examination of supporting documents, may not work for “soft” information. That type of information includes an understanding of an entity’s information systems, the business, and how information can be manipulated within the system. Because traditional audit procedures are not appropriate for gathering this kind of information, inquiry is the only way to obtain evidence about these matters. Thus, it is essential that auditors improve the effectiveness of their inquiry techniques.

The information-gathering phase of SAS No. 99 requires you to gather a great deal of “soft” information about the entity. The standard significantly expands the audit requirement and guidance regarding the inquiries of management and others. The purpose of this chapter is to provide additional suggestions on how you can make those inquiries more effective.

By Way of Analogy...

Suppose that you were assigned to conduct an inventory observation at a client. It is the first time you have ever done an inventory observation.

Would you “wing it”?

Probably not. Most likely you would do a fair amount of preparation. Among other things, you would become familiar with the objectives of your assignment and the procedures you would perform to achieve those objectives. You would prepare an audit program to structure your procedures to make sure you cover everything you should. The pressure you have to perform is even greater than normal because there are no “do-overs” in an inventory observation.

¹ The Canadian Institute of Chartered Accountants (CICA) published the results in *Audit Enquiry: Seeking More Reliable Evidence From Audit Enquiry*. This is an excellent source of information for auditors wishing to improve the effectiveness of their inquiries. This report can be ordered directly from the CICA.

Inquiry of entity personnel is every bit as “legitimate” an audit procedure as a more traditional procedure, such as observation. As with an inventory observation, we may have only one chance to “get it right.”

And yet, most auditors prepare very little for an inquiry, even the most crucial ones that can affect the entire engagement. They wing it. An inquiry is not a conversation. It is a structured process designed for a specific purpose.

Your Role as Interviewer

Before performing the interview, you should prepare and understand your role as the interviewer.

- *Have a clear objective.* Make sure you know what you are looking for. Do you just want information about the way a process works? For example, how do journal entries and other adjustments get posted to the general ledger? Or are you asking for thoughts and impressions? For example, where is the entity most vulnerable to fraud? Have a clear understanding of how the information you gather will be used. Are you trying to corroborate the representations of other entity personnel? To design your audit procedures? Clearly defined objectives will help you probe for additional information after the person you are interviewing has answered the first question.
- *Understand the client’s business.* The better you understand the client’s business—such as its business model, the key operational processes, and how it compares to its peers—the better the inquiry. An in-depth understanding of the entity leads to more relevant and perceptive questions, and to a more insightful understanding of the responses.
- *Be prepared to listen and guide.* As CPAs we are accustomed to giving expert advice. Clients come to us for answers, and we provide them. We also receive expert advice from others. We have a question and ask someone for “the answer.” This is the type of professional conversations we most often engage in—hierarchical, linear, solutions-driven. Inquiries about fraud tend to be more intuitive. As the interviewer, look to ask questions and step aside. Don’t interrupt and think that you’ve found the “right answer.” There may not be one. Recognize that in an interview, a lot of pertinent information is *volunteered*. Create situations in which the person being interviewed feels comfortable volunteering information without being cut off or dismissed.
- *Check your assumptions at the door.* Chapter 3 of this Practice Aid describes how all of us bring a set of assumptions to any given situation. Before conducting an interview, review the assumptions and biases you bring to the situation. This review will accomplish two important things: (1) you will “deframe” your frame of reference, guarding against a biased interpretation, and (2) you will convey an unbiased attitude toward the person being interviewed, which will make him or her more open.

Starting the Interview

During the introductory phase of the interview, you will want to make sure that the person being interviewed feels at ease. Establish a nonthreatening tone. Make sure that the two of you are free from distractions and in a private setting.

Early on in the interview you should state its purpose. For example, “I’m hoping you can help me understand the procedures you follow to close the books and post journal entries to the general ledger.” Note that this explanation of purpose includes a description of the subject’s role in the interview (“I need you to help me understand...”). Throughout the interview, it is useful to include the interviewee as part of the process. A general description of the purpose of the interview is better than a more specific description. Explain that the inquiries you are making are routine and, if possible, provide an estimate of how long you think the interview will last. Avoid sensitive questions or questions phrased in a way that may generate a defensive response.

Structuring Questions

After the introductory phase of the audit, you will move into the information-gathering phase of the interview. The exact circumstances of each interview will vary, which will affect the way you phrase your questions. In its research, the CICA noted that effective questions, regardless of their circumstances, share the following characteristics.

- They make sense to the respondent.
- They use vocabulary that is common to both you and the respondent.
- They elicit the information required.

As you move through the information-gathering phase, you will want to move from the broad to the specific, from trying to elicit information indirectly to more direct questions. SAS No. 99 requires you to ask some rather direct questions of entity personnel regarding their knowledge of fraud or possible fraud. Asking these direct and sensitive questions right away may not be effective at gathering the information you need. Instead, work toward the direct questions by asking broader questions first. Make sure that you provide the proper context for asking the direct kinds of questions required by SAS No. 99. An example might be:

Auditor: Part of my job is to identify material misstatements due to fraud and areas of the company that are vulnerable to fraud. You understand that, don’t you?

Client: Yes.

Auditor: I’m curious about your observations. Where do you think the company is most vulnerable to someone stealing assets?

Periodically, the participant will provide an answer that requires follow-up. In those situations, it is helpful to use the respondent's words and phrases to ask for additional information:

Client: I've never liked the way we handle those postclosing adjustments.

The auditor may ask several follow-up questions:

Auditor: Tell me about the adjustments.

Auditor: How do you handle postclosing adjustments?

Auditor: What is it you don't like?

Auditor: Who likes the way the company handles postclosing adjustments?

In this exchange, note that the auditor has followed the general rule of proceeding from the broad, nonthreatening, to the specific and possibly sensitive.

In his training course *Fraud Examination: Investigation Methods*, Joseph Wells offers the following tips for asking questions during the information-gathering phase of an interview.²

- Ask questions in a manner that will develop the facts in a systematic order.
- Ask only one question at a time, and frame the question so that only one answer is required.
- Ask straightforward and frank questions.
- Give the respondent ample time to answer. Do not rush.
- Try to help the respondent remember, but do not suggest answers. Be careful not to imply a particular answer through facial expressions, gestures, methods of asking questions, or types of questions asked.
- Repeat or rephrase questions, if necessary, to get the facts.
- Be sure that you understand the answers. If they are not perfectly clear, have the respondent interpret them at that time instead of saving this for later.
- Provide the respondent an opportunity to qualify his or her answers.
- Separate facts from inferences.
- Have the respondent give comparisons by, for example, percentages, fractions, and comparisons to last year, to ascertain accuracy.
- Get all the facts. Almost every respondent can give you information beyond what was initially provided.
- Some interviewers give the respondent an opportunity to provide a "free narrative" of the situation at the beginning of the interview. Once the respondent has given this narrative account, ask questions about every item.

² This course is published and available from the AICPA. The questions cited here appear on pages 1 through 7 of the materials.

Signs of Deception

Fraud experts are trained to spot clues that the person being interviewed is not being truthful. SAS No. 99 does *not* anticipate that auditors performing a generally accepted auditing standards (GAAS) audit will be similarly trained in these advanced interrogation skills, but the following information may be helpful.



Practice Pointer. Early in the interview, try to establish a “baseline” for the interviewee’s reactions to relatively factual, nonthreatening questions. Later in the interview, when asking more sensitive questions, be alert for changes from this baseline response.

Nonverbal Clues

The Institute of Internal Auditors conducted studies designed to help internal auditors perform more effective interviews. Their monograph *Conducting Internal Audit Interviews*³ concluded that over 50 percent of a person’s message is communicated nonverbally. Most nonverbal clues come in clusters. Here are some things—usually in combination with each other—that might indicate the person you are interviewing is trying to deceive you.

- *Barriers.* When someone being interviewed feels uncomfortable with a particular line of questioning, he or she may put up nonverbal barriers to try to keep the interviewer at a comfortable distance. Barriers such as the following may indicate that the person being interviewed would rather avoid discussing the topic.
 - Blocking their mouth, for example with their hands, pens, or pencils, or chewing on hair or corners of papers or folders.
 - Crossing their arms and legs. The higher the arms are crossed, the greater the barrier.
 - Making distracting noises, such as finger tapping or drumming.
 - Leaning away from the interviewer, usually toward the door or a window, in an effort to create spatial distance.
- *Signs of stress.* In most people, lying will produce stress, which can manifest itself physically. Here are some nonverbal signs of stress.
 - Neck and face turning red and blotchy
 - Yawning outside of drowsiness or boredom, particularly among younger individuals.
 - Changes in the person’s normal pattern of eye contact.
 - Excessive eye blinking or closing the eyes for extended periods of time
 - Wobbling or bouncing knees up and down quickly
 - Shuffling the feet or crossing them at the ankles and putting them beneath the chair.

³ J. W. Harmeyer, S. P. Golden, and G. E. Summers, *Conducting Internal Audit Interviews* (Altamonte Springs: Institute of Internal Auditors Research Foundation, 1984).

Verbal Clues

In his training course *Fraud Examination: Investigation Methods*, Joseph Wells offers the following verbal clues that the person being interviewed may be either avoiding your question or answering it dishonestly.⁴

- Changes in speech patterns, such as speeding up or talking louder.
- Stalling for time. For example, repeating the question or complaining about the physical environment where the interview is taking place.
- Attempts to add credibility. For example taking an oath such as “I swear to God,” or “To tell you the truth.” Another way to add credibility is tell the interviewer to check his story with another party.
- Selective memory, for example, the use of the phrase “I can’t recall.”
- Overqualified responses, for example, the use of the phrase “To the best of my memory.”
- Reluctance to end the interview. Someone who has been honest and totally candid generally is ready to terminate the interview. Those who have been trying to deceive you may try to keep you a little longer to try to convince you they were telling the truth. Those who have withheld information may want you to keep asking questions so that they may “come clean.”
- Tolerant attitudes. The dishonest individual typically has a relatively tolerant attitude toward someone who may have committed fraud. For example, suppose you asked the question, “What should happen to someone who intentionally recorded false journal entries to boost profits?” The person with nothing to hide usually will make a strong statement, such as, “They should be fired or prosecuted.” Another person with knowledge of a similar fraud might provide a softer answer such as “It depends on the circumstances.”

Concluding the Interview

At the end of the interview, review the key points covered and ask the respondent if the information you have is correct. Consider asking if there is any other information the two of you should discuss. Examples of questions that can be used for this purpose include:

- If you were trying to...[understand how a fake journal entry could be entered into the general ledger], what would you do?
- Is there anything we haven’t covered that you think we should have?
- Do you have anything else to say?

⁴ This course is published and available from the AICPA. The questions cited here appear on pages 1 through 7 of the materials.

CHAPTER 5: RESPONDING TO THE RISK OF IMPROPER REVENUE RECOGNITION

As described in Chapter 2, Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), includes a presumption that improper revenue recognition is a fraud risk. The objective of this chapter is to provide additional suggestions and guidance on revenue recognition issues.¹

Revenue recognition focuses on *when* revenue can be reported in the financial statements. An entity's revenue recognition policies describe the conditions that must be met before it can recognize revenue in the current period.

Revenue Recognition Accounting Concepts

Financial Accounting Standards Board (FASB) Concepts Statement No. 6, *Elements of Financial Statements*, defines revenue as:

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Conceptually, companies create *economic* value continually throughout this operating cycle. Theoretically, revenue could be recognized incrementally and continuously at many different points in the process. As a practical matter, the continuous recognition of revenue is impossible. Thus, for accounting purposes, we choose one event—the recognition event—to recognize revenue (and the corresponding expenses).

When does that event occur? In his essay “Revenue Recognition,” Professor David Hawkins describes the results of his analysis of revenue recognition practices:

An analysis of revenue recognition practices seems to indicate that revenue is typically recognized when the event that *reduces the risk of ultimately receiving a determinable amount of revenue is reduced to a minimum level* considered product by those issuing and using financial statements...Determining [this] critical event in novel situations can require management judgment which must be exercised in the light of a thorough, objective analysis of the particular circumstances and the generally accepted accounting principles applicable to analogous situations. [Emphasis added]²

¹ The auditing of revenue transactions is inextricably linked to the accounting guidance. At the time this book was written, certain elements of generally accepted accounting principles related to revenue recognition were being revisited. The completeness and effectiveness of the auditing procedures described in this chapter ultimately will depend on the changes made to the accounting literature.

² David F. Hawkins, “Revenue Recognition” (Harvard Business School Publishing, 1995).

In assessing an entity's revenue recognition practices, two important questions to consider are:

1. Is its designation of the recognition event appropriate?
2. Are its accounting policies consistent with this designation?

The Accounting Literature

Conceptual Basis

FASB Concept Statement No 5, *Recognition and Measurement in Financial Statements of Business Enterprises* provides the conceptual basis for revenue recognition. Paragraph 83 of FASB Concept Statement No. 5 states that recognition of revenue involves consideration of two factors:

1. Being *realized or realizable*.
2. Being *earned*.

Paragraph 84(a) of FASB Concept Statement No. 5 states that revenues from manufacturing and selling activities are commonly recognized at the time of sale, usually meaning *delivery*.

The rest of this chapter explores in detail the meaning of the key terms in italics.

Individual Pronouncements

Individual accounting pronouncements have been developed to provide guidance on revenue recognition for specific industries or transactions. For example, guidance on revenue recognition for sales of software is provided in Statement of Position (SOP) 97-2, *Software Revenue Recognition* (as modified by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*).

In general, the purpose of these individual pronouncements is to describe how the revenue recognition concepts described in FASB Concept Statement No. 5 should be applied to certain transactions. If an entity is involved in these transactions, it should follow the guidance in the relevant pronouncement. Otherwise, it should follow the conceptual guidance contained in FASB Concept Statement No. 5.

The Securities and Exchange Commission

Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, represents the SEC staff's views on how the FASB conceptual guidance on revenue recognition should be applied. The SAB reflects the basic principles of revenue recognition in existing generally accepted accounting principles (GAAP) and does *not* supersede any existing authoritative literature.

Financial statement preparers of public companies are most directly affected by SABs. However, those who work for nonpublic companies may find the information contained in SAB No. 101 useful.

Revenue Recognition Criteria—Realizable

The general revenue recognition criteria state that revenue is recognized when *realized or realizable*. A sale has not taken place until there exists an actual, firm *agreement between the seller and buyer*. Contingent payment terms indicate that the revenue is not realizable because there is no firm agreement about sales price.

Indications that there is a lack of agreement between the buyer and seller include the following.

- The use of letters of intent in lieu of signed contracts or agreements
- Sales merchandise that is shipped in advance of the scheduled shipment date without evidence of the customer's agreement or consent or documented request for such shipment
- Sales recorded upon shipment of a product to customers who have been given a free tryout period after which the customer can return the product with no obligation
- Recognition of sales when customers have unilateral cancellation or termination provisions

Sales to distributors (rather than to end-users) may raise additional concerns. It is not unusual for sellers to offer incentives or concessions to distributors that normally are not offered to retail, end-user customers. If your company sells to distributors, a firm sales agreement does not exist (and therefore revenue should not be recognized) in those circumstances in which the distributor's obligation to pay for the product is contingent on the following:

- Resale to another (third) party (for example, the end user)
- Receipt of financing from another (third) party

The SEC

In SAB No. 101, the SEC clarifies that an agreement does not exist until it is *executed* by both parties. If it is the entity's normal business practice to require a written sales agreement, a verbal agreement between the parties or the premise that the contract *will be signed shortly* does not constitute an agreement between the parties.

The interpretative response to question 2 in SAB No. 101 also provides guidance on consignment sales and other situations in which revenue should not be recognized even when delivery of the product has occurred.

Revenue Recognition Criteria—Earnings Process

The general revenue recognition criteria state that revenue is recognized upon *completion of the earnings process*. The earnings process is complete when the entity has "substantially accomplished what it must do to be entitled to the benefits represented by the revenues."

Circumstances that indicate that the earnings process may not be complete include the following:

- There are sales that require substantial continuing seller involvement after delivery of merchandise.
- There are sales in which evidence indicates the customer's obligation to pay for the merchandise depends on fulfillment by the seller of materially unsatisfied conditions.
- Goods are preinvoiced while still in the process of being assembled.
- Shipments are sent to and held by freight forwarders pending return to the company for required customer modifications.

The SEC

Determining when the earnings process is complete is especially difficult when the customer pays an up-front fee for products or services that are delivered or performed over time. At issue is whether the company should recognize the initial fee as revenue when it is paid or as the services or goods are performed or delivered. Consider the following examples, which the SEC provided in question 10 of the frequently asked questions in SAB No. 101.

- A company charges users a fee for nonexclusive access to its Web site that contains proprietary databases. The fee allows access to the Web site for a one-year period. After the customer is provided with an identification number and trained in the use of the database, there are no incremental costs that will be incurred in serving this customer.
- An Internet company charges a fee to users for advertising a product for sale or auction on certain pages of its Web site. The company agrees to maintain the listing for a period of time. The cost of maintaining the advertisement on the Web site for the stated period is minimal.
- A company charges a fee for hosting another company's Web site for one year. The arrangement does not involve exclusive use of any of the hosting company's servers or other equipment. Almost all of the projected costs to be incurred will be incurred in the initial loading of information on the host company's Internet server and setting up appropriate links and network communications.

In each of these cases, revenue should be recognized over time. Even though the majority of the cost and effort is incurred by the seller at the front-end of the agreement, the SEC staff believes that the substance of the transaction is that the buyer is paying for a service that is delivered over a period of time. The earnings process is completed as the service is provided—that is, revenue should therefore be recognized over the same time period.

Multiple-Element Arrangements

Many companies now offer complete, packaged solutions to their customers, which may involve the delivery or performance of multiple products, services, and/or rights to use assets, and performance may occur at different points in time or over different periods of time.

Some arrangements are accompanied by initial installation, initiation, or activation services and generally involve either a fixed fee or a fixed fee coupled with a continuing payment stream. The continuing payment stream generally corresponds to the continuing performance and may be fixed, variable based on future performance, or composed of a combination of fixed and variable payments.

The issue is how to account for these so-called “multiple-element arrangements.” For example, is it acceptable to allocate a portion of the total fee to each element? Or should you defer the entire fee until *all* the elements are delivered?

Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, provides the primary guidance on accounting for multiple-element arrangements. That consensus position addresses the following issues:

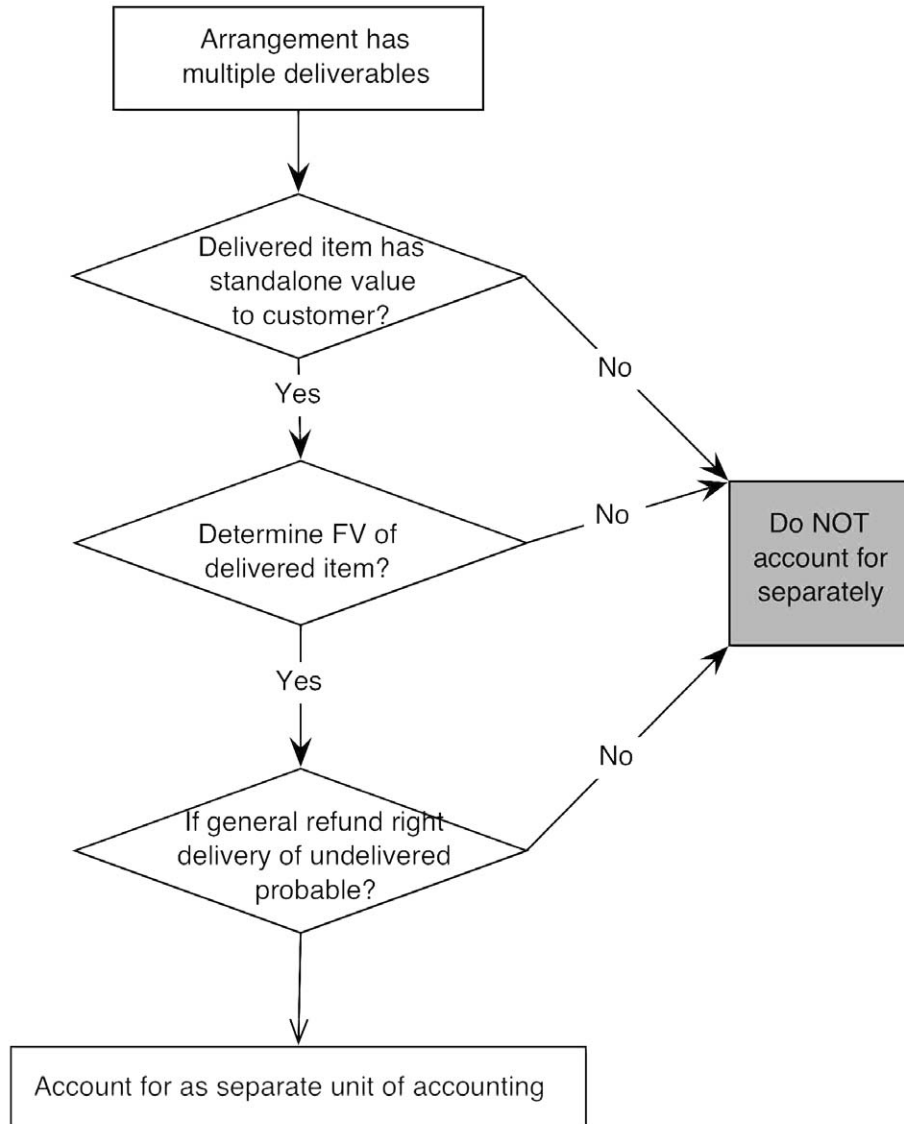
- How should an entity determine whether an arrangement with multiple deliverables has “multiple units of accounting,” which would allow revenue to be recognized in stages, as the revenue recognition criteria were met for each separate unit?
- If the entity does have multiple units of accounting, how should the total fee be allocated among the units?
- What effect, if any, do customer rights due to nonperformance have on the recognition of revenue?
- What is the impact, if any, of the following:
 - A customer’s ability to cancel a contract and incur a cancellation penalty
 - Consideration that varies as a result of future customer actions
 - Consideration that varies as a result of future seller actions

Separate Units of Accounting

When accounting for revenue transactions with multiple deliverables, the first, most fundamental determination is whether the arrangement has more than one unit of accounting. For example, an entity may have to determine whether the arrangement is composed of one unit (which would require revenue to be recognized only after the delivery of *all* components of the arrangement) or multiple units (which would allow for partial revenue recognition as each unit was delivered).

