The Auditor's Responsibilities To Detect Fraud:

Recently Issued Statement of Auditing Standards (SAS) No. 82 and Its Potential Effect on Fidelity Claims

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The purpose of this paper is to explore the new Auditing Standard, SAS No. 82, and its possible effect on fidelity claims, recoveries and underwriting.

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The Auditor's Responsibilities to Detect Fraud:

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A. Introduction

In 1993, both the AICPA Division for CPA firms SEC Practice Section and the AICPA Board of Directors recommended the appointment of a task force to review the auditor's responsibility to detect fraud. These recommendations supposedly were not a response to efforts by the Securities Exchange Commission under Section 10A(a) of the Exchange Act[1] to establish procedures in accordance with Generally Accepted Auditing Standards regarding required audits of financial statements for companies required to be registered with the SEC.

In addition, a survey by KPMG Peat Marwick in 1994 indicated that independent auditors were the source of only 5% of frauds detected in various contexts.[2] (See 1994 Fraud Survey Of KPMG Peat Marwick, attached as Exhibits A and B.)

The AICPA Auditing Standards Board then reviewed Statement on Auditing Standards (SAS) No. 53, entitled *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and determined a new SAS should be developed specifically related to financial statement fraud. Thus, in 1994 the Auditing Standards Board appointed the Fraud Task Force to draft a Statement on Auditing Standards to clarify and define the auditor's responsibility to detect fraud.

The Fraud Task Force developed SAS No. 82, entitled *Consideration of Fraud in A Financial Statement Audit*. The primary objective of SAS No. 82 is to raise the level of audit performance with regard to detection of fraud during an audit engagement.

SAS No. 82 is effective for all audits of financial statements for the period ending on or after December 15, 1997.[3]

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[1]USCA э10A(a).

[2]QUINTON F. SEAMONS, FRAUD FORUM: IMPLEMENTING THE NEW FRAUD AUDITING STANDARD 10 (1996).

[3]AICPA, STATEMENT ON AUDITING STANDARDS: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 28 (1997).

B. Comparison of the Old Standard, SAS No. 53, with the New Standard, SAS No. 82

1. What the Old Standard, SAS No. 53, Required

In October, 1987, the National Commission on Fraudulent Financial Reporting, organized in the 1980's by a number of private accounting organizations, recognized that fraud and its effects are the concern and responsibility of many parties, including management, boards of directors, internal auditors and independent auditors. The Commission acknowledged that independent auditors cannot guarantee the accuracy or reliability of financial statements. However, the Commission recognized the independent auditor's role could be enhanced - particularly with respect to fraudulent financial reporting.

In 1988, the Auditing Standards Board issued SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*. Since the issuance of SAS No. 53, the subject of fraud has continued to draw the interest of ever-growing constituencies. Independent auditors have been the target of litigation and criticism, at least some of which has resulted from misconceptions regarding the auditor's responsibilities with respect to fraud.[4]

Some users of audited financial statements place too much reliance on the auditor's findings, in part, due to misconceptions about the auditor's responsibilities. Three of the more common misconceptions are that the audit will:

(1) detect all material errors and irregularities in the financial statements,
(2) discover all illegal acts committed by the client, and
(3) ensure the financial health of the entity.

The auditor's responsibilities for these items were defined by SAS No. 53.

SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU 316.02 and .03), defines the terms *errors* and *irregularities* as follows.

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[4] MICHAEL J. RAMOS, CONSIDERING FRAUD IN A FINANCIAL STATEMENT AUDIT: PRACTICAL GUIDANCE FOR APPLYING SAS NO. 82, at 4 (Anita M. Lyons ed., 1997).

The term *errors* refers to *unintentional* misstatements or omissions in financial statements. Errors may involve:

- Mistakes in gathering or processing accounting data from which financial statements are prepared.
- Incorrect accounting estimates arising from oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

The term *irregularities* refers to *intentional* misstatements or omissions in financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud, and misappropriation of assets, sometimes called defalcations. Irregularities may involve the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared.
- Misrepresentation or intentional omission of events, transactions, or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

The primary factor that distinguishes errors from irregularities is whether the underlying cause of a misstatement of financial statements is intentional or unintentional.

An audit made in accordance with Generally Accepted Auditing Standards (GAAS) should be designed to provide reasonable assurance that errors and irregularities material to the financial statements will be detected. The auditor is expected to exercise due care and a proper degree of professional skepticism in performing the audit and in evaluating the findings. However, AU 316.08 indicated that since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor's report is not a guarantee. Thus, the failure to detect a material misstatement in the financial statements does not, in an of itself, indicate that the audit was not made in accordance with GAAS.

