SAS No. 99--Consideration of Fraud in a Financial Statement Audit
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SAS no. 99 as printed below does not reproduce the appendix or exhibit to the standard. The appendix, “Examples of Fraud Risk Factors,” can be found on the AICPA Web site at www.aicpa.org/anti
fraud/programs-and-controls. This section requires the auditor to evaluate the entity’s programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)

The section requires the auditor to respond to the results of the assessment in three ways:

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. (See paragraph 50.)
B. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed. (See paragraph 51 through 56.)
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. (See paragraphs 57 through 67.)

SAS No. 99—Consideration of Fraud in a Financial Statement Audit

INTRODUCTION AND OVERVIEW
1. Statement on Auditing Standards (SAS) No. 1, Codification of Auditing Standards and Procedures (AICPA, Professional Standards, vol. 1, AU sec. 110, 02, “Responsibilities and Functions of the Independent Auditor”), 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 statement establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud.

2. The following is an overview of the organization and content of this section:

- Identification of fraud risks
- Consideration of fraud risks
- Assessing the identified risks
- Reporting the results of the assessment

3. Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

4. Auditors often conduct matters relating to the performance of such services.

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11. Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

12. Auditors often conduct matters relating to the performance of such services.
6. Two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

- Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements that are material. These misstatements are made by management users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles (GAAP). Fraudulent financial reporting may be accomplished by the following:
  - Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
  - Missrepresentation or intentional omission from the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manipulation, and misappropriation of cash or other assets. Fraudulent financial reporting need not be the result of a grand plan or conspiracy. It may be that management representatives rationalize the appropriateness of a material misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements, including interim statements, expected to be corrected later when operational results improve.

- Misstatements arising from misappropriation of assets (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services that have not been received. Misappropriation of assets may be achieved by false or misleading records or documents, possibly created by circumventing controls. The scope of this Statement includes only those misappropriations of assets for which the effect of the misappropriation causes the financial statements not to be fairly presented, in all material respects, in conformity with GAAP.

7. Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise honest individuals can commit dishonest acts in an environment that imposes sufficient pressure on them. The greater the influence of pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.

8. Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Management can either direct employees to perpetrate fraud or solicit their help in carrying it out. In addition, management personnel at a component of the entity may be in a position to manipulate the accounting records of the component in a manner that causes a material misstatement in the consolidated financial statements of the entity. Management override of controls can occur in unpredictable ways.

9. Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Control weaknesses may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation. For example, management that engages in fraudulent financial reporting might alter shipping documents. Employees or members of management who create, alter, or destroy records of cash and other payments may commit fraud by forging signatures or escalating electronic approvals on disbursement authorizations. An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as expected to be experts in such authenticating techniques. In addition, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed.

10. Fraud also may be concealed through collusion among management, employees, or third parties. Collusion may cause the auditor who has properly performed the audit to conclude that a risk assessment is adequate when it is not. Collusion might be provided when it is, in fact, false. For example, through collusion, false evidence that controls have been operating effectively may be presented to the auditor, or consistent misleading explanations may be given to the auditor by more than one individual within the entity to explain an unexpected result of an analytical procedure. As another example, an auditor may find that cash receipts are not banked, a subsidiary ledger may not be satisfactorily reconciled to its control account, or the results of an analytical procedure performed during the audit may not be consistent with expectations. However, these conditions may be the result of circumstances other than fraud.

- Frauds have been committed by management override of existing controls using such techniques as (a) recording fictitious journal entries, particularly those recorded close to the end of an accounting period to manipulate operating results, (b) intentionally biasing assumptions and judgments used to estimate account balances, and (c) altering records and terms related to significant and unusual transactions.
Documents may legitimately have been lost or misfiled; the subsidiary ledger may be out of balance with its control account because of an unintentional accounting error; and unexpected analytical relationships may be the result of unanticipated changes in underlying economic factors. Even reports of alleged fraud may not always be reliable because an employee or outsider may be mistaken or may be motivated for unknown reasons to make a false allegation.

