

## CHAPTER 3 – EARNINGS MANAGEMENT AND FRAUD

**3.1** This chapter describes earnings management and fraud. It summarizes the profession's standards that define the auditor's responsibilities for, and provide guidance to auditors on, the detection of fraud. It also explores the concepts of "earnings management" and "quality of earnings," and how earnings management is related to and may constitute fraud. The chapter concludes with the Panel's findings on the effectiveness of audits in detecting fraud and its recommendations for improving the conduct of audits through strengthened standards that would include a number of steps – including a "forensic-type" fieldwork phase – to improve the likelihood that auditors will detect fraudulent financial reporting.

### DEFINITIONS AND PROFESSIONAL RESPONSIBILITIES

**3.2** Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, distinguishes fraud from error on the basis of whether the underlying action that results in a misstatement of the financial statements is intentional or unintentional. The SAS notes that, while fraud is a broad legal concept, the auditor's concern with fraud specifically relates to fraudulent acts that cause a material misstatement of the financial statements.<sup>1</sup> SAS No. 82 not only is a complex and detailed standard, but also calls for the exercise of considerable judgment.

**3.3** Two types of intentional misstatements are relevant to the auditor's consideration of fraud – misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements, perhaps as part of a scheme to "manage earnings."

**3.4** Misappropriation of assets (sometimes referred to as defalcation) involves the theft of an entity's assets, accompanied by financial statement misrepresentation. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets or causing an entity to pay for goods or services not received. Misappropriation of assets may involve one or more individuals among management, employees or third parties.

**3.5** SAS No. 82 explains many of the limitations under which an auditor operates, including the fact that fraud may be concealed through falsified documentation, including forgery. A financial statement audit rarely involves authentication of documentation, and auditors are not trained as or expected to be experts in such authentication. Fraud also may be concealed through collusion among management, employees or third parties. Auditors also do not possess

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<sup>1</sup> In *Accounting Irregularities and Financial Fraud: A Corporate Governance Guide* (2000 edition), p. 4, Michael R. Young, a litigation partner of Willkie Farr & Gallagher specializing in securities and financial reporting, observes, "Technically, a distinction can be drawn between an irregularity and fraud insofar as an irregularity consists of an intentional misstatement in financial statements, whereas an irregularity evolves into fraud only when those financial statements are shown to another who then justifiably relies on them to his or her detriment. In common parlance, though, the terms are being used interchangeably. . . ."

investigative powers, such as the power to subpoena witnesses and obtain evidence under oath. Furthermore, the evidence that auditors gather in an audit is often only persuasive; it is rarely conclusive. And lastly, audits are designed to detect only *material* misstatements.

**3.6** Accordingly, a financial statement audit performed in accordance with generally accepted auditing standards (GAAS) is not a “fraud audit” or a detailed forensic-style examination of evidence. Forensic audit procedures typically are performed on a limited number of accounts – as a separate engagement and not as part of an audit of financial statements performed in accordance with GAAS – to determine the extent of a known or suspected fraud. In the absence of such knowledge, even a forensic-type audit cannot guarantee that fraud will be detected. It is widely believed that converting GAAS audits to fraud audits would involve costs far in excess of the foreseeable benefits to the public. SAS No. 82 recognizes that, because of the nature of evidence generated in a GAAS audit and the characteristics of fraud, a GAAS audit provides only reasonable, but not absolute, assurance that material misstatements will be detected.

**3.7** Auditors are required to assess the risk of fraud in all audits. SAS No. 82 requires the auditor specifically to assess the risk of material misstatement from fraud; it indicates risk factors that the auditor should consider and provides guidance on how the auditor should respond to the risk assessment. 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.”

**3.8** The general standard of due professional care requires the auditor to exercise *professional skepticism*, which means having an attitude that includes a questioning mind and a critical assessment of audit evidence. The standard states that “the auditor neither assumes that management is dishonest nor assumes unquestioned honesty.”<sup>2</sup> This differs from the assumptions normally made by forensic auditors and investigators empowered by law. Forensic auditors, for example, generally assume dishonesty unless there is evidence to the contrary.

**3.9** SAS No. 82 categorizes risk factors related to fraudulent financial reporting. Among the risk factors are those related to management’s characteristics and influence over the control environment, some of which relate to the motivation for management to engage in fraudulent financial reporting, and personal characteristics bearing on integrity and management style. SAS No. 82 also discusses risk factors specifically related to misappropriation of assets: the susceptibility of assets to theft and the lack of controls designed to prevent or detect misappropriations. It provides examples of risk factors in each of these two categories and guidance on other matters that auditors may become aware of that should be considered in assessing the risk of material misappropriation of assets.

**3.10** Many of the factors cited in SAS No. 82 are subjective and difficult to assess, and risk factors may exist in circumstances where fraud does not. Even when risk factors are present, the auditor’s response to them is not definitively prescribed by the standard. SAS No. 82 states that “the auditor’s judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors.”

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<sup>2</sup> Some observers characterize this standard as proffering a “neutral” concept of professional skepticism.

**3.11** The Auditing Standards Board (ASB) has commissioned research to evaluate the effectiveness of SAS No. 82. The results of the research are expected to be available in 2000.<sup>3</sup>

## **EARNINGS MANAGEMENT: THE CONTINUUM FROM LEGITIMACY TO FRAUD**

**3.12** Reports and allegations of inappropriate earnings management were influential in prompting the Panel's project, and the Panel devoted considerable attention to earnings management.<sup>4</sup>

### **Framing the Issue**

**3.13** The term *earnings management* covers a wide variety of legitimate and illegitimate actions by management that affect an entity's earnings. The Panel neither sought nor formulated a precise definition of earnings management.<sup>5</sup> Rather, it sought to understand the phenomenon that ranges from legitimate managerial activities at one end of the spectrum to fraudulent financial reporting at the other. It focused on the entire spectrum and how the auditor's role in enhancing the credibility of financial information is affected by the different ways in which earnings can be managed.

**3.14** Virtually all managerial activities have a potential effect on earnings, and in that sense constitute earnings management; otherwise, the activities presumably would not be undertaken. Earnings management generally implies, however, that the activities undertaken are designed

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<sup>3</sup> In October 1998, the AICPA issued a *Request for Research Proposals for an Assessment of SAS No. 82*. The broad objectives sought are to assist the ASB in its assessment of the effectiveness of SAS No. 82 and in its efforts to improve related guidance by addressing how emerging businesses and technology affect the process of detecting material misstatements caused by fraud.

<sup>4</sup> In his speech, *The "Numbers Game"* (NYU Center for Law and Business, September 28, 1998), Arthur Levitt, Chairman of the Securities and Exchange Commission (SEC), remarked, "Well, today, I'd like to talk about another widespread, but too little-challenged custom: earnings management. This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system."

