FRAUD IN A FINANCIAL STATEMENT AUDIT:
WHAT EVERY AUDITING STUDENT SHOULD
KNOW ABOUT SAS NO. 99

A Student Educational Manual
Provided by the
American Institute of CPAs

By

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I. LEARNING OBJECTIVES

After completing this educational supplement, you will be able to:

1. State the CPA’s responsibility for detecting fraud in a financial statement audit.
2. Explain the need for an attitude of professional skepticism in performing an audit.
3. Discuss the characteristics of fraud and the three conditions required for fraud to occur.
4. List and describe the two types of financial statement fraud that are covered by SAS No. 99 Consideration of Fraud in a Financial Statement Audit.
5. Describe the requirements of SAS No. 99.
6. Identify individuals or groups within a company that an auditor is obligated to communicate with when he or she finds or suspects fraud.
7. Determine when the auditor may be obligated to communicate information about fraud to parties external to the company.
II. THE AUDITOR’S RESPONSIBILITY FOR FRAUD AND THE IMPORTANCE OF PROFESSIONAL SKEPTICISM

RESPONSIBILITY FOR FRAUD

1. One of the most important paragraphs in the authoritative auditing literature is the following (AU sec. 110, par. 2):

   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. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

2. Note the parallel structure between the paragraph above and the auditor’s standard report (focus on the concept of “material misstatements”).

   Independent Auditor’s Report

   We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

   We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

   In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

   [Signature]

   [Date]

3. Misstatements due to Errors and Fraud

   Causes:

   Errors—Unintentional misstatements or omissions of amounts or disclosures in financial statements.
Fraud (previously referred to as irregularities)—Intentional misstatements or omissions of amounts or disclosures in financial statements. Audits are concerned with misstatements arising from two distinct types of acts:

**Fraudulent Financial Reporting** — Intentional misstatements in financial statements to deceive financial statement users.

**Misappropriation of assets** (also referred to as “defalcations”) — Theft of company’s assets the effect of which has not been appropriately reflected in the financial statements.

### Causes of Misstatements

- **Errors**
- **Fraud**
  - Fraudulent Financial Reporting
  - Misappropriation of Assets

**PROFESSIONAL SKEPTICISM BACKGROUND INFORMATION (AU 230)**

4. In every audit, the exercise of professional skepticism is paramount. In many audit failures involving fraud, inadequate professional skepticism is frequently cited as a significant reason why the material misstatement was not detected by the auditor.

5. The third general standard of the generally accepted auditing standards is: Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

6. In discussing due professional care, the standards state that:

   A. Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Standards go on to state that an auditor should neither assume that management is dishonest nor assume unquestioned honesty.
B. Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process.

C. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.
III. OUTLINE OF STATEMENT ON AUDITING STANDARDS NO. 99, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT

CHARACTERISTICS OF FRAUD

1. The difference between errors and fraud is that fraud is intentional (although determining intent is often difficult).

2. Although fraud is a broad legal concept, the auditor’s interest relates to determining whether misstatements exist, and not with making legal determinations of whether fraud has occurred.

3. The two types of misstatements due to fraud are those which are the result of:
   A. **Fraudulent financial reporting**—intentional misstatements, omissions of amounts or disclosures.
   B. **Misappropriation of assets**—theft of an entity’s assets, also referred to as defalcations.

4. When fraud occurs there are three conditions that must be present:
   A. **Incentive/pressure**—a reason to commit fraud.
   B. **Opportunity**—e.g., ineffective controls, override of controls.
   C. **Attitude/rationalization**—ability to justify the fraud to oneself.

5. Management has a unique ability to perpetrate fraud because it can directly or indirectly manipulate accounting records and present fraudulent financial information by overriding controls or directing employees to carry out the fraud.

6. Although fraud is ordinarily concealed, certain conditions (such as missing documents) may suggest the possibility of fraud.

7. Audits provide reasonable, and not absolute assurance of detecting material fraud.

PROFESSIONAL SKEPTICISM AND THE RISK OF FRAUD

8. An auditor should conduct the audit with a mindset that recognizes the possibility of material misstatement due to fraud, even if no fraud has been discovered in the past and the auditor believes that management is honest.