Illustration 5-1 summarizes the guidance contained in EITF Issue No. 00-21 relating to determining whether the arrangement has multiple units of accounting.

Illustration 5-1 EITF 00-21: Determining Separate Units of Accounting



As indicated in the flowchart, for a delivered item to be considered a separate unit of accounting, all the following conditions must be met:

- The delivered item has value to the customer on a standalone basis. This condition is met if it is sold separately by *any* vendor or the customer could resell it on a standalone basis.
- There is objective and reliable evidence of the fair value of the undelivered item. In general, the price of a deliverable when it is sold regularly on a standalone basis is the best evidence of fair value. The price of the element in the multiple-element arrangement sales contract is *not* considered objective and reliable.
- If the customer has a general right of return, the delivery or performance of the undelivered item is probable and substantially in control of the seller.

Measurement and Allocation of Consideration

The amount of total arrangement consideration must be fixed or determinable, other than with respect to the customer's refund rights. Refund rights consist of:

- General rights of return within the scope of FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- Contractual provisions that provide the customer with the right to return a delivered product for a refund or other concessions *only if* the seller fails to deliver any undelivered elements.

In determining the total amount of consideration, the seller should assume that customer actions will not result in any incremental consideration.

In general, the total consideration of a multiple-element arrangement should be allocated to individual elements based on their relative fair values. The amount allocable to a delivered item is limited to that amount that is *not* contingent upon the delivery of additional items or meeting other specified performance conditions.

The SEC

SAB No. 101 provides additional guidance on accounting for multiple-element arrangements that generally is consistent with that provided in EITF Issue No. 00-21. In question 4 of the FAQs on SAB No. 101, SEC staff stated that it will not object to a method of accounting for multiple-element arrangements that includes the following conditions:

- To be considered a separate element, the product or service in question represents a separate earnings process. The best indicator that a separate element exists is that a vendor sells or could readily sell that element unaccompanied by other elements.
- Revenue is allocated among the elements based on the fair value of the elements. The fair values used for the allocations should be reliable, verifiable, and objectively determinable. The allocation of revenue among the elements based solely on cost plus a profit margin that is not specific to the particular product or service is not acceptable because, in the absence of

other evidence of fair value, there is no objective means to verify what a profit margin should be for the particular element(s).³

If sufficient evidence of the fair values of the individual elements does not exist, revenue would not be allocated among them until that evidence exists. Instead, the revenue would be recognized as earned using revenue recognition principles applicable to the entire arrangement as if it were a single-element arrangement.

- If an undelivered element is essential to the functionality of a delivered element, no revenue allocated to the delivered element is recognized until that undelivered element is delivered.

Revenue Recognition Criteria—Delivery

To recognize revenue, the product or service sold must be *delivered*. The general revenue recognition criterion states that revenue typically is recognized upon *delivery*, but the term *delivery* encompasses more than the physical shipment of the product. For a product to be considered delivered, the seller should substantially complete or fulfill the terms specified in the arrangement. When a partial shipment is made in which the portion not shipped is a critical component of the product, revenue should be deferred.

Other circumstances in which revenue should be deferred due to lack of delivery include the following.

- Sales are billed to customers before the delivery of goods and held by the seller (known as “bill and hold” or “ship in place” sales). However, as discussed in the following section, revenue from some bill-and-hold sales may be recognized if certain conditions are met.
- Shipments are made after the end of the period. Books that are kept open to record revenue for products shipped after the end of the period do *not* satisfy the delivery criterion for the current period.
- Shipments are made to a warehouse or other intermediary location without the instruction of the customer.
- Goods are preinvoiced before or in the absence of actual shipment.
- Purchase orders are recorded as completed sales.

For companies that provide services rather than products, revenue generally is recognized as the service is provided.

³ The Securities and Exchange Commission (SEC) staff makes reference to Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, paragraphs 35 through 42, and SOP 97-2, *Software Revenue Recognition*, paragraphs 9 through 14 (as modified by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*), for guidance on allocating among elements.

Bill-and-Hold Sales

In a bill-and-hold transaction, a customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment to designated locations. Normally, such an arrangement does not qualify as a sale because delivery has not occurred. Under certain conditions, however, when a buyer has made an absolute purchase commitment and has assumed the risks and rewards of the purchased product but is unable to accept delivery because of a compelling business reason, bill-and-hold sales may qualify for revenue recognition.

The interpretative response to question 3 of SAB No. 101 specifies certain conditions or criteria that a bill-and-hold transaction of a public company should meet to qualify for revenue recognition. In addition, it specifies certain factors that should be considered in evaluating whether a bill-and-hold transaction meets the requirements for revenue recognition.

Although accounting and auditing enforcement release (AAER) No. 108 is not binding on nonpublic companies, they may find it useful in analyzing bill-and-hold transactions.

The SEC

SAB No. 101 clarifies that delivery occurs when the customer:

- Takes title to the product
- Assumes the risks and rewards of ownership

The SAB also states that a seller should *substantially complete* or fulfill the terms specified in the arrangement for delivery or performance to have occurred.⁴ If revenue is recognized upon substantial completion of the arrangement, all remaining costs of performance or delivery should be accrued.

Customer Acceptance Provisions

Customer acceptance provisions may be included in a contract for a variety of reasons, including:

- To allow the customer to test the product
- To require the seller to perform additional services
- To identify other work necessary to be done before accepting the product

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.

⁴ According to the Staff Accounting Bulletin (SAB), only inconsequential or perfunctory actions may remain incomplete such that the failure to complete the actions would *not* result in the customer receiving a refund or rejecting the delivered products or services performed to date. In addition, the seller should have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating the remaining costs.

Other Guidance

SAB No. 101 provides additional guidance on when delivery of a product or performance of a service has been performed for the following revenue transactions:

- Delivery or performance of multiple deliverables (see interpretative response to questions 3 and 6 of SAB No. 101)
- Licensing arrangements (see interpretative response to question 3 of SAB No. 101)
- Layaway sales (see interpretative response to question 4 of SAB No. 101)
- Nonrefundable up-front fees (see interpretative response to question 5 of SAB No. 101)

Revenue Recognition When Right of Return Exists

It is not unusual for companies to provide their customers with the right of return—in fact, some would argue that the rights of customers to return merchandise are a part of our shared cultural values. For sellers, the sale of products with the right of return poses an accounting issue, namely, should revenue be recognized, and if so, how the possible sales returns should be accounted for.

FASB Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*, provides guidance for sales of a product when the buyer has the right to return it. Certain transactions and industries are excluded from the Statement.

According to FASB Statement No. 48, revenue from sales transactions that provide the customer with the right to return the product should be recognized at time of sale only if certain conditions are met. If revenue is recognized at time of sale, a liability for expected returns also should be recognized.

If the conditions for immediate revenue recognition are not met, sales recognition should be postponed until the right of return substantially expires or until such time that the conditions are met.

The key to applying FASB Statement No. 48 is in determining whether the conditions for immediate revenue recognition have been met. When a sales transaction includes a right of return, FASB Statement No. 48 lists six conditions, *all* of which must be met in order to recognize revenue at the time of sale.

The most subjective of these conditions is the requirement that the amount of future returns can be reasonably estimated. FASB Statement No. 48 provides specific guidance on a number of factors that may impair, but not necessarily preclude, the ability to make a reasonable estimate. These are:

- The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand.
- Relatively long periods in which a particular product may be returned.

- Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers.
- Absence of a large volume of relatively homogeneous transactions.

The SEC

In the interpretative response to question 9 of SAB No. 101, the SEC provided a list of other factors that may preclude an entity from making a reasonable and reliable estimate of product returns. These factors are:

- Significant increases in or excess levels of inventory in a distribution channel (sometimes referred to as “channel stuffing”).
- Lack of “visibility” into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of sales to end users.
- Expected introductions of new products that may result in the technological obsolescence of and larger-than-expected returns of current products.
- The significance of a particular distributor to the entity's business, sales, and marketing.
- The newness of a product.
- The introduction of competitors' products with superior technology or greater expected market acceptance.
- Other factors that affect market demand and changing trends in that demand for the entity's products.

Audit Issues in Revenue Recognition

Many audits take a “balance sheet” approach, tying down the numbers at the beginning and end of the reporting period. This approach is fine, but you *cannot overlook revenue recognition issues*. On a fundamental level, you have to understand the client's earnings process. With that information, you can critically assess whether the client's revenue recognition procedures are appropriate.

Audit Planning Considerations

In planning your audits, you should obtain a sufficient understanding of the client's industry and business, its products, its marketing and sales policies and strategies, its internal control structure, and its accounting policies related to revenue recognition. During the planning phase of the audit, you should seek to identify conditions that increase the risk of misstatement. Those conditions may include:

- New product or service introductions or new sales arrangements
- Sales to distributors or resellers

- Substantial sales at the end of the accounting period
- Individually significant sales
- Unusual or complex revenue transactions
- Control environment considerations, such as:
 - Aggressive accounting policies or practices
 - Pressure from senior management to increase revenues and earnings
 - Lack of involvement by the accounting or finance department in sales transactions or in the monitoring of arrangements with distributors

Because material misstatements due to fraudulent financial reporting often result from an overstatement or understatement of revenues, SAS No. 99 states that you should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

Brainstorming

As described in Chapter 2 of this Practice Aid, engagement teams are required to have a brainstorming session prior to or in conjunction with the information-gathering phase of the audit. One of the main objectives of that session is to sensitize engagement team members to the possibility that fraud may exist at the client and to help the team exchange ideas about how and where they believe the entity's financial statements might be susceptible to material misstatements due to fraud.

Knowledge of common frauds related to improper revenue recognition can help engagement teams conduct more effective brainstorming sessions. Typical revenue recognition frauds include:

- *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. A variation on this theme is to ship the goods to a warehouse that is undisclosed to the auditors, which creates a legitimate shipping document the entity can use to mislead the auditor into thinking that the goods were actually shipped to a customer. Fictitious sales 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 for which 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.* These include, 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 coconspirator 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.

Many fraud schemes are designed to accelerate the recognition of revenue; however, you should be alert for conditions that may motivate management to *delay* revenue recognition. For example, when sales estimates for a subsequent year are soft and management has met their earnings target for the current year, they may be tempted to improperly delay revenues into the next year. Additionally, an owner of a privately held entity may be motivated to improperly delay revenue recognition as a means of minimizing taxable income.

Nature of Business and Accounting for Revenue

In gaining an understanding of the nature of the entity's business, you might consider questions that are relevant to the entity's revenue recognition, such as the following.

- What products does the company sell? Do any characteristics of the product itself pose revenue recognition issues? Characteristics might include:
 - The bundling of products with services may make it difficult to determine when the earnings process is substantially complete.
 - New products are sold with concessions such as liberal cancellation provisions or free trials.
 - Products are shipped in components.
 - Products require substantial continuing seller involvement after delivery of merchandise.
- What are the company's current marketing campaigns? Does the company provide sales incentives that raise revenue recognition, measurement, or presentation issues?
- What are the company's policies and procedures relating to revenue transactions? Could these relate to:
 - Receiving and accepting orders
 - Extending credit
 - Relieving inventory, billing, and recording sales transactions
 - Receiving and recording sales returns
 - Authorizing and issuing credit memos
 - Determining proper cut-off of sales at the end of the accounting period
- What are the company's standard shipping methods and terms? Examine:
 - When does title to the goods pass to the buyer?
 - Are shipments sent directly to customers or third-party warehouses?

- How are shipments of nonsale items (for example, products shipped for demonstration purposes) separated from sales?
- Have there been recent changes to the entity's shipping policies?
- Does the company enter into transactions that require special audit consideration, including but not limited to:
 - Barter transactions
 - Transactions involving side agreements
- What are the company's revenue recognition policies? Are they an appropriate application of accounting principles in the context of the industry in which it operates?
- Has there been a change in the company's revenue recognition policy and, if so, why?
- What is the company's practice with regard to sales and payment terms? Are there any deviations from industry norms or from the entity's own practices? These include:
 - Sales terms that do not comply with the company's normal policies
 - The existence of longer-than-expected payment terms or installment receivables
 - The use of nonstandard contracts or contract clauses with regard to sales
- Do the results of preliminary analytical procedures indicate anomalies that suggest revenue recognition issues? Examples of anomalies that may require follow-up include:
 - Significant sales volume at or near the end of the reporting period
 - Unusual volume of sales to distributors

Identifying Risks of Material Misstatement Due to Fraud

Be alert for the following, which may indicate incentives/pressures to fraudulently misstate revenues, opportunities to carry out the fraud, or attitudes/rationalizations to justify the fraud. The Appendix to SAS No. 99 provides examples of fraud risk factors relating to fraudulent financial reporting, almost all of which may be relevant to revenue recognition.

In addition to those items provided in SAS No. 99, you may also want to be alert for the following.

- 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.

- Unusual reconciling of 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.
- Predated or postdated 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 before or just after the end of the period.

Other Issues to Consider

- *Side agreements.* Side agreements are used to alter the terms and conditions of sales as a way to entice customers to accept the delivery of the goods or services. These agreements may include terms (such as relieving the customer of some of the risks and rewards of ownership, or creating post-sale obligations) that preclude revenue recognition. Frequently, side agreements are hidden from the entity's board of directors and independent auditors, and only a very few individuals within the entity are aware of their existence.
- *Channel stuffing.* Channel stuffing (also known as *trade loading*) is a marketing practice that suppliers sometimes use to boost sales by inducing distributors to buy substantially more inventory than they can resell promptly. Inducements to overbuy may range from deep discounts on the inventory to threats of losing the distributorship if the inventory is not purchased. Channel stuffing without appropriate provision for sales returns is an example of booking tomorrow's revenue today in order to window-dress financial statements. Channel stuffing also may be accompanied by side agreements that provide for the return of unsold merchandise beyond the normal sales return privileges. Even when there is no evidence of side agreements, channel stuffing may indicate the need to increase the level of anticipated sales returns above historical experience.
- *Related-party transactions and significant unusual transactions.* Related-party transactions require special consideration because related parties may be difficult to identify, and related-party transactions may pose significant "substance over form" issues. Undisclosed related-party transactions may be used to fraudulently inflate earnings. Examples include the recording of sales of the same inventory back and forth among affiliated entities that exchange checks periodically to "freshen" the receivables, and sales with commitments to repurchase that, if known, would preclude recognition of revenue.

Significant, unusual, or highly complex transactions resulting in revenue recognition that are executed with customers who are not related parties similarly require special consideration because they also may pose "substance over form" questions and may involve the collusion of the entity and the customer in a fraudulent revenue recognition scheme.

Audit Response

SAS No. 99 (AU sec. 316.54) provides examples of responses to identified risks of material misstatements relating to fraudulent financial reporting. In addition to the procedures described in the standard, you also might consider the following.

- Examine inventory reports or other correspondence from distributors and reconcile this information with the company's records.
- Vouch all large or unusual sales made at quarter end and year end to original source documents.
- Perform a detailed review of the entity's quarter-end and year-end adjusting entries and investigate any that appear unusual as to nature or amount.
- Scan the general ledger, accounts receivable subledger, and sales journal for unusual activity.
- Check the clerical accuracy of the revenue journal or similar record and trace the postings of the totals to the appropriate account in the general ledger.
- Check the reconciliation of revenue journals during the audit period to the general ledger control account, or check the postings to the general ledger control account from sources other than the revenue journal for unusual or unexpected activity.
- Analyze and review deferred revenue accounts at end of the period for propriety of deferral.
- Analyze and review credit memos and other accounts receivable adjustments for the period subsequent to the balance sheet date.
- Scan the general ledger or subsidiary ledgers, as appropriate, for a period subsequent to year end for reversals of sales or large sales returns.
- Review significant year-end contracts for unusual pricing, billing, delivery, return, exchange, or acceptance clauses. Perform post-year-end specific review for contract revisions or cancellations and for refunds or credits issued.
- 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.
- Compare operating cash flow to sales; analyze by salesperson, location, or product.

Confirmations and Management's Representations

Standard confirmation requests, which typically confirm only the outstanding balance, may not always provide sufficient audit evidence to determine whether revenue transactions have been recorded. You should consider designing your confirmations to obtain information from customers about payment terms, right-of-return privileges, continuing obligations on the part of the seller, and other significant risks retained by the audit client. You also may wish to confirm the terms of individually significant sales and the absence of any side agreements. Because of concerns about fictitious sales, contract terms, and undisclosed side agreements, you should consider addressing the confirmation to a specific individual and obtaining additional oral confirmation from that individual.

Additionally, when performing alternative procedures for nonresponding confirmation requests, you should consider whether the evidence obtained from these procedures is as reliable as the evidence gained from direct confirmation from third parties.

Representations from management are not a substitute for the application of audit procedures. A management representation letter merely confirms in writing representations that management made to you during the course of the engagement. Examples of representations you may wish to obtain from management relating to revenue recognition include:

- The absence of any contingencies that affect the obligation of customers to pay for merchandise purchased.
- The disclosure of all side agreements with customers

In addition to obtaining representations from management, you also should consider making inquiries of others familiar with the transaction, for example, sales personnel.

CHAPTER 6: AUDITING ACCOUNTING ESTIMATES¹

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), recognizes that, because of their highly subjective nature, accounting estimates are susceptible to abuse and can be used to facilitate fraudulent financial reporting or possibly cover up a defalcation. SAS No. 99 (AU sec. 316.54) provides some guidance on auditing estimates (with a reference to the guidance contained in SAS No. 57, *Auditing Accounting Estimates* [AICPA, *Professional Standards*, vol. 1, AU sec. 342]). The purpose of this chapter is to offer suggestions on auditing estimates that are in addition to those currently contained in the auditing literature.²

The Auditor's Responsibilities

It is the auditor's responsibility to assess the evidence supporting management's estimate and to draw a conclusion about whether management's estimate and related assumptions are reasonably supported. As an auditor you are *not* trying to conclude that any given outcome is expected. What you are trying to do is determine whether certain assumptions are supportable and in turn provide a reasonable basis for the development of the estimate. This will allow you to form a conclusion about the reasonableness of the resulting estimate in the context of the financial statements taken as a whole.

Characteristics of Accounting Estimates

The characteristics of accounting estimates are fundamentally different from more objective information. It's important for you to understand these differences because the underlying characteristics of an accounting estimate dictate your auditing procedures. These procedures will be much different from the ones you use to audit more objective information.

Table 6-1 highlights some of the differences between an accounting estimate and a more objectively determined, "hard" amount.

¹ This chapter was adapted from *Auditing Estimates and Other Soft Accounting Information*, by Michael Ramos (New York: AICPA, 1998).

² Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), refers to accounting estimates in two different contexts. The first focuses on examples of auditor responses to identified risks of material misstatement due to fraud. This chapter provides suggestions on additional audit responses related to accounting estimates that go beyond the guidance contained in SAS No. 99. The standard also requires you to perform a retrospective review of significant accounting estimates to look for a possible bias on the part of management and their override of internal control. Chapter 2 of this Practice Aid describes this procedure—required on every engagement—in greater detail.

Table 6-1 Characteristics of Hard Information and Accounting Estimates

	<i>Hard</i>	<i>Estimates</i>
Past or future?	Based on past transactions	Based on future events
Actions or intentions?	Based on management’s previous actions	Based on management’s intentions about future actions
Available audit evidence?	Can confirm or observe	Difficult to confirm or observe
Precision of measure?	Measurements are more precise.	Measurements are less precise.