<sup>5</sup> The Panel is not aware of a single accepted definition of the term *earnings management*. In fact, differing characterizations or definitions of the term can be found. For example, in "Commentary on Earnings Management," *Accounting Horizons* (December 1989), p. 92, Professor Katherine Schipper observes that "by 'earnings management' I really mean 'disclosure management' in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining private gain (as opposed to, say, merely facilitating the neutral operation of the process)." In "A Review of the Earnings Management Literature and its Implications for Standard Setting," *Accounting Horizons* (December 1999), p. 368, Professors Paul M. Healy and James M. Wahlen state, "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." In *Accounting Irregularities and Financial Fraud: A Corporate Governance Guide* (p. 13) (see note 1), Michael R. Young describes the term as embracing two types of "managed earnings" and observes, "Now in talking about managed earnings, one has got to be careful. There are two types of managed earnings. One type is simply conducting the business of the enterprise in order to attain controlled, disciplined growth. The other type involves deliberate manipulation of the accounting in order to create the *appearance* of controlled, disciplined growth—when, in fact, all that is happening is that accounting entries are being manipulated" (emphasis in original).

either to smooth earnings over two or more interim or annual accounting periods or to achieve a designated earnings level, perhaps to meet securities analysts' forecasts.<sup>6</sup>

**3.15** Some earnings management activities involve legitimate discretionary choices of when to enter into transactions that require accounting recognition, not unlike legitimate year-end tax planning decisions made to accelerate deductions or defer taxable income. For example, advertising expenditures, which generally should be expensed when incurred, may be accelerated in the fourth quarter if the entity is exceeding its earnings target or deferred if it is failing to meet that target. Other earnings management activities involve legitimate choices of how to account for transactions and other events and circumstances – particularly those involving accounting estimates and judgments – in conformity with generally accepted accounting principles (GAAP). For example, implementation of a decision to enhance the entity's credit and collection activities may legitimately support reducing the estimate of bad debt expense. These are legitimate management decisions that affect reported earnings whose consequences are accounted for in conformity with GAAP.<sup>7</sup>

**3.16** Earnings management also may involve intentionally recognizing or measuring transactions and other events and circumstances in the wrong accounting period or recording fictitious transactions – both of which constitute fraud. Choosing the appropriate period in which to recognize a transaction requires both management's and the auditor's understanding of all the relevant facts and circumstances. For example, assume that an entity announces that – either in response to higher costs, to meet current-period sales targets or for any other reason – it will increase prices at the beginning of the next quarter, thereby stimulating some customers to purchase unusually high quantities before the end of the current quarter. If the sales meet all the criteria for revenue recognition, the entity should recognize the sales when the product is shipped, possibly resulting in an effective and legitimate management of earnings.<sup>8</sup> If, however, there is an unusual right-of-return privilege and there is no basis for estimating the returns that will take place, the transaction essentially becomes a conditional sale, and recognizing the revenue when the product is shipped violates GAAP and misstates the financial statements. If the right-of-return privilege has been concealed from the auditor as part of a scheme to increase reported earnings, the financial statement misstatement involves fraudulent financial reporting. This suggests that the wide variety of earnings management activities, which cannot always be classified easily, constitutes a continuum that ranges from complete legitimacy at one extreme to fraud at the other.

### **The Quality-of-Earnings Concept in the Continuum**

**3.17** Earnings management that constitutes “fraud” is distinctly different from earnings management that is perceived as reducing the quality of earnings. Similar to the term *earnings*

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<sup>6</sup> Many factors may influence how earnings management is carried out, even in entities that do not have “earnings” in the traditional sense. The valuation of securities can be influenced by financial measures such as revenue growth, operating margins, income tax ratios and cash flows from operations, among many others. In this chapter, earnings management subsumes all such factors.

<sup>7</sup> In certain circumstances, GAAP require disclosure of the effects of these decisions in the financial statements. Disclosures also may be required by the SEC's rules and regulations under Item 303 of Regulation S-K, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (MD&A).

<sup>8</sup> Disclosure may be required by the SEC's rules and regulations for MD&A (see note 7).

*management*, the term *quality of earnings* has no universally accepted definition, and what it means to one individual may not be what it means to another. For example, some might say that a company whose fixed asset depreciation policy results in higher reported earnings than it would have using that of competitors has a lower quality of earnings than its competitors. On the other hand, if the particular depreciation policy reflects a better utilization of fixed assets by, for example, implementing asset maintenance programs that extend their lives, the quality of earnings might be equal to or maybe even higher than that of the competitors. In the end, most would agree that inappropriately increasing earnings results in a lower quality of earnings.

**3.18** It is the acceptability of an accounting policy under GAAP that draws the line on the continuum distinguishing legitimate earnings management from fraud. However, determining whether or when the behavior in the earnings management continuum crosses the line from legitimacy to fraud in a specific situation is not always easy. Where legitimate earnings management is present, there indeed may be issues and debates about the quality of an entity's earnings, but not about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP. On the other side of the line is fraudulent financial reporting (unless the departure from GAAP is unintentional, in which case it constitutes "error") and not merely a lower quality of earnings.

**3.19** The auditor's responsibility to detect fraud was discussed earlier in this chapter, and responsibilities to report fraud to the audit committee were noted in Chapter 2. Auditors' responsibilities with regard to the quality of an entity's earnings, when fraud is not an issue, are distinctly different from their responsibilities to detect and report fraud. SAS No. 90 on audit committee communications requires the auditor to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles and the estimates and judgments underlying its financial statements. For example, the auditors should inform the audit committee when they believe that an entity's accounting policies are approaching unacceptability, even if the policies have not yet crossed into that territory. (The SAS was prompted in large part by the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.) Increased communications between audit committees and auditors should enhance the understanding by audit committees about quality-of-earnings issues and thereby improve financial reporting.

### **Motivation for Earnings Management and Fraud**

**3.20** The motivation to manage earnings comes in part from management's responsibility to direct the entity's operations in a way that achieves targeted results. The motivation also comes from pressures on management from sources both outside and inside the entity. External pressures come principally from the capital markets. Many observers believe that Wall Street's expectations significantly affect both appropriate and inappropriate management behaviors.<sup>9</sup>

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<sup>9</sup> In his speech, *The "Numbers Game"* (see note 4), Chairman Levitt observed, "Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices." He further stated, "As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting." Chairman Levitt also remarked, "Many in corporate America are just as frustrated and concerned about this trend as we, at the SEC, are. They know how difficult it is to hold the line on good practices when their competitors operate in the gray area between legitimacy and outright fraud."

Members of top management are especially subject to pressures to demonstrate that shareholder value has grown as a consequence of their leadership. Boards of directors are subject to pressures from stakeholders to enhance the value of the entity, and they in turn create internal pressures on management to meet financial and other goals and ensure the growth and prosperity of the entity. Boards oversee the stewardship of management and prescribe the basis for measuring performance and rewarding or penalizing management. Pressures by top management on others at different levels of the entity are everyday occurrences and are a natural part of the performance evaluation process.

**3.21** Not only are these pressures commonplace in today's environment, but also the personal consequences to management of meeting or failing to meet financial goals can be extraordinary. The system for financial rewards to management is frequently skewed toward participation in the growth of an entity's worth in the marketplace, especially, although not exclusively, for top management.<sup>10</sup> At many levels within an entity, financial incentives based directly or indirectly on accounting results can be significant. At some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud.

**3.22** Opportunity is a necessary feature of fraud, and it explains why management is in a unique position to perpetrate it. As the stewards of the entity, management possesses the power to manipulate the accounting records and prepare fraudulent financial reports.<sup>11</sup> Whatever controls might be present in an entity, management often has the ability to override them. Management can solicit whatever "help" it needs to carry out the fraud by directing or enlisting subordinates to assist. Thus, if collusion is needed to carry out the fraud, management can facilitate the collusion. If false documents need to be prepared, management can see that it is done. However, in those entities where the board of directors and management set the proper tone, promote high ethical standards and install appropriate controls to prevent and detect fraud, the opportunities to commit fraud can be reduced significantly.