9. An auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.
STAFF DISCUSSION OF THE RISK OF MATERIAL MISSTATEMENT DUE TO FRAUD

10. Prior to or while obtaining information to identify risks of fraud (below), the audit team should discuss the potential for a material misstatement due to fraud, including:
   A. “Brainstorming” among team members about how and where the financial statements might be susceptible to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets could be misappropriated
   B. Emphasizing the importance of maintaining the proper state of mind (professional skepticism) regarding the potential for material misstatement due to fraud.

11. The discussion should:
   A. Include consideration of known factors affecting incentives/pressures for fraud, opportunities, and culture or environment that enables management to rationalize committing fraud.
   B. Emphasize the need to maintain a questioning mind and to exercise professional skepticism.
   C. Include key members of the audit team (and specialists if considered necessary).

OBTAINING THE INFORMATION NEEDED TO IDENTIFY RISKS OF MATERIAL MISSTATEMENT DUE TO FRAUD; PROCEDURES SHOULD INCLUDE

12. Inquiries of management, the audit committee, internal auditors and others
   A. Among the inquiries of management are questions such as:
      (1) Does it have knowledge of fraud or suspected fraud affecting the entity?
      (2) Have there been allegations of fraud or suspected fraud?
      (3) Its understanding of fraud risks?
      (4) Programs and controls established to mitigate fraud risks?
      (5) Control over multiple locations?
      (6) Communications to employees about business practices and ethical behavior?
      (7) Whether management has reported to the audit committee the nature of the company’s internal control?
   B. Inquiries of the audit committee (or at least its chair) to obtain:
      (1) Its views regarding the risks of fraud and whether it has knowledge of fraud or suspected fraud.
      (2) An understanding of how it exercises oversight activities.
   C. Inquiries of appropriate internal audit personnel about:
      (1) Their views about the risks of fraud.
      (2) Whether they have performed any procedures to identify or detect fraud.
      (3) Whether management has satisfactorily responded to any findings relating to above procedures.
   D. Inquiries of others about the existence of fraud or suspected fraud, including:
      (1) Employees with varying level of authority who auditors come into contact with during the audit.
      (2) Operating personnel not directly involved in reporting.
      (3) Employees involved with complex or unusual transactions.
(4) In-house legal counsel.

E. Be aware in evaluating management’s responses to inquiries that it is often in the best position to perpetrate fraud.

13. Considering the results of **analytical procedures** performed in planning the audit:
   A. When unexpected results occur, consider the risk of material misstatement due to fraud.
   B. Perform analytical procedures on revenue during the planning of the audit to identify unusual or unexpected relationships.
   C. Because analytical procedures performed during planning often use data aggregated at a high level, results obtained often only provide a broad initial indication about whether a material misstatement exists.

14. An auditor should consider **fraud risk factors**, which are events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out fraud, or attitude/rationalization to justify a fraudulent action:
   A. The auditor should use professional judgment in determining whether a risk factor is present and in identifying and assessing the risk of material misstatement due to fraud.
   B. While fraud risk factors do **not** necessarily indicate the existence of fraud, they often are present when fraud exists.

15. Other information that should be considered includes the discussion among audit team members, reviews of interim financial statements, and the consideration of identified inherent risks.

**IDENTIFYING RISKS THAT MAY RESULT IN A MATERIAL MISSTATEMENT DUE TO FRAUD**

16. It is helpful when identifying risks of fraud to consider the three conditions ordinarily present when a material misstatement due to fraud ordinarily occurs— incentives/pressures, opportunities, and attitude/rationalization. Fraud experts often refer to these three conditions as the fraud triangle.

17. The auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific accounts, assertions, or whether they relate more pervasively to the financial statements as a whole.

18. The identification of a risk of material misstatement due to fraud includes consideration of the type of risk (fraudulent financial reporting or misappropriation of assets), the significance of the risk, the likelihood of the risk, and the pervasiveness of the risk.