By Way of Analogy...

When we audit a “hard” number, it is like we are affirming the winner after the race has already been run. We can see the results of the race, perform our tests, and declare who “appears to have won” and by how much.

Auditing an estimate is more like calling the winner of a race while it is still being run. We do not know who will win the race but must look at the facts that exist during the performance to come to a conclusion about the winner. Experts at racing have certain benchmarks to gauge the performance of the runners and how the race is progressing. For example, an experienced analyst may tell us that if Jones gets off to a fast start, she almost certainly will win. Jones’s start then serves as a benchmark for developing a conclusion about the outcome.

Similarly, the audit of an accounting estimate forces us to come to a conclusion about the reasonableness of an amount before the transaction has been completed. For example, we must assess the reasonableness of an estimated return allowance before all the items have been returned. Our task in this chapter is to help you develop the expertise you need to be able to establish touchstones for “calling the race” while it is still in progress.

Audit Approach for Accounting Estimates

During the planning phase of the audit, you will identify significant accounting estimates and focus your attention on those that have the highest risk for potential misstatement. Once you’ve accomplished that, you will need to gather and assess the audit evidence supporting the estimate.

When auditing an accounting estimate, you will focus on assessing the quality of the process and the reasonableness of the inputs to that process.

By Way of Analogy...

If you take a golf lesson, your instructor will dissect your swing. He or she probably won’t even need to watch the flight of the ball. Instead, the instructor will observe how you set up—your grip, the position of your body, your posture. Next, he or she will focus on the swing, how you take the

club away from the ball, enter into a back swing, then transition forward, striking the ball and following through.

Most instructors don't even have to watch the ball to tell you where it went. Based solely on what they observe about your set up and swing, they can tell you with reasonable accuracy how well you struck the ball and how it flew.

When we audit an objectively determined amount, it is like we tracked the flight of a golf shot, went out to the fairway (or into the woods, as the case may be), saw where the ball landed, and reported the position back to the golfer. When we audit an estimate, we are acting like a golf instructor, carefully observing the quality of the inputs (set-up) and the integrity of the process (the swing) to make an educated guess as to where the ball most likely landed.

Characteristics of a Quality Process

A high-quality estimation process is characterized by two important features:

- *Good faith effort.* A client makes a good faith effort to develop an estimate when they:
 - Make a diligent effort to develop appropriate assumptions
 - Exercise care not to mislead the financial statement users
 - Develop information that is consistent with their plans
- *An appropriate model.* A model is simply a representation of the situation to be analyzed, for example the number of customers that will return a given product. To be appropriate, a model must accurately represent the situation to be analyzed.

Quality Inputs and Significant Assumptions

Remember the old saying, “garbage in, garbage out.” The quality of your client’s accounting estimate is only as good as the quality of the underlying assumptions used to make the estimate. When auditing an estimate, you therefore need to assess the quality of the entity’s assumptions.

Your first step should be to identify the assumptions that are most significant to the estimate. Pay particular attention to those assumptions that are:

- Sensitive to variation
- Inconsistent with historical patterns
- Subjective and susceptible to misstatement and bias

Beware of Hidden Assumptions

Be on the lookout for assumptions that are built into the client’s estimation process. For example, suppose an estimate of the allowance for doubtful accounts is based on individual allowances for the various categories of aged receivables: 1 percent for current receivables, 5 percent for

receivables over 30 days, and 25 percent for receivables over 60 days. These percentages are based on the company's past experience. The following are two frequent situations that create built-in assumptions:

- *Same as last year.* Circumstances change, and the assumptions used previously may no longer be appropriate.
- *Global assumptions for nonhomogeneous populations.* The example in the preceding paragraph used fixed percentages for certain categories of receivables. The underlying assumption is that all items in the category are similar. If the population is not constructed carefully, that assumption might not be valid.

Characteristics of Quality Assumptions

Garbage in, garbage out—not all assumptions are created equal. How can you tell a high-quality assumption from a wild guess? Consider the following.

- *Consistency.* The assumptions need to be consistent with each other, the historical data, and any other relevant information, such as industry data.
- *Known changes or trends.* The assumptions should consider planned changes or trends in the business or industry. For example, deteriorating economic conditions should be considered when assessing assumptions relating to the allowance for doubtful accounts.
- *Management's plans.* The assumptions must reflect management's plans for the future. A plan is something management *intends* to do, not merely an option of something they *could do*.

Two Techniques for Gathering Audit Evidence

Up to this point, we've stressed the need for you to focus on the client's estimation process and underlying assumptions as a way for you to get "comfortable" with the client's accounting estimate. This approach assumes that if you have high-quality input and a good process, the output (the estimated amount) will be reliable.

You cannot ignore completely the final estimated amount, however. You should perform some substantive procedures directed at the amount itself to make sure it seems reasonable. Techniques that can help you make this determination include:

- *Hindsight.* Use post-balance sheet information to refine estimates and corroborate reasonableness of assumptions and estimates.
- *Ranges.* Develop a range of what you consider to be a reasonable amount and determine whether the client's estimate falls within that range.

Management's Ability and Intent

Management's future plans and their positive intent and ability to carry out those plans are key assumptions underlying the development of almost all accounting estimates.

In assessing management's ability and intent keep in mind that management's *plans* are different from management's *options*. When assessing ability and intent, be sure that the client's future plans are based on management's positive intent to take action.

The positive intent to take action is not the same as the lack of intention to take a contrary action. For example, the mere absence of management's intent to sell a debt security is not the same thing as management's positive intent to hold that security to maturity.

Suggestions for assessing management's ability and intent include the following.

Inquiry. Make inquiries of the client regarding the specific details of their plan. Table 6-2 provides suggestions for making inquiries of the client regarding their intended future plans.

Table 6-2 Making Inquiries of the Client

<i>Suggestion</i>	<i>Description</i>
Corroborate management's answer with other inquiries.	<ul style="list-style-type: none"> • Extend inquiries to people outside of management and outside of the accounting department. • Try to corroborate management's statements about the existence of a plan. • Assess whether field personnel believe the plan is achievable.
Be skeptical and disciplined.	<ul style="list-style-type: none"> • Look for inconsistencies between what management <i>say</i> and what they <i>do</i>. • Understand the who, what, when, where, why, and how of the plan. • Lack of details may indicate the "plan" is merely an option of what might be done.

History. Management's past history and behavior in similar situations can provide you with strong evidence about their intended future actions. Here are some questions you should consider when analyzing management's past behavior:

- What actions has management taken in the past under similar situations? Are those actions consistent or inconsistent with management's stated future plans?

- If previous actions are consistent with future plans, are the internal and external conditions in the future expected to be similar to the conditions in the past? For example, if your client was able to successfully restructure a debt obligation in the past, will it be able to do so in the future, given the existing capital market and other economic conditions?
- Does the company have a history of successfully implementing previous plans? Or do stated plans rarely materialize?

Written plans. Management may be able to provide you with written plans and other documentation to support their assumptions about future actions. Table 6-3 provides suggestions for obtaining and analyzing these documents.

Table 6-3 Obtaining and Analyzing Documentation

<i>Suggestion</i>	<i>Description</i>
Sources of information	Documentation about future plans may include: <ul style="list-style-type: none"> • Budgets • Marketing plans or surveys • Sales backlog orders • Minutes of the board • Engineering studies
What to look for	The mere existence of written documentation is not sufficient for you to reach a conclusion about the reasonableness of management’s plans. You still should consider: <ul style="list-style-type: none"> • Is the documentation relevant? • What other information is available to corroborate the conclusions in the documentation?

Business reason. As an auditor with an appropriate level of professional skepticism, you should ask yourself why management is undertaking the plan they have presented to you. Are they presenting this plan as a way, however well-intentioned, of resolving an existing audit issue? Or does the plan have a real business purpose? What economic benefits will accrue to the company if it follows this plan?

You should take some “comfort” in management’s plans and intentions when they coincide with the company’s business strategy. Be skeptical of plans that seem to lack a clear business purpose.

Ability. It’s not enough for management to have a plan of what they intend to do. As an auditor, you also should assess management’s ability to carry out their plan. In assessing management’s

ability to carry out their plan, it helps to separate the risk factors into those internal to the company that management can exercise some control over, and those factors external to the company over which management has no such control. In general, plans that rely significantly on external factors and the actions of others are riskier than plans that can be controlled mostly by management. Here are some suggestions for assessing internal factors.

- *Consider length of time.* Projects that take an extended period of time may require significant financial and other resources. Does management have the resources to “stay the course” and stick with their plan?
- *Assess the need and availability of financing.* When plans require significant amounts of financing, you should consider the source, availability, and cost of that financing.
- *Consider the need for specialized knowledge.* Some plans require specialized knowledge, such as engineering, sales and marketing, production, or labor. If this knowledge is not available currently, what plans have been made to acquire it?

Fraud Risk and Accounting Estimates

The vast majority of all financial statements include an accounting estimate of some sort. Auditors are accustomed to gathering and assessing evidence supporting these estimates. SAS No. 99 serves as a reminder that, because of their subjective nature, accounting estimates are vulnerable to manipulation and perpetration of fraudulent financial reporting. The standard draws your attention to several estimates that are particularly vulnerable to manipulation, including:

- Asset valuations (including asset impairment issues)
- Estimates related to specific transactions (for example, acquisitions, restructurings, or disposals of a segment of the business)
- Significant accrued liabilities

Chapter 2 of this Practice Aid describes the approach required by SAS No. 99 as an iterative process that involves several phases, including brainstorming, gathering information, identifying and assessing the risks of material misstatement due to fraud, and responding to identified risks. In planning your audit approach for accounting estimates, you should be sure that it is fully integrated into this process described by SAS No. 99. For example, you should consider adding a discussion of estimates to the brainstorming session.

Beware of Bias

This chapter focuses on assessing the integrity of the entity’s estimation process. However, because of the highly subjective nature of many of the assumptions underlying an estimate, a bias held by one making the assumptions can subvert even the best estimation process. Further, as described in Chapter 3, it is typical for us to be unaware of our biases, which means that auditors

will have a difficult time approaching this issue “head on.” That is, asking entity personnel to describe their biases relating to an assumption will likely be met with a blank stare.

Chapter 3 also briefly describes the psychology of bias. Based on that description, here are some questions you might consider for detecting possible bias of entity personnel.

- What information does management tend to screen out? What events do they believe will not occur?
- What events have occurred recently that management interpreted in such a way that it seemed counterintuitive? (For example, the business failure of an important customer, typically a negative development, was interpreted as a positive opportunity for the company.)
- What is the history of the entity or its management (for example, never had a problem generating revenue, always able to find financing, and a surplus of demand for its product or services)? How might this past history create a bias?
- What biases are part of the culture of the organization or the personality of its members?
- What “shortcuts” does entity management take in processing information? What “categories” are implied by these shortcuts?

CHAPTER 7: TYPICAL FRAUDS AND COMMON RESPONSES

The purpose of this chapter is to help you design extended audit procedures whenever you believe planned audit procedures are insufficient 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 the typical fraud schemes you might discover in that area. As described in Chapter 3, it is relatively unusual for auditors to encounter a fraud and thus, they can become lulled into believing that the risks of material misstatement due to fraud may be negligible at their client. One of the keys for overcoming this assumption and developing a more skeptical attitude is for auditors to become familiar with the types of fraud that might occur. The descriptions included in this chapter are designed to do just that. You should consider discussing these common frauds as part of your brainstorming session.
- A listing of what you may discover during the information-gathering and risk assessment phase of the audit that may indicate the existence of the specified frauds.
- A description of audit procedures that may help you detect material misstatements resulting from those frauds. As indicated in Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), your response to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures. The example procedures in this chapter go beyond the example procedures included in SAS No. 99 (AU sec. 316.53).

For fraud schemes relating to the misappropriation of assets, a listing of supplemental internal control questions helps you and your clients identify control deficiencies 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 chapter, like the entire book, is written for auditors performing an audit in accordance with generally accepted auditing standards (GAAS). When you extend your audit procedures, you should continuously evaluate whether the procedures you perform are part of a GAAS audit or part of a fraud examination consulting engagement.

The material presented in this chapter consists of the author's observations and recommendations. The example audit procedures are not required by SAS No. 99.

Extended Audit Procedures Misappropriation of Assets

Accounts Receivable

Typical Frauds

Most frauds relating to the misappropriation of collections on accounts receivable involve the diversion of payments received from customers. The scheme is fairly simple to perform, for example, an employee opens a 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 this bogus 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 bogus credits to the account*. To conceal the fraud, the employee posts credit memos or other noncash reductions (for example, representing a sales return or the write-off) to the customer account from whom 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.

Finally, 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

Be alert for the following, which may be present when the frauds described here are occurring or have occurred.

- Unexplained differences noted by customers on their accounts receivable confirmations.
- Significant delays between the time when the customer states a payment was made and the 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.

Example Audit Procedures

The following audit procedures will 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 these procedures are already being performed, consider expanding their extent, for example, 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.
- 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 transaction.
- 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.

Expanding Your Internal Control Questionnaire

Your internal control questionnaire may have questions aimed at identifying the client's vulnerability to the misappropriation of accounts receivable. Make sure the person completing the questionnaire understands the implication of these questions. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud. As a client service matter, however, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud.

**Internal Control Questions
Related to Fraud**

Accounts Receivable

	<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?	_____	_____

Extended Audit Procedures Misappropriation of Assets

Inventory

Typical Frauds

One of the more common inventory frauds is the theft of inventory for personal use. This is more 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 right 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 will 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 good inventory as scrap.

What to Look For

Be alert for the following, which may be present when the frauds described here 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 (that is, showing goods were shipped from the company) without corresponding sales documentation.

Example Audit Procedures

The following audit procedures will help detect the frauds described here. 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 these procedures are already being performed, consider expanding their extent, for example, 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 further 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 make surprise counts of items received into inventory.

Expanding Your Internal Control Questionnaire

Your internal control questionnaire may have questions aimed at identifying your client's vulnerability to the misappropriation of inventory. Make sure that the person completing the questionnaire understands the implication of these questions. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud. As a client service matter, however, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud.

**Internal Control Questions
Related to Fraud**

Inventory

	<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 persons responsible for inventory recordkeeping 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 a proper segregation of duties between those with the authority to sell scrap and those with the responsibility for doing so?	_____	_____

Extended Audit Procedures Misappropriation of Assets

Purchasing and Payroll

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 entered into company records as a legitimate vendor. The embezzler then produces invoices for the fake vendor, which get processed by the accounts payable system. Sometimes the embezzler is responsible for authorizing payment; other times not. The scheme may also require collusion between various people, 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.

What to Look For

Be alert for the following, which may be present when the frauds described here are occurring or have occurred.

- Fictitious vendors
 - Photocopied invoices or invoices have obviously been tampered with (for example, sections have been “whited out” and typed over).
 - Invoice numbers from the same vendor occur in an unbroken consecutive sequence.
 - Invoices from companies have a P.O. box address or no phone number.
 - Invoices from companies have 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 have the same address and phone number.
 - Vendor names appear to be a “knock-off” of 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 is low.
 - Tips or complaints are received from other employees or honest vendors.
 - Key contracts are awarded with no formal bid process.
- 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 will help detect the frauds described in the previous list. 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 these procedures are already being performed, consider expanding their extent, for example 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.
- 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.
- 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.

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 may have questions aimed at identifying your client's vulnerability to the misappropriation of assets in the purchasing and payroll functions. Make sure that the person completing the questionnaire understands the implication of these questions. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud. As a client service matter, however, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud.

Internal Control Questions Related to Fraud

Purchasing and Payroll

	<i>Yes</i>	<i>No</i>
1. Is there adequate segregation of duties between purchasing, receiving, and the accounts payable function?	_____	_____
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 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? ¹	_____	_____
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 payroll records in a timely fashion?	_____	_____
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?	_____	_____

¹ “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.

Extended Audit Procedures Misappropriation of Assets

Cash

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 (1) withdraw cash directly for their own benefit or (2) pay personal expenses. For example:

- An employee wrote checks payable to cash and posted the debit to various expense accounts. When the bank statement came back with the canceled checks, she simply discarded the ones she had cashed then proceeded to perform the bank reconciliation.
- An employee used company checks to pay personal credit card bills. Each month, he had a credit card bill approximately equal to the company's required payroll tax withholding. Instead of making the payroll tax deposit, he wrote a check to the credit card company. He discarded these checks when they were returned with the bank statements. He also discarded the notices received from the IRS stating that the company's payroll withholding deposits had not been made.

There are infinite variations on 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 for avoiding 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. In that way, 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 will increase the tip on a credit card receipt.

What to Look For

Be alert for the following, which may be present when the frauds described above are occurring or have occurred:

- Large, unexplained reconciling items in the bank reconciliations.
- 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.

Example Audit Procedures

The following audit procedures will 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 these procedures are already being performed, consider expanding their extent, for example by selecting more items.

- Examination of 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 or to employees. Compare endorsement to payee. Make sure all canceled checks are accounted for.
- Obtain a bank cut-off statement. Cut-off statements are ordered from the bank and delivered directly to the auditor who reconciles them.
- 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.
- 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.

Expanding Your Internal Control Questionnaire

Your internal control questionnaire may have questions aimed at identifying your client's vulnerability to the misappropriation of cash. Make sure that the person completing the questionnaire understands the implication of these questions. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud. As a client service matter, however, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud.

Internal Control Questions Related to Fraud

Cash

	<i>Yes</i>	<i>No</i>
1. Are all bank accounts reconciled on a timely basis?	_____	_____
2. Is the person who reconciles the bank accounts different from the person responsible for cash disbursements?	_____	_____
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 other control procedure?	_____	_____
9. If company employees process a significant amount of cash transactions, does the company adequately control and monitor these transactions?	_____	_____

Extended Audit Procedures Misappropriation of Assets

Computer Schemes

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 without adequate logical access control (which is not uncommon 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 bogus file maintenance transactions.* File maintenance activities include such transactions as changing a customer's address or adding a new employee to the payroll. Bogus 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 remove that employee from the payroll records. A failure to do this 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:

- *Bogus instructions.* A computer programmer may place bogus instructions into a computer program so 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 fraud schemes listed here. In addition to the items listed elsewhere, be alert for the following, which may be present when the frauds described here 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 because of:

- *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.* Many off-the-shelf computer programs contain logical access controls, such as password protection. Unfortunately, entities often fail to install these controls or 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). Again, 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 *Auditing in Common Computer Environments*, an Auditing Procedures Study published by the AICPA.

Example Audit Procedures

The following audit procedures will 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 these procedures are already being performed, consider expanding their extent, for example 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 may have questions aimed at identifying your client's vulnerability to computer fraud. Make sure that the person completing the questionnaire understands the implication of these questions. "No" responses may not change your control risk assessment or your assessment of the risk of material misstatement due to fraud. As a client service matter, however, you should consider discussing these items with your client and explaining how the lack of certain controls leaves the company exposed to fraud.

Internal Control Questions Related to Fraud

Computer Schemes

	<i>Yes</i>	<i>No</i>
1. Is there a 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 a 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 databases?	_____	_____
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 it?	_____	_____

Extended Audit Procedures Fraudulent Financial Reporting

Inventory

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 that were not checked by the auditors.
- Entering inventory count tags for nonexistent 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.

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

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.
- Lack of control over the population of used count tags.
- Slow inventory turnover; increases in certain types of inventory or in branches or other locations not examined by auditors.
- Inability to produce vendor invoices supporting purchases (for example, invoices unavailable while performing price test work).
- 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 and not 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, will help detect the frauds described here. 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.

- Account for all inventory tags used during the physical count.
- Expand the number of test counts.
- Rigorously 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 review procedures of gross profit; analyze according to location or inventory type.
- Perform analytical review procedures of inventory balances and purchases; analyze according to location or inventory type.

Extended Audit Procedures Fraudulent Financial Reporting

Overvalued Assets

Typical Frauds

Overvaluing assets is a relatively simple way to directly manipulate reported earnings because overstated assets usually result in understated expenses. Common schemes for reporting overvalued assets include:

- Improper capitalization of costs that should have been expensed.
- Failure to recognize impairment losses on long-lived assets.
- Recognition of fictitious assets, for example, through the use of related-party transactions, the manipulation of intercompany accounts, or the failure to write off expired assets.
- Recognition of assets that the company does not have title to.
- Unreasonable or unsupported asset valuation allowances.
- Unreasonable or unsupported estimates of fair value, for assets required to be reported at fair value.
- Improper classification of marketable securities such as trading, available-for-sale, or held-to-maturity.
- Manipulation of depreciation expense, for example through unreasonable assumptions about the useful lives of assets or their residual values.