**3.23** Another feature of fraud perhaps is obvious – concealment. Concealment usually is an all-important goal of the perpetrator of a fraud, and the schemes for concealment vary from the patently simple to enormously complex. Concealment of fraud from the auditors often is a paramount objective, and for that reason successfully assessing the risk of fraud and designing audit procedures for its detection can be very difficult. At best, some might assert that observable risk factors present in a given situation could suggest the possibility of fraud.<sup>12</sup>

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<sup>10</sup> For example, compensation plans for management-level personnel based on the notion of "pay-for-performance" or "pay-for-value" often involve the use of stock options or other equity-type instruments, the ultimate compensatory value of which depends largely on the increase in the company's stock price over time.

<sup>11</sup> The Panel recognizes that, in the vast majority of cases, management exercises a high level of integrity and professionalism in preparing financial reports.

<sup>12</sup> SAS No. 82 lists risk factors relating to misstatements arising from fraudulent financial reporting in three categories: management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial viability. It also discusses risk factors relating to misstatements arising from misappropriation of assets.

### **Crossing the Line: From Trickle to Waterfall**

**3.24** Academics and others have conducted a substantial amount of research on fraud.<sup>13</sup> Some of the research, as well as anecdotal evidence, suggests that fraud often starts out small, like a trickle.<sup>14</sup> What ends up as a massive financial fraud – in effect, a waterfall – rarely starts with a grand plan or conspiracy. It often starts so small that the participants do not believe they are stepping over the line. Rather, they believe that they are doing nothing more than legitimately managing earnings, merely exploiting ambiguities in the accounting rules.<sup>15</sup>

**3.25** Frauds often start in one of the first three quarters of an entity's fiscal year.<sup>16</sup> Auditors have limited responsibilities for interim financial information (generally quarterly financial reports). Auditors are engaged to review that information, but it is not subjected to the same scrutiny as are the full year's audited financial statements.<sup>17</sup> Furthermore, matters potentially material to an interim financial report might not be material to the annual financial statements, and therefore may not receive scrutiny from the auditors either in their limited quarterly reviews or the annual audit. Perpetrators may use this fact to their advantage in their efforts at concealment. In addition, manipulations of earnings in interim periods often are rationalized by management as being only temporary "borrowings," since there is plenty of time left in the year to correct the problem. The rationalization also may include a belief that the manipulations are intended to avoid earnings volatility and surprises, and therefore are in the shareholders' best interests.

**3.26** The trickle becomes a waterfall when this "borrowing" accelerates and the perpetrators end up either taking positions that are indefensible or developing a scheme for concealment that will avoid discovery.<sup>18</sup> Sometimes by the end of the fiscal year, the "borrowing" is still relatively small, but may continue to grow in future years. Sometimes by the end of the fiscal year, the manipulations have grown but they either may escape detection by the auditors or, if found, are

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<sup>13</sup> Some of that research involves certain "high-profile" cases of fraud involving public entities, while other research focuses on frauds that receive little or no press coverage. An example of research involving public entities is that commissioned by the Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, published in March 1999 (1999 COSO Report). Data from the 1999 COSO Report was used in a study commissioned by the ASB, *Fraud-Related SEC Enforcement Actions Against Auditors: 1987-1997* (August 2000). The Panel also undertook its own study of SEC Accounting and Auditing Enforcement Releases (AAERs), which is described in Appendix F.

<sup>14</sup> Young, p. 11 (see note 1) states, "*It starts out small.* Massive financial fraud does not start with a grand plan or conspiracy."

<sup>15</sup> While the concept of "materiality" generally is not viewed as an accounting ambiguity, it too can be exploited. For a discussion of the concept of materiality, see "Materiality, Waived Adjustments and Analysts' Expectations" in Chapter 2.

<sup>16</sup> The 1999 COSO Report, p. 34 (see note 13), states, "From our readings of the AAERs, we observed that many frauds allegedly were initiated in a quarterly Form 10-Q, with the first manipulation sometimes at relatively small amounts. After observing that the fraud was undetected in initial attempts, the fraud scheme was repeated in subsequently issued quarterly or annual financial statements, with the fraud amount often increasing over time and generally stretching over two fiscal years."

<sup>17</sup> SAS No. 71, *Interim Financial Information* (as amended), addresses the limitations of auditors' reviews of that kind of information.

<sup>18</sup> "Taking positions" is not limited to management taking positions to justify its actions with the external auditors. Management also can "take positions" with other members of management, internal auditors and boards of directors (or audit committees) unbeknown to external auditors, regulators or others.

judged to be “immaterial errors.”<sup>19</sup> When these manipulations come to light and they are material, they often lead to a restatement of the financial statements and usually to allegations of “audit failure.” Restatements of previously audited financial statements raise questions about whether the system that provides assurances about both the quality of audits and the reliability of financial reports is operating effectively.

### **The Panel’s Perspectives About the Responsibilities of Auditors and Others**

**3.27** The Panel is concerned that the auditing profession has not kept pace with a rapidly changing environment. The Panel believes that the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management. It believes that audit firms should aspire to “zero defects” as their goal and endeavor to eliminate audit failures completely.<sup>20</sup> They should promote that goal to their personnel starting on their first working day. Constant reminders and reinforcements should be present throughout the careers of all professionals, and compliance with firm policies and procedures should be a major factor in their advancement and compensation. Professional skepticism should mean more than only words in the auditing standards – it should be a way of life for auditors. The objectives in an audit should include detecting material financial statement fraud – that goal should drive both auditing standards and the way they are applied. By meeting that objective, audits will serve to deter fraud as well as detect it.

**3.28** The Panel accepts the premise that a GAAS audit is not, and should not become, a fraud audit. It accepts the premise that reasonable, not absolute, assurance is a sufficiently high standard of responsibility. It believes that this is a high enough standard to provide the assurance about the reliability of audited financial information that the capital markets need for their proper functioning. While accepting these premises, the Panel nonetheless is concerned that auditors may not be requiring as much evidence to achieve reasonable assurance as they have in the past, especially in areas where they believe that risk is low.

**3.29** The Panel’s perspective is that, even in the face of the strengthened auditing standards issued over the past 15 or so years, audit firms may have reduced the scope of audits and level of testing, at least in part as a result of redesigning their audit methodologies.

**3.30** The Panel recognizes that the primary responsibility for the prevention and detection of fraud rests with management, boards of directors and audit committees.<sup>21</sup> Management should

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<sup>19</sup> If the errors were judged to be material, the financial statements would not be issued until they had been corrected. If the auditors have determined that evidence of management fraud may exist, they are required to communicate the matter directly to the audit committee, and in certain circumstances to the SEC.

<sup>20</sup> The Panel notes that an allegation of an audit failure does not necessarily mean there was one. However, the Panel’s research and analysis of cases alleging audit failures (Appendix F) and cases that have been resolved support its concerns about the effectiveness of audits in detecting fraud. Aspiring to “zero defects” does not imply there would never be an undetected material financial statement fraud, since the standard of responsibility for auditors is that of “reasonable assurance,” not “absolute assurance” (see “Definitions and Professional Responsibilities” earlier in this chapter). Furthermore, a “zero defects” goal does not mean that auditors’ failure to detect a material financial statement fraud implies a lack of compliance with GAAS.

