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## STANDING ADVISORY GROUP MEETING

### FINANCIAL FRAUD

SEPTEMBER 8-9, 2004

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#### Introduction

The Standing Advisory Group ("SAG") will discuss issues relating to the detection of fraud. This paper provides SAG members with background information about financial fraud and current issues relevant to the auditor's detection of fraud in connection with an audit of financial statements.

As discussed at the last SAG meeting, held on June 21-22, 2004, the current standard on fraud, Statement on Auditing Standards ("SAS") No. 99, *Consideration of Fraud in a Financial Statement Audit*, is part of the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") interim auditing standards.<sup>1/</sup> Based, in part, on comments from SAG members at this last meeting, the staff has prepared this briefing paper to consider issues relevant to a new fraud standard.

#### Background

The auditor's responsibility for the detection of fraud has changed dramatically over the years. Prior to the establishment of authoritative auditing pronouncements, auditors looked to papers or books authored by various individuals in the profession. In the latter part of the 19<sup>th</sup> century, one of the more widely used works in the field of auditing was *Auditing: A Practical Manual for Auditors* by Lawrence R. Dicksee. This publication, as well as other contemporaneous writings, expressed the view that the

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<sup>1/</sup> PCAOB interim auditing standards include those auditing and related professional practice standards in effect as of April 16, 2003.

This paper was developed by the staff of the Office of the Chief Auditor in order to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.

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auditor is responsible for the detection of fraud, as well as for the detection of technical errors and other errors of principle. In that era, much of the professional literature focused on defalcation or the theft of assets concealed in the accounting records, which is referred to in current standards as misstatements arising from misappropriation of assets. The mandate for the auditor to take responsibility for the detection of defalcations eroded with the passage of time.

This erosion was first evident in textbooks and then later in the initial issuance of professional standards. For example:<sup>2/</sup>

In the first three editions (1912, 1916, and 1923) [of *Auditing, Theory and Practice*<sup>3/</sup>], Montgomery acknowledged that in the formative days of auditing 'students were taught' that 'the detection or prevention of fraud' and 'the detection or prevention of errors' were the 'chief objects' of an audit. He went on to explain that the former 'chief objects' must be relegated to a subordinate position because those who retain auditors 'have enlarged their demands and now require a vastly broader and more important class of work.' Subsequent editions of *Montgomery's Auditing* gave less and less emphasis to the detection of fraud until, in the eighth edition (1957), it was described as a 'responsibility not assumed,' with the observation that, 'The American Institute [now known as the AICPA] has properly pointed out that if an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive.'

As the profession established formal standards for the auditor, the Committee on Auditing Procedures (a predecessor to the AICPA's Auditing Standards Board ("ASB"))

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<sup>2/</sup> *Report, Conclusions, and Recommendations*, Cohen Commission (1978), pp. 33-34.

<sup>3/</sup> This work and other editions by Robert H. Montgomery were widely regarded in the profession as authoritative, before the comprehensive development of auditing standards. This work eventually became known as *Montgomery's Auditing*.

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attempted to guide the investing public to expect that the auditor's ability – and responsibility – to detect fraud was limited:<sup>4/</sup>

In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. *However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result.* Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. *The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.* [emphasis added]

This standard also drew a distinction between two types of fraud – defalcations and similar irregularities, and deliberate misrepresentation by management. The standard also acknowledged a different, but not clearly articulated, level of responsibility for defalcations versus deliberate misrepresentation by management, which was acknowledged to be more closely associated with the objective of the ordinary examination.

After the Equity Funding fraud,<sup>5/</sup> the AICPA, in 1974, established the Commission on Auditor's Responsibilities (also referred to as the Cohen Commission) to determine

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<sup>4/</sup> Paragraph .05 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*. The original pronouncement was issued in 1960 as Statement on Auditing Procedures ("SAP") No. 30. This as well as the other SAPs were codified as SAS No. 1, *Codification of Auditing Standards and Procedures*.

<sup>5/</sup> Founded in 1960, Equity Funding Corporation of America sold life insurance policies and mutual funds. Management created a fraudulent scheme

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whether existing standards for the auditing profession needed to be revised. In its recommendations with respect to the auditor's responsibility for the detection of fraud, the Cohen Commission suggested a more active stance than that of the auditing profession:<sup>6/</sup>

The essential basis for an explicit statement on the independent auditor's responsibility for the detection of fraud is that users of financial statements should have the right to assume that audited financial information is not unreliable because of fraud and that management maintains appropriate controls to safeguard assets. An audit should be designed to provide reasonable assurance that the financial statements are not affected by material fraud and also to provide reasonable assurance on the accountability of management for material amounts of corporate assets.