What to Look For

Be alert for the following, which may be present when the frauds described above are occurring or have occurred.

- Unusually high fixed-asset balances, when compared to total assets or to comparable entities.
- Unrealistically large changes in asset balances.
- Unusual or unexplained relationship between depreciation expense and fixed asset balances.
- Events or changes in circumstances that indicate assets may have been impaired.
- Missing documents related to asset transactions.
- Journal entries affecting the reported amount of assets, particularly entries made near the end of the reporting period or those that are unsupported or unauthorized.
- Unusual discrepancies between the entity's asset-related records and the general ledger.

Example Audit Procedures

Auditors have an advantage when auditing for overvalued assets because they direct their audit procedures toward *an amount the entity has already recorded*. This is much easier than trying to detect transactions or amounts that the entity has *not* recorded, such as unrecorded liabilities. In addition to your normal procedures to address the assertions related to assets, you also might consider performing the following:

- Extending the scope of detailed audit procedures related to the acquisition of fixed assets, such as the examination of supporting documents.
- Physical observation of fixed assets.
- Confirm the terms of significant fixed asset additions with the counterparty to the transaction.
- Confirm that the entity has title to reported assets through a review of relevant legal documents or public records.

Extended Audit Procedures Fraudulent Financial Reporting

Underreported Liabilities

Typical Frauds

The fraudulent underreporting liabilities can have a direct positive effect on an entity's financial position and its reported earnings. Common schemes to underreport liabilities include the following:

- Understating accounts payable, for example, by recording purchases in subsequent accounting periods, overstating purchase returns, or falsifying documents that make it appear liabilities have been paid off.
- Recognizing unearned revenue as earned revenue.
- Failure to record all debt or other liabilities.
- Failure to recognize contingent liabilities.
- Underreporting future obligations, such as warranty costs.

What to Look For

Be alert for the following, which may indicate that one of the frauds mentioned above is occurring or has occurred.

- Unusual or unexplained trends in accounts payable balances or differences between the entity's payables balances and those of comparable entities.
- Evidence of contingent liabilities in attorney's letter responses, correspondence from regulatory agencies or others, or other information gathered during the engagement.
- Significant purchases of assets with no recorded debt.
- Unusual or unexplained relationships between interest expense and recorded liabilities.
- Unexplained significant decreases in liabilities.
- Unusual relationship between the trend in the accrual for estimated warranty expense and sales.
- Receiving reports received near the end of the reporting period without a corresponding invoice.
- Amounts listed on vendor's statements that were not reported as purchases.
- Discrepancies in debt confirmations.
- Obligations reported as being discussed by management in the entity's minutes, but not reported in the accounting records.

Example Audit Procedures

In addition to the audit procedures typically performed related to liabilities, you might also consider the following:

- Perform lien searches on entity properties to search for unrecorded debt.
- Confirm the existence and terms of liabilities, including payables, with third parties.
- Read internal correspondence and correspondence between the entity and third parties to identify the existence or possible underreporting of liabilities.

CHAPTER 8: COMPUTER ASSISTED AUDIT TECHNIQUES

For many years, fraud experts have recognized that computer assisted audit techniques (CAATs) can be a powerful tool to help detect indicators of fraud. CAATs provide you with the ability to apply audit techniques that would be either impossible to perform manually or very inefficient or ineffective if applied manually. The purpose of using CAATs, as with performing manual procedures, is the identification of the signs of possible material misstatements due to fraud. CAATs are a perfect opportunity to use computerized procedures to make the audit more effective and efficient. In general, CAATs allow you to:

- Identify patterns in the data that may indicate fraud
- Quickly examine large volumes of information

For the purposes of helping you identify or respond to the risks of material misstatement due to fraud, the most popular CAATs involve the use of data extraction software.

Data Extraction Software

Data extraction software is used to read, analyze, and manipulate client data that is stored electronically. After telling the software how the client's data is organized (the file record layout), you can manipulate that data in a variety of ways, including:

- Sort data into different categories, including numeric, date (for example, aging analysis), or other nonfinancial criteria (for example, sales by region, product, or salesperson)
- Join and match files, for example, matching the vendors paid per the accounts payable master file against the approved vendor file as a way to determine if any payments were made to unapproved vendors.
- Select individual items that meet specified criteria for additional test work. Criteria may be financial (all invoices over a certain dollar amount) or nonfinancial (all payments made to a certain vendor).
- Perform analytical procedures.

Sample Uses of CAATs to Identify Material Misstatements Caused by Fraud

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and this Practice Aid describe numerous example procedures that will help you identify or respond to the risks of material misstatement due to fraud. In this section, we summarize those tests that may be performed using CAATs.

Fraudulent Financial Reporting

General Ledger Analysis

- Identify journal entries that meet certain criteria and require additional test work, for example:
 - Nonstandard entries.
 - Journal entries that exceed a specified dollar amount or occurred during a particular time.
 - Entries made by individuals who typically do not make journal entries.
 - Journal entries with no explanation, description, or account numbers.

Revenue Recognition

- Match recorded sales to customer database. Identify sales to customers not listed in the database, which may indicate sales made to nonexistent customers.
- Match recorded sales to electronic shipping records and/or customer purchase orders. Unmatched sales may indicate sales that were recorded before shipment or without being ordered.
- Search sales records for duplicate invoices, which may indicate duplicate billing as a way to increase reported sales.
- Search recorded sales for sales to related parties.
- Search sales records for entries made directly via journal entries or other unusual sources.
- Search sales and shipping records and identify sales that meet certain criteria (for example, over a certain dollar amount or those made to a certain customer or shipped after a certain date) for additional test work.
- Analyze revenue using disaggregated data. For example, compare revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods or budgeted amounts.

Inventory

- Search inventory records for entries made directly via journal entries or other unusual sources.
- Analyze increases in inventory or inventory turnover at locations not visited by auditors.
- Analyze gross profit using disaggregated data, such as individual products or location.
- Compare inventory quantities for the current period with prior period or perpetual records. Use disaggregated data, such as category of inventory, location, or other criteria.
- Search inventory records for unusual entries or adjustments, such as negative entries for inventory received.
- Sort physical inventory records by:
 - Tag number, to test tag control, or
 - Item serial number to test the possibility of item omission or duplication.

Misappropriation of Assets

Cash

- Analyze expense account activity at a disaggregated level. Compare current-year activity to prior-year activity. Look for patterns that may indicate someone is debiting expense accounts as a way to conceal a defalcation.
- Analyze sales returns by employee or compare current period to prior period.
- Sort disbursements by check number and look for missing or duplicate check numbers.

Accounts Receivable

- Search accounts receivable records and identify credit entries and other adjustments or credit balances.
- Match accounts receivable aging to invoice and shipping files. Look for mismatched dates that may indicate incorrect aging.
- Analyze credit memos at a disaggregated level, for example, by customer, sales person, or product. Look for unusual patterns or trends, such as a large number of credits issued for the customers of a particular salesperson.

Accounts Payable and Payroll

- Search accounts payable and vendor files for indications of fictitious vendors, including:
 - Vendor invoices from the same vendor that occur in an unbroken consecutive sequence.
 - Vendors with only a P.O. box address and/or no phone number.
 - Different vendors that have the same address and phone numbers.
 - Vendor names that are very similar to the names of approved vendors, for example, ABC Enterprises instead of The ABC Company.
- Match accounts payable and vendor file with employee data. Look for vendors with the same address or phone number as an employee, as this could indicate a fictitious vendor.
- Analyze payment details and look for prices from a particular vendor that are unreasonably high when compared to the prices for the same or a similar product from a different vendor. This unusual relationship may indicate a kickback scheme.
- Sort payments by amount and identify transactions that fall just under control limits established by the entity.
- Search payroll records for indications of a “ghost employee,” for example:
 - Employees with duplicate addresses, checking accounts, or Social Security numbers.
 - Employees with no withholding taxes, insurance, or other normal deductions.

Benford's Law

Benford's law was developed by Frank Benford, a research engineer for GE during the first half of the 20th century. Benford's law predicts the occurrence of digits in data, and it concludes that the first digit in a large population will be a 1 about 30 percent of the time. Less frequently the digit will be a 2, even less frequently a 3, and so on. A 9 will be a first digit only 5 percent of the time.

Not all populations will have distributions according to Benford's law. For example, suppose that it costs an entity a minimum of \$5.50 to ship all products that weigh less than two pounds and that most products shipped weigh less than two pounds. In this circumstance, the digit 5 will probably occur more frequently than predicted by Benford's law.

To use Benford's law to help identify risks of material misstatement caused by fraud, you should make sure that the population has the following characteristics:

- No minimum or maximum values
- No price break points (for example, \$5.50 to ship all products less than two pounds)
- No assigned numbers (for example, Social Security numbers)

Fraud specialists can use Benford's law to identify indicators of possible frauds. When populations of data are analyzed and the distribution of digits does not follow Benford's law, that may indicate the data has been manipulated or fraudulently prepared. For example, an auditor might analyze disbursements from the accounts payable files or debit entries to expense accounts and compare the digit frequency to Benford's law. Discrepancies between actual and predicted occurrence of digits may indicate fraudulent transactions.

Audit Considerations When Using CAATs

When determining whether and how to use CAATs on your audit, the factors to consider include the following:

- *Audit objective.* To determine whether CAATs are appropriate for your engagement, you first should consider the objective of the tests you want to perform and whether these tests are: (1) possible and (2) most efficient if performed by computer. Making this determination will require you to have a good understanding of the capabilities of the data extraction or analysis software. You also will have to work closely with the client to determine the timing and availability of all the necessary data files.
- *Auditor's knowledge, expertise, and experience.* You should evaluate your own ability to perform any CAATs. You or your team should have a thorough understanding of the basics of data processing, as well as a working knowledge of the data extraction software. If you do not possess that information in-house, some companies can provide it to you on an outsource

basis. For example, you can provide your client's data files and other information to a third party, who will perform the data extraction and analysis for you.

- *Reliability of the entity's information technology (IT) system.* The entity's IT system must be able to generate reliable information. If past client history indicates that the accounting system is less than reliable and requires many adjustments to generate financial information, the use of CAATs may not be efficient or effective.
- *Completeness and accuracy of data received from the client.* It is imperative that you review the data files you receive from the client *before* you perform any analysis, extraction, or other test. Make sure that you obtain information from the client that will allow you to verify the completeness and accuracy of the information received. For example, you might want to obtain a record count or a total of key information. It also helps to obtain a printout of the first and last 100 or so records so you can compare these to the electronic information you received. The file that you use to perform your tests must be a complete and accurate copy of the client's financial information, otherwise the results of the tests you perform will not be valid.
- *Postprocessing review.* After you have completed your procedures, you should review the results for possible indications that the files were not read or processed properly. For example, an unusual number of exceptions or the absence of items that should have been identified for follow-up, may indicate that the processing was performed incorrectly.

Additional Resources

Data Extraction Software and Processing

- Interactive Data Extraction & Analysis (IDEA). One of the leading data extraction software packages. www.caseware.com or www.audimation.com.
- ACL. One of the leading data extraction software packages. www.acl.com.
- AuditWatch. Provides training on both IDEA and ACL. Also provides outsourced data extraction services for auditors. www.auditwatch.com.
- PPC Guide to Data Extraction Software. www.ppcnet.com.

Use of CAATs to Identify or Respond to Risks of Fraud

- Audit Tools. Products, services, training and links to information about the use of CAATs. www.audittools.com.
- Colorado Accountants. Information and links to other sites on general use of CAATs. www.coloradoaccountants.com/Systems/dataextract.htm.
- Investigating by Computer. A self-study, CD-ROM-based course available from the Association of Certified Fraud Examiners. www.cfenet.com.

- Publications from Global Audit Publications, an independent division of ACL:
 - *Fraud Detection: Using Data Analysis Techniques to Detect Fraud*, by David Coderre.
 - *Fraud Toolkit for ACL* by David Coderre.
 - *Digital Analysis Using Benford's Law: Tests & Statistics for Auditors*, by Mark Nigrini.
 - *CAATs & Other BEASTs for Auditors*, by David Coderre.
- Mark Nigrini, "I've Got Your Number," *Journal of Accountancy* (May 1999). A discussion of Benford's law and how auditors might use it.

EPILOGUE: LOOKING AHEAD

As I've worked on this book, I've come to believe that Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), has the potential to significantly advance the profession—to help us do our jobs more effectively, to audit smarter. It is a standard that reaches into all areas of the audit process and it moves us in a different direction, away from the “checklist mentality” and into more of a thinking person’s audit. It puts professional skepticism front and center and forces us to examine the *psychology* that we bring to our engagements. Depending on how the standard is implemented, it has the potential to be a watershed for how we think about and perform our engagements.

As an auditor, I would like to see the development of the following initiatives, which would continue what the issuance of SAS No. 99 has only just begun.

- *Professional skepticism.* If this is the cornerstone of auditing, more work needs to be done to understand the psychology of auditing, the assumptions and biases that are part of our current mindset, and how auditors can learn to develop and deploy an appropriate level of skepticism on their engagements.
- *More effective inquiries.* Auditors gather a great deal of information through inquiry; it is one of our primary auditing procedures. And yet, for all its importance, most auditors are never trained in how to conduct an effective inquiry. This weakness in our collective skills reduces the effectiveness of our audit procedures. For example, for years, observers of the profession have called for the application of more effective analytical procedures. Remedies invariably focus on how to perform a better analysis. That is not the problem—CPAs have analytical skills in spades. The problem with the performance of analytical procedures is that auditors have never been trained to ask the right questions and to structure their inquiries in a way that gathers the information they need to conduct an effective analysis. The same phenomenon occurs whenever inquiries are a significant part of the information gathering process, for example, understanding internal control, or the client’s business, or auditing estimates. SAS No. 99 places even more emphasis on inquiries as an effective audit procedure. To more effectively implement SAS No. 99 and to improve the effectiveness of existing standards, additional guidance on conducting inquiries is needed.
- *Analysis vs. synthesis.* Analysis involves the *breaking apart* of an item into its component parts and then examining those parts to see how they’re related. Synthesis is the opposite. Synthesis is the *combining* of elements to create a new, complex whole.

As auditors, we are trained in (and some would argue, genetically predisposed toward) analysis. SAS No. 99 reminds us that effective auditing also involves synthesis, taking a wide variety of information and forming it into a coherent statement of where and how fraud is most likely to occur at the entity.

What is the process for synthesizing information and how does this process differ from analysis? How can auditors improve their ability to synthesize information? Audit effectiveness would be improved if we as a profession could begin to explore and discuss these questions.

- *Skills training.* SAS No. 99 introduces new procedures that require skills that, by and large, receive little if any formal training. Client inquiry and the ability to synthesize information are just two of these skills. The brainstorming requirement of SAS No. 99 calls for facilitation skills and a large dose of intuitive, nonlinear thinking. All of these skills will directly benefit the entire profession, not just auditors performing a generally accepted auditing standards audit. Work should be done to identify these skills and develop effective diffusion strategies so they can be adopted by the profession and those about to enter it. Do auditors need formal training on fraud detection and investigation matters? Will more formal training on fraud matters help us to better serve the public interest? Those questions should be addressed.
- *Make fraud expertise available to smaller firms.* With a renewed emphasis on detecting material misstatements caused by fraud, it is plausible that many auditors will need to use a fraud specialist on their engagements in the same way they use other specialists (for example, technology specialists or those with expertise in valuing particular assets). Many of the larger CPA firms have fraud specialists on staff to help with auditors performing a GAAS audit. But what about firms who do *not* have these resources? Somehow, fraud expertise must be made available to firms that do not possess it in-house or do not have the resources to acquire it. For example, strategic alliances between CPA firms performing GAAS audits and firms that specialize in fraud could be formed. Even a database of firms that provide fraud investigation and detection services would be a major help to GAAS auditors who need this type of expertise.

All future initiatives in this area should be developed in the same type of environment present during the writing of SAS No. 99. That environment was relatively apolitical and devoid of marketing, public relations, or other extraneous needs creating artificial pressures and arbitrary deadlines. The result was a standard that demonstrates an ongoing commitment to improving the profession, a commitment that existed long before it became a political imperative, and one that will continue long after the current situation facing the profession passes.

APPENDIX A: INDUSTRY-SPECIFIC CONDITIONS THAT MAY INDICATE THE PRESENCE OF FRAUD

Introduction

During the planning and performance of an audit, you may identify information that indicates the presence of one of the three conditions of the fraud triangle (incentive/pressure, opportunity, and attitude/rationalization). These conditions or events are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often have been present in circumstances where fraud exists.

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides fraud risk factor examples that have been written to apply to most enterprises. The purpose of this Appendix is to provide examples of industry-specific fraud risk factors and other conditions that may indicate the presence of a material misstatement due to fraud. Remember that fraud risk factors are only one of several sources of information you consider when identifying and assessing risk of material misstatement due to fraud.

Contents of the Appendix

The industry-specific fraud risk factors that follow include interpretations of some of the SAS No. 99 example risk factors tailored to particular industries. Each section should be used to supplement, but not replace, the example risk factors included in SAS No. 99.

One of the key changes to audit practice that SAS No. 99 sought to impose was a better linking of auditor response to identified fraud risk factors. To help you develop more effective audit programs, the following sections also contain example audit procedures you may perform in response to specifically identified risks.

Additional Resources

You may be interested in fraud risk factors and possible audit responses for specialized industries that are not listed here. *The CPA's Handbook of Fraud and Commercial Crime Prevention*, published by and available through the AICPA, is an excellent source for this information. Specialized industries included in Appendix A to that handbook that are not included in this Practice Aid include:

- Construction contractors
- High technology

- Manufacturing
- Media and communications
- Professional services
- Recreation
- Natural resources
- Retail
- Transportation
- Wholesale

Banks, Savings Institutions, and Credit Unions

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each type of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

The following are examples of risk factors that might result in misstatements arising from fraudulent financial reporting.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High degree of competition or market saturation, accompanied by narrowing margins.
 - (1) An increase of competitor investment products that are close alternatives for the institution's deposit products (for example, mutual funds, insurance annuities, and mortgage loans), placing pressure on the institution's deposit rates.
 - (2) Competitor product pricing that results in loss of customers or market share for such products as loan, deposit, trust, asset management, and brokerage offerings.
 - b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - (1) A failure or inability to keep pace with or to afford rapid changes in technology, if the financial stability or profitability of the particular institution is placed at risk due to that failure or inability.
 - (2) Significant unexpected volatility (for example, in interest rates, foreign exchange rates, and commodity prices) in financial markets where the institution has a

significant capital market presence and is exposed to loss of revenue or has not appropriately hedged its risk to price changes that effect proprietary positions.

- c. Significant declines in customer demand and increasing business failures in either the industry or overall economy.
 - (1) Deteriorating economic conditions (for example, declining corporate earnings, adverse exchange movements, and real estate prices) within industries or geographic regions where the institution has significant credit concentrations.
 - (2) 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 on gaining new members and offering commercial loans.
 - d. Rapid growth or unusual profitability, especially compared to that of other peer financial institutions.
 - (1) Unusually large growth in the loan portfolio without a commensurate increase in the size of the allowance for loan and lease losses.
 - e. New and existing accounting, statutory, or regulatory requirements.
 - (1) Substantially weak CAMELS, (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk) or, for bank-holding companies, BOPEC (bank's CAMELS rating, operation of significant nonbanking subsidiaries, parent's strength and operations, earnings of the banking organization, and capital of the banking organization) ratings.
 - (2) Regulatory capital requirements.
 - f. Decline in asset quality due to:
 - (1) Borrowers affected by recessionary declines and layoffs.
 - (2) Issuers affected by recessionary declines and industry factors.
2. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including incentive goals.
- a. Unrealistically aggressive loan goals and lucrative incentive programs for loan originations.
 - (1) Relaxation of credit standards.
 - (2) Excessive extension of credit standards with approved deviation from policy.
 - (3) Excessive concentration of lending (particularly new lending).
 - (4) Excessive lending in new products.
 - (5) Excessive pricing concessions not linked to enhanced collateral positions or other business rational (for example, sales of other products or services).

- b. Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations.
 - (1) Acquisition of another institution has been announced in the press with the terms dependent on the future financial results of the acquiring institution.
 - c. Willingness by management to respond to these pressures by pursuing business opportunities for which the institution does not possess the needed expertise.
 - d. Excessive reliance on wholesale funding (brokered deposits).
 - e. Speculative use of derivatives.
 - f. Failure to establish economic hedges against key risks (for example, interest rate) through effective asset liability committee (ALCO) processes.
 - g. Changes in a bank's loan loss accounting methodology that are not accompanied by observed changes in credit administration practices or credit conditions.
 - h. Frequent or unusual exceptions to credit policy.
 - i. Threat of a downgrade in the institution's overall regulatory rating (for example, CAMEL, MACRO, or BOPEC) that could preclude expansion or growth plans.
 - j. Threat of failing to meet minimum capital adequacy requirements that could cause adverse regulatory actions.
3. Management's or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:
- a. Heavy concentrations of their personal net worth in the entity.
 - b. Bank is privately owned by one person or family whose net worth or income (from dividends) is dependent on the bank.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
- a. Significant related entity transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
 - (1) Loans and other transactions with directors, officers, significant shareholders, affiliates, and other related parties, particularly those involving favorable terms.
 - (2) Be aware of special purpose entities, subprime, and predetorial lending by banks in an effort to obtain better yields.
 - (3) Transfers of impaired assets.
 - b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.