When the auditor concludes the financial statements are materially affected by an irregularity, the financial statements are not prepared in conformity with Generally Accepted Accounting Principles (GAAP). Accordingly, the auditor should insist the financial statements be revised by management. When this is done, the auditor can issue a standard audit report and express an unqualified opinion. However, if the financial statements are not revised, the auditor should express a qualified opinion or an adverse opinion because of the departure from GAAP and disclose all substantive reasons for his opinion in his audit report. In either case, the auditor is also required to communicate to the audit committee any material irregularities detected during the audit. The auditor ordinarily has no responsibility to disclose material irregularities to parties outside the

client.[5]

The primary factor that distinguishes fraud from error is whether intent or lack of intent is a factor in the underlying act. While the auditor may not be responsible for defining intent, it is the auditor's responsibility to obtain reasonable reassurance the financial statements are free of material misstatement. When transactions are considered intentional, they fall under SAS No. 82. Unintentional material misstatements are addressed under SAS No. 47.

The primary purpose of SAS No. 53 was to narrow the expectation gap between auditor and users of financial statements that arose from the user's misconceptions regarding audits. However, continued criticism and questions regarding the auditor's role and responsibility in the detection of material misstatement in financial statements has led to the development of SAS No. 82.

2. What the New Standard, SAS No. 82, Requires

Like SAS No. 53, SAS No. 82 was issued to respond to the three common misconceptions noted previously and to clarify the auditor's responsibility in the detection of material misstatement in financial statements - whether caused by error or fraud - is central to an audit. The SAS No. 82 supersedes SAS No. 53 and it is effective for audits of financial statements for periods ending on or after December 15, 1997.[6]

While SAS No. 82 may currently be the primary source regarding the auditor's responsibility for detecting material misstatement in financial statements, consideration should be given to the literature preceding SAS No. 82, which is affected and has subsequently been revised. This includes not only SAS No. 53, but also the following:

- SAS No. 1 and SAS No. 22 - address auditor's responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements, whether caused by error or fraud.
- SAS No. 47 - addresses audit risk, materiality and misstatements in financial statements.

[5]WALTER G. KELL ET AL., MODERN AUDITING 47-48 (4th ed. 1989).

[6]MICHAEL J. RAMOS, CONSIDERING FRAUD IN A FINANCIAL STATEMENT AUDIT: PRACTICAL GUIDANCE FOR APPLYING SAS NO. 82, at 4 (Anita M. Lyons ed., 1997).

- SAS No. 54 ξ addresses auditor's responsibility for detecting misstatements resulting from illegal acts. (See American Institute of Certified Public Accountants (AICPA) Professional Standards(CCH) AU Section 317, *Illegal Acts by Clients*.) There are similarities between the language in SAS No. 53, SAS No. 54 and Section 10A of the Reform Act, particularly with respect to communications concerning errors or irregularities and the definition of illegal act.

- Section 301 of the Private Securities Litigation Reform Act of 1995 (Reform Act), entitled *Fraud Detection and Disclosure*, amends the Securities Exchange Act of 1934 (Exchange Act) by adding Section 10A which pertains to *Audit Requirements*.

- Section 10A(a) of the Exchange Act provides that each required audit of financial statements of Exchange Act registrants shall include certain procedures in accordance with GAAS *as may be modified or supplemented from time to time by the SEC*. The requirement for these audit procedures applies only to companies that are registered, and defined as registrants, under the Exchange Act.

Before discussing SAS No. 82, a few comments are in order about some differences between SAS No. 82 and Section 10A(a) of the Reform Act.

It should be noted that the SAS No. 82 statement will apply to every audit, regardless of whether such entity is publicly traded or privately held. Section 10A of the Exchange Act applies only to registrants who must file financial statements with the SEC.

Section 10A(a) of the Exchange Act requires audit procedures that:

1) are *designed to provide reasonable assurance of detecting illegal acts* that would have a direct and material effect on the determination of financial statement amounts,
2) are *designed to identify related party transactions* that are material to the financial statements or otherwise require disclosure therein, and
3) *involve an evaluation of whether there is substantial doubt about the ability of the issuer to continue* as a going concern during the ensuing fiscal year.

The legislative hearings focused on detecting illegal acts in Subparagraph (1) and little attention was focused on Subparagraphs (2) and (3) dealing with related party transactions or going concern evaluations. However, authoritative accounting literature already addressed illegal acts as well as related party transactions and going concern evaluations. (See AICPA Professional Standards(CCH) AU Section 317, *Illegal Acts*, Section 334, *Related Parties*, and Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.) The Reform Act did not identify issues not already addressed by the accounting profession. What was new is that the SEC now has express authority to modify or supplement audit standards, at least in these three

areas, if not generally.[7]

There may be problems in reconciling the various terms in the accounting literature and the term *illegal act* in Section 10A(e) of the Reform Act. The terms in accounting literature are *irregularity*, *error*, *defalcation*, *mistake*, *intentional distortions*, etc. SAS No. 82 relies heavily on accounting literature detailed above to impose additional responsibility on auditors to detect fraud. Such literature never imposed an affirmative responsibility on auditors to detect fraud. There has been a general recognition that auditors are not competent to determine whether conduct is illegal. However, Section 10A of the Reform Act imposes a "direct affirmative duty" on the auditor.[8] SAS No. 54 and *Illegal Acts by Clients*, AU Section 317.03 of the AICPA Professional Standards(CCH) currently state:

> Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training experience and understanding of the client and its industry may provide for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

SAS No. 82 basically does two things. It:

1) describes the auditor's responsibilities relating to fraud in a financial statement audit, and
2) provides guidance on what auditors should do to meet those responsibilities.