In responding to this and other recommendations of the Cohen Commission, the AICPA issued SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities*. The standard used the term "irregularities" instead of "fraud." ("Fraud" was mentioned only in the definition of irregularities.) Also, this standard repeated the phrase about the auditor's role that had been used as a limitation on responsibility for decades: "the auditor is not an insurer or guarantor; if his examination was made in accordance with generally accepted auditing standards, he has fulfilled his professional responsibility." A similar statement exists today in the PCAOB's interim auditing standards.

In 1985, the National Commission on Fraudulent Financial Reporting (commonly referred to as the Treadway Commission),<sup>7/</sup> was charged with determining the causes of fraudulent financial reporting and the auditor's role in detecting and preventing it. During this time period, the ASB was active. While considering the recommendations of

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through the issuance of bogus life insurance policies. In 1973, Equity Funding collapsed after a disgruntled employee disclosed the existence of this massive financial fraud.

<sup>6/</sup> *Report, Conclusions, and Recommendations*, Cohen Commission (1978), p. 36.

<sup>7/</sup> *Report of the National Commission on Fraudulent Financial Reporting* (October 1987). The Treadway Commission was a private-sector initiative, jointly sponsored and funded by the AICPA, American Accounting Association, Financial Executives International, Institute of Internal Auditors, and the National Association of Accountants.

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the Treadway Commission, the ASB was trying to close the so-called "expectation gap" (that had been identified by the Cohen Commission) between what the public perceived as the role of external auditors and the auditing profession's view of its duties and responsibilities. In 1988, the ASB issued the nine "expectation gap" SASs. Included among this cluster of standards was SAS No. 53, *The Auditor's Responsibility To Detect and Report Errors and Irregularities*, which superseded SAS No. 16. Once again, the standards did not embrace the term "fraud," and there was little mention of this term in the standard. Not until 1997 did the ASB make significant changes in the area of fraud, when it issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. This standard was subsequently superseded (in 2002) with the issuance of SAS No. 99, by the same name.

Since as far back as 1940, the Securities and Exchange Commission ("SEC") has taken the position that an audit can be expected to detect certain kinds of fraud:<sup>8/</sup>

Moreover, we believe that, even in balance sheet examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits whether resulting from collusive fraud or otherwise. We believe that alertness on the part of the entire [audit] staff, coupled with intelligent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they assume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted. Without underestimating the important service rendered by independent public accountants in their review of the accounting principles employed in the preparation of financial statements filed with us and issued to stockholders, we feel that the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that it might not disclose every minor defalcation.

In 1995, Congress enacted the Private Securities Litigation Reform Act, which among other things, requires auditors of issuers to include in their audits "procedures

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<sup>8/</sup> Accounting Series Release No. 19, *In the Matter of McKesson & Robbins, Inc.* (1940).

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designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."<sup>9</sup> SAS No. 82 was, in part, the profession's response to this new statutory requirement.

The SEC's position has not changed over time. For example, Section 704 of the Sarbanes-Oxley Act 2002 ("Act") directed the SEC to "review and analyze all enforcement actions by the Commission involving violations of reporting requirements imposed under the securities laws, and restatements of financial statements, over the 5-year period preceding the date of enactment of the Act, to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management, such as revenue recognition and the accounting treatment of off-balance sheet special purpose entities." In January 2003, the SEC released the *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* ("SEC Study"). In summarizing the actions the SEC brought against auditors, violations of the auditing standards were cited in 57 of the 227 enforcement matters in the SEC Study. These violations include over-reliance on representations from management; misapplication of analytical procedures; and failure to gain sufficient competent evidential matter.

### Fraud and SAS No. 99

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316), similar to its predecessor, SAS No. 82, uses the term "fraud" and acknowledges that an objective of an audit of financial statements is to obtain reasonable assurance that the financial statements are free of material misstatements, including those arising from fraud. In SAS No. 99 fraud is defined as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit." SAS No. 99 describes two types or categories of misstatements – misstatements in financial statements due to fraudulent financial reporting and misstatements arising from misappropriation of assets. The nature and causes of the events leading to classification of fraud in these two categories can be significantly different. For example, management is more likely to engage in fraudulent financial reporting due to the misuse of its authority or other factors, while employees may be more likely to steal assets from a company (that is, to misappropriate assets or commit defalcations).

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<sup>9</sup> Auditors are also required to include procedures to identify related party transactions and to evaluate "whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year."

