

*American Accounting Association ♦ Auditing Section  
Auditing Standards Committee*

May 1, 2002

Charles E. Landes  
Director, Technical Standards  
AICPA  
New York

**RE: Invitation to Comment on the Exposure Draft of the Proposed Statement on Auditing Standard, *Consideration of Fraud in a Financial Statement Audit* (File Ref. 2691)**

Dear Mr. Landes:

The Auditing Standards Committee (ASC) of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on the proposed Statement on Auditing Standards (SAS), *Consideration of Fraud in a Financial Statement Audit*. Overall, the ASC supports a standard addressing fraud that supersedes Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit* that extends the requirements of assessing and addressing fraud risk present for auditing clients. With that spirit in mind, the ASC provides the following recommendations for making the proposed SAS more effective and easier to implement.

*Commentator Guide to Significant Issues*

We support the use of the “commentator guide to significant issues” because it highlights the challenging aspects of the standard and the willingness of the Auditing Standards Board (ASB) to significantly revise the proposed SAS should helpful suggestions for improvement be made during the comment period. Further, this acknowledgement by the ASB demonstrates that this standard might not represent the final answer in considering fraud in a financial statement audit. Some of the questions posed in the commentator guide will need to be addressed using empirical research mechanisms, and many of these studies will need a sufficiently large data set based on the consequences of adopting a new SAS. We encourage the ASB to continue to seek research relating to the consideration of fraud in a financial statement audit subsequent to the adoption of a new fraud SAS.

*Paragraph 7*

Should this paragraph also mention the difficulties associated with evaluating incentives (since it mentions the difficulties associated with evaluating rationalization). For example, a statement could be included that states that while professional-oriented incentives might be possible to identify, personal-oriented incentives generally are difficult to identify.

### *Paragraph 8*

This paragraph appears somewhat vague because of its reliance on several examples. We suggest replacing the examples following the sentence, “Fraud may be concealed... falsifying documentation.” We recommend replacing the examples with a more direct sentence, such as “Auditors should evaluate the sufficiency of evidence and sufficiently corroborate management explanations, but they generally are not trained as or expected to be experts in falsified documentation for issues such as forgery, fake businesses, etc.”

### *Paragraph 10*

We recommend breaking this paragraph into two paragraphs because we believe that there are two separate and important topics addressed, with the second and perhaps most important topic occurring halfway through the existing paragraph. The first half of the paragraph addresses management override opportunities in an effective manner. However, the last sentence in the current paragraph discusses management actions to reduce fraud opportunities. We believe this sentence should be the topic sentence of a new paragraph and expanded to incorporate the explicit terms, control environment, control activities, and monitoring to make the discussion consistent with existing authoritative guidance.

### *Paragraph 11*

This paragraph is somewhat unclear as written. The topic sentence implies that the paragraph will address conditions for which the possibility that fraud may exist. However, after giving a few examples, the paragraph turns into a warning against jumping to conclusions about fraud. What is the paragraph’s purpose? We suggest revising the paragraph to make its purpose clear by using the paragraph to support the main content of the topic sentence.

### *Paragraph 12*

This paragraph is somewhat troublesome given the first 11 paragraphs preceding it. The paragraph could be misinterpreted as saying that unknowingly relying on audit evidence that is actually fraudulent might be acceptable because auditors do not provide absolute assurance. By having evidence and relying on it inappropriately, auditors actually have failed to provide reasonable assurance. What this paragraph appears to be identifying is that a failure to provide reasonable assurance might not be the fault of auditor negligence (as would be the case in other instances of failing to provide reasonable assurance). However, the last sentence is of little help because it reiterates only a subset of fraud characteristics from earlier paragraphs without stating why they are being provided. We recommend providing explicit examples of when failing to detect fraud might result in failing to provide reasonable assurance that is not caused by auditor negligence. To address the difference between absolute and reasonable assurance, we recommend noting that the nature, extent, or timing of audit evidence might not detect fraudulent activity because the scope involves examining clients’ financial statements on a test basis, which creates a certain amount of audit risk that cannot be eliminated.

*Paragraph 13*

The guidance relating to who should participate in discussion is somewhat vague. For instance, the guidance could be interpreted as being able to include only 2 members out of a significantly large team of, for example, 8 or 10 auditors. Why not require all auditors assigned to the job for more than a minimum percentage of total audit hours? By utilizing a percentage (e.g., 10 percent), the requirement can account for varied sizes of audit engagements. We believe that most, if not every, engagement team member should participate in the interactive discussion (as opposed to reading a summary memo) whenever possible to gain the insights of other team members and potentially offer fresh perspectives. Otherwise, there is little difference in having the discussion versus having a fraud risk memo in the audit documentation that all team members are responsible for reading.

*Paragraph 15*

The last sentence of the paragraph appears incomplete. Why not supplement the inclusion of discussion about management override with opportunities for collusion and misrepresentation (in the form of evidence, discussions, and/or documents). These additional mechanisms were discussed in paragraphs 9 and 8 as difficult to detect in a manner similar to how management override was described in paragraph 10.

*Paragraph 16*

We recommend including a reference to what was included currently in paragraph 11 about jumping to conclusions about fraud. We agree that professional skepticism requires the use of a questioning mind and critical evaluation of evidence. However, this paragraph perhaps could encourage auditors to overreact to fraud indicators. We are aware of the prevailing belief that a lack of professional skepticism has contributed to failures to detect fraud and highly encourage an emphasis being placed on its application. However, we encourage emphasizing to auditors that they use careful judgment and sufficient, competent corroborative evidence in reaching conclusions about the presence of fraud in financial statements.