19. A presumption of improper revenue recognition is a fraud risk.

20. The auditor should always address the risk of management override of controls.
ASSESSING THE IDENTIFIED RISKS AFTER CONSIDERING PROGRAMS AND CONTROLS

21. AU 319 requires the auditor to obtain an understanding of internal control sufficient to plan the audit; this understanding allows the auditor to:
   A. Identify types of potential misstatements.
   B. Consider factors that affect the risk of material misstatement.
   C. Design tests of controls when applicable.
   D. Design substantive tests.

22. As a part of obtaining an understanding of internal control sufficient to plan the audit, the auditor should evaluate whether the client’s programs and controls that address the identified risks of material misstatement due to fraud have been suitably designed and placed in operation.

23. After the auditor has evaluated the client’s programs and controls in this area, the auditor’s assessment of the risk of material misstatement due to fraud should consider these results.

RESPONDING TO THE RESULTS OF THE ASSESSMENT—AS RISK INCREASES

24. Overall responses:
   A. Assign personnel with more experience and exercise more supervision.
   B. More carefully consider significant accounting policies.
   C. Make auditing procedures less predictable.

25. Responses that address specifically identified risks:
   A. General types of responses:
      (1) Nature—more reliable evidence or additional corroborative information.
      (2) Timing—perform at or near end of reporting period, but apply substantive procedures to transactions occurring throughout the year.
      (3) Extent—increase sample sizes, perform more detailed analytical procedures.
   B. Examples of modifications of the nature, timing, and extent of procedures:
      (1) Perform procedures on a surprise or unannounced basis (e.g., inventory observation, counting of cash).
      (2) Request inventory counts at end of reporting period.
      (3) Make oral inquiries of major customers and suppliers in addition to written confirmations.
      (4) Perform substantive analytical procedures using disaggregated data.
      (5) Interview personnel in areas where risk of material misstatement due to fraud has been identified.
      (6) Discuss the situation with any other auditors involved with audit (e.g., an “other auditor” who audits a subsidiary).
C. Additional examples of responses for a high risk of fraudulent financial reporting may result in increased:
   (1) Analysis of revenue recognition.
   (2) Consideration of inventory quantities.
   (3) Consideration of management estimates (e.g., allowance for doubtful accounts).

D. Additional responses for a high risk of misappropriation of assets
   (1) If a particular asset is susceptible to misappropriation, obtain understanding of controls and/or physical inspection may be appropriate.
   (2) More precise analytical procedures may be used.

26. Responses to further address the risk of management override of controls:
   A. Examine journal entries recorded in the general ledger and other adjustments (e.g., entries posted directly to financial statement drafts) for evidence of possible material misstatement due to fraud.
   B. Review accounting estimates for biases, including a retrospective review of previous year estimates so as to provide guidance on management’s past performance in this area.
   C. Evaluate the business rationale for significant unusual transactions.

EVALUATING AUDIT EVIDENCE

27. The assessment of risks of material misstatement should be ongoing throughout the audit.

28. Conditions identified during fieldwork may change or support a judgment concerning the assessment:
   A. Discrepancies in accounting records that may indicate fraud, such as:
      (1) Transactions not recorded in a complete or timely manner, or improperly recorded.
      (2) Unsupported or unauthorized balances or transactions.
      (3) Significant last minute adjustments.
      (4) Evidence of inappropriate employee access to systems.
   B. Conflicting or missing audit evidence, such as:
      (1) Missing, unavailable or altered documents.
      (2) Unexplained items on reconciliations.
      (3) Inconsistent, vague or implausible responses to inquiries.
      (4) Unusual discrepancies between records and confirmation replies.
      (5) Missing inventory or physical assets.
      (6) Unavailable or missing electronic evidence, inconsistent retention policies.
   C. Problematic or unusual relationships between auditor and management, such as:
      (1) Denial of access to records, facilities, employees, customers, vendors others.
      (2) Undue time pressures.
      (3) Management complaints or intimidation.
      (4) Unusual delays in providing information.
      (5) Tips or complaints about alleged fraud.

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(6) Unwillingness to facilitate auditor access to electronic files.
(7) Denial of access to IT operations staff and facilities.
(8) Unwillingness to add or revise disclosures in financial statements

29. The auditor should evaluate whether analytical procedures performed as substantive tests or in the overall review stage indicate a previously unrecognized risk of material misstatement due to fraud:
A. If not already performed, the auditor should perform analytical procedures on revenue at the overall review stage of the audit; unusual relationships include:
   (1) Large amounts of income recorded in the last week or two of the year.
   (2) Income inconsistent with trends in cash flows from operations.