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SAS No. 99, which is an interim auditing standard of the PCAOB, still contains a considerable amount of discussion that primarily serves the purpose of disclaiming any responsibility on the part of auditors to detect fraud. This language focuses on a lack of responsibility rather than articulating a clear statement of responsibility that acknowledges the auditor's role of protecting public investors. For example, SAS No. 99 includes the following statements (all paragraph references are to AU sec. 316):

- 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. (Paragraph .08)
- Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation. . . . An audit conducted in accordance with GAAS [generally accepted auditing standards] rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication. 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. (Paragraph .09)
- 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 evidence provided is persuasive when it is, in fact, false. (Paragraph .10)
- 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 rely unknowingly on 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. (Paragraph .12)

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- Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. (Paragraph .31)
- Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, 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 the misstatement is intentional or not. (Footnote 4 of paragraph .05)

As previously mentioned, the phrase in the interim auditing standards about the auditor's role and his or her limited responsibility is as follows (paragraph .13 of AU sec. 230, *Due Professional Care in the Performance of Work*):

Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with generally accepted auditing standards.

All parties in the financial reporting process should act with integrity and pursue the objective of preventing and detecting fraud. The primary responsibility for preventing and detecting fraud rests with senior management and the board of directors. The tone set by senior management – the corporate culture within which financial reporting occurs – is the most important factor in maintaining the integrity of the financial reporting process. Directors and, in particular, directors on the audit committee, are responsible to stockholders for overseeing this process. The auditor cannot be a substitute for high standards of conduct by management, the board of directors, and the audit committee, but the auditor can be an important factor in preventing and detecting material fraud in financial statements.

Fraud typically is perpetrated by members of management or employees who normally take steps to conceal the fraud from the auditor and others inside and outside

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the company. Acts of concealment vary considerably in complexity and sophistication and do not have a uniform effect on the auditor's ability to detect fraud.

Most fraudulent financial reporting involves collusion in the sense that several members of senior management or employees might be involved and that, in many instances, falsified documentation is presented to the auditor. Accordingly, the auditor should plan and perform the audit and evaluate the results of auditing procedures with the possibility in mind of collusion and falsification of documents. As the SEC noted in the 1940s, the auditor can be expected to detect gross overstatements of assets and earnings even when there is a collusive fraud.

### **Discussion Questions –**

1. Is it appropriate for stockholders to expect auditors to detect fraud that could have a material effect on the financial statements?
2. Does SAS No. 99 appropriately describe the auditor's responsibility for detecting fraud?

### **Continuum of Risk and Fraud Risk Factors**

Auditing standards have provided (since the issuance of the "expectation gap" SASs in 1988) that the auditor should assess the risk of fraud that exists in the particular circumstances and adjust the audit procedures performed and evidence obtained in response to that level of risk.

SAS No. 53, *The Auditor's Responsibility To Detect and Report Errors and Irregularities* (superseded by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*), used an approach of using risk factors to identify a high risk of fraud and responding to that risk by performing a different level of auditing in those circumstances.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, and its predecessor, SAS No. 82, adopted a continuum approach that assumes varying levels of risk of fraud. SAS No. 99 requires the auditor to identify at what point along the continuum the company resides and respond in the audit approach to the identified risk level.

The appendix to this briefing paper contains a list of risk factors (from SAS No. 99) that relate to misstatements in financial statements due to fraudulent financial

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reporting and risk factors that relate to misstatements arising from misappropriation of assets. These risk factors identify where along the continuum the company resides. Also, the auditor is expected to always have a response to the assessed risk level. However, SAS No. 99 does not require any specific identification of those areas with a higher assessed level of risk.

SAS No. 99 does not attempt to present a bridge between these risk factors and the auditor's assessment of the risk level. A single risk factor could create a high-level risk of fraud or several factors could be present and still result in a low risk. The risk level is dependent on the importance of the factors in the circumstances. Another issue to consider is whether the auditor should identify those situations in which the *risk is high* and assure that the responses are adequate in light of this high risk.

### **Discussion Questions –**

3. Is this list of fraud risk factors helpful to the auditor?
4. Are there other significant fraud risk factors?

### **Areas with a Higher Risk of Material Misstatement Due to Fraud**

Fraudulent financial reporting can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the company's performance. Earnings management typically starts out with small actions or biased judgments by management. Pressures and incentives may lead these actions to increase to the extent that they become abusive and violate accounting principles and result in fraudulent financial reporting. Such situations could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. It is important for the auditor to be aware of circumstances or factors that may indicate earnings management, particularly as they relate to positions or judgments that may create intentional material misstatements in the financial statements.