<sup>21</sup> *Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity, A Guide for Directors, CEOs, and Senior Managers*, issued in 1998 by the National Association of Corporate Directors and Grant Thornton



create a culture that deters fraud and should set and communicate clear corporate policies against improper conduct. Directors and audit committees should oversee management's activities and demonstrate a strong commitment and involvement when problems arise. Auditors serve an important role in detecting material financial statement fraud. While they cannot be a substitute for the enforcement of high standards of conduct by management, boards of directors and audit committees, auditors can be an important factor in promoting high standards.

**3.31** It is with these perspectives in mind, as well as its findings, that the Panel has formulated the recommendations in this chapter.

## **FINDINGS**

### **QPR Findings**

**3.32** The QPR probed the risk assessment process and responses related to the risk of fraudulent financial reporting, as well as the risk of misappropriation of assets when called for in selected key areas. The QPR also looked into the overall integration of the fraud risk assessment process with engagement risk (client acceptance and continuance) assessments, discussed in Chapter 2. Furthermore, it probed into the involvement of concurring partners in the risk assessments.

#### ***Fraudulent Financial Reporting***

**3.33** The QPR reviewers agreed in virtually all cases with the assessment of the risk of fraudulent financial reporting and agreed that the right people were involved in the assessment. They agreed that the assessment process was appropriate and thorough. The QPR also affirmed that the risk of fraudulent financial reporting was considered in evaluating the overall audit results and in determining whether additional audit tests or follow-up actions were necessary. In general, the QPR found that the engagement risk and fraud risk assessments were appropriately linked. In addition, the QPR confirmed the appropriate involvement of concurring partners in the process. Lastly, the QPR disclosed concern in about 12% of the engagements regarding the adequacy of documentation.

**3.34** One area considered by the QPR that is closely related to the issue of fraudulent financial reporting and whether audit tests are adequate to address the possibility of its occurrence is the area of non-standard entries.<sup>22</sup> Financial statement misstatements often are perpetrated by using non-standard entries to record fictitious transactions or other events and circumstances, particularly near the end of the reporting period. The QPR disclosed that in about 15% of the

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LLP, sets forth "basic principles" and "implementation approaches" for corporate directors and independent auditors, among others, to employ in dealing with fraud and other illegal activity.

<sup>22</sup> *Non-standard entries* is a term that is not precisely defined, although it is in common use among accountants and auditors. Such entries sometimes are referred to as "top-side entries," "post-closing entries," "manual adjustments," "management entries" or "unusual adjustments." In general, they are financial statement changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

engagements the auditors did not have an adequate understanding of the client's system for preparing, processing and approving non-standard entries. Furthermore, in about 31% of the engagements reviewed, the auditors did not perform procedures to identify and review non-standard entries, whether made at the end of the period or at other times. When the auditors did perform such procedures, the reviewers generally believed that the procedures were appropriate and that the individuals who identified and reviewed the entries had the appropriate knowledge and skills to do so in a meaningful manner.

### ***Misappropriation of Assets***

**3.35** The QPR probed into the risk of material misappropriations of assets in key areas where the reviewers believed that the risk was significant. Only in a few such key areas did the reviewers believe that was the case. For the most part, the QPR reviewers agreed that the risk assessments relating to misappropriation of assets were appropriately made, the right people made them at the right time, and the responses to the results of the assessments were appropriate. In one engagement, the reviewer agreed with the risk assessment but observed that a relatively inexperienced person had made the assessment without the benefit of specialized industry knowledge; however, the reviewer did not disagree with the response to the assessment by the engagement team.

**3.36** In these same key areas, the QPR reviewers also reviewed the inherent risk and control risk assessments, distinct from the risk of misappropriation of assets. In addition, the reviewers addressed the involvement of information technology specialists and the appropriateness of the substantive tests carried out in the areas. The QPR reviewers indicated that the procedures performed in these key areas generally were consistent with the procedures in all other key areas. This may indicate that the auditors did not place any special emphasis on the areas where the risk of material misappropriation of assets was considered significant. This fact by itself is neither good nor bad, but it may indicate a tendency of auditors not to place much importance on the risk of asset misappropriation.<sup>23</sup>

### **The Panel's Broader Consideration of Fraud**

**3.37** The Panel undertook a broad consideration of the auditor's responsibility for the detection of fraud. In addition to the QPR process, the Panel studied the input received from focus groups, interviews with forensic auditors, public hearings and responses to its survey questionnaire. The Panel reviewed the 1999 COSO Report and discussed the results of the litigation research undertaken on its behalf. It also considered the views of the legal profession and regulators, including the testimony received at its October 1999 public hearings. Writings by a number of authors knowledgeable in the area of fraudulent financial reporting also were considered.<sup>24</sup>

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<sup>23</sup> The Panel noted during its study of AAERs (see Appendix F) a few instances of materially misstated financial statements resulting from misappropriation of assets.

<sup>24</sup> For example, the Panel considered Young (see note 1) and Joseph T. Wells, *Occupational Fraud and Abuse* (1997). Mr. Wells, CFE, CPA, is founder and chairman of the Association of Certified Fraud Examiners.

**3.38** In some cases, auditors interviewed in focus groups and other settings expressed uncertainty about their *responsibility* to detect fraud. They also expressed doubt about their *ability* to detect fraud, especially fraud involving collusive activities or falsified documentation. While many auditors expressed general familiarity with forensic auditing techniques, no evidence pointed to any significant use of such techniques in GAAS audits.

**3.39** The Panel’s analysis of recent SEC AAERs (Appendix F) involving the Big 5 audit firms or their clients provided insights into the apparent causes of actual or alleged fraudulent financial reporting or audit failures (or weaknesses in the auditing procedures employed) and into some of the characteristics that frequently were present.

**3.40** Most of the misstatements involved relatively routine accounts and transactions as opposed to complex judgmental areas and more esoteric accounts and transactions, such as derivatives or other complex financial instruments, restructuring reserves, business combinations, or in-process research and development charges. Approximately 70% of the cases involved the overstatement of revenue – resulting from either premature revenue recognition or fictitious revenue.

**3.41** The entities with the most sophisticated frauds often were concerned about concealing them from the auditors and particularly about making the numbers and the relationships among them “look right” to the auditors when they performed their analytical procedures. A favorite technique for accomplishing this was to “play around” with the numbers, often through the use of non-standard entries, until they “looked right.”

**3.42** Other common characteristics of the cases included entities using information technology to facilitate the frauds, significant changes in an entity’s business that increased inherent risk, management override of controls, material frauds at relatively small divisions or subsidiaries that the auditors did not visit, inadequate substantive tests, and audit engagement personnel not appearing to have adequate training, experience or supervision.

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**3.43** The Panel arrived at certain fundamental conclusions. First, the basic responsibility of auditors to obtain reasonable, but not absolute, assurance that the financial statements are not materially misstated sets the responsibility at an appropriate level.<sup>25</sup> To raise the level of assurance from that of *reasonable* to a higher standard, such as *high* or *virtually certain*, would put an unreasonable burden on the auditing profession and place an unjustified cost burden on entities subject to audit. Survey respondents and commentators at the October 1999 public hearings generally agreed with that assessment.