12. As indicated in paragraph 1, 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 fraud or error. However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to alter the procedures performed. Audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

THE IMPORTANCE OF EXERCISING PROFESSIONAL SKEPTICISM

13. Due professional care requires the auditor to exercise professional skepticism. See SAS No. 1, Codification of Auditing Standards and Procedures (AICPA, Professional Standards, vol. 1, AU sec. 230.07–09, “Due Professional Care in the Performance of Work”), because of the characteristics of fraud, the auditor's exercise of profession skepticism is an ongoing question of whether the information and evidence obtained suggests that a material misstatement or entity fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should be satisfied with less-than-persuasive evidence because of the belief that management is honest.

DISCUSSION AMONG ENGAGEMENT PERSONNEL REGARDING THE RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD

14. Prior to or in conjunction with the information-gathering procedures described in paragraphs 19 through 34 of this Statement, members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include:

a. Any change of the use 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. (See paragraph 15.)

b. An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud. (See paragraph 16.)

c. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the knowledge, objectivity, and judgment that would affect the entity that might (a) increase incentives/pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud. The discussion should also occur in paragraphs 20 through 23 questioning mind as described in paragraph 16 and, for this purpose, setting aside any prior beliefs the audit team members may have that management is honest and has integrity. In this regard, the discussion should include a consideration of the risk of management override of controls.

d. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs 28 through 30.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs 31 through 33.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph 34.)

Making Inquiries of Management and Others Within the Entity About the Risks of Fraud

20. The auditor should inquire of management about:

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

b. Whether management is aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from outside parties, analysts, regulators, short sellers, or others

c. Management's understanding of 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

d. The entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, detect, and detect fraud, and how management monitors those programs and controls. For example, programs and controls an entity may implement to prevent, detect, and detect fraud, see the exhibit titled "Management Anti-Fraud Programs and Controls" at the end of this Statement.

5 In addition to these inquiries, SAS No. 85, Management Representations (AICPA, Professional Standards, vol. 1, AU sec. 333), as amended, requires the auditor to obtain selected written representations from management regarding fraud.

SAS No. 55, Consideration of Internal Control in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319.06 and 07), as amended, 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 described in SAS No. 55.

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- 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

21. The inquiries of management also should include whether management has reported to the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee) on how the entity's internal controls serve to prevent, deter, or detect material misstatements or fraud.

22. The auditor also should inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity. An entity's audit committee sometimes plays the role in monitoring the entity's assessment of the risks of fraud and the programs and controls the entity has established to mitigate these risks. The auditor should obtain an understanding of how the audit committee exercises oversight activities in that area.

23. For entities that have an internal audit function, the auditor also should inquire of appropriate internal audit personnel about their views about the risks of fraud, whether they have performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from these procedures, and whether management has knowledge of any fraud or suspected fraud.

24. In addition to the inquiries outlined in paragraphs 20 through 23, the auditor should inquire of others within the entity about the existence or suspicion of fraud. The auditor should use professional judgment to determine their views about 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 (see paragraph 20) or the audit committee (see paragraph 22).

25. Examples of others within the entity to whom the auditor may wish to direct these inquiries include:
- Employees with varying levels of authority within the entity, including, for example, entity personnel with whom the auditor comes in contact during the course of the audit in obtaining (a) an understanding of the entity's systems and internal controls, or (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for fluctuations noted as a result of analytical procedures
- Operating personnel not directly involved in the financial reporting process
- Employees involved in initiating, recording, or processing complex or unusual transactions—for example, a sales transaction with multiple elements, or a significant related party transaction
- In-house legal counsel

26. The auditor's inquiries of management and others within the entity are important because fraud often is uncovered through information received in response to inquiries. One reason for this is that such inquiries may provide individuals with an opportunity to convey information to the auditor that otherwise might not be communicated. Making inquiries of others within the entity, in addition to management, may be useful in providing the auditor with a perspective that is different from that of individuals involved in the financial reporting process. The responses to these other inquiries might serve to corroborate responses received from management. Alternatively, the auditor might provide information regarding the possibility of management override of controls—for example, a response from an employee indicating an unusual change in the way transactions have been processed. In addition, the auditor may obtain information from these inquiries regarding how effectively management has communicated standards of ethical behavior to individuals throughout the organization.

