SAS 99 CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT

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At first glance it may appear that SAS 99 (AU 316) was a reaction to the numerous scandals that have befallen the accounting profession in the recent past. In reality, SAS 99 was the product of four years of planning by the AICPA.

The effective date for this statement is for audits of financial statements for periods beginning on or after December 15, 2002.

SAS 99 does not change the overall responsibility of an auditor for detecting fraud, but it does make a significant change in how and what the auditor is required to do in order to fulfill responsibilities. The introduction and overview of SAS 99 (AU Section 316, paragraph .01) states:

> "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. [footnote omitted]" This section establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).

Therefore, SAS 99 states in the introduction that this statement is establishing standards and providing guidance, not changing the responsibility of the auditor.

Fraud definition

The first thing to be familiar with is the definition of fraud. SAS 99 (AU Section 316, paragraph .05) defines fraud as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit."

Two types of fraud

There are two types of fraud that are of concern to an auditor under SAS 99. First are misstatements arising from fraudulent reporting. The second consists of misstatements arising from misappropriation of assets. The latter of these two is the type of fraud that probably comes to mind for most people. That is because that type of fraud consists of employees who are misappropriating assets for some type of personal gain.

Fraudulent reporting, on the other hand, is the intentional misstatement of financial statements in order to mislead the user of said financial statements.

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Three conditions for fraud

There are three conditions, which have been well publicized, that are generally present when fraud occurs. The three conditions are incentive, opportunity, and rationalization:

- **Incentive—**the pressure or reason to commit fraud, such as the possibility of defaulting on loan covenants or unexpected personal bills that someone is unable to pay.
- **Opportunity—**the absence or the ineffectiveness of controls over assets or financial reporting.
- **Rationalization—**allows a person to commit a dishonest act by relating it to ones own ethical values and deeming it acceptable.

Of the three conditions listed above, typically the most difficult to detect is rationalization, because it goes to the thought process of the individual committing the act. The list of conditions is obviously not a requirement for fraud to exist, but in most situations these conditions will be identified. The key is that these three conditions are items to be aware of and look for while performing an audit. If one of these conditions is found, then the auditor should exercise professional skepticism, and should examine further to see if any other conditions exist and if other risk factors are present.

Professional skepticism

Auditors are required under SAS 99 to apply professional skepticism in gathering and evaluating audit evidence. This is not to say that the auditor is now assuming that the client is dishonest, but the auditor is also not going to assume that the client is automatically being honest. Our legal system is built on the innocent until proven guilty theory, and that is probably how many audits have been conducted. SAS 99 does not want the auditor to take the converse approach and assume guilt until proven innocent, but the auditor should have a neutral position on the information that is being gathered and evaluated. Professional skepticism is defined by SAS 99 (AU Section 316, paragraph .13) as “an attitude that includes a questioning mind and a critical assessment of audit evidence.”

Brainstorming

Brainstorming is a term that many have not heard since college or high-school when trying to come up with ideas for a paper or some other activity. SAS 99 is going to make auditors become “experts” with this particular activity. According to SAS 99 (AU Section 316, paragraph .14), “the audit team should discuss the potential for material misstatement due to fraud.” This discussion should include an “exchange of ideas or ‘brainstorming’ among the team members, including the auditor with final responsibility for the audit . . .”

This brainstorming session should also include a discussion of ways an audit client is vulnerable to a fraud that will materially misstate their financial statements, including how management could override controls and how assets could be misappropriated. The members of the audit team to be included in the brainstorming session are a matter of professional judgment, but ordinarily key members of the audit team should be involved.

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This brainstorming session may seem to be unimportant and useless, but this activity should be treated with the same care an auditor gives while performing any other required audit function, such as observing inventory. The brainstorming session is going to give the audit team ideas of where and how these fraudulent activities can occur, and the audit team is going to respond by planning and performing audit functions to confirm or rule out the ideas generated in the brainstorming session. Fraud that may result in a material misstatement could quite possibly be concealed from the savviest auditor, through many actions (including collusion), but the idea behind the brainstorming and SAS 99 is to identify areas where fraud could exist and examine those areas to the fullest extent. The risks of material misstatements due to fraud should be discussed among audit team members throughout the audit, not just during the planning phase.

Additional procedures

SAS 99 (AU Section 316, paragraph .19) gives the auditor procedures to perform that can be used to identify the risks of material misstatements due to fraud. The procedures include:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed.

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit.

c. Consider whether one or more fraud risk factors exist.

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud.

Pursuant to SAS 99 (AU Section 316, paragraph .20), the auditor should make the following inquiries of management:

- Whether management has knowledge of any fraud or suspected fraud affecting the entity

- Whether management is aware of allegations of fraud or suspected fraud . . .

- 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 a risk of fraud may be likely to exist

- Programs and controls 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

- 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

According to SAS 99 (AU Section 316, paragraph .21):

> The inquiries of management also should include whether management has reported to the audit committee or others with equivalent authority and responsibility [footnote omitted] (hereafter referred to as the audit committee) on how the entity's internal control [footnote omitted] serves to prevent, deter, or detect material misstatements due to fraud.