**3.44** Second, the premise of professional skepticism being based on an assumption of neither management’s honesty nor dishonesty should be continued, but auditing standards need to provide better guidance on how to implement that concept. The cooperation of management is

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<sup>25</sup> Some commentators observed that attempts should be made (or continued) to educate users about the responsibility of auditors to provide only reasonable assurance. The Panel does not discourage such efforts, but it believes that such efforts might be perceived as overly defensive on the part of the auditing profession.

critical to both an effective and an efficient audit. Converting GAAS audits to forensic, fraud-type audits would not be justified from a cost-benefit perspective and because of the potentially detrimental effects on the conduct of business. For example, a forensic audit likely would require significant additional time by management in dealing with the auditors and might distract management from effectively performing its day-to-day operations.

**3.45** The Panel realizes, however, that management generally is the party that precipitates fraudulent financial reporting.<sup>26</sup> Management ordinarily is in a position to collude or cause others to collude, and management may create or facilitate the creation of falsified documentation, all to the end of avoiding detection by auditors through normal auditing procedures. Management may have some motivation to perpetrate financial reporting fraud. Moreover, it is in a position to create opportunities for doing so and can facilitate its concealment. This poses a quandary to auditors: On the one hand, to accomplish the audit requires the cooperation of management; on the other hand, management is in a position to mislead the auditors in their quest for valid evidence.

**3.46** In summary, the Panel found that:

- The risk assessment and response process called for by SAS No. 82 falls short in effectively deterring fraud or significantly increasing the likelihood that the auditor will detect material fraud, largely because it fails to direct auditing procedures specifically toward fraud detection.<sup>27</sup>
- GAAS do not provide sufficient guidance to adequately implement the concept of professional skepticism because management usually is judged as possessing integrity (despite the fact that management may have at least some motivation to perpetrate fraudulent financial reporting). Presumably, if auditors judged management to not possess integrity, they would not continue to serve those clients. The Panel's findings, however, suggest that auditors do not always pursue sufficiently conditions discovered during an audit or corroborate adequately management representations made to them.<sup>28</sup>
- GAAS dismiss collusion as impossible or too difficult to detect and pointedly explain the lack of expertise of auditors with respect to determining the authenticity of documents. The Panel acknowledges that these factors are and will continue to be inherent limitations of an audit. The reality is, however, that all or most financial reporting frauds involve collusion and many involve falsified documentation.

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<sup>26</sup> The 1999 COSO Report disclosed that top senior executives frequently were involved in financial statement frauds. For example, it notes that in 72% of the cases reviewed, the chief executive officer was named in the SEC's AAER, and in 43% of the cases, the chief financial officer was associated with the financial statement fraud. Other management individuals named included controllers and chief operating officers. The Panel noted similar findings in its study of AAERs (see Appendix F).

<sup>27</sup> All of the audits reviewed in the QPR were subject to SAS No. 82. Furthermore, the Panel understands that the audits of a number of entities for which there have been allegations of audit failure also were subject to SAS No. 82.

<sup>28</sup> The term "red flags" is sometimes used to describe these conditions. The term often is used in a pejorative way, however, to imply an auditor's failure to pursue the obvious. The Panel recognizes that what might appear obvious in hindsight is not always obvious at the time and accordingly avoided use of the term.

- Auditors do not appear to place any special emphasis on the areas where the risk of misappropriation of assets is considered significant.
- Audit committees rarely address the potential for management to commit financial statement fraud or request auditors to perform specific tests to detect that possibility.

**3.47** Based on these findings, the Panel sought to develop substantive recommendations consistent with the auditor's responsibility to obtain reasonable assurance that would both enhance the prospects for the detection of material financial statement fraud and implicitly serve to deter or prevent such fraud.<sup>29</sup> The Panel was cognizant of the dangers of either going too far, or not going far enough.

## RECOMMENDATIONS

### *To the Auditing Standards Board:*

**3.48** The Panel recommends that the ASB develop stronger and more definitive auditing standards to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will detect fraudulent financial reporting.

**3.49** The Panel envisions that the new requirements would be over and above those that are now contemplated by a GAAS audit. The degree to which these requirements would require additional audit effort is likely to vary with a number of factors, such as the size and complexity of the entity's operations and the difficulty of applying accounting principles that call for management to make judgments involving subjective estimates. The additional audit effort also would be influenced by the auditors' risk assessments – including their assessments of management's motivations (potentially at many levels of an entity) to manage earnings and meet the expectations of the financial community or of higher levels of management – and their understanding and tests of internal control. The Panel believes that the incremental audit effort that would result from this recommendation ordinarily would neither constitute a dominant part of the audit nor be inconsequential. Under "Consideration of Exposure Draft Comments on the Forensic-type Phase" at the end of this chapter, the Panel provides the ASB with its observations on factors that ordinarily would influence how much additional audit effort would be required.

**3.50** The Panel further believes it is reasonable that the strengthened standards be effective starting with audits of financial statements for periods commencing after December 31, 2001.

**3.51** To implement the foregoing recommendation, the Panel recommends that the ASB require the following in all audits:

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<sup>29</sup> The Panel recognizes that, notwithstanding its recommendations, complying with GAAS cannot and will not guarantee that auditors will detect all material fraud.

### *Planning and Supervision*

- Discussion by supervisory engagement personnel (including the auditor with final authority, usually the engagement partner) with other engagement team members about the vulnerability of the entity to fraud.

This discussion should encompass what is expected of team members in dealing with a potential for fraud in the specific areas of the audit assigned to them. An important objective of these discussions would be to identify the appropriate engagement team members to address the potential for fraud (e.g., the engagement team members who should interview company personnel) and how their work is to be supervised and reviewed.

This recommendation requires a significant strengthening of the first standard of fieldwork that “the work is to be adequately planned and assistants, if any, are to be properly supervised.” The objective of a strengthened standard is to ensure a substantive dialogue among members of an engagement team about “what could go wrong” and “how fraud might be perpetrated.” This dialogue should guide how engagement team members address the possibility of fraud, including how procedures (including inquiries) might be designed to address that possibility. The strengthened standard should be sufficiently specific that these activities are carried out by engagement teams (and thus involve engagement partners) at all significant locations. The engagement team members to be involved in this dialogue should include information technology and other specialists assigned to the audit. Decisions about the actions to be taken by individual engagement team members should be documented.

### *Forensic-type Fieldwork Phase*

- Introduction of a “forensic-type fieldwork phase.” Not unlike the traditional planning, interim, final and review phases of audits, this new forensic-type phase should become an integral part of the audit, with careful thought given to how and when it is to be carried out. A forensic-type fieldwork phase does not mean converting a GAAS audit to a “fraud audit.” Rather, the characterization of this phase of a GAAS audit as a forensic-type phase seeks to convey an attitudinal shift in the auditor’s degree of skepticism. Furthermore, use of the word *phase* does not mean that the work cannot be integrated throughout the audit.<sup>30</sup>

During this phase, auditors should modify the otherwise neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, override of internal control and falsification of

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<sup>30</sup> The use of the word *forensic* in this recommendation also does not imply that the ASB needs to use that term in developing or modifying its standards. Similarly, the word is not being used in a legal sense and it does not imply that the results of the procedures necessarily would be suitable for use as “legal evidence.”

documents.<sup>31</sup> The key question that auditors should ask is “Where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it?”