27. The auditor should be aware when evaluating management's responses to the inquiries discussed in paragraph 20 that management is often in the best position to perpetrate fraud. The auditor should use professional judgment in deciding whether it is necessary to corroborate responses to inquiries with other information. However, when responses are inconsistent among inquiries, the auditor should obtain additional audit evidence to resolve the inconsistencies.

Considering the Results of the Analytical Procedures Performed in Planning the Audit

28. SAS No. 56, Analytical Procedures (AICPA Professional Standards, vol. 1, AU sec. 329.04 and .06), requires that analytical procedures be performed in planning the audit with an objective of identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning implications. In performing analytical procedures in planning the audit, the auditor develops expectations about plausible relationships that are reasonably expected to exist, based on the auditor's understanding of the entity and its environment. When comparing relationships with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying the risks of material misstatement due to fraud.

29. In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. An example of such an analytical procedure that addresses this objective is a comparison of sales volume, as determined from recorded revenue amounts, with production capacity. An excess of sales volume over production capacity may be indicative of recording fictitious sales. As another example, a trend analysis of revenues by month and sales returns by month during and shortly after the reporting period may indicate the existence of undisclosed side agreements with customers to return goods that would preclude revenue recognition.

30. Analytical procedures performed during planning may be helpful in identifying the risks of material misstatement due to fraud. However, because such analytical procedures generally use data aggregated at a high level, the results of those analytical procedures provide only a broad initial indication about whether a material misstatement of the financial statements may exist. Accordingly, the results of analytical procedures performed during planning should be considered along with other information gathered by the auditor in identifying the risks of material misstatement due to fraud.

Considering Fraud Risk Factors

31. Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, and rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

32. When obtaining information about the entity's environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud.

33. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in the Appendix. These illustrative risk factors are classified based on the three conditions generally present when fraud exists: incentive/pressure to perpetrate fraud, an opportunity to carry out the fraud, and attitude/rationalization to justify a fraudulent action. 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. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different business circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Considering Other Information That May Be Collected in Identifying Risks of Material Misstatement Due to Fraud

34. The auditor should consider other information that may be helpful in identifying risks of material misstatement due to fraud. Specifi
entify, the auditor occasionally considers factors that, generally, can lead to improper conduct by management, such as the effectiveness of the audit committee and the internal audit function, and the existence and enforcement of a formal code of conduct. In the case of a smaller entity, some or all of these considerations may be inapplicable or less important, and management may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and management example. Also, the risks of material misstatement due to fraud may vary among operating locations or business segments of an entity, requiring an identification of the risks related to specific geographic areas or business segments, as well as for the entity as a whole.

38. The auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. In determining if the risk of material misstatement due to fraud is a significant risk for the individual accounts, classes of transactions, and assertions will assist the auditor in subsequently designing appropriate auditing procedures.

39. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. For example, liabilities resulting from a restructuring may be deemed to have high inherent risk because of the high degree of subjectivity and management judgment involved in their estimation. Similarly, revenues for software developers may be deemed to have high inherent risk because of the complex accounting principles applicable to the recognition and measurement of software revenue transactions. Assets resulting from investing activities may be deemed to have high inherent risk because of the subjectivity and management judgment involved in estimating fair values of those values.

40. In summary, the identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including:

- 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 result in 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 auditor may consider specific controls designed to mitigate specific risks of fraud—for example, controls to address specific assets susceptible to misappropriation, and (b) broader programs designed to prevent, deter, and detect fraud—for example programs to promote a culture of honesty and ethical behavior.

