

Consideration of Fraud in a Financial Statement Audit

By Ed McMillan, CPA, CAE

An audit by an independent CPA firm is not designed to uncover fraudulent activity. The purpose of an audit is to provide reasonable assurance that the financial statements do not include any material misstatement as a result of fraudulent activity. During the auditing process, the CPA firm may uncover fraud, but this is not the reason the auditors are there.

In response to well-publicized incidents implicating auditors, the accounting profession promulgated Statement of Auditing Standard No. 99, "Consideration of Fraud in a Financial Statement Audit."

The primary objectives of this new auditing standard are the following:

- Renew the public's confidence in audit quality.
- Detect misleading financial statements.

Although the auditing CPA is still not held *responsible* or accountable for failing to detect fraud, the new standard does impose several new responsibilities on auditing CPAs in the areas of:

- Understanding the key elements of the Fraud Triangle
- Improved audit planning by requiring brainstorming sessions among audit team members
- Requiring a better understanding of the client's business

- Inquiries of key client personnel relating to existing or potential lapses in internal controls that may lead to fraud
- Analytical procedures based on professional skepticism
- Documentation of information gathering.

The Fraud Triangle

The *cornerstone* of SAS 99 is to educate both auditors and management about the conditions that are usually present when fraud occurs, and this is best understood by taking into consideration the three corners of the Fraud Triangle, as described in Section 1:

Incentive: There are endless incentives to commit a dishonest act, including financial hardship; vices such as drugs, alcohol or gambling; employee grievances; and the desire for material goods, among others. Desperate people often take desperate action.

Opportunity: The primary opportunity to commit fraud is provided by poor or weak internal controls. An incentive to steal coupled with an opportunity in the form of poor internal controls is a dangerous combination.

Rationalizing Action: Obviously, some fraudulent acts are committed by people fully aware that they are perpetrating a crime, and their conscience produces no guilt. However,

others feel they are righting a perceived wrong, such as a salary inequity, and have convinced themselves that they have earned and are owed the financial results of fraudulent acts, and therefore they are not stealing.

Once the auditing CPA understands that the elements of the Fraud Triangle are present in virtually all fraud, he or she is ready to proceed with the technical requirements of the new standard.

Improved audit planning

SAS 99 requires the audit team to improve the quality of the audit by mandating documented brainstorming sessions among audit personnel to assess client fraud risk. Some questions to ask may include:

- Are there any procedures that you are not comfortable with?
- What existing weaknesses in internal controls could be exploited?
- Who or which staff positions may be capable of perpetuating an embezzlement?
- How could revenues be misappropriated?
- Is collusion among staff a possibility?

Also, remember to summarize and *document* the brainstorming session to supplement audit work papers.

Understanding the business

SAS 99 requires auditors to improve their understanding of the client's business, to better assess fraud risk. Basic building blocks to educate the auditor about the client's business include:

- Comparison of actual versus budget revenues and expenses and investigation of material variances

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- Compilation of a five-year actual revenue and expense trend analysis and investigation of material variances
- Utilizing outside resources—for example, comparing the client's financial statements to the financial statements of similar clients and investigating material variances.

Tip: An often overlooked but excellent resource to help the auditor to better understand the client's business is the local or national association that represents your client's profession and often compile and sell operating ratio reports. These reports are excellent resources to supplement audit planning with regard to assessing risk.

Inquiries of client personnel

An aspect of the Sarbanes-Oxley Act that affects SAS 99 is mandatory inquiries of certain client personnel. Some fraudulent acts would have been exposed if only people were asked if they knew of the existence of fraud. Some people won't come forth and volunteer information unless they are

asked, because they are shy, reluctant to get involved, or the like.

Who should be interviewed? Positions to consider include, but are not limited to:

- The chief executive officer
- The treasurer
- The chief financial officer
- The controller
- Accounts payable clerks
- Accounts receivable clerks.

What questions should be asked?

The decision about which questions to ask is also a result of the brainstorming session, and is up to the judgment of the audit team.

Tip: Before making inquiries, put employees at ease and gain their confidence by telling them that auditors are *required* and have a duty to ask these questions, and that they have not been selected due to any suspicions of dishonesty.

Typical questions may include:

- Are you aware of the existence of fraud?

■ Have you ever been offered expensive gifts or cash by anyone attempting to conduct business with the organization?

■ Are you aware of any potential for fraud?

■ Has anyone ever approached you to be an accomplice in a fraud scheme?

■ Do you know what to do if you become aware of or are suspicious of illegal or unethical acts?

■ Are you aware of any conflicts of interest either within or outside of the organization that could lead to collusion or increased fraud risk? ☐

Ed McMillan is the author of two just-released books published by John Wiley & Sons: Preventing Fraud in Nonprofit Organizations and Policies & Procedures To Prevent Fraud And Embezzlement: Guidance, Internal Controls and Investigation, both available in ACCE's online bookstore. He can be reached at emcmillan@sprintmail.com and his website is www.nonprofitguru.com.

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