- (1) Significant estimates generally include the allowance for loan losses, and the valuation of servicing rights, residual interests, and deferred tax assets, fair value determinations, and the recognition of other impairment losses (for example, goodwill and investments).
 - c. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult “substance over form” questions.
 - (1) Could include consolidation questions with special purpose entities (SPEs).
 - (2) The institution has material amounts of complex financial instruments and derivatives that are difficult to value, or the institution uses complex collateral disposition schemes.
 - d. Frequent or unusual adjustments to the allowance for loan and lease losses.
 - e. Loan sales that result in retained beneficial interests. Valuation of retained beneficial interests is based on estimates and assumptions and are susceptible to manipulation if not properly controlled.
 - f. Complex transactions that result in income or gains, such as sale and leasebacks, with arbitrarily short leaseback terms.
 - g. Deferred tax assets, arising from net operating loss carryforwards, without valuation allowances.
 - h. Deferral of loan origination costs that exceed the appropriate costs that may be deferred under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.
2. Internal control components are deficient as a result of the following:
- a. Inadequate monitoring of controls, including automated controls and controls over financial reporting, such as lack of oversight of critical processes in the following areas:
 - (1) Cash and correspondent banks—reconciliation and review.
 - (2) Intercompany or interbranch cash or suspense accounts and “internal” demand deposit account—monitoring of activity and resolution of aged items.
 - (3) Lending—lack of credit committee.
 - (4) Treasury—securities/derivatives valuation (selection of models, methodologies, and assumptions).
 - (5) Regulatory compliance—lack of knowledge of pertinent regulation.
 - (6) Deposits—lack of monitoring unusual and significant activity.
 - b. Ineffective internal audit function.
 - c. Lack of board-approved credit (underwriting and administration) or investment policies.

- d. Vacant staff positions remain unfilled for extended periods, thereby preventing proper segregation of duties.
- e. Lack of appropriate system of authorization and approval of transactions in areas such as lending and investment, where policies and procedures for authorization of transactions are not established at the appropriate level.
- f. Lack of independent processes for establishment and review of allowance for loan losses.
- g. Lack of independent processes for evaluation of other than temporary impairments.
- h. Inadequate controls over transaction recording including setup of loans on systems.
- i. Lack of controls over perfection of interests in lending collateral.
- j. Inadequate methods of identifying and communicating exceptions and variances from planned performance.
- k. Inadequate accounting reconciliation policies and practices, including appropriate supervisory review, monitoring of stale items and out of balance conditions, and timeliness of write-offs.
- l. Failure to establish adequate segregation of duties between approval transactions and disbursement of funds.
- m. Lack of control over the regulatory reporting process, where key decision makers also have control over the process.
- n. Lack of adequate reporting to the board of directors and executive management regarding credit, interest-rate, liquidity, and market risks.
- o. Change from an internal audit function that has been outsourced to the external auditor or other provider to a new in-house internal audit department or another outsourcing provider.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- 1. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations.
 - a. Existence of a regulatory cease and desist order, memorandum of understanding, or other regulatory agreements (whether formal or informal), which concern management competence or internal control.
 - b. Repeat criticisms or apparent violations cited in regulatory examination reports, which management has ignored.

2. Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
 - a. Consideration of "business issues" (for example, shareholder expectations) in determining significant estimates.
 - b. Adjustments to the allowance for loan losses by senior management or the board for which there is no written documentation.
 - c. Unusual propensity to enter into complex asset disposition agreements.
3. Control-related recommendations from internal and/or external auditors are ignored.
4. High level of customer complaints (especially when management does not fix the cause of them promptly).
5. Internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment.
6. Internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent).
7. The scope of internal audit's activities is not appropriate (for example, balance between financial and operational audits, coverage, and rotation of decentralized operations).
8. Internal audit has limited authority to examine all aspects of the client's operations or fails to exercise its authority.
9. Internal audit does not adequately plan, perform risk assessments, or document the work performed or conclusions reached.
10. Internal audit does not adhere to professional standards.
11. Internal audit has operating responsibilities.
12. Inability to prepare accurate and timely financial reports, including interim reports.
13. Planning and reporting systems (such as business planning; budgeting, forecasting, and profit planning; and responsibility accounting) that do not adequately set forth management's plans and the results of actual performance.
14. A low level of user satisfaction with information systems processing, including reliability and timeliness of reports.
15. Understaffed accounting or information technology department, inexperienced or ineffective accounting or information technology personnel, or high turnover.
16. Lack of timely and appropriate documentation for transactions.
17. Management or ownership frequently requires dividends at or near the maximum allowable by law. In closely held companies, executive management/ownership combines high dividends with frequently substantial increases in cash salary or bonus compensation. The bank has been cited for dividend violations by regulatory authorities.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Incentives/Pressures

SAS No. 99 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 or she should consider it in addressing the risk of material misstatement arising from misappropriation of assets.

1. Adverse relationships between the institution and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, the following may create adverse relationships:
 - a. It is likely that the institution will be merged into or acquired by another institution and there is uncertainty regarding the employees' future employment opportunities.
 - b. The institution has recently completed a merger or acquisition, employees are working long hours on integration projects, and morale is low.
 - c. The institution is under regulatory scrutiny and there is uncertainty surrounding the future of the institution.
2. Members of executive management evidence personal financial distress through indications such as frequent informal "loans" or "salary advances" to key executive officers or their family members.

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Large amounts of cash on hand and wire transfer capabilities.
 - b. Easily convertible assets, such as bearer bonds or diamonds, that may be in safekeeping.
 - c. Inadequate or ineffective physical security controls, for example, overliquid assets or information systems.
 - d. Access to customer accounts.

2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate management oversight of employees responsible for assets.
 - (1) Vacant branch manager positions or manager away on leave without replacement for an inordinate amount of time, causing a considerable lack of management oversight.
 - (2) The independent risk management function does not have the appropriate level of sophistication or the capability to effectively monitor and measure the risks, such as capital markets trading activities.

 - b. Inadequate job applicant screening and/or monitoring of employees:
 - (1) Federal Bureau of Investigation background checks, credit reports, and bonding eligibility screening are not incorporated into the hiring process for employees with access to significant assets susceptible to misappropriation.
 - (2) A monitoring process does not identify employees with access to assets susceptible to misappropriation who are known to have financial difficulties.

 - c. Inadequate segregation of duties and independent checks:
 - (1) Lack of independent monitoring of activity in internal demand deposit accounts and correspondent bank accounts.
 - (2) No independent monitoring and resolution of customer exceptions/inquiries related to electronic-funds-transfer (EFT) transactions, loan disbursements/payments, customer deposit accounts, securities/derivatives transactions, and trust/fiduciary accounts.
 - (3) Lack of key periodic independent reconciliations (in addition to reconciliations of subledgers to the general ledger) for wire transfer, Treasury, trust, suspense accounts, automated teller machines, and cash.
 - (4) Lack of segregation of duties in the following areas:
 - EFT—origination, processing, confirmation, and recordkeeping.
 - Lending—relationship management, underwriting (including approval), processing, cash collection/disbursement, and recordkeeping. No periodic confirmation of

- customer loan information or indebtedness by personnel independent of the relationship officer.
 - Treasury—trading, processing, settlement, and recordkeeping. The derivatives 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. There is no independent confirmation of individual trades.
 - Trust—relationship management, transaction authorization, transaction execution, settlement, custody, and account recordkeeping. There is 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.
 - Fiduciary—issuance, registration, transfer, cancellation, and recordkeeping.
 - Charged-off loan accounts and recoveries.
 - Dormant and inactive demand deposit accounts (DDA) and the escheatment process.
- d. No independent mailing of customer statements.
 - e. Lack of control over new accounts.
 - f. “Due from” bank accounts are not reconciled on a regular basis, and open items are not reviewed.
 - g. Loans are purchased from loan brokers, but the loans are not reunderwritten before purchase.
 - h. The institution is small and has limited staff, which does not allow for adequate segregation of duties.
 - i. There is a lack of appropriate system of authorization and approval of transactions.
 - (1) No verification of EFT initiation and authorization, including those instances when bank employees initiate a transaction on a customer’s behalf.
 - (2) Frequent underwriting exceptions to board-established credit authorization limits.
 - (3) Frequent instances of cash disbursements on loans that have not yet received all approvals or met all preconditions for funding.
 - (4) 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.)
 - j. Poor physical safeguards over cash, investments, customer information, or fixed assets.
 - (1) Lack of adequate physical security over the EFT operations area and customer records.
 - (2) Access to the vault is not appropriately limited to authorized employees acting within the scope of their job.

- (3) Lack of dual control over the vault, negotiable instruments (including travelers' checks and money orders), and blank check stock.
 - (4) Lack of accountability over negotiable instruments.
- k. Inadequate training of tellers and operations personnel regarding:
- (1) "Knowing your customer."
 - (2) Recognizing check fraud and kiting activities.
 - (3) Controls over cash, negotiable instruments, and EFT.

Brokers and Dealers in Securities

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High degree of competition or market saturation, accompanied by declining margins.
 - (1) High-degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities or registered investment companies/mutual funds, accompanied by declining margins.
 - b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - (1) 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.
 - c. Unusually high level of "soft dollar" brokerage activities.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - a. The pressure on management to meet the expectations of analysts and rating agencies.

3. Management or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:
 - a. The structure of incentive plans induces traders to take unusually greater risks.
 - b. There is unusually high level of internal competition for capital allocation among product types/trading desks.
4. Research analysts are not independent. Their compensation is controlled by investment banking or other areas for which the firm receives fees from covered companies.
5. Extensive benefits are provided to money managers that may drive fraudulent behavior. The value of such benefits is included in the commissions generated by customers on trades directed by money managers.
6. There are certain arrangements between the broker who directs the trade and the market maker who executes the trade that are not in the best interest of the customer.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. 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. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.
 - (1) Unusually significant increase in unsettled trades at year end.
 - (2) A high degree of complex accounting standards relating to, for example, financial instruments and off-balance sheet transactions.
2. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of controls, including automated controls and controls over interim financial reporting.
 - (1) A failure by management and the board of directors to set parameters (for example, trading limits, credit limits, and aggregate market risk limits) and to continuously monitor trading activities against those parameters.
 - (2) Lack of sufficient access controls for front-office and back-office systems.
 - (3) Lack of adequate "Chinese Wall" between investment banking and trading (that is, potential for insider trading).
 - (4) Failure to monitor the filling of customer orders from the firm's inventory (for example, front-running and excessive mark-up).

- (5) Lack of review of customer lists and insufficient controls surrounding the customer account approval and maintenance process for both cash and margin accounts.
 - (6) A lack of sufficient controls over the review process of new products, structured finance, and off-balance-sheet transactions.
 - (7) A lack of sufficient controls over the valuation process of less liquid securities, including controls over the changes of valuation pricing and the appropriate segregation of duties.
- b. High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
 - (1) A failure by management to ensure that the brokers are properly trained, appropriately licensed, and adequately supervised.
 - (2) Lack of policies and training over the range of product offerings.
 - (3) 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.
 - c. Ineffective accounting and information systems, including situations involving reportable conditions.
 - (1) Lack of board approval and a specialist's independent evaluation of in-house developed valuation models.
 - d. Use of error accounts to hide trading errors, made to meet commitments to clients, particularly for block trades in meeting a predetermined value-weighted average price (VWAP).
 - e. Use of valuation reserves for other purposes, such as to hide errors or expenses. Assumptions in valuation reserves may be changed without adequate approval.
 - f. Use of customer collateral for firm purposes. Tested by possession or control procedures.
 - g. Use of subsidiaries to manage earnings.
 - h. Transactions accounted for as sales as opposed to financing.
 - i. Use of different valuations of same product in two related companies.
 - j. No provisions to record stock-borrow transactions. Use of the security to cover a theft of customer-related security.
 - k. Poor controls over corporate actions in which the client fails to receive entire benefit.
 - l. Not properly valuing collateral or reflecting the extent of cross-collateralization on rate swaps.
 - m. Weak controls causing a failure to record trades on a timely basis and a lack of proper floor supervision, which may facilitate customers' poor trading activity.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
 - a. Unusually aggressive interpretations of regulatory rules (for example, net capital rules and weekly reserve formula) when the company is reaching minimum net capital required by the Securities and Exchange Commission (SEC).

Auditor Responses

In addition to the sample responses presented in SAS No. 99, an auditor may want to consider the following responses.

- Extend confirmation procedures concerning agreements with counterparties (for example, leases, clearing, custody, margin, and subordinated debt).
- Extend confirmation procedures concerning the terms of selected transactions (for example, swaps, financing transactions, and fails) with counterparties.
- Review the results of valuation testing performed by departments of the company (for example, 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 (for example, stress testing and valuations).
- 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 the SEC rules and regulations.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Large amounts of securities (for example, bearer instruments) held in the company's vault.
 - b. Commingling of customer securities with the entity's securities at a custodian bank.
2. Inadequate internal control over assets may increase the susceptibility to misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate management oversight of employees responsible for assets.
 - (1) Lack of management oversight of extensive retail branches, or overseas branches and subsidiaries.
 - (2) Inadequate supervision of traders' trading practices and limits, especially for those generating a large proportion of the entity's total revenue.
 - b. Inadequate segregation of duties or independent checks.
 - (1) Lack of segregation of duties between the front-office (that is, execution of trades) and the back-office (that is, settlement and accounting for trades).
 - (2) Lack of independent review of periodic reconciliations (for example, settlement accounts, cash accounts, and stock records).
 - (3) Failure to confirm failed transactions on a timely basis.

- (4) Failure to periodically review items in suspense accounts.
 - (5) Failure to review the aging of items, including failed transactions and receivables.
 - (6) Lack of or infrequent independent pricing of inventory performed by middle-office or back-office (that is, risk management and controller's group).
- c. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- (1) Lack of safeguarding and insuring securities in transfer.
 - (2) Lack of sufficient access controls for cash wiring systems.
- d. Lack of timely and appropriate documentation of transactions.
- (1) Lack of documentation related to "soft dollar" brokerage activities.
 - (2) Lack of documentation related to derivative transactions with counter parties, such as ISDA master agreements.
- e. Lack of controls relating to the rehypothecation of securities.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, an auditor may want to consider the following responses.

- Review exception and 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 online fund wiring system terminals.
- Review revenue trend of an individual trader over a period of time.
- Review level of errors and broker chargebacks of commissions.

Employee Benefit Plans

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressure

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. Significant declines in customer demand and increasing business failures exist in either the industry or the economy in which the entity operates.
 - (1) The plan sponsor is in an industry that is declining in stability, which could lead to difficulties in meeting financial commitments to the plan, including contributions and/or debt repayments (leveraged employee stock ownership plan (ESOP)).
 - b. 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.
 - c. Plan sponsor or plan restructuring (for example, layoffs, spin-offs, business combinations, and bankruptcy).
 - d. Severely deteriorating financial condition or the threat of regulatory intervention of the plan.
 - e. The plan has limited investment options or the plan has invested significantly in employer securities or other employer assets (for example, real estate).
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- a. 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.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
 - (1) Indications of significant or unusual parties-in-interest transactions not in the ordinary course of operations.
 - (2) Excessive or unusual transaction or prohibited party in interest transactions with the plan sponsor/administrator.
2. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of controls, including automated controls and controls over interim financial reporting.
 - (1) Failure by management to have adequate valuations performed, including actuarial valuations and valuations of real estate partnerships and other hard-to-value plan assets.
 - (2) The plan administrator lacks an understanding of the major regulations that govern the plans (that is, Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code).
 - b. Unusually high levels of participant complaints and corrections to account balances or plan records.
 - c. Lack of qualified service provider organization or change in service provider.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Management displaying a significant disregard for regulatory authorities.
 - a. Management displaying a significant disregard toward compliance with ERISA and Internal Revenue Code and Department of Labor (DOL) regulations.

- b. The plan administrator or trustees have been investigated by the DOL or IRS for fiduciary violations in operating the plan.
2. 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.
3. 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).
4. Named fiduciary not actively involved in the plan's activities.
5. High level of plan participant complaints.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, 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 adviser (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.
- *Procedures.* Apply the following procedures to fully understand a party in interest transaction:¹
 - 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

¹ See Chapter 11 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for further audit guidance.

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.

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

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate segregation of duties related to benefit payments, contributions, investment transactions, and loans or independent checks.
 - (1) No independent records of the plan are maintained to enable the plan administrator to periodically check the information to the custodian.
 - b. Inadequate management oversight of employees responsible for assets.
 - (1) Lack of review of investment transactions by trustees, sponsors, or investment committees.

- (2) Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan.
- c. Inadequate system of authorization and approval of transactions.
 - (1) Insufficient approval over transactions with parties-in-interest that could lead to prohibited transactions.
- d. Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
 - (1) Trustee does not prepare required supplemental information (for example, historical cost records not maintained).
- e. Lack of controls surrounding benefit payments, including the termination of payments in accordance with plan provisions.
- f. Lack of appropriate segregation of plan assets from the sponsor's assets or inappropriate access to plan assets by plan sponsor.
- g. SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, report indicates a lack of controls at an outside service provider.
- h. Use of service provider that does not provide a SAS No. 70 report.
- i. 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).

Auditor Responses

In addition to the sample responses presented in SAS No. 99, an auditor in an employee benefit plan 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* (AICPA, *Professional Standards*, vol.1, AU sec. 342).
- 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 recordkeeping amounts for a defined contribution plan. If the trustee/custodian

records are higher than the recordkeeping totals (excluding accrual adjustments), an unallocated asset exists that should be allocated to participant accounts. If the trustee/custodian records are lower than the recordkeeping totals (excluding accrual adjustments), plan assets may have been misappropriated requiring further investigation by the auditor (for example, reconciliation of monthly trustee/custodian activity to the recordkeeper).

- 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 the total employee contributions per the payroll register to the recordkeeping 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 auditors 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 cancelled 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.
- Review plan expenses to ensure that the plan is not paying for expenses that the employer should be paying for.

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 on the circumstances.

- A pension plan notifies participants who have reached the age of 70½ 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. The completed forms are provided to a supervisor for approval and submitted to the insurance company (custodian) for payment. For all participants reaching the age of 70½, 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 he would like to receive his 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 of \$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 was made to reimburse the plan that paid the expenses because it is fully funded.
- Continuation of pension benefits to a deceased participant. A participant dies but his relatives or other persons do not report his death in order to continue receiving his pension checks.
- A health and welfare supervisor submits phony claims using the names of the plan participants who have the same last name as he or she does. The checks are diverted to the supervisor before they can be mailed to the plan participant in question.

State and Local Government Entities: Basic Financial Statements

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. New accounting, statutory, or regulatory requirements.
 - (1) Imminent or anticipated adverse changes in program legislation or regulations could impair the financial stability and profitability of the entity.
 - (2) Under Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, some governments' net assets may be in deficit positions, while the fund balances are positive. This may result in significant pressure for management to misstate financial statements.
 - b. Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates.
 - (1) Major taxpayers in declining industries or tenuous financial condition.
 - (2) Declining property values or tax base or other restrictions on revenue recognition or realization.
 - (3) A stagnant tax base or revenue base, declining enrollments, or declining demand or use.

- c. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - (1) Rapid changes in major taxpayers' industries, such as significant technology changes, customer bases, or product obsolescence.
 - (2) Decreases in interest rates when the government owns significant amounts of investments that are highly sensitive to interest rate changes.
- 2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - a. Substantial political pressure on management creating an undue concern about reporting positive financial accomplishments.
 - b. Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures.
 - (1) 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.
 - c. Marginal ability to meet debt repayment or other debt covenant requirements.
 - (1) 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.
 - d. 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.
 - e. Perceived or real adverse effects of reporting poor financial results on significant pending transactions.
 - f. Significant investments in high risk financial instruments or high risk ventures.
 - g. An individual or individuals with no apparent executive position(s) with the entity apparently exercising substantial influence over its affairs or over individual departments or funds (for example, a major political donor or fundraiser, or major employer in the community).
 - h. A motivation for management to engage in fraudulent financial reporting.
 - (1) Substantial political pressure on management creates an undue concern about federal program accomplishments.
- 3. Management or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:
 - a. Significant portions of their compensation (for example, bonuses, stock options, or other incentives), being contingent upon achieving aggressive targets for operating results, financial position, or cash flow.