In addition to being cognizant of fraud risk factors, SAS No. 99 (AU sec. 316) requires the auditor to have a mindset in planning and performing audit procedures that is responsive to the identified fraud risk. For example, paragraph .15 of SAS No. 99 (AU sec. 316) requires that, in participating in the required brainstorming session as part of planning the audit, members of the audit team "[set] aside any prior beliefs the audit

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team members may have that management is honest and has integrity." Because there is always a possibility that management has overridden controls in the furtherance of a fraud scheme, SAS No. 99 requires that certain procedures, such as review of journal entries, be performed in every audit.

### *Revenue Recognition*

Intentional overstatement of revenue by either premature recognition or recognition of fictitious or misrepresented transactions is a frequent cause of fraudulent financial reporting, and most of the improper accounting practices noted in the SEC Study occurred in the area of revenue recognition. For many years, more than half the financial frauds identified by the SEC have occurred through revenue recognition schemes. The SEC has made public accounting firms and the investing community well aware of this troubling statistic, well before the Enron, WorldCom, and Tyco debacles. Other studies and analyses of financial statement restatements also have cited revenue recognition as the principal problem area for errors in the financial statements, whether intentional or unintentional.

The improper timing of revenue recognition schemes cited in the SEC Study include holding the books open beyond the close of the reporting period; improper revenue recognition through "bill-and-hold" sales and side letter arrangements; and improper recognition of revenue from multiple element arrangements.

These findings are similar to the techniques cited by the Public Oversight Board's Panel on Audit Effectiveness in its study of 96 SEC Accounting and Auditing Enforcement Releases. Improper revenue recognition techniques included:

- Recognizing revenue contrary to agreements with customers;
- Manipulating cut-off by backdating shipping documents and delaying the recognition of product returns; and
- Recording fictitious transactions.

Senior management was implicated in 104 of the 126 enforcement matters involving revenue recognition (82.5%), according to the SEC Study.

Paragraph .41 of SAS No. 99 (AU sec. 316) creates a rebuttable presumption that there is a risk of material misstatement due to fraud relating to revenue recognition

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and provides select examples of responses to this risk in paragraph .54. In addition, paragraph .83 of SAS No. 99 (AU sec. 316) requires that the auditor document the reasons supporting a conclusion that revenue recognition does not present a risk of material misstatement due to fraud.

### Discussion Questions –

5. Should auditors presume that revenue recognition is a higher risk area demanding that the auditor perform more extensive procedures?
6. If so, to overcome this presumption, should auditors be required to identify and document persuasive supporting reasons that the risk of material misstatement due to fraud is *remote*?
7. Should a proposed standard on fraud include specific procedures that auditors would be required to perform with respect to revenue recognition?
8. Should auditors be required to inquire of sales and marketing personnel and internal legal counsel about their knowledge of the company's customary and unusual customer terms or conditions of sales?
9. Are there other practice problems you are aware of in this area?

### *Significant or Unusual Accruals*

Management has used significant or unusual accruals to intentionally distort results of operations. These manipulations have included failing to recognize losses due to the impairment of assets and intentional overstatement of accruals in one period so that these accruals can be reversed in future periods to manage earnings in those periods. Among other things, these accruals include allowances for bad debts and loan losses; merger-related expenses in connection with business combinations; and so-called "restructuring reserves." Sometimes referred to as "cookie-jar reserves," the manipulation of these accounts was a principal focus of then-SEC Chairman Arthur Levitt's "Numbers Game" speech at New York University in September 1998, that focused on many problems created by earnings management.

Improper expense recognition schemes were right behind revenue recognition schemes as the most frequently cited on the list of improper accounting practices noted in the SEC Study. Fraudulent expense recognition schemes cited included the

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improper capitalization or deferral of expenses; underaccrual of expenses; improper use of restructuring or similar accrual accounts; and failure to record asset impairments.

A prime example of an improper expense recognition scheme through an accrual account occurred at WorldCom. According to the 2003 WorldCom investigative reports ("2003 Investigative Reports"),<sup>10/</sup> during 1999 and 2000, WorldCom improperly reduced the amount of reported accrued line costs (an estimated payable for costs incurred, but not yet billed to WorldCom) by approximately \$3.3 billion. In 2001 and the first quarter of 2002, WorldCom reduced the amount of reported line costs by improperly capitalizing \$3.5 billion of line costs. These line costs were normal, ongoing operating expenses, and should have been recognized immediately as a reduction of earnings.

The auditor should obtain an understanding of the basis for any accruals and should be concerned with the possibility of both material understatement and material overstatement. That is, the auditor should evaluate whether the accrual is properly stated and avoid focusing only on whether a liability or allowance is not understated. In addition, there has been a failure, on the part of auditors, to test the activity in the accrual accounts to gain assurance this activity has been accounted for properly in accordance with the relevant accounting principles and reported in the appropriate periods.