How do auditors' responsibilities differ from those under SAS No. 53? SAS No. 82 clearly states that auditors are responsible for planning and performing audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. It makes no difference whether those misstatements are unintentional or intentional. The auditor is responsible for planning and performing an audit to provide reasonable assurance about whether the financial statements are free of both types of material misstatement.

[7]QUINTON F. SEAMONS, FRAUD FORUM: IMPLEMENTING THE NEW FRAUD AUDITING STANDARD 1-11 (1996).

[8]QUINTON F. SEAMONS, FRAUD FORUM: IMPLEMENTING THE NEW FRAUD AUDITING STANDARD 11 (1996).

SAS No. 82 ξ describes two types of fraud: (1) fraudulent financial reporting, and (2) misappropriation of assets.

Responsibilities relating to fraud are stated within the context of materiality to the financial statements taken as a whole. *Auditors are not responsible for detecting fraud per se, but for detecting material misstatements caused by fraud*. Auditors are *not responsible* for detecting immaterial misstatements caused by fraud.

Auditors have always had the responsibility to detect material misstatement caused by fraud. These responsibilities have not changed with the issuance of SAS No. 82. What has changed with SAS No. 82 is that auditors are now required to *perform* the following:

- Consider the presence of fraud risk factors. SAS No. 82 provides examples (detailed below) of risk factors an auditor may consider for fraud related to a) fraudulent financial reporting, and b) misappropriation of assets misstatements. An auditor should become familiar with these risk factors and be alert for their presence at the client's.

- Assess the risk of material misstatement of the financial statements due to fraud. SAS No. 82 requires an assessment as to the risk of material misstatement due to fraud. This assessment is separate from but may be performed in conjunction with other risk assessments (for example, control or inherent risk) made during the audit. SAS No. 82 also requires reevaluation of assessments if other conditions are identified during fieldwork.

- Develop a response. Based on assessments of risk, SAS No. 82 requires development of appropriate audit response. In some circumstances, an auditor's response may be that existing audit procedures are sufficient to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud. In other circumstances, auditors may decide to extend planned audit procedures.

- Document certain items in the workpapers. SAS No. 82 requires auditors to document evidence of the performance of their assessment of risk of material misstatement due to fraud. Documentation should include risk factors identified as being present as well as the auditor's response to these risk factors.

- Communicate to management. If it is determined that there is evidence that a fraud may exist, an auditor should apprise the appropriate level of management, even if the matter may be considered inconsequential. SAS No. 82 also requires an auditor to communicate directly with the audit committee (or equivalent) if the matter involves fraud that would materially misstate the financial statements or fraud committed by senior management.

SAS No. 82 provides guidance on auditors' communication about fraud to management, the audit committee (if applicable) and others, including those outside the entity.

How do the auditor's performance requirements of SAS No. 82 differ from those under SAS No. 53? *Before* the application of SAS No. 82, auditors were *required to consider the presence* of risk material misstatements due to errors or irregularities and assess that risk as part of the overall audit risk. Auditors were also *required to design and perform* audit procedures appropriate for the assessed risk. The *difference under SAS No. 82* is that auditors *must specifically assess and respond to the risk of material misstatement due to fraud and assess risk from the perspective of the broad categories* listed in the SAS. Additionally, under SAS No.82, auditors must meet new documentation and communication requirements.

SAS No. 82, Paragraphs 16 and 18 divide the risk factors that relate to misstatements from fraudulent financial reporting into three categories, and misstatements from misappropriation of assets into two categories. In addition, SAS No. 82, Paragraphs 17 and 19 give examples of the risk for financial reporting and misappropriation as follows:

16. Risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped in the following three categories:
    a. *Management's characteristics and influence over the control environment*. These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
    b. *Industry conditions*. These involve the economic and regulatory environment in which the entity operates.
    c. *Operating characteristics and financial stability*. These pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

17. The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting for each of the three categories described above:
    a. *Risk factors relating to management's characteristics and influence over the control environment*. Examples include:
        - A motivation for management to engage in fraudulent financial reporting. Specific indicators might include:
            - A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.
            - An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.