*Paragraph 17*

We recommend adding a procedure “d” (move current “d” to “e”) that requires auditors to “Make inquiries of management and others within the entity to obtain their views about whether strategic objectives are being met and about the status of any other activities that have been provided to stakeholders via public disclosure. An expansion of this concept can occur within the existing paragraphs 18-25. Management representations about goals of an organization, including strategic, operational, or financial, create expectations on the part of shareholders and other key stakeholders that are made known to management. These expectations create a significant amount of pressure on management, particularly at such time that management becomes aware that such expectations cannot be met. While parts of the proposed SAS reflect these pressures (specifically the first bullet of “b” under “Incentives/Pressures” in Appendix A), we recommend revision to further emphasize the impact of strategy and public disclosures on fraud risk.

*Paragraph 18*

While identifying personal rationalization risk factors often is not possible on the part of auditors, we recommend including a bullet that requires an inquiry of management of any known behavioral changes in key management or accounting personnel that reflects increased stress levels that could increase fraud risk. One example that could be included is an increase in the number of complaints to superiors about salary, perquisites, promotions, etc. While a positive response is not likely, such inquiry calls management's attention to the rationalization aspect of the fraud triangle, which has traditionally received much less attention in organizations compared to incentives and opportunities.

*Paragraph 21*

We recommend expanding this guidance of questioning those personnel in the internal audit function to include outside representatives serving the internal audit function (e.g., an outsourced internal audit function with another public accounting firm). We do not see a fundamental difference in who performs the internal audit function when evaluating the guidance contained in paragraph 21.

*Paragraph 27*

We recommend expanding the example of performing a revenue trend analysis to incorporate expectation formation. The current example only instructs auditors to consider overall revenue trends within and between audit periods. We recommend inserting a sentence that first requires auditors to form an expectation of revenue trends within and between years based on what has been learned about the company's operating performance up to the point of the engagement when the analytical procedure is being performed.

*Paragraph 32*

The second and third bullets, significance and likelihood of the risk, should be moved and reworded to enhance the distinctiveness of each aspect (as written the bullets are somewhat confusing and redundant). We suggest, "The likelihood of the risk, that is the likelihood that the risk results in an event impacting the financial statements." The next bullet on significance of the risk should be revised to "The significance of the risk, that is, whether the impact on the financial statements results in a material misstatement." Otherwise, combine both bullets.

*Paragraph 37*

This paragraph closes with the impacts of identifying fraud risk as being related to individual accounts, classes of transactions, or assertions but does not discuss the impacts of when the risk relate more pervasively to the financial statements as a whole (as alluded to in the prior sentence). Should a statement about the impacts of this type of fraud risk be included in the paragraph?

*Paragraph 45*

This paragraph mentions that it might not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. While we agree

with this statement, we question whether it is written to sufficiently empower auditors to withdraw from the engagement because they perceive the fraud risk to be too high, regardless of whether auditing procedures could be designed that sufficiently address the risk of material misstatement due to fraud. We recommend that the paragraph be expanded to allow for this option, with the reference to paragraph 77 (that incorporates considerations when withdrawing) in tact.

*Paragraph 46*

This paragraph (including bulleted items) is somewhat confusing. Why should an auditor follow these bullets *in response* to fraud risk? Should not prudent auditing already reflect each of these bullets? The term “more” is used in several of the bulleted items; however, we recommend changing the heading from “Overall Responses to Fraud Risk” to something like “Aspects of Audit Engagements that Address Fraud Risk” and revising the first sentence accordingly. The spirit of the paragraph should be from the perspective of as a default and not as a response.

*Paragraph 48*

The last bulleted item on extent could be expanded to allow for the use of a specialist should a fraud risk assessment be significant enough to warrant more expertise than available. For example, specialists can be engaged to perform background checks on key executives for who integrity is in question.

*Paragraph 50*

The first bullet under “revenue recognition,” which discusses substantive analytical procedures, should be revised to better emphasize the need to develop expectations. We suggest revising the first sentence by adding, “to uncover unusual or unexpected trends” to the end of the first sentence. The second sentence should be revised to say, “...audit techniques also may be useful...” for transitional purposes.

*Paragraph 63*

We suggest expanding the guidance for evaluating accounting estimates for bias to include an evaluation of the process for developing estimates. For example, does management have a formal process for determining estimates on a periodic basis that requires documentation or does management only make estimates at the end of a period without the use of a formal process?

We believe that our suggestions will lead to an improved Statement on Auditing Standards from both procedural and implementation perspectives. Feel free to contact our committee for elaboration on or clarification of any comment. Our committee is glad to be of assistance to the Auditing Standards Board whenever academic perspectives on auditing issues are viewed as a value adding resource.

Respectfully Submitted,

Kay Tatum  
University of Miami  
Chair  
Auditing Standards Committee  
Auditing Section  
American Accounting Association

Brian Ballou  
Auburn University  
Vice Chair  
Auditing Standards Committee  
Auditing Section  
American Accounting Association

*Other ASC Members:*

Stephen Asare, University of Florida  
Karla Johnstone, University of Wisconsin-Madison  
Konrad Kubin, Virginia Polytechnic University  
Larry Rittenberg, University of Wisconsin-Madison  
Roger Simnett, University of New South Wales