Moreover, the auditor should evaluate whether the indications of fraud with respect to the transactions detected could have implications for other audit areas. For example, if the auditor has detected the overstatement of an accrual account for acquisition-related costs that could be reversed into income in future periods to manage earnings, the auditor should consider the possibility of a similar overstatement related to other acquisitions or other accrual accounts.

### **Discussion Questions –**

10. Should auditors presume that significant or unusual accruals are a higher risk area demanding that the auditor perform more extensive procedures?

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<sup>10/</sup> *Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc., March 31, 2003. Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, June 9, 2003.*

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11. If so, to overcome this presumption, should auditors be required to identify and document persuasive supporting reasons that the risk of material misstatement due to fraud is *remote*?
12. Should auditors be required to test the activity within accrual accounts during the period and not just the ending balances?
13. Should auditors be required to apply substantive tests of details (that is, not rely on analytical procedures only) to corroborate the support for management's judgments and assumptions?
14. Should a proposed standard on fraud include other specific procedures that auditors would be required to perform with respect to significant or unusual accruals?
15. Are there other practice problems you are aware of in this area?

### *Related Parties*

Senior management can improperly inflate earnings by using undisclosed related parties to conceal the economic substance of transactions or otherwise distort financial position and results of operations through inadequate disclosure. The existence of related parties and transactions with such parties increases inherent risk because such transactions necessarily involve a conflict of interest. A separate briefing paper discusses the audit issues relevant to related parties and transactions with those parties.

### **Discussion Questions –**

16. Should auditors presume that transactions with related parties are a higher risk area demanding that the auditor perform more extensive procedures?
17. If so, to overcome this presumption, should auditors be required to identify and document persuasive supporting reasons that the risk of material misstatement due to fraud is *remote*?
18. Should auditors be required not only to inquire of management, but also the entire board of directors, about related parties and transactions with those parties?

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19. Are there other practice problems you are aware of in this area?

### *Estimates of Fair Value*

Current accounting standards permit use of a variety of approaches to estimate fair value. Some are based on quoted prices for similar assets and liabilities in an active market, some adjust quoted prices for differences in cash flows and other factors relevant to the asset or liability being measured, and some estimates rely on the results of other valuation techniques such as pricing models or similar methodologies.

More recent financial frauds, such as Enron, have made headlines in the financial press due in part to fraudulent pricing models. When fair value cannot be measured by reference to quoted market prices in active markets, the auditor is to obtain evidence that is adequate to determine whether the method of measurement is appropriate and whether management's related assumptions are reasonable and suitably supported. Some estimates of fair value involve the use of valuation techniques that are based on assumptions that depend primarily on internal data or management's intent.

### **Discussion Questions –**

20. Should auditors presume that assets or liabilities valued using pricing models or similar methods are a higher risk area demanding that the auditor perform more extensive procedures?
21. Should a proposed standard on fraud include specific procedures that auditors would be required to perform with respect to such fair value estimates?
22. Are there other practice problems you are aware of in this area?

### **Other Areas Related to Fraud**

#### *Analytical Procedures*

Analytical procedures, used as substantive tests, are tests of financial or nonfinancial information made by studying and comparing relationships among data and trends in the data. Examples of analytical procedures that might be performed in an audit include ratio analyses, comparisons of operating results from quarter to quarter, and comparisons of recorded amounts with expectations developed by the auditor. In

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addition, the auditor will typically study key performance indicators used by company management in managing the day-to-day operations of the company. Examples of key performance indicators include: revenue and backlog by product or service line; revenue per customer or per employee; gross profit margin by product; days sales outstanding; inventory turnover; and various expense categories as a percentage of sales.

The interim auditing standards require the auditor to evaluate whether the results of analytical procedures performed as substantive procedures or in the review phase of the audit indicate a potential material misstatement due to fraud or a previously unrecognized risk of such misstatements. The interim auditing standards define substantive tests as including both analytical procedures and tests of details. The auditor must apply substantive procedures to material account balances. However, the auditor determines the mix of tests of details and analytical procedures based on considerations about efficiency and effectiveness, including the assessment of the risk of material misstatement.