Auditing standards should require in this phase:

- Performance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal control by management (recognizing that management includes many levels of personnel in an entity, including personnel outside of the United States, and not just top corporate-level management). The nature, timing and extent of such tests should be guided (at a minimum) by the following criteria.<sup>32</sup>
- Tests should be centered around the balance sheet date for balance sheet accounts and throughout the year (including the latest quarter) for income statement accounts, in the following areas (some of which may overlap)<sup>33</sup>:
  - High-risk areas (at the specific account and assertion level) identified by the engagement team as areas where the opportunity to perpetrate fraud is higher than normal.<sup>34</sup> Candidates for such identification would include balance sheet or income statement accounts affected by revenue recognition policies, deferred costs, asset additions resulting from complex transactions such as business combinations accounted for as purchases, reserves that are highly dependent on management’s intentions or representations, accounts (or elements of them) not subject to systems-driven controls, and related party transactions.
  - Areas for which Accounting Principles Board Opinion No. 20 requires disclosure of significant accounting policies<sup>35</sup>

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<sup>31</sup> See note 2 regarding the “neutral” concept of professional skepticism in the auditing standards. The Panel recognizes that to presume the possibility of management dishonesty may be thought by some to imply a distrust of management. That would be erroneous.

<sup>32</sup> The ASB might consider providing guidance on procedures thought to be especially useful in forensic (fraud-type) audits that also could be applied, as an option, in GAAS audits. The Panel recognizes that fraud-type audits usually are conducted only after fraudulent activity has been suspected or detected and that many procedures employed in those audits would be impractical or impossible to apply in a GAAS audit. For example, in some fraud-type audits, company personnel are interviewed with their own legal counsel present or under grants of immunity.

<sup>33</sup> Centering certain tests around the balance sheet date may, in some cases, put pressure on auditors because of deadline considerations. These pressures may be exacerbated unless management fully cooperates with these audit efforts. Auditors may wish to emphasize the importance of this cooperation, for example, in their engagement letters.

<sup>34</sup> Identifying the high-risk areas calls for risk assessments involving the exercise of professional judgment. These risk assessments, of necessity, involve an understanding of the control environment and the entity’s policies and procedures for preventing financial statement fraud. To provide guidance for making such risk assessments, the ASB may wish to consider the outcome of the academic research on the efficacy of SAS No. 82 (see note 3) and other similar undertakings (see note 13 to Chapter 2). See also “Consideration of Exposure Draft Comments on the Forensic-type Phase” at the end of this chapter.

<sup>35</sup> A number of cases of fraudulent financial reporting have involved these areas, and the disclosed accounting policies inaccurately portrayed the entity’s actual accounting policies. Accounting policy disclosures often relate to industry practices or matters unique to the specific entity.

- Material balance sheet accounts that generally “turn over” several times throughout the year (e.g., trade receivables, inventory, payables, cash and securities)
- Non-standard entries (including entries made to computer records) requiring management’s involvement or approval. (The ASB should define the term *non-standard entries* for this purpose.<sup>36</sup>)
- Auditors should consider incorporating a surprise or unpredictability element in their tests. Examples of what they should consider include the following:
  - Recounts of inventory items or unannounced visits to locations
  - Interviews of financial and non-financial company personnel in different areas or locations. Interviews of company information technology personnel may be appropriate to inquire about possible overrides of computer-related controls. Inquiries of company personnel (including legal personnel) responsible for addressing reports by company employees or others alleging irregularities also should be made. (For example, some companies have employee “hot lines” that enable confidential reporting of possible improprieties or violations of company policies.)
  - Requests for written confirmations from company employees regarding matters about which they have made representations to the auditors
  - Requests for written confirmations from customers or vendors that otherwise would not be undertaken and that are carefully tailored to address the nature and specific terms of the underlying transactions, for example, to assist in identifying “side agreements” allowing a right of return or other concessions
  - Tests of accounts not ordinarily performed annually
  - Tests of accounts traditionally or frequently deemed “low risk”
- The tests should be either tests of details or precise substantive analytical procedures, but not tests of controls. (Tests of controls may not be effective in detecting fraud because management can override controls.)

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<sup>36</sup> See note 22.



- The external auditor should not use the work of internal auditors in carrying out tests directed at the possibility of fraud.<sup>37</sup> The internal auditors may provide limited direct assistance to the external auditor, and may perform similar procedures to supplement the work of the external auditor.
- Use of technologically advanced auditing tools should be encouraged.
- Non-corporate and non-U.S. locations should be covered by substantive tests directed at the possibility of fraud. Some rotation over a reasonable number of audit periods would be acceptable.<sup>38</sup>
- Re-review by supervisory audit personnel, at the conclusion of the audit, of high-risk areas to reassess whether conditions identified during fieldwork or test results (e.g., exceptions and related explanations by entity personnel) might call for additional tests.

#### *Retrospective Audit Procedures*

- Introduction of retrospective audit procedures, calling for an analysis of selected opening balance sheet accounts of previously audited financial statements. The accounts should be selected using risk-based or other criteria specified by the ASB. The ASB also should provide guidance on the types of tests to be applied to the accounts. The objective of the audit tests should be to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight. This retrospective look at and testing of accounts that previously had been audited is intended to act as a fraud deterrent by posing a threat to the successful concealment of fraud, not to second-guess reasonable judgments based on information available at the time the financial statements were originally issued. Consequently, the auditor should modify the otherwise “neutral” concept of professional skepticism, as discussed above.

#### *Review and Documentation*

- Review and documentation as follows:

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<sup>37</sup> The admonition not to use internal auditors in the forensic-type phase should not be construed as rejecting the concepts in SAS No. 65, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements* (see “Internal Auditors” in Chapter 2). To the contrary, the Panel sees many opportunities for internal auditors to address issues of financial statement fraud, including interacting with the external auditors in helping them develop their assessments of risk, and conducting their own internal audit tests to detect fraud. Furthermore, external auditors may take into consideration the results of internal audit tests designed to detect fraud in deciding on their own tests. However, because the essence of the forensic-type phase involves an attitudinal shift in the professional skepticism of the external auditors in performing tests and evaluating their results, ceding that responsibility to internal auditors would not be appropriate.

<sup>38</sup> In Chapter 2, the Panel made related recommendations under “Multi-location Audits” and recommendations on materiality used in planning the audit under “Establishing Auditing Standards.” The ASB may wish to consider those recommendations in providing guidance on the coverage of locations in the forensic-type phase. See also “Consideration of Exposure Draft Comments on the Forensic-type Phase” at the end of this chapter.

- Debriefing of engagement team members assigned to perform retrospective procedures and procedures during the forensic-type phase by supervisory personnel, and assessing the propriety of follow-up actions and conclusions reached, both of which should be documented
- Specific documentation relating to the retrospective procedures and the procedures carried out during the forensic-type phase of the audit, including the results of the assessments made

The Panel also recommends, with respect to interim financial information, that the ASB:

*Procedural Guidance for Interim Periods*<sup>39</sup>

- Include in its standards specific guidance for the application of procedures in interim periods using a forensic-type approach equivalent to that described above. In this connection, the Panel believes that the ASB should consider the observations in the 1999 COSO Report that many frauds are initiated in interim periods.<sup>40</sup>
- Provide criteria for the areas that should be addressed in reviews of interim financial information. Such criteria might include, for example, areas involving a high degree of subjectivity (e.g., merger-related or restructuring reserves), areas involving complex accounting standards (e.g., software revenue recognition), related party transactions and areas where controls are particularly susceptible to being overridden (e.g., sales cut-off).
- Provide guidance on how procedures employed in interim periods that address the potential for fraud in financial reporting also may be useful as “continuous auditing” techniques to improve full-year audits.<sup>41</sup> The Panel understands the need to separate auditors’ responsibilities in an audit of financial statements from those in a limited review of interim financial information. However, it encourages the ASB to research and address concepts of continuous auditing in furtherance of a more effective audit model.