There are also other inquiries that should be directed to the audit committee and the internal auditors (see SAS 99, AU Section 316, paragraphs .22 and 23).

Inquiries of others in the entity should be directed to those employees that the auditors determine appropriate. The others questioned should be able to provide additional information about fraud risk factors or corroborate items found in discussions with management. The statement does not identify specific inquiries, but it does identify possible personnel to make further inquiries (see AU Section 316, paragraph .25). Again, this list is not an exclusive list, but examples:

- Employees with varying levels of authority within the entity . . .

- Operating personnel not directly involved in the financial reporting process

- Employees involved in initiating, recording, or processing complex or unusual transactions . . .

- In-house legal counsel

Inquiries of management and other personnel should be used to receive communications from the client that may not have been received had the questions not been presented to the client. In many situations, after frauds have been unveiled, it was discovered that personnel within had knowledge of the fraud or suspected the fraud and they would have told someone if asked, but no one asked. SAS 99 intends to change that, with inquiries of management and others within the entity.

Identifying risks

Identification of risk includes assessing the risk itself, including type, significance, likelihood, and pervasiveness of the risk. Assessing these four attributes will help to identify where the auditor needs to focus auditing procedures.

According to SAS 99 (AU Section 316, paragraph .41), "the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition." This becomes even more of an issue when revenue is subject to estimates, as is the case with construction accounting. The most difficult aspect of assessing the fraud risk associated with revenue recognition for a contractor is that a contractor's revenue is based in part on estimates, which in some cases can change the outcome of a statement tremendously if that estimate is inaccurate. The reason this is difficult is because the auditor has to determine whether the contractor is committing fraud or whether the contractor just simply missed the cost-to-complete on a particular contract. In assessing this risk, all factors must be looked at and not just the fact that gross profit on a contract faded from one year to the next.

INQUIRIES OF MANAGEMENT AND OTHER PERSONNEL SHOULD BE USED TO RECEIVE COMMUNICATIONS FROM THE CLIENT THAT MAY NOT HAVE BEEN RECEIVED HAD THE QUESTIONS NOT BEEN PRESENTED TO THE CLIENT.

After considering all of the above, management override is still a possibility, which is why the risk of management override must be considered separately from any conclusions reached on previous risks.

Internal controls can lessen the risk of material misstatement due to fraud if designed and implemented properly. Thus, when assessing fraud risk the auditor must factor in whether the client has a proper set of internal controls, because proper internal controls can help prevent fraud before it even begins.

The auditor's response

The auditor, after assessing risk, must now respond to the identified risks of material misstatement. SAS 99 (AU Section 316, paragraph .48) lists three responses of the auditor as follows:

> *a.* A response that has an overall effect on how the audit is conducted—that is a response involving more general considerations apart from the specific procedures otherwise planned.
>
> *b.* A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed.
>
> *c.* A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

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The assignment of personnel and supervision, application of accounting principles, and predictability of auditing procedures are all items considered as a response involving the overall audit. The controllers of audit clients probably know what the auditor is going to ask for before the question is even posed in certain instances. The reason for this is that the audit is typically done at the same time, with the same personnel, and the same set of circumstances. As can be ascertained, this is a recipe for disaster, because if the client can predict what is going to be examined, then they have the opportunity to commit fraud. Therefore, using some unpredictability in the audit can help to diminish the fraud risk by limiting the opportunity to commit fraud.

The nature, timing, and extent of auditing procedures are an extension of the unpredictability mentioned previously. Some examples of modifying the nature, timing, and extent of auditing procedures, listed by SAS 99 (AU Section 316, paragraph .53), are paraphrased here:

1. Perform procedures on an unannounced basis.
2. In addition to written confirmations, use oral inquiries of customers and vendors.
3. Analyze data on different time periods, different locations, business lines, etc.
4. Interview personnel involved in activities that have been identified as a fraudulent risk factor.

Management override is probably the most difficult risk to assess and respond to because, by its very definition, there are no checks and balances for this risk. Some responses may include: examine journal entries and the reason for a particular journal entry, reviewing accounting estimates for biases, and evaluating business rationale for significant unusual transactions.

Evaluating audit evidence

The assessment of risk should be done throughout the entire audit, not just at specific times. This being said, at or near the end of fieldwork, the auditor should evaluate the evidence that has been accumulated over the course of the audit. This evaluation is typically a judgment on the part of the auditor as to whether a fraud risk resulting in a material misstatement has been identified and a proper response has been performed.

Communication to management

Pursuant to SAS 99 (AU Section 316, paragraph .79), "[w]henever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management." The fraudulent act may seem and be inconsequential to the audit, but to the management of that entity, that act is probably very important. It may also be a good idea to relay to management where a fraudulent activity could occur.

Documentation

As listed in SAS 99 (AU Section 316, paragraph .83), the auditor should document the following:

> • The discussion among engagement personnel in planning the audit regarding the susceptibility of an 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

Conclusion

As firms begin to perform 2003 audits, this process will have a significant impact on each engagement. Therefore, proper planning to implement the new standard will be a necessity for most CPA firms. It is also possible that some of the CPAs performing audits were already performing some of the procedures mentioned above, but not in a formalized manner. ■