    - A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.
    - An interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.
- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include:
    - An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.
    - Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee.
    - Inadequate monitoring of significant controls.
    - Management failing to correct known reportable conditions on a timely basis.
    - Management setting unduly aggressive financial targets and expectations for operating personnel.
    - Management displaying a significant disregard for regulatory authorities.
    - Management continuing to employ an ineffective accounting information technology, or internal auditing staff.
- Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
- High turnover of senior management, counsel, or board members.
- Strained relationship between management and the current or predecessor auditor. Specific indicators might include:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.
    - Formal or informal restrictions on the auditor that inappropriately limit his or her access to people or information or his or her ability to communicate effectively with the board of directors or the audit committee.
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.

b. *Risk factors relating to industry conditions*. Examples include:

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

c. *Risk factors relating to operating characteristics and financial stability*. Examples include:

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity, including need for funds to finance major research and development or capital expenditures.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect in the entity, such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or individual(s) that control(s) the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements, debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- Threat of imminent bankruptcy or foreclosure, or hostile takeover.
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are

reported.
- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

18. Risk factors that relate to misstatements arising from misappropriation of assets may be grouped in the two categories below. The extent of the auditor's consideration of the risk factors in category *b* is influenced by the degree to which risk factors in category *a* are present.
    a. *Susceptibility of assets to misappropriation*. These pertain to the nature of an entity's assets and the degree to which they are subject to theft.
    b. *Controls*. These involve the lack of controls designed to prevent or detect misappropriation of assets.
19. The following are examples of risk factors relating to misstatements arising from misappropriation of assets for each of the two categories described above:
    a. *Risk factors relating to susceptibility of assets to misappropriation*
        - Large amounts of cash on hand or processed.
        - Inventory characteristics, such as small size, high value, or high demand.
        - Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
        - Fixed asset characteristics, such as small size, marketability, or lack of ownership identification.
    b. *Risk factors relating to controls*
        - Lack of appropriate management oversight (for example, inadequate supervision or monitoring of remote locations).
        - Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.
        - Inadequate recordkeeping with respect to assets susceptible to misappropriation.
        - Lack of appropriate segregation of duties or independent checks.
        - Lack of appropriate system of authorization and approval of transactions (for example, in purchasing).
        - Poor physical safeguards over cash, investments, inventory, or fixed assets.
        - Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
        - Lack of mandatory vacations for employees performing key control functions.[9]

After assessing risk factors and developing a response, the auditor is required to document identified risk factors, such as a known history of securities law violation or lack of job application and background checks for employees with access to vulnerable assets.

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[9]AICPA, STATEMENT ON AUDITING STANDARDS: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 11-15 (1997).

SAS No. 82, Paragraph 37 states:

> 37. In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud (see paragraphs 12 through 14). Where risk factors are identified as being present, the documentation should include (*a*) those risk factors identified and (*b*) the auditor's response (see paragraphs 26 through 32) to those risk factors, individually or in combination. In addition, if during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required (paragraph 33), such risk factors or other conditions, and any further response that the auditor concluded was appropriate, also should be documented.[10]

SAS No. 82, Paragraph 38 categorizes the extent of communications based upon:

1) the auditor's determination that there is evidence of fraud, or
2) the auditor's identification of risk factors that have continuing control implications.

In the first case, the matter should be brought to the attention of an appropriate level of management. In the second case, the matter may be reportable to senior management and/or the audit committee.

SAS No. 82, Paragraphs 38-40 state:

> 38. Whenever the auditor has determined that there is evidence that fraud may exist, the matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the expected nature and extent of communications about misappropriations perpetrated by lower-level employees.
>
> 39. When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit

[10] AICPA, STATEMENT ON AUDITING STANDARDS: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 26 (1997).

committee. (Alternatively, the auditor may decide to communicate with the audit committee.) (See SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* [AICPA, *Professional Standards*, Vol. 1, AU sec. 325].) The auditor also may wish to communicate other risk factors identified when actions can be reasonably taken by the entity to address the risk.

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

a. To comply with certain legal and regulatory requirements.
b. To a successor auditor when the successor makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, Professional Standards, vol. 1, AU sec. 315).
c. In response to a subpoena.
d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that received governmental financial assistance.

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs 38 through 40 with parties outside the client.[11]

3. Comparison of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, with SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*

In the AICPA self-study course, *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under New SAS No. 82*, Ms. Jane M. Mancino, CPA, of the AICPA, provides a visual comparison between SAS No. 53 and SAS No. 82 as follows:

[11] AICPA, STATEMENT ON AUDITING STANDARDS, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 27-28 (1997).

	Effective for Audit Periods Ending on 12/15/97 and After	Before 12/15/97
	SAS No. 82	**SAS No. 53**
Scope	Deals solely with auditor's consideration of fraud in a financial statement audit	Deals with both errors and irregularities in a financial statement audit
Definitions	Provides an expanded description of fraud and covers both fraudulent financial reporting and misappropriations (Paragraphs 3-10)	Defines both errors and irregularities. Notes that irregularities include both fraudulent financial reporting and misappropriations of assets
Detection Responsibility	The ASB considers the detection responsibility in SAS No. 82 to be the same as that under SAS No. 53, however, the detection responsibility in SAS No. 82: • has been clarified • uses the term *fraud*, rather than the term *irregularities* • covers both planning and performing the audit	