A Consideration of the Risk of Management Override of Controls

41. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See paragraph 54 for examples of auditing procedures related to the risk of improper revenue recognition.)

ASSESSING THE IDENTIFIED RISKS AFTER TAKING INTO ACCOUNT AN EVALUATION OF THE ENTITY’S PROGRAMS AND CONTROLS THAT ADDRESS THE RISKS

43. SAS No. 55 requires the auditor to obtain an understanding of each of the five components of internal control sufficient to perform the audit. It also notes that such knowledge should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, design tests of controls when applicable, and design substantive tests. Additionally, SAS No. 55 notes that controls, whether manual or automated, can be designed in combination of two or more people or inappropriate management override of internal control.

44. As part of the understanding of internal control sufficient to plan the audit, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation. These programs and controls may involve (a) specific controls designed to mitigate specific risks of fraud—for example, controls to address specific assets susceptible to misappropriation, and (b) broader programs designed to prevent, deter, and detect fraud—for example programs to promote a culture of honesty and ethical behavior.

The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies may exacerbate the risks (see paragraph 80). The exhibit at the end of this Statement discusses examples of programs and controls an entity might implement to create a culture (continued on page 112)

18 SAS No. 47 (AU sec. 312.16) provides guidance on the auditor’s consideration of the extent to which auditing procedures will be performed at selected locations or components.

17 For a discussion of indicators of improper revenue recognition and common techniques for overstating revenue and illustrative audit procedures, see the AICPA Audit Guide: Auditing Revenue in Certain Industries.

16 See footnote 10.
RESPONDING TO THE RESULTS OF THE ASSESSMENT

46. A auditor’s response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence. As noted in paragraph 13, professional skepticism is an attitude that includes a critical assessment of the competency and sufficiency of audit evidence. Examples of the application of professional skepticism include: (a) identifying risks of material misstatement due to fraud as (i) assessing the design and operating effectiveness of controls, and (ii) performing substantive testing of balances, classes of transactions, and related assertions; (b) obtaining additional evidence concerning the entity’s controls over transactions that use significant accounting estimates or make complex transactions, and related assertions; and (c) considering the implications of significant events occurring after the balance sheet date.

47. The auditor’s response to the assessment of the risks of material misstatement of the financial statements due to fraud is influenced by the nature and significance of the risks identified as being present (paragraphs 35 through 42) and the evidence gathered from the specific procedures performed (paragraphs 43 through 45).

48. The auditor responds to risks of material misstatement due to fraud in the following three ways:

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 (see paragraph 50).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs 51 through 56).

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 unexpected scale or nature of such override (see paragraphs 57 through 67).

49. The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In that case, withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action (see paragraph 78).

OVERALL RESPONSES TO THE RISK OF MATERIAL MISSTATEMENT

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

i. **Assignment of personnel and supervision.** The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the assessment of the risks of material misstatement due to fraud for the engagement (see SAS No. 1, AU sec. 326.15–21). Furthermore, the auditor may choose to employ computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts or transactions during the audit.

ii. **Accounting principles.** The auditor should consider management’s selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions. In this respect, the auditor should have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements. In developing judgments about the quality of such principles (see SAS No. 61, Communication With Audit Committees [AICPA, Professional Standards, vol. 1, AU sec. 380.11]), the auditor should consider whether their collective application indicates a bias that may create such a material misstatement of the financial statements.

iii. **Predictability of auditing procedures.** The auditor should include an element of unpredictability in the selection from year to year of auditing procedures to be performed—for example, performing substantive tests of selected account balances and assertions not otherwise tested due to their materiality or risk, adjusting the timing of testing from that otherwise expected, using differing sampling methods, and performing procedures at different locations or at locations on an unannounced basis.