The 2003 Investigative Reports on WorldCom were very critical of the auditor's reliance on analytical procedures:

...it appears that Andersen's audit approach disproportionately relied on finding unexplained variations in WorldCom's financial statements as its means of determining whether there were any accounting irregularities. Andersen failed to take into account that management might have manipulated the financial statements to eliminate any variations. Given the poor state of the telecommunications industry in 2000 and 2001, management's ability to continue to meet aggressive revenue growth targets, and maintain a 42% line cost expense-to-revenue ratio, should have raised questions. Instead of wondering how this could be, Andersen appeared to have been comforted by the absence of variances. Indeed, this absence led Andersen to conclude that no follow-up work was required.

This use of analytical procedures by Andersen highlights a fundamental weakness in using analytical procedures as primary substantive tests. Analytical procedures are likely to be ineffective in detecting fraud because management can easily make unsupported entries to bring reported relationships into an expected or desired pattern. The WorldCom audit brings into focus the importance of the auditor

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making a probing analysis of significant or unusual entries to evaluate whether they indicate fraud.

### Discussion Questions –

23. In performing and evaluating the results of analytical procedures, should auditors be required to identify key performance indicators of the issuer and the issuer's industry?
24. Should auditors be required to compare the key performance indicators to the same measures in prior periods, to budgets, to the experience of the industry as well as principal competitors within the industry?
25. Should auditors be required to compare nonfinancial information (such as operating statistics) with the audited financial information?
26. Do auditors overrely on analytical procedures when used as substantive tests? That is, should auditors be provided definitive direction as to when analytical procedures are appropriate and when analytical procedures should not be used?
27. Are there other practice problems you are aware of in this area?

### *Quarterly Financial Information*

Financial frauds often start with manipulation of quarterly earnings. A public company's financial reporting process includes the preparation and presentation of quarterly financial information. The auditor should evaluate the implications of the risk of material misstatement of the quarterly information due to fraud as part of the annual audit. The independent auditor of a public company or issuer is required to review the company's interim financial information before the company files its quarterly report on Form 10-Q or Form 10-QSB with the SEC. In addition, many issuers are required to include selected quarterly financial data in their annual (and certain other) filings with the SEC. Thus, a review of a company's interim financial information is required for the fourth quarter, for these registrants, even though the company will not file a report on Form 10-Q or 10-QSB. SAS No. 100, *Interim Financial Information* (AU sec. 722), is the principal authoritative source for the auditor when conducting reviews of interim financial information.

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SAS Nos. 99 and 100 provide limited guidance for the auditor to integrate quarterly reviews with the annual audit and for the auditor to be alert for possible fraud during the performance of these review procedures.

### Discussion Questions –

28. Should auditors be required to perform certain procedures with respect to the higher risk audit areas (that is, revenue recognition, related parties, and other high risk audit areas) while performing quarterly reviews?
29. Should a proposed standard provide specific direction for auditors to follow up each quarter on material matters from the prior annual audit and quarterly reviews? (For example, if during the annual audit the auditor has been told that a significant receivable will be collected within 60 days, then the auditor should follow up on that matter in the first quarter of the next period.)
30. Should auditors be required to audit significant or unusual transactions concurrently with a review of the quarterly financial information?
31. Although financial statements are not formally prepared for the fourth quarter, should auditors perform certain procedures with respect to the financial information for the fourth quarter?
32. Are there other practice problems you are aware of in this area?

### *Journal Entries*

Journal entries include adjustments at or near the close of a period to ensure that all assets, liabilities, revenues, and expenses are properly recorded and reflected in the appropriate periods. Journal entries also include consolidating entries used to consolidate subsidiaries when preparing consolidated financial statements.

As previously mentioned, SAS No. 99 requires the auditor to review journal entries for the purpose of identifying significant and unusual entries that might be indicative of fraud. However, this standard does not provide explicit imperatives for the auditor when reviewing journal entries. For example, paragraph .58 of SAS No. 99 (AU sec. 316) states that, "the auditor should *design procedures* to test the appropriateness of journal entries recorded in the general ledger and other adjustments . . . made in the preparation of the financial statements." [emphasis added] Furthermore, this standard

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seems to focus on selection for testing from among all journal entries rather than identification of significant or unusual nonstandard journal entries.

Nonstandard journal entries often have been used to perpetrate or conceal fraudulent financial reporting. Nonstandard journal entries are made to the accounting records (including computer records) or, in some cases, directly to draft financial statements, that usually are initiated by management and are not routine or associated with the normal processing of transactions. These entries sometimes are referred to as top-side entries, post-closing entries, manual adjustments, management entries, or unusual adjustments. These entries are often made by senior management who direct accounting personnel to make entries without support. In some cases the entries are made in large round amounts near the end of reporting periods, but management might attempt to conceal them by allocating amounts among numerous entries of uneven amounts and by backdating entries so that they appear to have been recorded during the period.