	Detection Responsibility 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. **Risk Assessment** The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in each of the related categories in Paragraphs 16 and 18 (of SAS No. 82).	**Risk Assessment and Detection Responsibility** The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

<table>
<tr><th></th><th>SAS No. 82</th><th>SAS No. 53</th></tr>
<tr><td>Risk Factors</td><td>Provides close to 40 examples of risk factors for both fraudulent financial reporting and misappropriation of assets in the following categories:

<u>Categories of Risk Factors Relating to Fraudulent Financial Reporting</u>
• Management’s characteristics and influence over the control environment
• Industry conditions
• Operating characteristics and financial stability

<u>Categories of Risk Factors Relating to Misappropriation of Assets</u>
• Susceptibility of assets to misappropriation
• Controls</td><td>An assessment of the risk of material misstatements should be made during planning. It identifies 16 factors in the categories listed below that may be considered:

∃ Management characteristics
∃ Operating and industry characteristics
∃ Engagement characteristics

It also identifies nine risk factors that may influence the assessment of audit risk at the balance or class level.</td></tr>
<tr><td>Other Conditions</td><td>Provides 13 examples of other conditions that may be identified during fieldwork that change or support the risk assessment

• Discrepancies in accounting records
• Conflicting or missing evidential matter
• Problematic relations between auditor and client</td><td>None</td></tr>
<tr><td>Response to Risk</td><td colspan="2">Both SAS No. 82 and SAS No. 53 note that the auditor’s response to risk may affect:

• Engagement staffing and extent of supervision
• Professional skepticism
• Nature, timing and extent of procedures performed

SAS No. 82 provides examples of specific responses to:

• Risk at the account balance, class of transactions, and assertion level
• Risk of fraudulent financial reporting
• Risk of misappropriation of assets</td></tr>
</table>

<table>
<tr><th></th><th>SAS No. 82</th><th>SAS No. 53</th></tr>
<tr><td>Professional Skepticism</td><td>An expanded discussion of professional skepticism has been moved to AU Section 230, Due Professional Care in the Performance of Work, to highlight the importance of exercising professional skepticism throughout the audit.</td><td>Discusses the concept of professional skepticism and describes professional skepticism in planning and performing the audit.</td></tr>
<tr><td>Responses to Detected Misstatements Due to Fraud</td><td colspan="2">For fraud with an immaterial effect on the financial statements, the auditor should:

• Refer the matter to an appropriate level of management at least one level above those involved.
• Be satisfied that implications for other aspects of the audit have been adequately considered.

For fraud with a material effect on the financial statement or for which the auditor is unable to determine potential materiality, the auditor should:

• Consider implications for other aspects of the audit.
• Discuss the matter ad approach to further investigation with an appropriate level of management at least one level above those involved.
• Attempt to determine whether material fraud exists and, if so, its effect.
• If appropriate, suggest that the client consult with legal counsel.</td></tr>
<tr><td>Documentation Requirements</td><td>The auditor should document:

• Those risk factors identified as present and the auditor’s response to those risk factors.
• If other risk factors are identified during the audit that cause the auditor to believe that an additional response is required, the auditor should document those risk factors or conditions and any further response the auditor concluded was appropriate.</td><td>None</td></tr>
</table>

	SAS No. 82	SAS No. 53
Inquiries	Auditor should inquire of management (1) to obtain their understanding regarding the risk of fraud in the entity and (2) to determine whether they have knowledge of fraud that has been perpetrated on or within the entity If the entity has established a program to prevent, deter, and detect fraud, the auditor should inquire of those persons overseeing such programs as to whether the program had identified any fraud risk factors.	
Communications	When the auditor has identified risk factors that have continuing control implications, the auditor should consider whether these risk factors represent reportable conditions that should be communicated to senior management and the audit committee. Other communications requirements in SAS No. 82 (Paragraphs 35, 38 and 39) are very similar to those in SAS No. 53. Whenever the auditor determines there is evidence that a fraud may exits, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statement should be reported directly to the audit committee.[12]	

[12] MICHAEL J. RAMOS, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT: THE AUDITOR'S RESPONSIBILITIES UNDER NEW SAS NO. 82, at C1-C5 (1997).

C. Potential Effect on the Insurer

1. On Underwriting

One of the changes brought about by SAS No. 82 is the requirement of the auditor to communicate about fraud to management, the audit committee and others. With the foregoing in mind, I have drafted the following changes:

The requirement to communicate specifically about fraud is a change. The Standard reaffirms the general requirement of the auditor to communicate to appropriate levels of management and to the audit committee.

The underwriter will now be able to request from senior management, the audit committee and the board of directors, all documentation and other audit information involving evidence of fraud. Documentation and information can also be requested about whether auditors have identified risk factors that have continuing control implications. It may even be possible to have the insured's auditors "sign off" as to whether any risk factors were identified and discussed with the insured, as part of the underwriting process.