RESPONSES INVOLVING THE NATURE, TIMING, AND EXTENT OF PROCEDURES TO BE PERFORMED TO ADDRESS THE IDENTIFIED RISKS

51. The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity’s programs and controls. However, because management may have the ability to override controls that otherwise appear to be operating effectively (see paragraph 8), it is unlikely that audit risk can be reduced to an appropriately low level by performing only tests of controls.

52. The auditor’s response to address specifically
date of completion of the count and the end of the reporting period.  
■ Making oral inquiries of major customers and suppliers in addition to sending written confirmations, or sending confirmation requests to a specific party within an organization.
■ Performing substantive analytical procedures using disaggregated data, for example, comparing gross profit or operating margins by location, line of business, or month to auditor-developed expectations.  
■ Interviewing personnel involved in activities in areas where a risk of material misstatement due to fraud has been identified to obtain their insights about the risk and how controls address the risk (see paragraph 24).
■ If other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work that needs to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.  

Additional Examples of Responses to Identified Risks of Misstatements ARISING FROM FRANTITIONAL FINANCIAL REPORTING  
54. The following are additional examples of responses to identified risks of material misstatement relating to fraudulent financial reporting:  
■ Revenue recognition. Because revenue recognition is dependent on the particular facts and circumstances, as well as accounting principles and practices that can vary by industry, the auditor ordinarily will develop auditing procedures based on the auditor's understanding of the entity and its environment, including the composition of revenues, specific attributes of the revenue transactions, and unique industry considerations. If there is an identified risk of material misstatement due to fraud that involves improper revenue recognition, the auditor may want to consider:  
—Performing substantive analytical procedures not based solely on using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.  
—Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements.  
■ For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the rights to return, refund, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.  
—Inquiring of the entity's sales and marketing personnel or their knowledge of any unusual terms or conditions associated with these transactions.  
—Being physically present at one or more locations at period end to observe goods being shipped or being received for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.  
—For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.  
■ Inventory quantities. If there is an identified risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis (see paragraph 53) or to conduct inventory counts at all locations on the same date. It may be appropriate to require for inventory counts to be conducted at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.  
■ Also it may be appropriate for the auditor to perform additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard.  
—Furthermore, additional testing of count sheets, tags, or other records, or the retention of copies of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate completion.  
—Following the physical inventory count, the auditor may evaluate control procedures directed at the quantities included in the priced out inventories to further test the reasonableness of the quantities counted—for example, comparison of quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records. The auditor also may consider using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.  
■ Management estimates. The auditor may identify a risk of material misstatement due to fraud involving the development of management estimates. This risk may affect a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other postretirement benefit obligations, or environ-

mental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. As indicated in SAS No. 57, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1, AU sec. 342), estimates are based on subjective as well as objective factors and there is a potential for bias in the subjective factors, even when management's estimation process involves competent personnel using relevant and reliable data.  
■ In addressing an identified risk of material misstatement due to fraud involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained (see SAS No. 57, AU sec. 342.09 through 342.14). In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of a derivative), it may be appropriate to engage a specialist or develop an independent estimate for comparison to management's estimate. Information gathered about the entity and its environment may help the auditor evaluate the reasonableness of such management estimates and underlying judgements and assumptions.  
—A retrospective review of similar management judgments and assumptions applied in prior periods (see paragraphs 63 through 65) may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

Examples of Responses to Identified Risks of Misstatements ARISING FROM MISAPPROPRIATIONS OF ASSETS  
55. The auditor may have identified a risk of material misstatement due to fraud relating to misappropriation of assets. For example, the auditor may conclude that the risk of asset misappropriation at a particular operating location is significant because a large amount of easily accessible cash is maintained at that location, or there are inventory items such as laptop computers at that location that can easily be moved and sold.  
56. The auditor's response to a risk of material misstatement due to fraud relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit responses noted in paragraphs 52 through 54 may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified. For example, if a particular asset is highly susceptible to misappropriation and a potential misstatement would be material to the financial statements, obtaining an understanding of the controls related to the prevention and detection of such misappropriation and testing the operating effectiveness of such controls may be warranted. In certain circumstances, physical inspection of such assets (for example, counting cash or securities) or at near the end of the reporting period may be appropriate. In addition, the use of substantive analytical procedures, such as the development by the auditor of an expected dollar amount at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances.