One example of a use of journal entries to perpetrate fraud occurred at WorldCom. According to the 2003 Investigative Reports, WorldCom inflated revenue by making large, round-dollar journal entries to various revenue accounts, without support, which increased revenue in 1999 through the first quarter of 2002 by at least approximately \$958 million. This overstatement of revenue was a critical aspect of the fraud because the unsupported entries were necessary to meet the promises senior management made for double-digit revenue growth, and the results also reduced the ratio of line cost expenses to revenue.

### **Discussion Questions –**

33. Should a proposed standard on fraud contain explicit imperatives or expectations with respect to the review of journal entries?
34. If so, should specific direction about the review of journal entries be focused primarily on the review of nonstandard journal entries as opposed to all journal entries?
35. Should auditors be expected to review journal entries at the close of each reporting period – that is quarterly as well as annual reporting periods?
36. Should auditors be required to review post-closing journal entries, including top-side entries, for each reporting period?

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37. Should auditors be required to review consolidating journal entries for each reporting period?
38. Are there other practice problems you are aware of in this area?

### *Discussions with the Audit Committee*

An audit committee is generally required to have procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. The auditor also might receive complaints and concerns directly or through other sources. These complaints or concerns might specifically allege instances of fraud or might indicate related problems such as aggressive accounting.

### **Discussion Questions –**

39. Should auditors be required to inquire of the audit committee about information on complaints and concerns (from whistleblowers and others) that have been submitted to the board of directors or audit committee?
40. Should auditors make such inquiries for each quarter and annual reporting period?

### **Detection of Illegal Acts**

Section 10A of the Securities Exchange Act of 1934 ("Section 10A") also addresses financial fraud. Section 10A, added by the Private Securities Litigation Reform Act of 1995, appears to have had very little impact on the timely reporting of financial fraud and other illegal acts. On September 3, 2003, at the request of Congressman John D. Dingell, the U.S. Government Accountability Office ("GAO") issued an updated report on reporting under Section 10A.

Section 10A requires a report to be submitted to the SEC when the auditor detects a likely illegal act that could have a material impact on a company's financial statements and when management or the board does not take appropriate action to remedy the situation. According to the GAO's September 3, 2003 report on Section 10A, the SEC had received only 29 such "10A letters" from implementation of this requirement on January 1, 1996 through May 15, 2003.

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According to paragraph .05 of SAS No. 54, *Illegal Acts by Clients* (AU sec. 317), "the auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud . . ." Also, SAS No. 54, similar to SAS No. 99, has language that limits the auditor's responsibility. An example of such language is as follows: ". . . an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed" (paragraph .07 of SAS No. 54).

Among other specific procedures required of auditors under Section 10A, an auditor is required to include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." Also, under Section 10A, an auditor has certain reporting obligations if, during the course of an audit, he or she becomes aware of a possible "illegal act" – defined as "an act or omission that violates any law, or any rule or regulation." Further, Section 10A requires a report to be submitted to the SEC when the auditor detects a likely illegal act that could have a material effect on a company's financial statements and if management or the board does not take appropriate action to remedy the situation. Under Section 10A, fraudulent financial reporting, such as intentional overstatement of revenue, would be an illegal act subject to the reporting requirements even though the auditing literature discusses this matter in SAS 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316), rather than SAS No. 54, *Illegal Acts by Clients* (AU sec. 317).

### **Discussion Questions –**

41. Should a proposed standard on fraud include specific procedures for auditors to perform in discharging their obligations under Section 10A?
42. Should a new standard on the auditor's responsibility for the detection of illegal acts by their audit clients also be considered?
43. Are there other practice problems you are aware of in this area?

### **Involvement of Forensic Accountants in an Audit of Financial Statements**

Paragraph .50 of SAS No. 99 states that "the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with

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specialized skill and knowledge, such as forensic... specialists... to the engagement." Paragraph .05 of SAS No. 73, *Using the Work of a Specialist* (AU sec. 336), states "this section does not apply to situations covered by section 311, *Planning and Supervision*, in which a specialist employed by the auditor's firm participates in the audit." According to paragraph .01 of SAS No. 73, a specialist is a person (or firm) possessing special skill or knowledge in a particular field *other than accounting or auditing*. A forensic accountant participating in an audit generally performs investigative services that makes use of a CPA's skills including the application of accounting and auditing knowledge as well as investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

Paragraph .02 of AU sec. 230, *Due Professional Care in the Performance of Work*, states that "due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of fieldwork and reporting." For example, to perform adequately the fraud detection procedures that might be performed by a forensic accountant in an audit of financial statements, the forensic accountant should learn critical background information about the company, its business, and its environment. This background information is, for example, particularly important for effective participation in the brainstorming session required by paragraph .14 of SAS No. 99 (AU sec. 316).