The ability to request all documentation and other audit information involving evidence of fraud and whether auditors have identified risk factors that have continuing control implications will have two significant effects on underwriting. First, if it is a new account, the underwriter may be able to request that the existing insurer be immediately placed on notice of a claim in connection with documentation and other audit information involving evidence of fraud. Alternatively or in conjunction with a request to place the current insurer on notice, the underwriter may be able to propose a manuscript exclusion dealing with the fraud documented in the audit.

Second, with the documentation and other information identifying risk factors, the underwriter may be able to request that the account institute specific loss control measures, to reduce or eliminate the risk factors, as a condition to writing the account.

However, underwriters should be aware that some auditors have questioned their responsibility to detect certain defalcations, such as at a retailing company where thefts were reflected in cost of goods sold after book inventories were adjusted to actual quantities on hand. Many believe the auditor should know when inventory shrinkage is not in line with other entities in the same industry. Consequently, some auditors believe the amount contributed to a theft should be shown on a separate line labeled *theft expense*, even though there is no such requirement under GAAP.[13] Thus, even though the audit may address fraud or theft, it may result from the auditor's position that inventory adjustments exceed industry norms, not from specifically documented employee thefts.

[13]Jane M. Mancino, *The Auditor and Fraud*, JOURNAL OF ACCOUNTANCY, April 1997, at 32, 33.

Underwriters should also be aware that SAS No. 82 requires the auditor to specifically assess the risk of material misstatement of the financial statements, due to fraud, in every audit. The auditor is not expected to determine the risk of fraud as high or low, but to consider risk factors relating to fraudulent financial reporting and misappropriation of assets in each of the categories shown in Paragraphs 16, 17, 18 and 19 of SAS No. 82 (pages 8-11). In the context of this statement, risk assessment is a process rather than a rating or a score. Auditors will consider the presence of fraud risk factors as they relate to a) fraudulent financial reporting, and b) misappropriation of assets. The auditors will document certain items in their workpapers. Documentation should include risk factors identified as being present as well as the auditors' response to these risk factors.

If the identified risk factors (examples on pages 8 through 11) are evidence that fraud may exist, the matter should be brought to the attention of an appropriate level of management. This communication is generally appropriate, even if the matter is deemed inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization.

If the identified risk factors do not appear to be evidence of fraud but have continuing control implications, these risk factors may be considered reportable conditions: Reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee, or just the audit committee, as required by SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*.[14] The auditor may communicate other risk factors identified when actions can be reasonably taken by the insured to address the risk.

And underwriters should know that with the specific consent of the insured, the insured's auditors may disclose client information, such as a list of risk factors identified during the audit, to third parties or communicated to the insured (Code of Professional Conduct).[15]

I'm sure the documentation and communication by auditors to the insured, as required under SAS No. 82, will provide underwriters additional opportunities to obtain greater amounts of information for underwriting purposes. The impact on underwriting will be how the underwriter is able to use that information.

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[14] AICPA, PROFESSIONAL STANDARDS 1 AU э325.

[15] AICPA, PROFESSIONAL STANDARDS 2 ET э300.

2. On Claims

Just as SAS No. 82 should have two potential major effects on underwriting, it should have two potentially significant effects on claims. The first is likely to be in the number of claims reported. The second is likely to be whether communication about fraud in previous audits will serve as a basis to assert that discovery occurred prior to the policy period and/or whether there has been an automatic termination of coverage.

Historically, external auditors have been infrequent discoverers of fraud. According to KPMG 1994 Fraud Survey (Exhibit A), external auditors uncover 5% of the fraud discovered. However, this should increase due to SAS No. 82.

Many accounting and insurance practitioners currently believe the new SAS No. 82 will cause auditors to intensify their procedures in such areas as:

1) reviewing cash,
2) testing inventory counts,
3) testing vendor authenticity,
4) testing operating expenses, and
5) reviewing internal controls.

Expansion of the audit process, particularly in an attempt by the auditors to evaluate the risk factors relating to misappropriation of assets, will include:

1) more cash counts,
2) surprise inventory counts,
3) square footage testing,
4) quantitative analysis,
5) internal comparative analysis, and
6) industry comparisons.

It is logical to conclude that with the expanded requirements for auditors relating to testing and detection of fraud, the number of fidelity and theft claims will increase throughout the United States. While it generally takes five years to discover fraud, SAS No. 82 should have an immediate impact on claims for medium and large insureds.

However, the claims may not be valid, rather the result of more stringent accounting methods. Many of the claims would be subject to exclusions, i.e., inventory calculation. It will take three to four years for the full effect of SAS No. 82 to become apparent. The anticipated increase in the number of claims will warrant the professional scrutiny of the fidelity insurer. Examples of this are as follows:

Claims presented which do not meet policy conditions:

1) within policy period,
2) within claim reporting period required by policy,
3) timely notification to insurer,
4) contact police, and
5) insufficient supporting documentation.

However, the increased aggressive accounting and increased communications to management of the aforementioned analytical symptoms will encourage the insured to put the carrier on notice of a potential employee dishonesty loss.