Responses to Further Address the Risk of Management Override of Controls  
57. As noted in paragraph 5, management is in a unique position to (continued on page 116)
perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare or manipulate financial statements by over-riding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways. Accordingly, in addition to overall responses (paragraph 50) and responses that address specifically identified risks of material misstatement (fraud see paragraphs 51 through 56), the procedures described in paragraphs 58 through 67 should be performed to further address the risk of management override of controls.

58. Examining journal entries and other adjustments for evidence of possible material misstatement due to possible fraud. When examining entries in financial statements due to fraud often involve the manipulation of the financial reporting process 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 changing adjustments, repror combination, and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (see paragraph 61). The auditor should:(a) determine the timing of the testing. (See paragraph 62.)

60. 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.

61. The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider:

- The auditor's assessment of the risk of material misstatement due to fraud. The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing and indicate the extent of testing necessary.
- The effectiveness of controls that have been implemented over journal entries and other adjustments. Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of the controls testing necessary, provided that the auditor has tested the operating effectiveness of those controls. However, even though controls might be implemented and operating effectively, the auditor's procedures for testing journal entries and other adjustments should include the identification and testing of specific items.
- The entity's financial reporting process and the nature of the evidence that can be examined. The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and processes. 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 general ledger journal entries to be tested and examining 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. When information technology (IT) is used in the financial reporting process, journal entries and other adjustments might exist only in electronic form. Electronic evidence often requires extraction of the desired data by the auditor with IT knowledge and skills of the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments for testing.

62. 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 and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished, the auditor should consider whether there also is a need to test journal entries throughout the period under audit.

63. Reviewing accounting estimates for biases that could result in material misstatement due to fraud. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting often is accomplished through intentional misstatements or accounting estimates. As discussed in SAS No. 47 (AU sec. 312.36), the auditor should consid--

25 SAS No. 55, as amended, requires the auditor to obtain an understanding of the automated and manual procedures an entity uses to prepare financial statements and related disclosures for testing internal controls over financial reporting. This understanding includes (a) the procedures used to enter transaction data into the general ledger; (b) the procedures used to initiate, record, and process journal entries in the general ledger; and (c) other procedures used to record recurring and nonrecurring adjustments to the financial statements.

26 See SAS No. 57, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1, AU sec. 342.02 and 342.16), for a definition of accounting estimates and a listing of examples.
er whether differences between estimates best supported by the audit evidence and the estimates made in the financial statements exist and if they are individually reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor should reconsider the estimates taken as a whole.

64. The auditor also should perform a retrospective review of significant accounting estimates evaluated in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management. The significant accounting estimates selected for testing should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates. This review, however, is not intended to call into question the auditor's professional judgments made in the prior year whose basis was based on information available at the time.

65. If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor should evaluate whether circumstances producing such a bias represent a risk of a material misstatement due to fraud. For example, information coming to the auditor's attention may indicate a risk that adjustments to the current-year estimates might be recorded at the instruction of management to arbitrarily achieve a specified earnings target.

66. Evaluating the business rationale for significant unusual transactions. During the course of the audit, the auditor may become aware of significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment. The auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

67. In understanding the business rationale for the transactions, the auditor should consider:

- Whether the form of such transactions is overly complex (for example, involves multiple entities within a consolidated group or unrelated third parties).
- Whether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors.
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors.
- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

EVALUATING AUDIT EVIDENCE

68. Assessing risks of material misstatement due to fraud through the audit and the auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. Conditions may be identified during fieldwork that change or support a judgment regarding the assessment of the risks, such as the following:

- Discrepancies in the accounting records, including:
  - Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy
  - Unsupported or unauthorized balances or transactions
  - Last-minute adjustments that significantly affect financial results
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties
- Tips or complaints to the auditor about alleged fraud
- Conducting or missing evidential matter, including:
  - Missing documents
  - Documents that appear to have been altered
  - Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
  - Significant unexplained items on reconciliations
  - Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures (See paragraph 72)
  - Unusual discrepancies between the entity's records and confirmation replies
  - Missing inventory or physical assets of significant magnitude
  - Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies
  - Inability to obtain evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

- Problematic or unusual relationships between the auditor and management, including:
  - Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought
  - Undue time pressures imposed by management

69. SAS No. 45, "Omnibus: Statement on Auditing Standards—1983 (AICPA, Professional Standard, vol. 1, AU sec. 334, "Related Parties"), provides guidance with respect to the identification of related-party relationships and transactions, including transactions that may be outside the ordinary course of business (see, in particular, AU sec. 334.06).

70. As discussed in paragraph 9, auditors are not trained or expected to be experts in the authentication of documents; however, if the auditor believes that documents may not be authentic, he or she should investigate further and consider using the work of a specialist to determine the authenticity.

71. Denial of access to information may constitute a limitation on the scope of the audit that may require the auditor to consider qualifications or disclaimers on the audit opinion. (See SAS No. 58, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 508.24)).
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A comparison of bad debt write-offs to comparable industry data, which employees cannot manipulate, may provide unexplained relationships that could indicate a possible theft of cash receipts.

An unexpected or unexplained relationship between sales volume as determined from the accounting records and production statistics maintained by operations personnel—which may be more difficult for management to manipulate—may indicate possible misstatement of sales.

73. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

74. Evaluating the risks of material misstatement due to fraud at or near the completion of fieldwork. At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations (for example, collusive relationships noted in paragraphs 69 through 73) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. This evaluation primarily is a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.28

75. Responding to misstatements that may be the result of fraud. When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud.29 That determination affects the auditor's evaluation of materiality and the related responses necessary as a result of that evaluation.30

76. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatement is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size likely would establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a nonmanagement employee.31 Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management.32 In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (a) the nature, timing, and extent of the tests of balances or transactions and (b) the overall assessment of the effectiveness of controls if control risk was assessed below the maximum.

77. If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to determine whether the effect is material, the auditor should:

a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereof.

b. Consider the implications for other aspects of the audit (see paragraph 76).

c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.33

d. If appropriate, suggest that the client consult with legal counsel.

78. The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility.34 Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (a) the implications about the integrity of management and (b) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not possible to definitively describe when withdrawal is appropriate.35 The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

28 To accomplish this communication, the auditor with final responsibility for the audit may want to arrange another discussion among audit team members about the risks of material misstatement due to fraud (see paragraphs 14 through 18).

29 See footnote 4.

30 SAS No. 47 (AU sec. 312.34) states in part, "Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material." SAS No. 47 (AU sec. 312.11) states, "As a result of the interaction of qualitative and quantitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." However, see paragraphs 79 through 82 of this statement for discussion of the auditor's communication responsibilities.

31 SAS No. 47 (AU sec. 312.86) states that there is a distinction between the auditor's response to detected misstatements due to error and those due to fraud. When fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

32 See SAS No. 58 for guidance on auditors' reports issued in connection with audits of financial statements. If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate. See footnote 11.

33 If the auditor, subsequent to the date of the report on the financial statements, becomes aware of facts that existed at that time that might have affected the report had the auditor been aware of such facts, the auditor should refer to SAS No. 1, Codification of Auditing Standards and Procedures (AICPA Professional Standards, vol. 1, AU sec. 361). "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report." Furthermore, SAS No. 84, Communications Between Predecessor and Successor Auditors (AU sec. 315.21 and 22) provides guidance regarding communications with a predecessor auditor.

34 The requirements to communicate noted in paragraphs 79 through 82 extend to any intentional misstatement regardless of the occurrence of fraud. The communication may use other terms than fraud—for example, irregularity, intentional misstatement, misappropriation, or defalcation. If there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms.