Other examples of unusual or unexpected analytical relationships and possible causes

<table>
<thead>
<tr>
<th>Change</th>
<th>Possible Cause</th>
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</thead>
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<td>Net income to cash flows may appear unusual</td>
<td>Fictitious revenue and receivables</td>
</tr>
<tr>
<td>Changes in inventory, payables, sales, or cost of goods sold as compared to preceding period</td>
<td>Theft of inventory, but inability to manipulate all related accounts</td>
</tr>
<tr>
<td>Company profitability inconsistent with industry trends</td>
<td>Numerous possible misstatements</td>
</tr>
<tr>
<td>Bad debt write-offs high</td>
<td>Theft of cash receipts</td>
</tr>
<tr>
<td>Sales volume per accounting records differs from production statistics</td>
<td>Misstatement of sales</td>
</tr>
</tbody>
</table>

30. The auditor should evaluate risks of material misstatement due to fraud at or near completion of fieldwork.

31. When misstatements are identified, the auditor should consider whether such misstatements may indicate fraud.

32. When misstatements are or may be the result of fraud, but the effects are not material to the financial statements, the auditor should evaluate the implications. Examples of immaterial frauds include:
   A. A misappropriation of cash from a small petty cash fund normally would have little significance.
   B. A misappropriation involving management may be indicative of a more pervasive problem and may require the auditor to consider the impact on the nature, timing, and extent of tests of balances or transactions, and the assessment of the effectiveness of controls.

33. If the auditor believes the misstatements may be the result of fraud and has determined it could be material to the financial statements, but has been unable to evaluate whether the effect is material, the auditor should:
   A. Attempt to obtain audit evidence to determine whether fraud has occurred and its effect.
B. Consider implications for other aspects of the audit.
C. Discuss the matter and an approach for further investigation with an appropriate level of management at least one level above those involved, and with senior management and the audit committee.
D. If appropriate, suggest the client consult with legal counsel.

34. The risk of fraud may be so high as to cause the auditor to consider withdrawing from engagement; factors affecting decision:
   A. Implications about integrity of management.
   B. Diligence and cooperation of management or the board of directors.

COMMUNICATING ABOUT FRAUD TO MANAGEMENT, THE AUDIT COMMITTEE AND OTHERS

35. Whenever there is evidence that fraud may exist, the matter should be brought to an appropriate level of management, even if the matter might be considered inconsequential:
   A. All fraud involving senior management, and any fraud (by anyone) that causes a material misstatement should be reported directly to the audit committee.
   B. The auditor should reach an understanding with the audit committee regarding communications about misappropriations perpetrated by lower-level employees.

36. If risks have internal control implications the auditor should determine whether they represent reportable conditions and need to be communicated to the audit committee.

37. The auditor may choose to communicate other risks of fraud.

38. Disclosure of fraud beyond senior management and its audit committee is not ordinarily a part of the auditor’s responsibility, unless:
   A. Required by specific legal and regulatory requirements.

NOTE: These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a reportable event or is the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required, under certain circumstances, pursuant to Section 10A(b)1 of the Securities Exchange Act of 1934 relating to an illegal act that has a material effect on the financial statements.

   B. To a successor auditor.
   C. In response to a subpoena.
   D. To a funding agency or other specified agency in accordance with requirements of audits of entities that receive governmental financial assistance.

DOCUMENTING THE AUDITOR’S CONSIDERATION OF FRAUD

39. The documentation should include:
   A. Details of the discussion among audit team of risk of material misstatement due to fraud, including how and when discussion occurred, participants, and subject matter.
B. Procedures performed to obtain information to identify and assess risks of material misstatement due to fraud.

C. Specific risks of material misstatement due to fraud that were identified and auditor’s response to those risks.

D. If auditor did not identified improper revenue recognition as a risk of material misstatement due to fraud, the reasons for that conclusion.

E. Results of procedures performed to further address risk of management override of controls.

F. Other conditions and analytical relationships or other responses required and any further responses the auditor concluded were appropriate to address such risks or conditions.