### Discussion Questions –

44. Should a forensic specialist, whether employed by the auditor's firm or engaged by the auditor, be regarded as a member of the audit team? Would treating a forensic accountant as a SAS No. 73-type-specialist create an artificial distinction between the work necessary to detect fraud and the work necessary to complete an audit?
45. What professional standards should apply to forensic accountants participating in an audit of financial statements? Should auditors obtain the necessary skills to detect fraud, including forensic skills?
46. Is it acceptable for an auditor to assign responsibility to or otherwise use the work of a forensic specialist engaged by the company in an audit of financial statements and treat that person's work as the work of a specialist under SAS No. 73, *Using the Work of a Specialist* (AU sec. 336)?

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### *Forensic Services and Independence*

SEC rules prohibit an accountant from providing expert opinions or other litigation support services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation, regulatory, or administrative investigations or proceedings. For example, the auditor's independence would be impaired if the firm was engaged to provide forensic services as part of a litigation services engagement, whether the need for those services was identified in performing an audit of financial statements or in other circumstances..

A registered public accounting firm that, during the course of performing an audit of financial statements, detects indications of fraud affecting those financial statements might be requested by management or the audit committee to expand the scope of the audit and perform an in-depth investigation to determine the impact of the alleged fraudulent activities on the client and its financial statements.

### **Discussion Questions –**

47. Can auditors obtain the reasonable assurance required by paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*, without performing investigations to determine the impact of alleged fraudulent activities on the financial statements?
48. What restrictions on the arrangements for the in-depth investigation would be necessary to avoid an impairment of independence?

### *Mindset of the Auditor*

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316) requires the use of some audit procedures that are forensic in nature and also requires a mindset in planning and performing procedures that is responsive to the identified fraud risk. For example, paragraph .13 of SAS No. 99 states:

The auditor should conduct the engagement with a *mindset that recognizes the possibility that a material misstatement due to fraud could be present*, regardless of any past experience with the entity and *regardless of the auditor's belief about management honesty and integrity*.  
[emphasis added]

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Paragraph .15 of this standard requires that in participating in the brainstorming session as part of planning the audit, the members of the audit team "[set] aside any prior beliefs the audit team members may have that management is honest and has integrity." Because there is always a possibility that management has overridden controls in the furtherance of a fraud scheme, SAS No. 99 requires that certain procedures, such as review of journal entries, which have been involved in many known fraud schemes, be performed in every audit.

Further, the auditor is required to exercise professional skepticism which "requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred." (Paragraph .13 of SAS No. 99).

### **Discussion Question –**

49. Does a forensic accountant employ an investigative mindset that is different from the professional skepticism of an auditor of financial statements?

### **Other Practice Issues**

#### **Discussion Question -**

50. Are there other practice issues that should be addressed in an auditing standard on financial fraud?

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### **APPENDIX**

#### **Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting<sup>11/</sup>**

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

##### **Incentives/Pressures**

a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

b. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

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<sup>11/</sup> These examples of fraud risk factors were taken from the appendix to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316).

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- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

c. Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow
- Personal guarantees of debts of the entity

d. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

### **Opportunities**

a. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

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- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
  - A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
  - Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
  - Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
  - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
  - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
- b. There is ineffective monitoring of management as a result of the following:
- Domination of management by a single person or small group (in a nonowner-managed business) without compensation controls
  - Ineffective board of directors or audit committee oversight over the financial reporting process and internal control
- c. There is a complex or unstable organizational structure, as evidenced by the following:
- Difficulty in determining the organization or individuals that have controlling interest in the entity
  - Overly complex organizational structure involving unusual legal entities or managerial lines of authority
  - High turnover of senior management, counsel, or board members

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d. Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems, including situations involving reportable conditions

### **Attitudes/Rationalizations**

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

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts

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- Management failing to correct known reportable conditions on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
  - Formal or information restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

### **Risk Factors Relating to Misstatements Arising From Misappropriation of Assets<sup>12/</sup>**

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

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<sup>12/</sup> These examples of fraud risk factors were taken from the appendix to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316).

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be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

### **Incentives/Pressures**

a. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

b. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefits plans
- Promotions, compensation, or other rewards inconsistent with expectations

### **Opportunities**

a. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lacking observable identification of ownership

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b. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations
- Inadequate job applicant screening of employees with access to assets
- Inadequate recordkeeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

### **Attitudes/Rationalizations**

Risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising

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from misappropriation of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

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