35 Alternatively, the auditor may decide to communicate solely with the audit committee.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

79. Regardless of whether the audit has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is 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. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower-level employees.

80. If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have a material impact on the audit (whether or not the auditor discovers fraud), the auditor should consider whether these risks represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee.36 (See SAS No. 60, Communication of Internal Control Related Matters Noted in an Audit [AICPA, Professional Standards, vol. 1, AU sec. 325.04]). The auditor also should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or otherwise help prevent, detect, and deter fraud (see paragraph 44) represent reportable conditions that should be communicated to senior management and the audit committee.

81. The auditor also may wish to communicate other risks of fraud identified as a result of the assessment of the risks of material misstatement due to fraud. Such a communication may be a risk to the overall audit or to a particular audit area, such as a committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communicating about the quality of the entity's accounting principles (see SAS No. 61, AU sec. 380.11).

82. The disclosure of possible fraud to parties other than the client's senior management and its audit committee ordinarily is not part of the
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auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose to parties outside the entity may exist:

a. To comply with certain legal and regulatory requirements.
b. To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, "Communications Between Predecessor and Successor Auditors." (AICPA, Professional Standards, vol. 1, AU sec. 315)
c. In response to a subpoena.
d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.

Because potential conflicts between the auditor's ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs 79 through 81 with parties outside the client.

Documenting the Auditor's Consideration of Fraud

63. The auditor should 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 (See paragraphs 14 through 17.)
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud (See paragraphs 19 through 34.)
- Specific risks of material misstatement due to fraud that were identified (See paragraphs 35 through 45.), and a description of the audit response to those risks (See paragraphs 46 through 56.)
- If the auditor has not identified a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reason supporting the auditor's conclusion (See paragraph 41.)
- The results of the procedures performed to further address the risk of management override of controls (See paragraphs 58 through 67.)
- 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 (See paragraphs 68 through 73.)
- The nature of the communications about fraud made to management, the audit committee, and others (See paragraphs 79 through 82.)

Effective Date

84. This Statement is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of this Statement is permissible.

[The appendix to SAS no. 99 is deleted here. To view the appendix, "Examples of Fraud Risk Factors," go to www.aicpa.org/antifraud/risk].

AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 1, CODIFICATION OF AUDITING STANDARDS AND PROCEEDURES

AICPA, Professional Standards, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"

1. This Statement amends Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures (AICPA, Professional Standards, vol. 1, AU sec. 230.12, "Due Professional Care in the Performance of Work") to include a discussion about the characteristics of fraud and a discussion about collusion. (The new language is shown in boldface italics; deleted language is shown by strikethrough.)

Reasonable Assurance

10. The exercise of due professional care allows the auditor to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.

11. The independent auditor's objective is to obtain sufficient competent evidential matter to provide to his or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work. As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.

AMENDMENT TO SAS NO. 85, MANAGEMENT REPRESENTATIONS

AICPA, Professional Standards, vol. 1, AU sec. 333.06, and Appendix A.

1. This Statement requires the auditor to make inquiries of management about fraud and the likelihood of fraud. In support of and consistent with these inquiries, this amendment revises the guidance for management representations about fraud currently found in SAS No. 85, Management Representations (AICPA, Professional Standards, vol. 1, AU sec. 333, paragraph 6h, and Appendix A). New language is shown in boldface italics; deleted language is shown by strikethrough.

h. Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud in knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in

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We are providing this letter in connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [date] and for the [period(s)] for the purpose of expressing an opinion as to whether the [consolidated] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity], in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [consolidated] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm to the best of our knowledge and belief, [as of date of auditor's report] the following representations made to you during your audit:

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

76. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
   a. Management, fraud involving management, or employees who have significant roles in the internal control.
   b. Employees who have significant roles in internal control, or
   c. Business operations or Others where the fraud could have a material effect on the financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.