- (1) A significant portion of entity-wide, department, or fund management 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.
4. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.
 - a. Unrealistically aggressive budget or program goals.

Opportunities

1. There is ineffective monitoring of management as a result of the following:
 - a. A governing body that lacks appropriate background knowledge or experience regarding the function and responsibilities of government.
 - b. A vendor, such as a management company, who provides turnkey services of a department, exercises substantial influence over the affairs of the entity.
2. There is a complex or unstable organizational structure as evidenced by the following:
 - a. Overly complex organizational structure involving unusual legal entities or managerial lines of authority, or contractual arrangements without apparent programmatic or government purpose.
 - (1) 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).
3. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of controls, including automated controls.
 - (1) Lack of established policies or controls related to investment risk levels.
 - (2) Inadequate controls over process to prepare offering documents related to initial offerings of municipal securities.
 - (3) Inadequate controls over process to prepare required continuing disclosures related to those municipal securities.
 - b. An increased perception of opportunity by employees/management to perpetuate a fraud when a fraud has occurred in the past at that entity and there were no negative ramifications to the perpetrators(s), for example, no substantive investigations, no criminal charges, and no terminations.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
 - a. An excessive interest in meeting or exceeding the entity's budgetary targets or maintaining fund balance or debt coverage requirement through the use of unusually aggressive accounting practices.
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
 - a. 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 code of conduct.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, an auditor may want to consider the following responses to fraud risk factors.

- Additional or more focused analytical procedures concerning actual to expectation 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 program managers who have motives to produce particular budgetary, programmatic, or financial results.
- Confirmation of transaction details with other governments (for example, grants, tax collections, receivable/payable balances), pertaining to year-end cut-offs.
- Additional inquiry and tests on collectibility of interfund receivables, particularly those reporting large continuing balances.
- More focused review of documentation of write-offs of uncollectible taxes and other receivables.

- Confirmation with revenue sources to determine if revenue recognized was for services performed prior to year end, and vouching revenue to bank statements to ensure that the revenue was received in the availability period.
- A more rigorous search for unrecorded liabilities by more closely examining disbursements made after year end. (Consider looking at wire transfers, debit memos, and other EFTs, not just checks.)
- More detailed analysis of investment portfolios and investments policies; and use of investment risk specialists to better assess the risk levels of the entity's investments.
- Review of "top-level" adjustments made by management.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate segregation of duties or independent checks, especially in areas such as purchasing, accounts payable, cash handling, and force account labor supervision.
 - b. Lack of appropriate management oversight.
 - c. Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.
 - d. Inadequate recordkeeping with respect to assets susceptible to misappropriation.
 - e. Poor physical safeguards over cash, investments, inventory, or fixed assets.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, 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 the identity of participants can be verified.
- Observation of benefit payment distribution to identify “ghost” program participants (another option: reconciling terminated employees per the human resources system with active employee lists per the payroll system).
- Use of confirmation letters to ensure the existence of program participants.
- Review of 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.)
- Examination of outstanding encumbrances and encumbrances that were released in the first part of the next year to determine if the encumbering of the funds was appropriate and legal.

State and Local Governmental Entities and Not-for-Profit Organizations: Recipients of Federal Awards

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: Fraudulent Financial Reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Auditors should note that since SAS No. 99 applies only to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Some of the following factors and conditions are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. New accounting, statutory, or regulatory requirements.
 - (1) Imminent or anticipated adverse changes in program legislation or regulations that could impair the financial stability and profitability of the entity.
 - b. High degree of competition or market saturation, accompanied by declining margins.
 - (1) High degree of competition for federal funding, especially when accompanied by declining availability of federal funding nation-wide or region-wide.
 - c. Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates.
 - (1) A stagnant tax base, revenue base, or declining enrollments, or eligible participants.

- (2) Declining federal program funding, declining program participant populations, or declining benefit amounts.
 - d. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - (1) Rapid changes in federal programs, such as significant centralization or decentralization initiatives, funding shifts from federal to state or local levels, increases or decreases in participant populations, higher vulnerability to significant changes in compliance requirements, or pending program elimination.
 - e. Threat of imminent program terminations or significant reduction in scope, the effect of which could have a material financial impact on the entity.
 - f. A mix of fixed-price and cost-reimbursable program types that create incentives to shift costs or otherwise manipulate accounting transactions.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
- a. A motivation for management to engage in fraudulent financial reporting.
 - (1) Substantial political pressure on management creates an undue concern about federal program accomplishments.
 - b. Need to obtain additional debt or equity financing to stay competitive, including the need for funds to finance major research and development or capital expenditures.
 - (1) 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 federal program, including need for funds to finance major research and development or capital expenditures.
 - c. An individual or individuals with no apparent executive position(s) with the entity appear to exercise substantial influence over its affairs or over other individual federal programs (for example, a major donor or fundraiser, or a politician).
3. Management or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:
- a. Significant portions of their compensation (for example, bonuses, stock options, or other incentives) being contingent upon achieving aggressive targets for operating results, financial position, or cash flow.
 - (1) A significant portion of entity-wide or program 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.

4. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.
 - a. Unrealistically aggressive budget or program goals.

Opportunities

1. There is ineffective monitoring of management as a result of the following:
 - a. A vendor, such as a management company, that provides turnkey services of a department, exercises substantial influence over the affairs of the entity.
2. There is a complex or unstable organizational structure as evidenced by the following:
 - a. Overly complex organizational structure involving unusual legal entities or managerial lines of authority, or contractual arrangements without apparent programmatic or government purpose.
 - (1) 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).

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
 - a. An excessive interest by management or employees in meeting or exceeding the entity's budgetary targets through the use of unusually aggressive accounting practices.
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
 - a. 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 code of conduct.

3. Management displaying a significant disregard for regulatory authorities.

- a. Management displaying or conveying an attitude of disinterest regarding strict adherence to federal rules and regulations, such as those related to participant eligibility, benefit determinations, or eligibility.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, an auditor may want to consider the following responses to fraud risk factors.

- Additional or more focused analytical procedures concerning actual to expectation 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 program managers who have motives to produce particular budgetary, programmatic, or financial results.
- Confirm transaction details with other governments (for example, grants, tax collections, or receivable/payable balances) pertaining to year-end cut-offs.
- Additional inquiry and tests on collectibility of interfund 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 before year end, and vouch revenue to bank statements to ensure 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. (Consider looking at wire transfers, debit memos, and other EFTs, not just checks.)
- More detailed analysis of investment portfolios and investments policies; and use of investment risk specialists to better assess the level of risk of the entity's investments.

Part 2: Misappropriation of Assets

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Auditors should note that since SAS No. 99 applies only to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with

specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Some of the following factors and conditions are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate segregation of duties or independent checks, especially in areas such as outreach, intake, eligibility determination, and benefits awards.
 - b. Inadequate system of authorization and approval of transactions, such as purchasing, benefit determinations, and eligibility.
 - c. Lack of timely and appropriate documentation of transactions, such as eligibility and benefit determinations.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, 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 the identity of participants can be verified.
- Observation of benefit payment distribution to identify “ghost” program participants (another option: reconciling terminated employees per the human resources system with active employee lists per the payroll system).

- Use of confirmation letters to ensure the existence of program participants.
- Review of governmental entity's purchasing practices to make sure that prices are reasonable for the products purchased (inflated prices a possible indication or disclosure of purchasing agent acceptance of bribes, gratuities, or kickbacks).
- Examination of outstanding encumbrances and encumbrances that were released in the first part of the next year to determine if the encumbering of the funds was appropriate and legal.

Health Care Organizations

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - (1) A failure or inability to keep pace with the rapid growth on medical technology, if the financial stability or profitability of the particular entity is placed at risk due to that failure or inability.
 - b. 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:
 - (1) Improper billing of services performed by residents.
 - (2) Inappropriate transfers or discharges.
 - (3) Illegal arrangements involving physicians.
 - (4) Improper referrals.
 - (5) Billing for nonapproved medical devices.

(You 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.)

2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - a. Intense pressure from governmental bodies and health maintenance organizations to embrace cost containment and efficiency enhancement programs.
3. Management or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:
 - a. Bonuses or incentive compensation are tied to operating results.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. The existence of many complex third-party payor contracts.
2. There is ineffective monitoring of management as a result of the following:
 - a. A board of directors mainly composed of local business people and doctors. A board composed of such people, combined with large available financial resources, creates the potential for insider business deals.
 - b. A board of directors composed of people who lack the necessary experience and skills to properly oversee a health care organization.
3. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of significant controls, including automated controls.
 - (1) Lack of oversight or control of various affiliations in an integrated health delivery system.
 - (2) Lack of management review of dispersed locations.
 - (3) Insufficient board or senior management oversight of critical processes, such as:
 - Establishment of allowance for uncollectible accounts and contractual adjustments, build-up of unallocated reserve.
 - Incident monitoring, follow-up, and settlement.
 - Business affiliations and combinations.
 - Regulatory compliance.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
 - a. Lack of an effective corporate compliance program.
2. Management displaying a significant disregard for regulatory authorities.
 - a. Failure to respond to recent regulatory reviews.
3. Attitude that generally accepted accounting principles (GAAP) is not as strict for nonpublic entities (for example, often seen in setting up "cookie-jar" reserves or ignoring other than temporary impairments).
4. Attitude that materiality can be stretched further for not-for-profits.

Auditor Response

In addition to the sample responses presented in SAS No. 99. 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 and accounts receivable runoff (actual cash) by specific payors to the recorded allowance or the testing and analysis of the collectibility of a sufficient number of accounts to arrive at an independent conclusion about the adequacy of the allowance.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Large amounts of cash payments received for medical care.
 - b. Pharmaceutical inventory with high street value, or in high demand.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, 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.

Insurance Companies

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. New accounting, statutory, or regulatory requirements.
 - (1) New criteria used by rating agencies to assign ratings to insurers.
 - (2) Impact of codification of statutory accounting principles.
 - (3) Demutualization.
 - (4) Changes in risk-based capital requirements.
 - (5) Changes in consolidation criteria (for example, SPEs)
 - (6) Changes in liability recognition for GMDBs and other proposed GAAP changes affecting the insurance business.
 - b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - (1) Rapidly changing distribution network results in different sales vehicles without adequate controls (for example, possible use of the Internet).
 - (2) Changes in interest rates may have a significant impact on the financial results of many life insurance companies.

- c. Rapid growth or unusual profitability, especially compared to that of other companies in the same industry.
 - (1) Unusual and considerable increases in the number of policyholders over a short period of time.
 - (2) Loss ratios significantly different from companies offering similar insurance coverages.
 - (3) Unusual or significant increases in fee income (for variable products where fees are a direct result of assets under management) in a period of market decline, as compared to other companies in the same industry.
 - (4) Unusual increases in the number of policies in mature lines of business, potentially indicating inadequate pricing to gain business from competitors.
 - d. Emerging trends in claims settlement and litigation, including:
 - (1) Identification of emerging new classes of claims.
 - (2) Plaintiffs' expanded theory of liability.
 - (3) Court coverage decisions and judicial interpretations.
 - (4) Expanded liability due to changes in legislation.
 - e. High degree of competition or market saturation, accompanied by declining margins.
 - (1) Rapid development of new products reacting to the market environment without adequate review of long-term strategies.
 - (2) Volatility of earnings due to market environment that could cause a company to manipulate earnings.
 - f. Volatility of earnings due to catastrophic losses could cause the company to manipulate earnings in other areas.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
- a. Profitability or trend expectations of investment analysts.
 - b. Pressure to maintain or improve ratings from rating agencies.
 - c. Close to tripping risk-based capital (RBC) requirements.

Opportunities

- 1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
 - (1) Unusual or complex intercompany reinsurance transactions.

- (2) Transactions entered into with affiliates, the impact of which are to increase statutory surplus.
 - (3) Complex and/or inconsistent expense allocation agreements.
- b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- (1) Estimates for loss and loss adjustment expenses, reinsurance recoverables, deferred acquisition costs (DAC), reserves, and others based on unusually subjective judgments.
 - (2) Significant purchases and sales of securities that do not have an active market, which could indicate “parking losses.”
 - (3) Aggressive policies related to revenue recognition for administrative-service type contracts.
 - (4) Improper classification of normal operating losses as “catastrophe-related” in financial reporting (for example, management discussion and analysis, footnote disclosure). Also, the diversion of an insurer’s resources in dealing with a catastrophe could put a strain on internal controls.
- c. Significant, unusual, or highly complex transactions, especially those close to period end, that pose difficult “substance over form” questions.
- (1) High yields on investments that appear to be low risk.
 - (2) Transactions that “convert” nonadmitted assets to admitted assets.
 - (3) Numerous and complex off-balance-sheet financing transactions.
 - (4) Reinsurance transactions that embody loss assumptions that are very different from industry or historical trends in order to pass the “transfer of risk” rules.
 - (5) Transactions that “convert” realized capital gains/losses to ordinary income or vice versa.
 - (6) Significant closing journal entries for insurers that maintain their books on a statutory basis of accounting, which requires the need to post several statutory-to-GAAP adjusting entries.
 - (7) Significant or unusual amount of quarter-end or year-end manual entries posted after consolidation.
 - (8) Estimates of the value of closely held securities.
 - Agreements accounted for as reinsurance transactions that do not transfer risk.
2. There is ineffective monitoring of management as a result of the following:
- a. Domination of the board of directors because it is composed primarily of a company’s close business partners (for example, agents, bankers, and lawyers)
3. There is a complex organizational structure as evidenced by the following:
- a. Significant transactions included in noninsurance affiliates with the sole purpose of excluding such activity from the statutory-basis financial statements filed with the insurance regulators.

4. Internal control components are deficient as a result of the following:

- a. Information systems cannot account for the complex features of insurance policies issued. (for example, policies with complex deductible features).

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend or statutory capital position.
 - a. Risk transfer criteria for reinsurance transactions rarely met.
 - b. Use of discretionary reserves to manipulate earnings.
2. A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
 - a. Lack of board or management oversight of critical processes:
 - (1) Underwriting—control risk, price risk.
 - (2) IT systems or resources to effectively administer complex insurance or reinsurance contract provisions.
 - (3) Monitoring of creditworthiness of reinsurers.
 - (4) Suspense account clearance.
 - (5) Treasury—securities/derivatives valuation (selection of models, methodologies, and assumptions).
 - (6) Establishment of loss and loss adjustment expense reserves.
 - (7) Investment decisions.
 - (8) Understanding of critical accounting policies and significant estimates.
 - b. No business risk management responsibility or function.
 - c. No accounting policy responsibility or function.
 - d. Management's inattention to establishing independent reporting lines for key assurance functions (for example, internal audit and quality control reviews of claims and underwriting).
 - e. Lack of insurance-industry or finance experience on the audit committee.
3. Management displaying a significant disregard for regulatory authorities.
 - a. Existence of a regulatory enforcement action.

- b. Prior examination findings not addressed or inadequately addressed.
 - c. Mandated restatements of regulatory financial reports due to inappropriate accounting treatment.
 - d. Assessments of market conduct fines.
4. A strained relationship between management and the current or predecessor auditor, as exhibited by the following:
- a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters such as the reasonableness of sensitive estimates (for example, loss and loss adjustment expense reserves, allowances for uncollectible reinsurance, DAC, and other amounts).
 - b. Issuance of reportable condition or material weakness letters.
 - c. Failure of management to address reportable condition or material weakness issues on a timely basis.
5. Nonfinancial management's excessive participation in or preoccupation with the selection of the accounting principles or the determination of significant estimates.
- a. Lack of management to establish controls over accounting policy issues.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Incentives/Pressures

1. Adverse relationships between the entity and employees with authority over cash and assets could motivate employees to misappropriate those assets.
 - a. History of workforce reductions (for example, combining regional claims offices).

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation, for example, opportunities to misappropriate assets increase when there are the following:
 - a. Significant activity and/or balances present in suspense accounts.
 - b. Large volume premium checks received by the insurance company rather than being sent to a lockbox.
 - c. Premiums are not directly remitted to the insurer but are instead collected by the agent.
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate segregation of duties or independent checks.
 - (1) Lack of rotation or review of claim adjusters on long-term claims.
 - (2) Custodial reconciliations performed by an individual who records the amount to the ledger.
 - b. Inadequate management oversight of employees responsible for assets.
 - (1) Lack of adequate monitoring of underwriting policies and procedures.
 - (2) Lack of management review or control processes over year-end or month-end transactions.
 - (3) Extensive use of managing general agents (MGAs) with little or no supervision by management.
 - (4) Lack of internal audit and/or claim quality review functions.
 - (5) Inadequate payment approval process.
 - (6) Lack of review or inadequate controls over system overrides (for example, claim payments and commissions)
 - (7) Lack of strong custodial controls over cash/investments.
 - c. 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.
 - d. Large volume of duplicate claims processed.
 - e. Large volume of claims paid to post office boxes.

- f. Large volume of claims paid to the same claimant.
- g. Large volume of claims paid to employees.

Attitudes/Rationalizations

Risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets, are not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Failure to report all instances of fraud to the audit committee.
2. Failure to properly staff internal audit and other (claims/underwriting) quality control functions.
3. Poor relationships between management, employees, and agents that may appear to justify misappropriations of assets.
4. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.

Investment Companies

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
 - (1) Significant transactions with affiliates that are not approved by the board of directors in accordance with Section 17 of the Investment Company Act.
 - (2) Transactions involving affiliates that are not readily apparent in the circumstances, or apparent but not properly disclosed.
 - b. Significant investments for which readily available market quotes are not available and inadequate procedures for estimating these values.
 - c. Significant investments in derivative financial instruments for which value is very difficult to estimate.
2. Internal control components are deficient as a result of the following:
 - a. A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
 - b. Unusual and considerable influence of the portfolio manager over pricing sources and fair valuation methodology used to value securities.

- c. Lack of board's involvement in the establishment of the fair valuation policies and procedures or lack of oversight over those policies and procedures.
- d. Ability of management to unilaterally override internal control system, particularly security valuations.
- e. Lack of adviser's supervisory or oversight procedures over the subadviser.
- f. Inadequate controls around the calculation of the net asset value.
- g. Reconciliation of security holdings with the custodian that are infrequent and incomplete.
- h. Inadequate monitoring of the fund's tax status as a regulated investment company.
- i. Inadequate monitoring of the fund's compliance with its prospectus requirements.
- j. Transfer agency controls are ineffective or implementation of user controls are ineffective.
- k. Lack of an appropriate policy regarding corrections of net asset value errors, or failure to comply with policy.
- l. Lack of board members' understanding of how portfolio management intends to implement the fund's investment objectives, thereby creating a situation in which management can aggressively interpret or disregard policies in place.
- m. Lack of board members' understanding of derivatives used by portfolio managers and involvement in approving or disapproving use of specific strategies such as embedded leverage, thereby creating a situation in which management can aggressively interpret or disregard policies in place.
- n. Incomplete or insufficient description of portfolio positions in accounting records to permit adequate monitoring of prospectus requirements.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- 1. Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
 - a. An excessive focus on maintaining a high rate of dividend payments regardless of the fund's actual earnings.
- 2. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations.
 - a. Past suspensions of ability to act as an investment adviser or requirement that the adviser be supervised by others.

3. A practice by management of committing to creditors and other third parties to achieve aggressive or unrealistic forecasts.
 - a. Commitment to achieving a low-targeted expense ratio at or below competitors' average.
4. Adviser's fee revenues (including performance incentives) directly related to either the value of fund assets or performance, if the adviser has substantial discretion in valuing portfolio investments and changes in fee revenues may be significant to the adviser.
5. Undisclosed use of soft-dollar credits and other items to reduce a gross ratio below a cap so the adviser does not have to reimburse the fund for excess expenses.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Use of soft dollar arrangements for the benefit of the adviser without client consent (including existence of undocumented or ill-defined arrangements).
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- a. Access to funds and securities and accounting for them directly controlled by adviser, with inadequate segregation of duties (or no direct communication between custodian and accounting personnel).
- b. 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 No. 70 report).
- c. Infrequent and incomplete reconciliation of security holdings with the custodian.
- d. Lack of clearly defined policy with respect to personal investing activities (for example, front-running fund trades or taking investment opportunities for personal use).
- e. Ineffective transfer agency controls or ineffective implementation of user controls in a service center environment.
- f. Lack of segregation of duties between portfolio management and trading, or absence of independent review of trading executions (for example, unexpected concentrations of trading with counterparties, poor trade executions, or higher-than-normal commissions that may indicate existence of collusion between portfolio personnel and counterparties).