G. Nature of communications about fraud made to management, the audit committee and others.
### Appendix 1: Examples of Fraud Risk Factors

#### 40. Misstatements Arising from Fraudulent Financial Reporting

<table>
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<th>Incentives/Pressures</th>
<th>Opportunities</th>
<th>Attitude/Rationalization</th>
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<tbody>
<tr>
<td>1. Threatened financial stability or profitability</td>
<td>1. Industry provides opportunities for</td>
<td>Relating to board members, management, or employees</td>
</tr>
<tr>
<td>• High degree of competition or sales saturation</td>
<td>• Related-party transactions beyond ordinary</td>
<td>• Ineffective communications, implementation, support or enforcement of ethics</td>
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<td>• High vulnerability to rapid changes (e.g., technology, interest rates)</td>
<td>• Company can dictate terms or conditions to suppliers or customers (may result in inappropriate transactions)</td>
<td>• Nonfinancial management excessive participation in selecting accounting principles or determining estimates</td>
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<td>• Declines in customer demand, business failures in industry</td>
<td>• Accounts based on significant estimates</td>
<td>• Known history of violations of securities or other laws</td>
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<td>• Operating losses</td>
<td>• Significant, unusual or highly complex transactions</td>
<td>• Excessive interest in maintaining or increasing stock price</td>
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<td>• Negative cash flows from operations</td>
<td>• Significant operations across international borders with differing business environments and cultures</td>
<td>• Aggressive or unrealistic forecasts</td>
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<td>• Rapid growth or unusual profitability</td>
<td>• Significant bank accounts in tax haven jurisdictions</td>
<td>• Failure to correct reportable conditions on a timely basis</td>
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<td>• New accounting, statutory, or regulatory requirements</td>
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<td>• Interest by management of employing inappropriate means to minimize earnings for tax reasons</td>
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<td>2. Excessive pressure on management to meet requirements or third party expectations due to</td>
<td>2. Ineffective monitoring of management allows</td>
<td>• Recurring management attempts to justify marginal or inappropriate accounting based on materiality</td>
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<td>• Profitability or trend level expectations</td>
<td>• Domination of management by a single person or small group without controls</td>
<td>• Strained relationship with current or predecessor auditor</td>
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<td>• Need for additional debt or equity financing</td>
<td>• Ineffective board of director or audit committee oversight</td>
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<td>• Marginal ability to meet exchange listing requirements</td>
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<td>• Likely poor financial results on pending transactions</td>
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<td>3. Management or directors’ financial situation threatened by</td>
<td>3. Complex or unstable organizational structure</td>
<td></td>
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<tr>
<td>• Significant financial interests in company</td>
<td>• Difficulty in determining organization or individuals with control of company</td>
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<tr>
<td>• Significant portions of compensation contingent on results of company</td>
<td>• Overly complex structure</td>
<td></td>
</tr>
<tr>
<td>• Personal guarantees of debts of company</td>
<td>• High turnover of senior management, counsel, or board members</td>
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<tr>
<td>4. Excessive pressure to meet financial target set up by directors or management</td>
<td>Internal control deficient</td>
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<tr>
<td></td>
<td>• Inadequate monitoring of controls</td>
<td></td>
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<tr>
<td></td>
<td>• High turnover rates or ineffective accounting, internal audit or information technology staff</td>
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<td></td>
<td>• Ineffective accounting and information systems</td>
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</table>
41. **Misstatements Arising from Misappropriation of Assets**