Many of these claims may be subject to the exclusions, as defined by the policy, such as:

1) defalcation by the insured on the insured's partners,
2) inventory calculations, and
3) a profit and loss computation or comparison.

As indicated earlier, some auditors believe that when analytical procedures or relationships are too unusual or too unrealistic (hereafter analytical symptoms), they should be detailed as such in the financial statements. Common examples of analytical symptoms include:

- Unexplained inventory shortage
- Excess purchases
- Too many debit or credit memos
- Significant increases or decreases in account balances
- Excess cash shortages
- Unreasonable expenses[16]

Some auditors believe the portion contributed to theft should be separately detailed, even though there is no requirement under GAAP.[17] The separation and detailing of analytical symptoms attributed to employee dishonesty will be increased. This, in turn, will cause an increase in the number of fidelity claims.

While many claims may be subject to exclusion language, greater emphasis will need to be placed on the *evidence of employee dishonesty* in relation to the *manifest intent to cause a loss and financial benefit received* language.

The greatest challenge may be related to the insured's possible statement that "only an

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[16]W. STEVE ALBRECHT ET AL., FRAUD BRINGING LIGHT TO THE DARK SIDE OF BUSINESS 99 (1995).

[17]Jane M. Mancino, *The Auditor and Fraud*, JOURNAL OF ACCOUNTANCY, April 1997, at 32, 33.

employee could have misappropriated" the claimed items. The carriers may have to increase their scrutiny as to reasons for the insured's loss, other than employee dishonesty.

It may be beneficial to carriers to narrow the policy language to differentiate between the external auditors' and the carriers' classification of employee dishonesty. This, in turn, would defer the filing of fidelity claims and the potential possibilities of misinterpretation of the carrier's policy by the insured and the courts.

It seems likely the expanded auditing requirements under SAS No. 82, related to testing, detecting and communicating risk factors and fraud, will consequently lead to the insureds reviewing their employee dishonesty policies. Subsequently, the number of fidelity claims being filed will increase.

How Frauds Are Discovered[18]