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<sup>39</sup> The ASB may choose to modify SAS No. 71 for this purpose, or, alternatively, to provide the guidance as an *integral* element of a full-year audit, or both. This recommendation is not intended to imply a new or different standard of responsibility for auditors conducting and reporting on reviews pursuant to SAS No. 71.

<sup>40</sup> The 1999 COSO Report states, “These observations highlight the importance of active review of quarterly financial statements by audit committees and external auditors. Close scrutiny of quarterly financial information and a move toward continuous auditing strategies may increase opportunities for earlier detection of financial statement improprieties.”

<sup>41</sup> The Panel is aware that the ASB adopted a strategic plan in 1997, *Horizons for the Auditing Standards Board: Strategic Initiatives Toward the Twenty-First Century*, which it updates annually. Those initiatives include defining and developing guidance on “continuous auditing” or “continuous assurance.” Another initiative involves evaluating the efficacy of SAS No. 82, which the ASB plans to review in the context of the academic research that it commissioned (see note 3).

***To audit firms:***

**3.52** The Panel recommends that audit firms:

- Begin working immediately with the concepts in the recommendations to the ASB to enhance the auditor's ability to detect financial statement fraud. The results of those efforts should be shared with the ASB for consideration in developing its standards, with the intent of expediting the standard-setting process.
- Develop or expand training programs for auditors at all levels oriented toward responsibilities and procedures for fraud detection. These programs should emphasize interviewing skills and the exercise of professional skepticism, as well as testing techniques. They also should emphasize (especially to staff and in-charge personnel) that misappropriation of assets is a significant risk and that being alert to its possibility at any level in an entity is necessary.<sup>42</sup> Training programs should include case examples of how defalcations might be effected, the types of controls over the safeguarding of assets that are effective in preventing and detecting defalcations, and how defalcations are concealed. Special emphasis should be given to how information technology might be used to misappropriate assets and disguise the results.

Using auditors with forensic audit backgrounds to assist in this training would be beneficial. Personnel with experience in industries where the risk of material misappropriations of assets is believed to be high (e.g., in certain cash-intensive industries) also might be used to assist in such training.

These programs should be implemented as soon as practicable, but in any event no later than when the ASB issues its strengthened standards. Furthermore, training programs of this nature should not be one-time events. Firms should be committed to refreshing and improving these programs as circumstances in clients and industries evolve and more is learned about fraud.

- Discuss with audit committees the vulnerability of the entity to fraudulent financial reporting and the entity's exposure to misappropriation of assets.

***To the SEC Practice Section Peer Review Committee:***

**3.53** The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Evaluate the implementation of the strengthened auditing standards issued by the ASB and evaluate the training programs developed in response to the Panel's recommendations to audit firms. The Peer Review Committee should develop guidance for peer reviewers to conduct these evaluations. The evaluations should address the priority given by the firms to fraud-related training; the involvement of

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<sup>42</sup> See note 23.

supervisory engagement personnel in planning, supervision and review; and the adequacy of documentation.

- Include their findings in this area in their reports to the SECPS Peer Review Committee.

***To audit committees:***

**3.54** The Panel recommends that audit committees:

- Request management to report on the control environment within the entity and how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent and detect financial statement fraud.<sup>43</sup> Such reporting should acknowledge, in explicit terms, that fraud prevention and detection are primarily the responsibility of management. It also should help audit committees assess the strength of management's commitment to a culture of intolerance for improper conduct. Furthermore, audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks.
- Accept responsibility for ascertaining that the auditors receive the necessary cooperation from management to carry out their duties in accordance with the strengthened auditing standards to be developed by the ASB.

***To the SECPS Quality Control Inquiry Committee:***

**3.55** The Panel recommends that the SECPS Quality Control Inquiry Committee (QCIC):

- Assess the results of the ASB's research on the effectiveness of SAS No. 82, together with information that it has on litigation involving allegations of fraud, to determine whether it believes that the ASB should consider providing further guidance on fraud risk assessment.<sup>44</sup>
- Initiate ongoing reviews with the ASB, the SECPS Peer Review Committee and the AICPA's Professional Ethics Executive Committee regarding factors that appear to be influencing audit performance, with a view toward enhancing auditors' fraud detection capabilities.<sup>45</sup> (QCIC is in a unique position to conduct these activities because it usually is the group that addresses allegations of audit failure on a timely basis and thus can act as a catalyst for appropriate action.)

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<sup>43</sup> Reports by management may be accompanied by or made jointly with those of internal auditors.

<sup>44</sup> The Panel recognizes that QCIC's access to information about allegations of audit failure in litigation cases is limited.

<sup>45</sup> QCIC should endeavor to conduct these reviews as a continual reexamination of lessons that might be learned. It also should consider the possibility of implementing a more encompassing process, including the development and maintenance of a comprehensive database of information on fraud.

## CONSIDERATION OF EXPOSURE DRAFT COMMENTS ON THE FORENSIC-TYPE PHASE

**3.56** The Panel strongly believes that its recommendation that the ASB develop stronger and more definitive auditing standards to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will detect fraudulent financial reporting is appropriate. It also has expressed its belief that the incremental audit effort that would result from its recommendation ordinarily would neither constitute a dominant part of the audit nor be inconsequential. Key to the implementation of its recommendation is that the ASB introduce into its standards the concept of a "forensic-type phase" in *all* audits. To that end the Panel has offered some guidance on implementation.

**3.57** A number of respondents to the Panel's Exposure Draft expressed objections to or reservations about the forensic-type phase and asserted that it would result in numerous, extensive and unnecessary or ineffective procedures, especially if applied across-the-board to all audits without regard to the individual or unique circumstances of the entity being audited.<sup>46</sup> Others expressed the view that the Panel's approach would discard traditional concepts of materiality to the point that auditors would be forced to deal with insignificant matters. Still others expressed the view that the introduction of any forensic concepts to a GAAS audit would exacerbate the so-called "expectation gap" and possibly create additional litigation risk to audit firms.

**3.58** Many respondents asked the Panel to either drop its recommendation or defer it until completion of the ASB-commissioned research on SAS No. 82.<sup>47</sup> Some respondents also asserted that new research should be undertaken. Some suggested that other research be given greater weight and carefully evaluated, including recent research on large audit firms' methodologies.<sup>48</sup> In addition, some respondents asked that the Panel recognize the need for the involvement of all corporate-governance constituencies (e.g., boards of directors, audit committees, management, and internal and external auditors) as part of a broad effort to deal with fraud, including fraudulent financial reporting. Furthermore, some respondents emphasized that auditors' risk assessments should govern the extent of work undertaken. Others pointed out the importance of internal control in preventing and detecting fraud and implored the Panel not to "give up" on controls.