<table>
<thead>
<tr>
<th>Incentives/Pressures</th>
<th>Opportunities</th>
<th>Attitude/Rationalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Personal financial obligations</td>
<td>1. Characteristics of assets&lt;br&gt;• Large amounts of cash on hand or processed&lt;br&gt;• Small, high value, or high demand inventory items&lt;br&gt;• Easily convertible assets (bearer bonds, diamonds, computer chips)&lt;br&gt;• Small marketable fixed assets</td>
<td>Attitude or behavior of those with access to assets susceptible to misappropriation&lt;br&gt;• Disregard for need for monitoring or reducing risks&lt;br&gt;• Disregard for internal control&lt;br&gt;• Behavior indicating displeasure or dissatisfaction with company or its treatment of employees&lt;br&gt;• Changes in behavior or lifestyle that indicate assets may have been misappropriated</td>
</tr>
<tr>
<td>2. Adverse relationship between company and employees&lt;br&gt;• Known or anticipated layoffs&lt;br&gt;• Changes in compensation&lt;br&gt;• Promotions, compensation or other rewards inconsistent with expectations</td>
<td>2. Inadequate internal control, including inadequate:&lt;br&gt;• Segregation of duties&lt;br&gt;• Job applicant screening of employees with access to assets&lt;br&gt;• Recordkeeping for assets&lt;br&gt;• Authorization or approval of transactions&lt;br&gt;• Reconciliation of assets&lt;br&gt;• Documentation of transactions (e.g., credits for merchandise returns&lt;br&gt;• Requirements for mandatory vacations&lt;br&gt;• Management understanding of information technology&lt;br&gt;• Access controls over automated records</td>
<td></td>
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</table>

| Characteristics of assets<br>• Large amounts of cash on hand or processed<br>• Small, high value, or high demand inventory items<br>• Easily convertible assets (bearer bonds, diamonds, computer chips)<br>• Small marketable fixed assets | Inadequate internal control, including inadequate:<br>• Segregation of duties<br>• Job applicant screening of employees with access to assets<br>• Recordkeeping for assets<br>• Authorization or approval of transactions<br>• Reconciliation of assets<br>• Documentation of transactions (e.g., credits for merchandise returns<br>• Requirements for mandatory vacations<br>• Management understanding of information technology<br>• Access controls over automated records | Attitude or behavior of those with access to assets susceptible to misappropriation<br>• Disregard for need for monitoring or reducing risks<br>• Disregard for internal control<br>• Behavior indicating displeasure or dissatisfaction with company or its treatment of employees<br>• Changes in behavior or lifestyle that indicate assets may have been misappropriated |
Appendix 2: Programs and Controls Related to Fraud

42. Programs in the following three areas may be implemented to help deter, prevent and detect fraud:

A. Creating a culture of honesty and high ethics:
   1. Setting tone at the top.
   2. Creating a positive workplace environment.
   3. Hiring and promoting appropriate employees.
   4. Proper training.
   5. Proper discipline for those committing fraud.

B. Management’s evaluation of processes and controls to mitigate risk of and reduce opportunities for fraud include polices and procedures to:
   1. Identify and measure fraud risks.
   2. Mitigate fraud risks.
   3. Implement and monitor appropriate controls and other measures.

C. Developing an appropriate oversight process:
   1. Effective audit committee or board of directors.
   2. Effective internal auditors.
   3. Assistance from independent auditors.
IV. CASE STUDY NO. 1
ABCABLE, INC.

ABCable, Inc. is a publicly traded cable provider. Among its current services are providing cable services, including television, Internet access and local telephone service. ABCable experienced rapid growth in all markets beginning in the late 1990s and continuing through now.

While revenues continue to grow, income is showing signs of declining to a level beneath that expected by analysts who follow the company. In an analysis of why, Sally Bens, financial vice president, discovered that maintenance of cable systems has become an increasingly large cost—particularly in new cable coverage areas. She pointed out to Bill Jones, the president, that in the relatively new areas maintenance is high, particularly when viewed from the perspective that the areas currently have few customers. Jones has suggested that it doesn’t seem right to face such high expenses when “everyone knows we will have a larger customer base in a few years in those areas.”

Shortly thereafter, Bens and Jones decided to transfer out of Cable Maintenance Expense and into the Capitalized Cable account enough of these expenses to enable net income to meet analysts’ forecasts. Documentation in some cases was created indicating a correction of an error and in some cases no documentation was created to support the entries.

Subsequently, these types of transactions were posted quarterly, on an “as needed” basis. Bens rationalized that it was indeed unfair to expense so much of the maintenance cost in rapidly growing areas. Jones didn’t give it a lot of thought other than to periodically remind Bens of how important meeting EPS growth rates was.

The above scheme does not meet generally accepted accounting principles and led to materially misstated financial statements. Under generally accepted accounting principles, these transactions should have been expensed. Thus, the ABCable overstated assets and income.