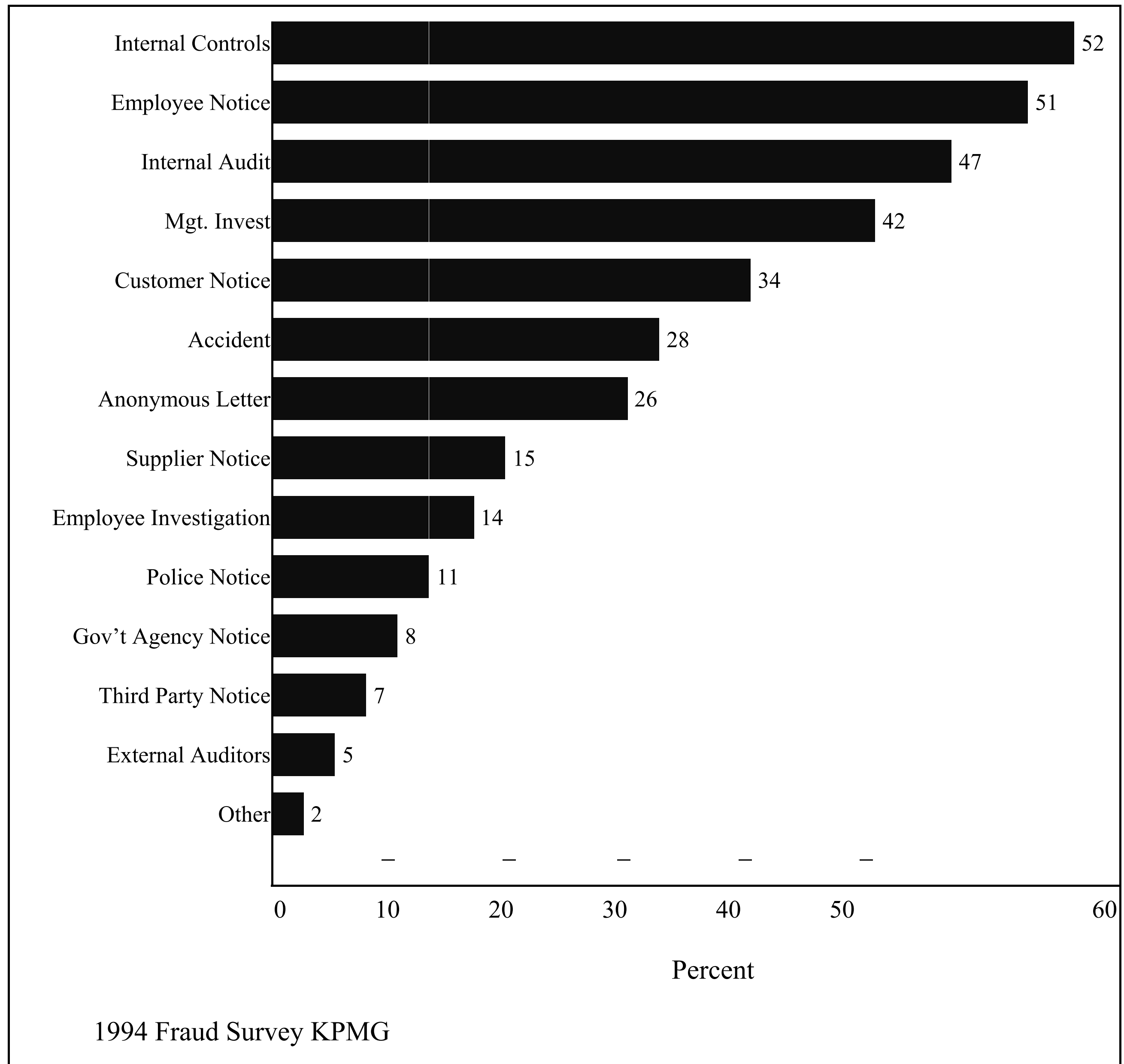

EXHIBIT A

[18] QUINTON F. SEAMONS, FRAUD FORUM: IMPLEMENTING THE NEW FRAUD AUDITING STANDARD exh. A (1996).

Areas Where Fraud Arises[19]

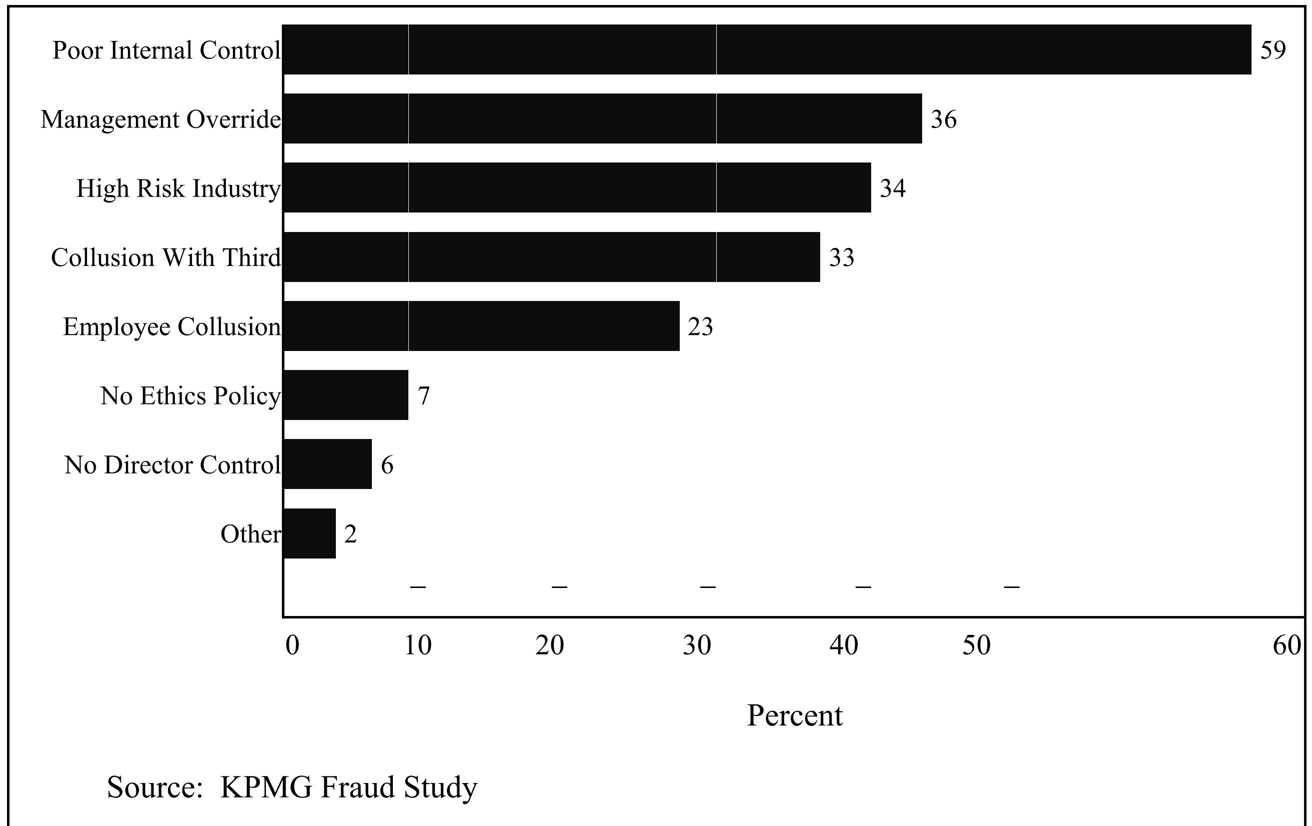

EXHIBIT B

[19] QUINTON F. SEAMONS, FRAUD FORUM: IMPLEMENTING THE NEW FRAUD AUDITING STANDARD exh. A (1996).