**3.59** The Panel believes it has considered the views of and issues raised by all of the respondents to the Exposure Draft, and accordingly it has expanded upon or clarified a number of its recommendations. It also believes, however, that the ASB and audit firms might benefit

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<sup>46</sup> Respondents to the Exposure Draft include those parties that provided testimony at the Panel's July 2000 public hearings (see Appendix N).

<sup>47</sup> See note 3.

<sup>48</sup> See note 13 to Chapter 2 on the research commissioned by the Joint Working Group. Some respondents to the Panel's Exposure Draft called for a collaborative effort among the ASB, the International Auditing Practices Committee (IAPC) and possibly other standard setters to address the audit risk model, including considering this research. In Chapter 7, the Panel has made recommendations to the ASB and the IAPC regarding collaborative efforts.

from an expanded discussion of the Panel's consideration of the factors that would influence how much additional audit work would be needed in the forensic-type phase and the nature of that work.

**3.60** The following discussion serves as additional implementation guidance, including the role of risk assessments and the importance of internal control, to assist in determining the nature and amount of additional audit effort in the forensic-type phase.

- *Risk Assessments*

Risk assessments alone are not a sufficient basis to eliminate the need for substantive tests in the forensic-type phase.<sup>49</sup> This basic premise applies to risk assessments made at either a broad level (i.e., engagement, inherent and control risk, including fraud risk) or an individual account or class of transactions level. Risk assessments are an important foundation – but only one aspect – for making decisions on which individual accounts or classes of transactions will be selected for testing and the nature, timing and extent of the tests.<sup>50</sup>

- *Preparation of Financial Statements*

The processes for preparing financial statements differ widely from entity to entity. At one extreme, entities rely heavily on automation (i.e., using computer technology) to process transactions and “close the books,” to the point that their financial statements can be prepared virtually without human intervention. This would be especially true when the financial statements do not require significant estimates and judgments by management. Entities at the other extreme rely to a high degree on manual systems (either literally manual or essentially manual, e.g., where the financial statement accounts are developed from data that is processed or summarized on computer-generated spreadsheets). The processes for preparing the financial statements of many entities lie somewhere between these two extremes and circumstances within a given entity can vary widely. Auditors need to analyze and assess the entity's particular circumstances and its processes for preparing financial statements. Considering where the highest possibility for human intervention, especially for management override, exists in the financial statement preparation process is an important step in designing the auditing audit work for the forensic-type phase.

- *Non-standard Entries*

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<sup>49</sup> This is consistent with a basic premise of GAAS as explained, for example, in the section on “Correlation of Control Risk and Detection Risk” in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, which states, “Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.”

<sup>50</sup> The Panel recognizes that its observations would mostly influence the extent of testing in the forensic-type phase. The types of individual accounts or classes of transactions selected for testing likely would influence the nature of the tests. The Panel's observations on the timing of testing, for the most part, are discussed in the description of the forensic-type phase.

All or virtually all entities record non-standard entries. These entries can provide an avenue for management to override controls that could lead to fraudulent financial reporting. Consequently, auditors need to design tests in the forensic-type phase to detect non-standard entries and examine their propriety. This aspect of the forensic-type phase affects not only the extent of testing, but also its timing, because such entries can be recorded at various times during the year.

- *Considering Internal Control*

Internal control functions at many levels. Controls can range from high-level oversight by management, to detailed review and reconciliation activities of employees, to numerous procedural steps and protocols carried out by individuals, to sophisticated controls embedded in computer systems. Understanding the way that internal control functions at varying levels is important to how the auditor addresses the forensic-type phase.

Controls at the individual account-balance or class-of-transactions level that have been subjected to controls testing by the auditor and have been judged to be operating effectively tend to influence the nature of and reduce the extent of tests in the forensic-type phase.<sup>51</sup> Auditors need to be especially alert to the possibility of management override, however, because management ordinarily possesses a deeper understanding of controls than does the auditor.

Auditors generally recognize that some financial statement accounts are partly or wholly a product of routine processing of transactions through well-controlled systems driven by sophisticated computer technology. Some of these routine processes may be highly integrated with the financial reporting process and are not readily susceptible to management override. Other systems process only some transactions routinely, while other transactions are processed after significant human intervention.

Management can influence the timing of the execution of some transactions, as well as when they are recorded in the accounts. This highlights the importance of tests of transaction “cut-offs,” especially at the end of quarterly or annual periods.

- *Accounts Subject to Management Judgments*

Certain aspects of a financial statement account, for example, the valuation assertion embedded in an inventory account, generally are more susceptible to management override. Consequently, accounts (or the assertions embedded in them) that require significant management judgments are generally more likely candidates for testing in the forensic-type phase. The complexity and subjectivity of the accounting principles that

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<sup>51</sup>Tests of controls directed toward the operating effectiveness of a control are discussed in paragraph 53 of the section in SAS No. 55 on “Consideration of Internal Control in Assessing Control Risk.” To support a control risk assessment significantly below the maximum level, auditors perform additional tests of controls, as discussed in the section in SAS No. 55 on “Further Reduction in the Assessed Level of Control Risk.”

apply and the potential for management to influence their selection and manner of application also should influence the nature and extent of the tests.<sup>52</sup>

- *Management's Monitoring Activities to Prevent or Detect Fraud*

The entity's preventive and detection controls over fraud are important considerations in deciding on the nature and extent of testing in the forensic-type phase. Auditors need to consider, however, whether those controls deal with fraudulent financial reporting, as opposed to, for example, misappropriation of assets or illegal acts only indirectly related to the financial statements. Auditors also need to consider the likelihood that such controls actually would serve to inhibit management fraud, if management (at any level) were inclined to override them.

In that regard, an important consideration is whether management has reported to the audit committee on the entity's control environment and how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent or detect financial statement fraud. Auditors' understanding of the audit committee's assessment of the strength of management's intolerance for improper behavior should influence the nature and extent of testing.

Auditors should be cautious, however, not to place excessive emphasis on management's high-level monitoring activities, including high-level monitoring of financial and non-financial data, as a reason for reducing the extent of testing in the forensic-type phase.

- *Materiality Issues*

In the section in Chapter 2 on "Establishing Auditing Standards," the Panel recommended that the ASB evaluate its guidance on materiality in the planning phase of the audit. That recommendation also applies to the forensic-type phase. The forensic-type phase seeks to implement a degree of "auditor-unpredictability," and it includes tests of accounts not ordinarily performed annually or tests of accounts traditionally or frequently deemed "low risk." Furthermore, the forensic-type-phase recommendations suggest some surprise tests and periodic coverage of non-corporate and non-U.S. locations. In the section in Chapter 2 on "Multi-location Audits," the Panel has made recommendations for improvements to standards in that area.<sup>53</sup>

The Panel does not intend for auditors to become embroiled in minutia in implementing the forensic-type phase. On the other hand, the Panel expects that auditors will exercise creativity in developing their approaches to this phase. Consequently, auditors normally would select some accounts or classes of transactions for testing in the forensic-type phase that fall below normal levels of planning materiality, or select some locations not normally included in the scope of their work.

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<sup>52</sup> These matters also should influence the selection of the accounts that should be subjected to retrospective audit procedures.

<sup>53</sup> See note 15 to Chapter 2 regarding the Panel's study of AAERs.



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Notwithstanding the foregoing, in *all* audits the degree of audit effort in the forensic-type phase should be more than inconsequential.