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Auditing Standards Update

NEW AUDITING STANDARDS STATEMENT NO.99

CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT

SAS No. 99, Consideration of Fraud in a Financial Statement Audit, is a significant new auditing standard issued that is contributing to the accounting profession's efforts to help restore confidence in the capital markets. It requires new heighten professional skepticism that presume fraud is possible and that consideration is blended in the audit process throughout the entire engagement.

It requires the identification and assessment of fraud risks and auditor response to such risks.

The standard includes an expanded fraud risk model from social sciences which considers 1)Incentives/pressure, 2) opportunities and 3)rationalizations related to fraud.

MANAGEMENT'S ROLE

Management is responsible for overseeing the activities carried out by its employees and for implementing and monitoring anti-fraud processes and controls. The most important way for management to prevent fraud is to communicate effectively, by both word and deed, a zero-tolerance policy. This may seem self-evident, but setting the right tone at the top goes a long way toward preventing fraud throughout an organization.

WHAT'S "OLD HAT"

Some steps required under SAS 99 are "business as usual" for auditors, such as:

- Exercising professional skepticism
- Initiating discussions among our audit team to identify risks within the organization
- Initiating discussions with our clients to identify risks or possible instances of existing fraud
- Identifying specific audit tests to help mitigate risks addressed during the planning
- Communicating instances of fraud to the appropriate level of management

WHAT'S "NEW AND HOT OFF THE PRESS"

A common thread among recent corporate accounting failures is financial statements that have been misstated through a manipulation of revenue. Improper revenue recognition can and does occur two ways:

1. overstating revenues to report greater earnings figures or
2. understating revenues to avoid tax consequences.

As a result, SAS 99 requires auditors to identify improper revenue recognition as a risk of material misstatement due to fraud, and to implement audit procedures to mitigate this risk.

A second cause of fraudulent financial statements is the processing of fictitious or unauthorized journal entries. SAS 99 requires auditors to review adjusted journal entries for potential fraud.

Auditors are now also required to consider the risk of management's override of internal controls. Even organizations with sound internal controls are not immune to having their systems, policies, and procedures compromised

Based on any risk findings by the audit team, there may be a decision to modify the nature, timing and extent of its audit procedures. For example, there recently has been an emphasis on the utilization of electronic data analysis tools.

WHAT DOES SAS 99 MEAN TO YOU, OUR CLIENTS?

As our clients, you will be seeing some changes in our audit approach.

Various levels of management, including the audit committee (if applicable), will be required to field more questions regarding your knowledge of fraud and risks within the organization.

Since there is an emphasis on electronic data analysis, you may be asked to provide certain reports from your general ledger in an electronic format suitable for our program.

The Management Representation Letters that you sign at the end of the audit will include more extensive wording as it relates to fraud, suspected fraud, and knowledge of allegations of fraud.

Ultimately, management is responsible for implementing sounds internal controls and procedures to prevent, deter, and detect fraud.

Inquiries of Management and Others

During the inquiry process, SAS 99 requires the auditor to ask employees of the company if they are aware of any fraud or suspected fraud and to inquire if they have ever been asked to, or witnessed another employee, circumvent the company's policies, procedures or controls.

Inquiry of management and others is used extensively throughout the audit planning process. In many cases, it serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures.

Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed.

Some examples of the members of management and others that auditors may consider interviewing include:

- The owner/manager in a small business.
- The president or chief executive officer.
- The controller.
- The chief financial officer
- Other employees
- Parties outside the entity

Fraud-Related Inquiries

As part of gathering the information needed to identify fraud risks, SAS No. 99 requires auditors to inquire of management or the owner/manager and others about:

- Their knowledge of any actual fraud or suspicions of fraud affecting the company.
- Their awareness of any allegations of fraud or suspected fraud affecting the company.
- Their understanding of the risks of fraud within the company, including any specific fraud risks the company has identified or account balances or transaction classes that may be susceptible to fraud.
- How they communicate to employees the importance of ethical behavior and appropriate business practices.
- Programs and controls the company has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.
- The nature and extent of monitoring multiple locations or business segments and whether any of them have a higher level of fraud risk.
- Whether they have reported to the audit committee (or its equivalent) about how the company's internal control serves to prevent, deter, and detect material misstatements due to fraud.

Inquiries about Fraud Risks for Management or the Owner/Manager

The following is a list of questions which may be consider of asking management or the owner/manager.

- Are you aware of any actual instances of fraud within the company?
- Have you seen any changes in employee behavior?
- Which types of transactions, account balances, financial statement classifications, or company locations are most at risk for intentional misstatement or theft?
- What would be the easiest way for someone to misstate the financial statements or steal assets without getting caught?
- If someone were going to overstate or understate net income, how would they do it?

Inquiries about Fraud Risk for Company Employees

The following is a list of questions which may be appropriate for employees at different levels.

- What is it like to work here? How is the overall morale?
- Do you know of anyone in the company who is manipulating the accounts or records?
- Are you upset with the company for any reason? Do you know of anyone who is?
- Have you ever been asked to ignore or override a policy or procedure that is part of your job? Who asked you?
- Have you noticed any unusual changes in the behavior or lifestyle of management or any other employees?
- Do you know of any employees who are under pressure to make ends meet financially?

Good or Bad?

Some business owners and CPAs believe that these requirements border on overkill and represent a kneejerk reaction to the Enron, Tyco and WorldCom scandals that spawned them.

Others are dismayed that SAS 99, in particular, changes the relationship between the CPA and business entity into one involving investigation.

Still others are relieved that these rules are in place to further clarify financial relationships and illuminate fraud.

If you would like more information about SAS 99 or internal controls, we invite you to call us, or you may check out the following websites: American Institute of Certified Public Accountants (www.aicpa.org) and the Association of Certified Fraud Examiners (www.cfenet.com).