Not-for-Profit Organizations

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Incentives/Pressures

1. Financial stability or the ability to generate excess revenues over expenses is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High degree of competition or market saturation, accompanied by declining margins.
 - (1) Unusually intense competition for the limited pool of resources, such as contributions and grants, exists, thereby pressuring management to present a particular financial picture in the hope of attracting those contributions and grants.
 - (2) An increase in not-for-profits (NPOs) trying to serve the same niche, thereby causing market saturation.
 - (3) Pressure to decrease costs because of market competition, such as privatization.
 - (4) Increased costs due to changes in market conditions or other factors.
 - b. The threat of imminent third-party funding termination or significant reductions in third-party funding.
 - (1) Political and economic events, causing dramatic decreases in resources, such as grants and contributions.

2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - a. An intense focus by external financial statement users, such as rating agencies and the media, on the amounts reported as program, management and general, and fund-raising expenses.
 - b. 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 the manner in which certain transactions are reported.
 - c. Funders or others pay undue attention to certain ratios, such as program expense to total expense, or fundraising costs to contributions.
 - d. An entity embroiled in a scandal or bad publicity that threatens its charitable base or, for regulatory or other economic reasons, its very existence.
 - e. Resource providers who set up restrictions or conditions based on amounts reported in the financial statements.
 - f. NPOs involved in certain activities which, if disclosed to the public, may affect contributions.

3. Management personal net worth is threatened by the entity's financial performance arising from the following:
 - a. Significant portions of their compensation represented by bonuses, or other incentives, being contingent upon achieving aggressive targets for operating results, financial position, or cash flow.
 - (1) A significant portion of management's compensation linked to aggressive program accomplishments or aggressive fund-raising targets.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.
 - (1) The existence of numerous split-interest agreements containing complex provisions.
 - b. Diverse programs funded by multiple sources involving many complex requirements that must be complied with.
 - c. Complex and changing administrative or programmatic requirements imposed by resource providers.
 - d. Several restricted gifts and/or purchase of service contracts with terms, which may create incentives to improperly shift costs among them.

2. There is ineffective monitoring of management as a result of the following:
 - a. Domination of management by a single person or small group without compensating controls.
 - (1) Executive director possesses significant power and latitude to manage programs, activities, and transactions and to override controls.
 - (2) Board member or group of board members possessing significant power or significant community influence, thereby potentially adversely affecting management and auditors' decisions.
 - b. Ineffective board of directors or audit committee oversight over the financial reporting process and internal control.
 - c. Board members or management—paid or volunteer—charged with oversight responsibilities, lacking the necessary background experience in NPO management and NPO program activities or lacking a commitment to fulfilling their duties.
 - d. A major donor or fundraiser exercising substantial influence over the affairs of the organization.
3. There is a complex or unstable organizational structure as evidenced by the following:
 - a. Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
 - (1) Significant subrecipient or subcontract relationships, without a clear program purpose or business justification.
 - (2) Unusual investment vehicles without appropriate board oversight.
 - (3) Multiple locations with inadequate management to properly oversee decentralized operations.

Auditor Responses

In addition to the sample responses presented in SAS No. 99, an auditor of a not-for-profit organization may want to consider the following responses.

- Send confirmations to donors not only to confirm the amount of promises to give in the future, but also to clarify the nature of any restrictions.
- 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 attempt to determine that all contribution revenue was recorded.
- Thoroughly analyze and test the assumptions underlying allocation of costs to various programs.
- Review reports received from subrecipients.

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Opportunities

1. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate management oversight of employees responsible for assets.
 - (1) 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.
 - b. Inadequate job applicant screening of employees and volunteers with access to assets.
 - (1) The presence of volunteers working in the organization, who have access to assets susceptible to misappropriation and who have not been adequately screened.
 - c. Lack of timely and appropriate documentation of transactions.
 - (1) Inadequately documented promises to give in the future.
 - d. Board members or management—paid or volunteer—charged with oversight responsibilities, lacking the necessary background experience in NPO management and NPO program activities or lacking a commitment to fulfilling their duties.
 - e. Fundraising, in general (due to inherent limitations on ability of management and auditor to perform full inclusion testing).
 - f. Fundraising from “anonymous donors.”
 - g. Fundraising involving currency.
 - h. Fundraising taking place outside of formal supervision.

Public Utilities

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. 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."
 - b. Considerable pressure to maintain or reduce rates that may create pressure on earnings.

Opportunities

1. Nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
 - (1) Consideration should be given to:
 - Significant regulatory deferrals.
 - Embedded regulatory assets.
 - The recognition of regulatory liabilities.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

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

Real Estate Entities

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

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

Incentives/Pressures

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

General:

- a. There has been a loss or possible loss of a significant tenant or group of tenants.
- b. There are major tenants experiencing financial difficulties that may affect their ability to meet lease obligations.
- c. There have been events or changes in circumstances that indicate that the carrying value of real estate assets may not be recoverable.
- d. Real estate assets are held for sale.
- e. Rental collection problems have been noted.
- f. The entity has sold real estate for which the collectibility of the sales price is not reasonably assured, the entity is obligated to perform significant activities after the date of sale, or the entity has a substantial continuing involvement in the property without transfer of substantially all risks and awards.

- g. There are real estate projects under development for which issues related to capitalization of expenses are evident.
- h. The entity has entered into sales-leaseback transactions.
- i. The entity's construction activities are subject to an overbuilt market, abnormal construction delays, or other potentially detrimental occurrences.

Factors applicable to real estate investment trusts (REITs):

- a. The REIT is in jeopardy of noncompliance with REIT tax requirements.
- b. There have been significant changes in the number of shareholders of the entity, or in the amounts of stock owned by its largest shareholders.
- c. There have been significant changes in the amount of real estate assets owned as a percentage of the entity's total assets.
- d. There have been significant changes in the nature of the investments that are the primary sources of the entity's income.
- e. There have been significant changes in the entity's established policies or strategies for distributing its income.

Factors applicable to real estate companies involved in lending activities:

- a. The entity has entered into transactions using futures, options, swaps, or other financial instruments for purposes other than to hedge against exposure to interest rate risk.
- b. The entity has a significant volume of commercial real estate loans in any geographic area.
- c. The entity has significant foreign loans.
- d. The entity has a significant amount of real estate acquired through foreclosure at the end of the current period.
- e. The entity has sold loans with recourse during the year.

Opportunities

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

General:

- a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
 - (1) Interdependent, multiple transactions between the same parties or their affiliates.
- b. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.

- (1) Complicated criteria for recognizing sales transactions, making it difficult to assess the completeness of the earnings process.
 - (2) Significant “side agreements” or transaction terms not previously disclosed.
- c. Key contracts awarded without a competitive bidding process.
 - d. Significant transactions for which documents are dated close to the last business day of the year.
 - e. Significant one-time fees or other payments (for example, easements and bill board).
 - f. Aggressive billing of expenses to tenants under expense recovery provisions of leases.

Factors applicable to real estate companies involved in lending activities:

- a. The entity has engaged in transactions that are defined as “ADC Arrangements” in the AICPA Practice Bulletin 1, Exhibit I.
- b. Several sales of foreclosed property or other troubled assets have been made to one individual or group, with financing by the entity.

2. Internal control components are deficient as a result of the following:

Factors applicable to real estate companies involved in lending activities:

- a. Inadequate monitoring of controls.
 - (1) The entity has an underwriting policy that does not require appropriate approvals based on the size and complexity of the loan.
- b. High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
 - (1) The individual responsible for the entity’s interest-rate risk management program is inexperienced in that area.

Attitudes/ Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor.

General:

1. Revenue recognition in accordance with lease terms when there are significant receivables due from the tenant.
2. Excessive optimism with respect to uncollected rents from tenants.
3. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
 - a. An excessive interest by management in maintaining or increasing the reported amount of real estate assets through the use of unusually aggressive appraisal assumptions.
 - b. The use by management of unusually aggressive accounting practices in recognizing revenue from real estate sales.
 - c. The use by management of unusually aggressive accounting practices in recognizing revenues from the termination of leases with tenants.
4. Aggressive assumptions related to subleasing space assumed by the entity as a result of a lease with a tenant(s).
5. The existence of tax indemnities.
6. Loan agreements have significant up-front or back-end fees, which are atypical and are not amortized into interest expense over the life of the loan.
7. Excessive capitalization of general, administrative, and overhead expenses.
8. Capitalization of interest and other costs on land and developments with limited actual development activity.
9. Inadequate responses or an unwillingness to respond to inquiries about known regulatory or legal issues (for example, the presence of environmental contamination on an entity-owned site).

Part 2: 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 are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that 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.

Risk factors that relate to misstatements arising from misappropriation of assets are also classified along the three conditions generally present when fraud exists: incentives/pressures, opportunity, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be

present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Opportunities

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

General:

- a. 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.
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

General:

- a. Real estate asset purchases or sales occur with related parties.
- b. Lease agreements exist with related parties at below-market terms.
- c. Debt of an individual or outside entity is guaranteed.
- d. Transaction with related parties exist in which capital items are combined with expense items.
- e. Capital items are expensed and billed to tenants as recoverable expenses.

Small, Privately Owned Businesses

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

The following list of example risk factors for small, privately owned businesses includes SAS No. 99 example risk factors most relevant to these entities as well as additional example risk factors.

Part 1: Fraudulent Financial Reporting

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High degree of competition or market saturation, accompanied by declining margins.
 - b. New accounting, statutory, or regulatory requirements.
 - c. Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates.
 - d. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - e. Operating losses making the threat of bankruptcy or foreclosure imminent.
 - f. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
 - g. Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - a. Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures.
 - b. Marginal ability to meet debt repayment or other debt covenant requirements.
3. Management's personal net wealth is threatened by the entity's financial performance arising from the following:
 - a. Heavy concentrations of their personal net worth in the entity.
 - b. Personal guarantees of debt of the entity that are significant to their personal net worth.

- c. 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 (for example, 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.
4. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
 - b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
 - c. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.
2. There is a complex or unstable organizational structure as evidenced by the following:
 - a. Difficulty in determining the organization or individuals that have controlling interest in the entity.
 - b. Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
 - c. High turnover of senior management or counsel.
3. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of controls, including automated controls.
 - b. High turnover rates or employment of ineffective accounting staff.
 - c. Ineffective accounting and information systems, including situations involving reportable conditions.

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such

information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. A failure for management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
3. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates.
4. Known history of violations or claims against the entity, its owner, or senior management alleging fraud or violations of laws and regulations.
5. A practice by management of committing to creditors and other third parties to achieve aggressive or unrealistic forecasts.
6. Management failing to correct known reportable conditions on a timely basis.
7. An interest by management in employing inappropriate means to minimize reported earnings for tax motivated reasons.
8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
9. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee.
 - d. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement.

Part 2: Misappropriation of Assets

The following are examples of risk factors related to misstatements arising from misappropriations of assets.

Incentives/Pressures

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

2. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
 - a. Known or anticipated future layoffs.
 - b. Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Large amounts of cash on hand or processed.
 - b. Company-issued credit cards.
 - c. Inventory items that are small in size, of high value, or in high demand.
 - d. Easily convertible assets.
 - e. Fixed assets that are small in size, marketable, or lacking observable identification of ownership.
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate segregation of duties or independent checks. Inadequate segregation of duties is quite often understandable in a small business environment in that it is a function of the entity's size. However, you should consider it in conjunction with other risk factors and with mitigating controls.
 - b. Inadequate management oversight of employees responsible for assets.
 - c. Inadequate job applicant screening of employees with access to assets.
 - d. Inadequate recordkeeping with respect to assets.
 - e. Inadequate system of authorization and approval of transactions (for example, in purchasing).
 - f. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
 - g. Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
 - h. Lack of mandatory vacations for employees performing key control functions.
 - i. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
 - j. Inadequate access controls over automated records.

Attitudes/Rationalizations

Risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets, are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from misappropriations of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee.
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated.

APPENDIX B: PITF PRACTICE ALERT 94-2, AUDITING INVENTORIES—PHYSICAL OBSERVATIONS

Date: July 1994 (Updated through July 1, 1999)

Notice to Readers

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force and is based on the experiences of the individual members of the task force and matters arising from litigation and peer reviews. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Introduction

The inventories of most commercial entities, especially those of manufacturers or distributors, are material to their financial statements. By its nature, accounting for inventories is complex and generally involves a great deal of detail and is therefore susceptible to inadvertent errors. For similar reasons and the fact that auditors test only a portion of the inventories, there exists more than a low risk of manipulation when management is disposed toward financial statement fraud.

This Alert discusses some ways in which inventory frauds have been perpetrated and presents information that might help prevent such frauds from going undetected. This Alert deals primarily with issues related to the physical existence of inventories. This Alert does not cover matters pertaining to inventory obsolescence, pricing or costing.

Inventory Fraud Schemes/Techniques

Unfortunately, in many cases of inventory fraud, client personnel at various levels knowingly participated and assisted in the scheme. The following are examples of inventory frauds:

- Including inventory that is not what it is claimed to be or valuing nonexistent inventory. Examples are:
 - Empty boxes or “hollow squares” in stacked goods.
 - Mislabeled boxes containing scrap, obsolete items or lower value materials.
 - Consigned inventory, inventory that is rented, or traded-in items for which credits have not been issued.
 - Diluted inventory so it is less valuable (e.g., adding water to liquid substances).

- Increasing or otherwise altering the inventory counts for those items the auditor did not test count.
- Programming the computer to produce fraudulent physical quantity tabulations or priced inventory listings.
- Manipulating the inventory counts/compilations for locations not visited by the auditor.
- Double-counting inventory in transit between locations.
- Physically moving inventory and counting it at two locations.
- Including in inventory merchandise recorded as sold but not yet shipped to a customer (“bill and hold sales”).
- Arranging for false confirmations of inventory held by others.
- Including inventory receipts for which corresponding payables had not been recorded.
- Overstating the stage of completion of work-in-process.
- Reconciling physical inventory amounts to falsified amounts in the general ledger.
- Manipulating the “roll-forward” of an inventory taken before the financial statement date.

Planning Considerations

Even though there are numerous ways inventory frauds can be orchestrated, a well planned audit—appropriately executed with professional skepticism—can thwart many inventory falsification schemes. The audit procedures to be applied stem from and are responsive to the auditor’s assessment of risk (i.e., What could go wrong?). The use of analytical procedures (e.g., review of preliminary high-to-low inventory-value listings or comparison of year-to-year quantities) in planning the audit often helps identify inventory locations, areas or items for specific attention or greater scrutiny during and after the physical count.

To plan an appropriate and effective inventory observation, it is important for the engagement team leaders to have an understanding of the client’s business, its products, its computer processing applications and relevant controls before the physical count occurs, including knowledge of the physical inventory or cycle count procedures and the inventory summarization, pricing and cutoff procedures.

When a client plans to count inventories at various dates or at a date other than that of the financial statements, the early consideration of its business, internal controls and their effectiveness, and cutoff procedures are especially important. Heightened risks or the lack of adequate internal controls may suggest that the inventory should be taken and observed at year end.

An appropriate understanding of the client’s business systems, relevant computer processing applications and inventory procedures helps determine the experience needed by the personnel assigned to observe the physical count and their individual responsibilities. Assigning junior personnel to observe the count at a complex manufacturing operation may or may not be prudent, depending on the extent of on-site supervision provided. Similarly, work-in-process inventory presents completion/valuation issues that may call for a more experienced auditor.

When the observation requires the use of personnel from another office or another CPA firm, adequate planning also enables the auditor to provide clear, comprehensive instructions about the scope of the engagement, the important risk factors, the relevant controls, cutoff procedures, and the expected level of reliance to be placed on internal controls.

The Actual Physical Count

- The risk of inclusion of duplicate or fictitious items is higher in areas and for items not test counted by the auditor. Testing some counts made by all count teams at locations visited and ensuring that hard-to-count items are test counted helps minimize the risk of misstatement.
- Applying analytical procedures to the final priced-out inventory detail can help identify inventory items that might require additional audit scrutiny.
- Although client personnel are often helpful to the auditor making test counts, making test counts of which client personnel are unaware provides added assurance. The auditor can also record the details of some quantities that the auditor did not actually count for comparison with the final inventory listing. Also, the auditor needs to maintain appropriate control over the audit work papers so the client is not aware of the details of the test counts.
- Because the description on a container may not always match the goods inside, it is a good idea to open some containers or packages. Checking for empty containers or “hollow squares” (i.e., spaces between stacks of boxes) and verifying the units of measure on tags or count sheets are meaningful procedures. When observing work-in-process inventory, the auditor also needs to consider the reasonableness of the recorded stage of completion.
- When incorrect counts are observed, the auditor considers the nature and significance of the errors and whether to increase the extent of test counts or expand other procedures. Recounts of particular areas or the work of particular count teams may be necessary.
- Scanning inventory tags or count sheets for unusual or unreasonable quantities and descriptions is a useful technique to verify their propriety. Subsequent to the physical count, it may be desirable to test large or unusual inventory quantities or items with large extended values that were not test counted during the observation.
- The need to monitor the client’s control over the physical count tags or sheets used should not be downplayed or overlooked. Paying close attention to tag/count sheet control procedures helps avoid the inclusion of improper items and ensures appropriate items are included in the final inventory listing.

Multiple Locations

Knowledge of all inventory locations is necessary to prevent the exclusion of any area(s) from audit consideration. Following are a few matters for auditors to consider related to multiple inventory locations.

To help discourage the shifting of inventory from one location to another, the merits of taking the physical inventory at all significant locations at the same time should be considered. When the physical count at each significant location will not be observed, informing management that observations will be performed at some locations without advance notice might help discourage the manipulation of the quantity or quality of the inventory. For locations not visited, the auditor may perform alternative procedures to detect material misstatements. Comprehensive analytical procedures subsequently applied to priced-out inventory summarizations may be one such technique (e.g., the analysis of year-to-year inventories by location, the relationship of inventory to sales levels, etc.). However, the auditor needs to remember that analytical procedures may not always detect erroneous changes in inventory.

Inventories Held for or by Others

Ascertaining whether all inventory items on hand are the property of the client can be difficult in some situations. A client's procedures for identifying, segregating and excluding from inventory goods held on consignment should be considered. Requesting information from selected suppliers about such goods helps in this regard. Once consignment goods have been identified, noting the descriptions, quantities, serial numbers and shipping advice numbers for some items will help the auditor determine whether those items were properly excluded from the client's inventory.

When a client consigns inventory to others or stores merchandise at a third-party location, written confirmation of the goods held is ordinarily obtained directly from the custodian. If such goods are significant in amount, one or more of the procedures discussed in AU section 331.14, "Inventories Held in Public Warehouses," which include visits to such locations and observation of physical counts, may be appropriate.

Use of Specialists

An auditor is not expected to possess the expertise of a specialist trained or qualified in another profession or occupation. Consequently, use of a specialist in certain situations to determine quantities (e.g., stockpiled materials, mineral reserves) or to value special-purpose inventory (e.g., high-technology materials or equipment, chemicals, works of art, precious gems) or to measure the stage of completion of long-term contracts may be appropriate. If the specialist used is affiliated or otherwise has a relationship with the client, the auditor will want to consider the need to perform procedures or otherwise test some or all of the specialist's assumptions, methods and findings. This will provide information about the reasonableness of the findings. Alternatively, the auditor could engage another specialist for this purpose.

Post-Observation Matters

The extent of audit procedures required normally increases when the inventory observation is performed at a date other than the balance sheet date. The extent and nature of the increase depends on the nature of the client's business, the type of inventory, inventory turnover period, the records maintained, the strength of the related internal controls, and the time interval between the observation and the date of the balance sheet. Interim physical inventories or the client's use of cycle count programs present different audit risks warranting careful assessment of controls, and by extension, different audit tests. This assessment of audit risks and key controls and the focused testing thereof, along with appropriate analytical procedures, are important audit procedures to consider in these circumstances. The guidance in AU section 313, "Substantive Tests Prior to the Balance-Sheet Date," is relevant in these circumstances.

Testing significant items in the reconciliation of the physical inventory to the general ledger helps identify inadvertent errors along with intentional misstatements. Significant reconciling items for those locations where the physical counts were not observed by the auditor generally merit scrutiny. Goods in-transit and inventory transfers between affiliates, locations or departments are tested to ascertain their existence and to determine the propriety of their inclusion or exclusion.

Conclusion

Unfortunately, there are no foolproof methods for assuring that all inventory counts are free from inadvertent or intentional misstatement. No audit will necessarily detect all fraudulent activity, especially when collusion to mislead the auditors occurs among client personnel or with third parties. However, understanding the client's business, its count procedures and controls and a resulting careful assessment of where and how quantity error might occur helps reduce the risk of inadvertent or intentional misstatement. Appropriate planning for the physical inventory observation together with healthy audit skepticism can effectively reduce the incidence of inventory misstatements.

This Practice Alert is not a complete list of all audit procedures, nor is every procedure discussed herein applicable in all circumstances. Additional information on this important subject is provided in the AICPA's Auditing Procedures Study, Audits of Inventories (Product No. 021045MJ, \$25).