1. Is this an example of fraudulent financial reporting or misappropriation of assets?

2. SAS No. 99 requires a number of inquiries of management, the audit committee, internal auditors, and others. Which, if any, individuals responding to these inquiries might be likely to reveal this scheme to the auditors?

3. This is an example of management override. What types of procedures does SAS No. 99 prescribe for management override? Which, if any, of these procedures would have a possibility of detecting the scheme?
V. CASE STUDY NO. 2
ROCKY MOUNTAIN ELECTRIC

Rocky Mountain Electric is an electrical wholesaler with two locations—one in Denver, and another in Aspen that just recently opened. The audit senior stayed in Denver to do the audit at the main store, and a staff accountant was sent to the Aspen (cross-state) store.

The staff accountant returned after a week and said that everything was fine at the Aspen store, which was good, thought the senior, because the audit fee had been cut from the previous year, and the audit team was under time pressure to finish the job.

One of the first things the senior did was look at the audit differences, and she noticed an adjustment in excess of $100,000—a debit to sales and a credit to accounts receivable. “To adjust the general ledger (GL) to the accounts receivable trial balance at the cross-state store” is how the description read. She asked the staff accountant how an error that big could happen, and he told her the store manager said they had some problems installing the accounting system at the new store.

The senior thought the adjustment was proper, since the general ledger balance was now in agreement with the subsidiary ledger. A little while later she was reviewing the analytical procedures and noted that the gross margin percentages at the cross-state store were quite a bit lower than the margins at the main store. In the workpapers was the explanation, “Per store manager, prices were reduced at cross-town store to attract customers in a new location.”

The next day, the senior was talking to the controller at the main store, and she mentioned how it looked like there had been a few problems at the Aspen store but they were working them out. “I guess those price reductions you had earlier in the year really worked to attract new customers,” she said.

“Price reductions?” said the controller. “What price reductions?”

The company was a wholesale distributor—they didn’t have sales like one might find in a retail store. The senior then brought up the problem the company had in installing the accounts receivable system at the Aspen store. The controller said that the senior must have been mistaken because no problems had ever been reported by the store manager.

The senior realized something wasn’t right, and after consulting with the manager and partner, the auditors discussed their concerns with the controller and company owner. The client and auditors agreed to investigate the situation further, so the auditors expanded their procedures, tracing customer payments for the Aspen store back and forth from the subledger to the GL.

That expanded testwork led to the discovery that the manager at the Aspen store was stealing payments by customers on accounts. That’s why the subledger was out of balance with the GL. To cover it up, the manager debited the sales account, which was why the gross margins didn’t make sense.
1. Is this an example of fraudulent financial reporting or misappropriation of assets?

2. What created an opportunity to commit the fraud?

3. What was the “trail” created by the fraud, that is, what circumstances tipped off the auditors that a fraud might have occurred?

4. The staff accountant originally missed these warning signs of fraud. What were some reasons why the signs were missed?
VI. CASE STUDY NO. 3
WELCO COMPANY

During the audit of Welco Company, the auditor noted in vouching items in Travel Expense that a receipt for $750 for the dinner of a salesman with a prospective customer seemed excessive. Upon closely examining the receipt, it seemed like a 1 had been changed to a 7—Changing the receipt from $150 t $750. Upon examining other items, two other dinner bills appeared to have been altered similarly. Yet, the auditor decided that at most a few thousand dollars were involved for a multi-billion dollar company—the amount was clearly not material. Since the risk of material fraud appeared remote, no additional work was done.

1. What is the auditor’s obligation, if any, to communicate this matter under SAS No. 99?

2. Assuming that the individual involved was the senior vice president of sales, what is the auditor’s obligation, if any, to communicate the matter under SAS No. 99?
VII. CASE STUDY NO. 4
PARADOX, INC

Assume that you are auditing Paradox, Inc., a manufacturer of hand-held personal digital assistants (PDAs). The following is information that you have extracted from the audit working papers.

• The market for PDAs is very competitive with several companies battling for market share, which in turn has put downward pressure on profit margins.

• Rapid advances in technology have further reduced the product life cycle. In the race to remain competitive a number of companies, including Paradox, have significantly increased their research and development efforts.

• Funding the increased R&D has been a growing concern for Paradox. The company currently is actively seeking capital.

• Paradox is a public company listed on the NASDAQ exchange. Top management’s compensation is heavily tied to the company’s profitability.

• The company does not have an internal audit function and the audit committee has not been very diligent in the past.

1. What are your responsibilities to make sure the financial statements are free from material misstatement?

2. How will SAS No. 99 affect the procedures you will perform for this audit?

3. SAS No. 99 requires you to conduct a discussion among engagement team personnel. Based on the background information provided, what “insights” would you share with the other audit team members? Describe your insights in terms of the three characteristics of fraud, incentive, and rationalization.
4. When performing field work, you find that in responding to an accounts receivable confirmation, a customer notes that the receivable relates to a purchase that was made under the company’s “new extended return policy” and the customer is still deciding whether to keep the items purchased. How does this new information affect your fraud risk assessments? How should you respond to this situation?
VIII. How Much Do You Know About SAS No. 99-A Short Quiz

1. Which of the following is **least** likely to be required on an audit?
   a. Evaluate the business rationale for significant, unusual transactions.
   b. Make a legal determination of whether fraud has occurred.
   d. Test appropriateness of journal entries and adjustment.

2. Which of the following is most likely to be an overall response to fraud risks identified in an audit?
   a. Only use certified public accountants on the engagement.
   b. Place increased emphasis on the audit of objective transactions rather than subjective transactions.
   c. Supervise members of the audit team less closely and rely more upon judgment.
   d. Use less predictable audit procedures.

3. Which of the following is **least** likely to be included in an auditor’s inquiry of management while obtaining information to identify the risks of material misstatement due to fraud?
   a. Are financial reporting operations controlled by and limited to one location?
   b. Does it have knowledge of fraud or suspect fraud?
   c. Does it have programs to mitigate fraud risks?
   d. Has it reported to the audit committee the nature of the company’s internal control?

4. Individuals who commit fraud are ordinarily able to rationalize the act and also have an

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<td>c. No</td>
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5. What is an auditor’s responsibility who discovers senior management is involved in what is financially immaterial fraud?
   a. Report the fraud to the audit committee.
   b. Report the fraud to the Public Company Accounting Oversight Board.
   c. Report the fraud to a level of management at least one below those involved in the fraud.
   d. Determine that the amounts involved are immaterial, and if so, there is no reporting responsibility.
6. Which of the following is most likely to be considered a risk factor relating to fraudulent financial reporting?
   a. Domination of management by top executives.
   b. Large amounts of cash processed.
   c. Negative cash flows from operations.
   d. Small high dollar inventory items.

7. Which of the following is most likely to be presumed to represent a fraud risk on an audit?
   a. Capitalization of repairs and maintenance expense into the property, plant and equipment asset account.
   b. Improper interest expense accrual.
   c. Introduction of significant new products.
   d. Improper revenue recognition.

8. Which of the following is not required by SAS No. 99, “Consideration of Fraud in a Financial Statement Audit”?
   a. Conduct a continuing assessment of the risks of material misstatement due to fraud throughout the audit.
   b. Conduct a discussion by the audit team of the risks of material misstatement due to fraud.
   c. Conduct the audit with professional skepticism, which includes an attitude that assumes balances are incorrect until verified by the auditor.
   d. Inquiries of the audit committee as to their views about the risks of fraud and their knowledge of any fraud or suspected fraud.

9. Which of the following need not be documented in relation to the auditor’s consideration of fraud?
   a. Nature of communications about fraud made to management.
   b. Procedures performed to obtain information to identify and assess risks of material misstatement due to fraud.
   c. Specific risks of material misstatement due to fraud that were identified.
   d. The assessed level of the risk of management override of controls.

10. When the risk of material misstatement due to fraud is considered high in a particular area, which of the following is a likely response?
    a. Perform tests on an interim basis throughout the period.
    b. Obtain more reliable evidence by expanding tests to include all transactions.
    c. Obtain additional corroborative information.
    d. Design tests of controls to substantiate weaknesses.