APPENDIX C: PITF PRACTICE ALERT 03-2, JOURNAL ENTRIES AND OTHER ADJUSTMENTS

Date: June 2003

Notice to Readers

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the experience of members of the Professional Issues Task Force (PITF) and information provided by the SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and has not been approved by any senior technical committee of the AICPA. The auditing portion of this publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards*. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards (SASs). If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate.

Introduction

The Auditing Standards Board has promulgated standards that address an auditor's understanding and evaluation of journal entries and other adjustments. For example, in SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*, the Auditing Standards Board expanded the auditor's required understanding of the automated and manual procedures an entity uses to prepare its financial statements and related disclosures to include procedures an entity uses to (a) enter transaction totals into the general ledger, (b) initiate, record and process journal entries in the general ledger, and (c) record recurring and nonrecurring adjustments, such as consolidating adjustments, report combinations and reclassifications, that are not reflected in formal journal entries.

In addition, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, states, "Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting by (a) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations,

and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) made in the preparation of the financial statements.”

SAS No. 99 further states, “Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity’s internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity’s internal controls. Accordingly, the auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.”

In response to the risk of management override, SAS No. 99, which will be effective for audits of calendar year 2003 financial statements, requires the auditor, in all audits, to (a) obtain an understanding of the entity’s financial reporting process and controls over journal entries and other adjustments, (b) identify and select journal entries and other adjustments for testing, (c) determine the timing of the testing, and (d) inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries or other adjustments.

The purpose of this Practice Alert is to provide auditors with guidance regarding the design and performance of audit procedures to fulfill the responsibilities outlined in SAS No. 99 regarding journal entries and other adjustments.

Obtaining an Understanding of the Entity’s Financial Reporting Process and Its Controls Over Journal Entries and Other Adjustments

SAS No. 99 states, “An entity may have implemented specific controls over journal entries and other adjustments. For example, an entity may use journal entries that are preformatted with account numbers and specific user approval criteria, and may have automated controls to generate an exception report for any entries that were unsuccessfully proposed for recording or entries that were recorded and processed outside of established parameters. The auditor should obtain an understanding of the design of such controls over journal entries and other adjustments and determine whether they are suitably designed and have been placed in operation.”

An entity’s financial reporting system also includes the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as business combinations, or a nonrecurring estimate such as an asset impairment. Additionally, nonstandard entries include consolidation entries, reclassification entries, and spreadsheet or other worksheet adjustments. Because of the risk of misstatements (intentional or unintentional) oftentimes linked to nonstandard journal entries and

other adjustments, the engagement team needs to obtain a thorough understanding of the entity's controls surrounding this aspect of the financial reporting process.

Obtaining an understanding of the entity's financial reporting process helps the auditor to identify important information such as:

- The entity's written and unwritten policies and procedures regarding the initiation, recording and processing of standard and nonstandard journal entries and other adjustments;
- The sources of significant debits and credits to an account;
- Individuals responsible for initiating entries to the general ledger, transaction processing systems, or consolidation;
- Approvals and reviews required for such entries and other adjustments;
- The mechanics for recording journal entries and other adjustments (for example, whether entries are initiated and recorded online with no physical evidence, or created in paper form and entered in batch mode);
- Controls, if any, designed to prevent and detect fictitious entries and unauthorized changes to journals and ledgers; and
- Controls over the integrity of the process used to generate reports used by the auditors.

Assessing the Risk of Material Misstatement Resulting From Journal Entries and Other Adjustments

Although SAS No. 99 requires the auditor to test journal entries and other adjustments regardless of the risk assessment, the nature, timing, extent and focus of the testing will be influenced by the auditor's risk assessments. The auditor should assess the nature and risk of management's incentive to manipulate earnings or financial ratios through financial statement misstatement. That assessment should be made in conjunction with the interim reviews as well as the year-end audit. For example, if a client has loan covenant ratios that depend on earnings, and net income is close to causing covenant violations, then the auditor may assess the risk of material misstatement as higher. The auditor may also assess the risk of material misstatement as higher when executive compensation is tied to earnings thresholds and earnings are close to the threshold. Additionally, market expectations in many cases have led to earnings manipulations. In those cases where the auditor determines that the risk of fraudulent journal entries is high due to questions regarding the integrity of management, the auditor should reassess his or her client acceptance/continuance decision.

SAS No. 99 states, "Members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include... an exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated."

Journal entries and other adjustments oftentimes exist only in electronic form, which requires extraction of the desired data by an auditor with information technology (IT) knowledge and skills or the use of an IT specialist. In audits of entities with complex IT systems, the IT auditors and/or IT specialists should be included in the brainstorming session. In the brainstorming session, the auditors normally will discuss the following:

- The various ways in which management could originate and post inappropriate journal entries or other adjustments.
- The kinds of unusual combinations of debits and credits that the engagement team should be looking for.
- The types of journal entries or other adjustments that could result in a material misstatement that would not likely be detected by standard audit procedures.

Inquiries of Individuals Involved in the Financial Reporting Process

SAS No. 99, paragraph 24, states, “The auditor should inquire of others within the entity about the existence or suspicion of fraud. The auditor should use professional judgment to determine those others within the entity to whom inquiries should be directed and the extent of such inquiries. In making this determination, the auditor should consider whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud—for example, others who may have additional knowledge about or be able to corroborate risks of fraud identified in the discussions with management... or the audit committee.” Where practical, regardless of the fraud risk assessment, the auditor should inquire of the entity’s accounting and data entry personnel about whether those individuals were requested to make unusual entries during the audit period. The auditor should also consider asking selected programmers and IT staff about the existence of unusual and/or unsupported entries and specifically inquire about these entries, including whether any were initiated directly by top management outside the normal accounting process. The auditor should not expect client personnel to volunteer information about known or suspected fraud. However, those same individuals may be more likely to provide information if asked directly.

Assessment of Completeness of Journal Entry and Other Adjustments Sources

It is important in testing journal entries and other adjustments that the auditor be aware of and consider the entire population of journal entries and other adjustments. The auditor’s ability to detect fraud is adversely affected if he or she is not assured of access to all of the journal entries posted and other adjustments made during the audit period. The auditor should be aware that journal entries and other adjustments may be made outside of the general ledger and should obtain a complete understanding as to how the various general ledgers are combined and the accounts are grouped to create the consolidated financial statements. For example, at large, multi-national companies, multiple general ledgers are utilized, adjustments are made to convert from local GAAP to U.S.

GAAP, and translation and other adjustments are made before the numbers are combined (perhaps at more than one level of sub-consolidation) and become subject to further elimination and adjusting entries. Appropriate procedures should be applied to all of the various sources of information from which journal entries and other adjustments are selected for testing to assist the auditor in assessing completeness. The nature and extent of these procedures will depend on the engagement risk assessments and the client's systems for recording transactions.

Identification and Selection of Journal Entries and Other Adjustments for Testing

After the auditor has made his or her assessment of the risk of fraudulent journal entries and other adjustments and has performed appropriate procedures to assess completeness, he or she should design procedures, based on that assessment, to test the appropriateness of the journal entries and other adjustments from the various sources previously identified including (a) journal entries recorded in the general ledger, and (b) top side consolidation or report entries that are not actually posted to the general ledger. The auditor should test the appropriateness of selected journal entries and other adjustments in all engagements — including those in which the risk of fraudulent journal entries is assessed as low. Those tests are performed to confirm that entries are appropriately approved by management, are adequately supported and reflect the underlying events and transactions. Such tests should be designed to detect inappropriate entries.

After considering the identified population of journal entries and other adjustments, the auditor should use professional judgment to determine the nature, timing and extent of the testing of journal entries and other adjustments. SAS No. 99 requires that the auditor consider:

- The auditor's assessment of the risk of material misstatement due to fraud.
- The effectiveness of controls that have been implemented over journal entries and other adjustments.
- The entity's financial reporting process and the nature of the evidence that can be examined.
- The characteristics of fraudulent entries or adjustments.
- The nature and complexity of the accounts.
- Journal entries or other adjustments processed outside the normal course of business.

For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor's procedures should include selecting, from the various sources of information from which journal entries and other adjustments are posted, specific entries and other adjustments to be tested and examining the support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques ("CAATs") (for example,

report writers, software or data extraction tools, or other systems based techniques) to identify the journal entries and other adjustments to be tested. In addition, the CAATs ordinarily are designed to detect the following:

- Entries made at unusual times of day, that is, outside regular business hours.
- Entries made by unusual users, blank or nonsensical user names, senior management, or the IT staff.
- Electronic entries that, through management manipulation, are not documented in the general ledger.

Additionally, it is normally beneficial if the CAATs filter out recurring transactions in order to identify nonrecurring transactions and foot the detail in accounting records. The CAATs should be designed specifically to assist in evaluating whether all journal entries and other adjustments are included in the population to be reviewed. Firms utilizing internal IT specialists to perform the CAATs should invest appropriate resources in training to ensure that the IT specialists are able to competently perform the procedures and understand the importance of detecting any inappropriate journal entries or other adjustments.

Characteristics of fraudulent journal entries may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or a consistent ending number. The auditor should look for unusual entries during both the year-end and quarter-end cut-off procedures. Additionally, any entries that were reversed at the beginning of the subsequent period should be scrutinized more carefully. Also, the auditor ordinarily should consider looking for unusual entries that affect revenue.

Inappropriate journal entries may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to errors in the past, (d) have not been reconciled on a timely basis or contained unreconciled differences, (e) contain intercompany transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. The auditor should recognize, however, that inappropriate journal entries also might be made to other accounts.

Several high profile cases that resulted in restatements and allegedly involved management fraud, purportedly extensively utilized inappropriate journal entries and other adjustments. In many of those instances, management accomplished the fraud by posting numerous improper journal entries in relatively small amounts, which impacted large balance sheet and income statement accounts thereby not resulting in a significant fluctuation being identified through analytical procedures. The affected accounts included receivables, inventory, fixed assets, accumulated depreciation, goodwill, prepaid expenses and operating expenses, among others. If management is committed to creating fraudulent financial statements it can design journal entries to, among other things:

- Mask the diversion of funds.
- Record topside adjustments that improperly increase revenue.
- Improperly adjust segment reporting.
- Improperly reverse purchase accounting reserves.
- Improperly write-off uncollectible accounts receivable to purchase accounting reserve accounts and intercompany accounts thereby not reducing income.
- Understate payables through the recording of post-closing journal entries to increase various revenue accounts.
- Improperly decrease accounts payable and general and administrative expenses.
- Improperly capitalize costs as fixed assets or construction in progress instead of expensing those costs as incurred.
- Improperly record adjustments to allowances.

In audits of entities that have several locations or components, the auditor should consider the need to select journal entries from locations based on factors set forth in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA Professional Standards, vol. 1, AU sec. 312.18). Those factors include (a) the nature and amount of assets and transactions executed at the location or component, (b) the degree of centralization of records or information processing, (c) the effectiveness of the control environment, particularly with respect to management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or component, (d) the frequency, timing, and scope of monitoring activities by the entity or others at the location or component, and (e) judgments about materiality of the location or component.

After considering the factors outlined above, as well as the number and monetary amount of journal entries and other adjustments, the auditor should select journal entries and other adjustments from the population and examine documentary evidence indicating that the journal entries are properly supported and approved by management. The selections should include both journal entries recorded in the general ledger and top side or report adjustments that are not actually posted to the general ledger. Because fraudulent journal entries often are made at the end of a reporting period, the auditor's testing ordinarily should focus on the journal entries made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished, the auditor should consider whether there is also a need to test journal entries throughout the period under audit. Additionally, if entries are used to correct errors in financial statements of a previous period, the auditor should evaluate whether those previously issued financial statements should be restated.

The auditor should introduce an element of unpredictability regarding the dollar amount and types of journal entries and other adjustments tested. Often, companies are able to perpetrate fraud when, over a period covering several engagements, management is able to determine the auditor's scope and/or strategy and therefore design inappropriate journal entries and other adjustments that have a high probability of not being tested.

SAS No. 100, *Interim Financial Information*, paragraph 23, states, “The accountant performing the review of interim financial information ordinarily will also be engaged to perform an audit of the annual financial statements of the entity. Certain auditing procedures may be performed concurrently with the review of interim financial information.” SAS No. 100 is effective for interim periods with fiscal years beginning after December 15, 2002. As a matter of good practice, the auditor should consider auditing journal entries and other adjustments concurrently with the interim reviews. The auditor should especially focus on journal entries and other adjustments that were reversed at the beginning of the subsequent period.

Other Adjustments

In many cases, entities utilize spreadsheets to group general ledger accounts and make consolidating adjustments, reclassifications and other adjustments to arrive at financial statement amounts. Those consolidating adjustments, report combinations and reclassifications that are not reflected in formal journal entries should also be tested based on the auditor’s risk assessment. Tests of other adjustments would normally involve comparing the adjustments to underlying supporting information, and considering the rationale underlying the adjustment as well as the reason it was not reflected in a formal journal entry.

Documentation

SAS No. 96, *Audit Documentation*, requires that audit documentation be sufficient to show that the accounting records agree or reconcile with the financial statements or other information being reported on. The results of procedures performed relative to the entity’s journal entries and other adjustments should be documented in the appropriate section of the current audit file. This documentation should include:

- The procedures used by the engagement team to assess the completeness of the population of journal entries and other adjustments subject to review and testing.
- The journal entries and other adjustments that were selected for testing and the basis therefore.
- The procedures performed to audit the journal entries and other adjustments.
- The conclusions reached.
- Who performed and reviewed the work.

About the Author

Michael Ramos is a full-time author who specializes in auditing and accounting matters. He also writes and occasionally teaches training courses, and he works with CPA firms on a variety of strategic training and communications matters. His most recent book is *Complying with Sarbanes-Oxley Section 404* (John Wiley & Sons). *Fraud Detection in a GAAS Audit* is the sixth Practice Aid he has written for the AICPA.

Introducing AICPA practice tools to help you prevent, detect and investigate fraud.

SAS No. 99 is the cornerstone of the AICPA's Anti-Fraud and Corporate Responsibility Program. This program is designed to rebuild investor confidence in the capital market system and re-establish the audited financial statement as a clear picture window into corporate America. From providing CPAs with expanded auditing guidance to establishing a new institute on fraud studies, the AICPA is determined to help reduce the incidents of financial statement fraud.

The Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, is more far-reaching than its predecessor, SAS No. 82. To help members fully understand and comply with the standard — and see their responsibility in fraud prevention and detection — the AICPA has developed a variety of programs and materials. The following continuing education courses and practice aids are now available:

Revised! Fraud Detection in a GAAS Audit

By Michael J. Ramos, CPA

The newly revised *Fraud Detection in a GAAS Audit* reviews the implementation requirements of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*. It offers you a detailed understanding of the requirements, guidance and lessons learned from firms that have complied with SAS No. 99's requirements. In addition, the appendix arms you with example industry-specific risk factors for twelve industries.

The revised edition of this popular practice aid now also includes PITF 03-2, *Journal Entries and Other Adjustments*. This Practice Alert provides guidance on the design and performance of audit procedures to fulfill the responsibilities outlined in SAS No. 99.

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Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS

Choose Text or Videocourse

The fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You'll learn the conceptual framework necessary to understand the characteristics of fraud.

Objectives

- Recognize how the new fraud standard differs from the existing standard and the effect on your audit experience
- Understand the auditor's responsibilities for detecting fraud during the performance of a financial statement audit
- Apply a risk assessment approach to detecting fraud in a financial statement audit

Prerequisite: None

Recommended CPE Credit (based on a 100-minute hour): Text — 8; Video/DVDcourse — 9

Recommended CPE Credit (based on a 50-minute hour): Text — 16; Video/DVDcourse — 19

QAS Credit: Text — 16;

Video/DVDcourse — 19

Author(s): Michael J. Ramos, CPA

Level: Intermediate

Format: Text

No. 731811

AICPA Member \$119.00

Nonmember \$148.75

Format: 120-min.VHS Tape/Manual

No. 181811

AICPA Member \$149.00

Nonmember \$186.25

Format: 135-min.DVD/Manual

No. 181821

AICPA Member \$149.00

Nonmember \$186.25

From the AICPA and the Association of Certified Fraud Examiners

Fraud and the CPA

All CPAs have a responsibility to be diligent in preventing and detecting financial statement fraud. Whether you are a preparer of financial statements, an auditor, or just want to help your company or your clients, this course will help you be more effective in preventing and detecting such devastating frauds. In today's environment, this is knowledge you can't afford not to have.

Objectives

- Gain insights from fraud specialists that will deepen your fraud knowledge enhance your professional skepticism and improve your decision processes
- Understand the different ways people "cook the books" and learn what to watch out for
- Go beyond the checklists and learn to think like a fraudster so you can catch them

Prerequisite: None

Recommended CPE Credit (based on a 50-minute hour): 8

QAS Credit: 8

Level: Basic

Format: CD-ROM

No. 731730HS

AICPA Member \$119.00

Nonmember \$148.75

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More AICPA Publications and CPE Self-Study Courses on Fraud Prevention, Detection and Investigation

The CPA's Handbook of Fraud and Commercial Crime Prevention

The CPA's Handbook of Fraud and Commercial Crime Prevention takes you through all the issues, both theoretical and practical.

The Handbook deals in detail with the controversial issues of write-offs, cookie-jar reserves, materiality and big-bath restructuring. All these issues are illustrated by a close analysis of cases that reveals how multimillion dollar frauds occur.

The world's top experts prepare you to fight fraud

This is your chance to learn effective prevention policies and methods of dealing with specific types of fraud from a team of leading fraud prevention professionals and forensic accounting experts from the famed Kroll firm: Tedd Avey, CPA, CA, CFE, Kroll Lindquist Avey, Toronto & Atlanta; Ted Baskerville, CA, CFE, Kroll Lindquist Avey, London; Alan E. Brill, CISSP, Kroll Associates, New York; Hazel de Burgh, CA, CFE, Kroll Lindquist Avey, Toronto; and Bill Jennings, CPA, CFE, Kroll Lindquist Avey, Chicago.

You'll get business sector-by-sector fraud prevention checklists and vulnerability grids

You'll get a breakdown of fraud in the following business sectors, complete with prevention checklists and fraud vulnerability grids: construction, financial services, government, high technology, manufacturing, media and communications, nonprofits, professional services, real estate, recreation, natural resources, retail, small businesses, transportation and wholesale.

Bonus: A Checklist CD-ROM

containing ready-to-use checklists in critical areas of fraud prevention.

Extra Bonus: *Report on Fraud* Newsletter subscription with 6 issues per year.

Annual updates keep you current and are shipped upon approval.

Loose-leaf

No. 056504

AICPA Member \$180.00

Nonmember \$225.00

Auditing for Internal Fraud

Everybody's talking about fraud. Auditing for Internal Fraud, this course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.

Objectives

- Develop fraud audit program
- Evaluate gaps in internal controls
- Design fraud prevention and detection programs
- Understand the auditor's professional responsibilities
- Identify critical indicators of fraud schemes

Prerequisite: None

Author: Michael Connelley, CFE, CPA

Recommended CPE Credit: 6

Level: Intermediate

QAS Credit†: 12

Format: Text

No. 730272

AICPA Member \$109.00

Nonmember \$136.25

SAS 99: An Advanced Analysis

"SAS 99: An Advanced Analysis" is an advanced-level discussion of how to implement the standard's requirements and is designed for participants who have a basic level of familiarity with the standard. Whether you audit publicly-held or privately-held organizations, make sure that you and your staff have the latest information available on how to effectively implement SAS No. 99.

Moderator: John Hudson, CPA

Speakers: Michael J. Ramos, CPA

David L. Cotton, CPA, CFE, CGFM

Objectives: N/A

Prerequisite: N/A

Recommended CPE Credit (based on a 100-minute hour): 2

QAS Credit: 4

Level: Intermediate

Format: CD-ROM

No. 737133HS

AICPA Member \$59.00

Nonmember \$59.00

Financial Reporting Fraud: A Practical Guide to Detection and Internal Control

Charles R. Lundelius, Jr., CPA/ABV

This guide, written by a CPA for CPAs in both public practice and industry, provides the knowledge necessary to minimize fraud exposure for the CPA, the employer, and the client. Through case studies, you'll find explanations on:

- Where to look for the fraud
- Who is most likely to perpetrate the fraud
- What the fraud is going to look like
- What should be done to expose the fraud
- What to do to cut down the risk of future fraud

Example scenarios and analysis illustrate key points, especially the red flags that CPAs, both internal and external, should be aware of and timely installed procedures and controls that could have prevented or limited the fraud.

Also Available from the AICPA

Go to www.cpa2biz.com/store for more information and to order these CPE self-study courses:

- Legal Elements of Fraud
- Detecting Misappropriation Schemes
- Introduction to Fraud Examination and Criminal Behavior
- The Fraud Trial
- Finding the Truth: Effective Techniques for Interview and Communication
- Fraud Investigation Methods
- Computer Fraud and Information Security
- Corporate Espionage

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