THE AUDITOR'S CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT

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The American Institute of Certified Public Accountants (AICPA) Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit,* in February 1997. This new SAS, which supersedes SAS no. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* is effective for audits of financial statements for periods ending on or after December 15, 1997. This article explains the new standard, and how it will affect the audit of your association, and why this statement is important to community and timeshare associations.

Why are an auditor's assessments of risk of material misstatement important to a board of directors? Because, while many association board members are very good at what they do in their individual professions, they may not be experts at running a multi-million dollar association. Most board members donate their spare time to the concerns of the association, and rely heavily upon third party individuals or employees, also known as "Association Managers". What many board members do not realize is that, even though they employ a management company or an on-site manager, the final responsibility for the affairs of the association rests with them. They may delegate tasks and authority, but they cannot delegate responsibility. This is why it is imperative that board members are cognizant of, and proactive toward, the internal controls which are set in place in the association. Board members should also look for management letters from their auditors in addition to the annual audit report, as any required reportable conditions, and any suggestions for improvement, will be found therein.

"The auditor is required to consider the risk of fraud that may materially misstate financial statements. Management (the Board of Directors) is responsible for the prevention and detection of fraud."

Auditor's Responsibility

The world seems to believe that CPA's are the "accounting police" and that our job is to find fraud whenever and wherever present, and prevent it. SAS no. 82 was written to heighten the auditor's awareness of the extent of his or her current responsibility in an audit for the detection of material misstatement due to fraud. The new language is as follows:

> "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. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected."

Therefore, while an auditor is required to consider the risk of fraud that materially misstates a financial statement, management (meaning the board of

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directors) is responsible for the prevention and detection of fraud. This is accomplished by adopting sound accounting policies, and establishing and maintaining an internal control system that will record, process, summarize and report transactions in accordance with the board's assertions embodied in the financial statements.

There is a huge difference between a **financial statement audit** and a **fraud "audit".** In a financial statement audit conducted in accordance with generally accepted auditing standards, the auditor's objective is to express an opinion on how fairly the financial statements present, in all material respects, the financial position (Balance Sheet), results of operations (Statement of Revenues and Expenses and Changes in Fund Balances), and cash flows (Statement of Cash Flows) in conformity with generally accepted accounting principles.

A fraud "audit" is basically a consulting service, where no opinion is given on the financial statements as a whole. Usually, in a fraud examination, a suspicion of fraud already exists, and the CPA is called in to perform certain agreed upon procedures, and report on the findings of those procedures.

What is Fraud?

From the auditor's point of view, the interest in fraud relates to fraudulent acts that cause a material misstatement of the financial statements. The difference between fraud and error is determined by whether or not the action that resulted in the misstatement was intentional or unintentional. The auditor is concerned with two types of misstatements caused by fraudulent behavior. One is *fraudulent financial reporting*, and the second is *misappropriation of assets*.

Fraudulent financial reporting happens for a variety of reasons, such as pressure to achieve certain budget results. It usually involves altering the accounting records from which reports are prepared. Information may be misrepresented in, or omitted from, the financial reports, or reports may be presented in an improper manner.

The misappropriation of assets is usually a greed related issue, and involves the acts of theft of assets. In the course of covering up the theft, the financial statements become misstated.

In both cases, the fraud usually occurs from a perceived pressure or incentive to commit fraud, and a perceived opportunity to do so. Concealment of the fraud may occur through falsified documents, forged signatures, fictitious invoices, and collusion with management, employees, or third parties. **Unfortunately, due to the concealment aspects of fraudulent activity, an audit may not detect a material misstatement resulting from fraud.** However, the auditor should assess the risk of material misstatement resulting from fraud inherent in each specific area of the financial statements, and design tests and audit procedures appropriate for the amount of risk assessed for each area.

In the course of assessing the risk of misstatement from fraudulent activity, the auditor should make inquiries of management as to their understanding of the risk of fraud within the organization, and whether or not they have any knowledge of fraudulent activities within and without the organization.

There are several risk factors, or "fraud indicators" that relate to both sources of misstatements, and a few are listed below.

Fraud indicators relating to financial reporting:

C A significant portion of management's

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compensation is in the form of bonuses, contingent upon achieving certain financial results.

C Domination of management by a single person or small group without compensating controls by the board of directors.

C Frequent disputes with the current or prior auditor and management on accounting, auditing or reporting matters.

C Restrictions on the auditor that inappropriately limit access to key people or information.

C Inability to pay current bills while reporting net positive earnings.

C Significant related party transactions not in the ordinary course of business.

C Adverse consequences on significant pending transactions if poor financial results are reported.

Fraud indicators related to misappropriation of assets:

C Lack of management oversight.

C Large amounts of cash on hand or cash regularly processed.

C Lack of job applicant screening procedures.

C Inadequate record keeping.

C Lack of appropriate segregation of duties.

C Lack of appropriate system of authorization and approval of transactions.

C Lack of timely and appropriate documentation of transactions.

C Poor physical controls over assets.

C Lack of mandatory vacations for employees.

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Fraud risk factors vary significantly in importance, and professional judgement is required in ranking the importance of various factors both individually and in combination. There is no "formula" in developing risk assessment, and risk factors can be customized. One thing an auditor must remember though is that in most cases where fraud is present, several of the usual risk factors do exist. Therefore, it is important that auditors are aware of the various types of fraud indicators as they perform an audit.

The assessment of risk of material misstatement due to fraud is done all throughout the audit process, from the engagement planning, to the procedures related to acceptance and continuance of clients and engagements, to the documentation of internal controls, and during the course of fieldwork. During the course of fieldwork, original risk assessments may change or support a judgement regarding initial risk assessments made at the planning level. Conditions which generally change a risk assessment from low to medium or high include discrepancies in the accounting records, conflicting or missing substantive evidence, or problematic relationships with client personnel.

At the completion of the audit, the auditor evaluates whether the accumulated results of procedures affect the risk assessments that were made during the planning stages of the audit. Again, this is a judgement call, but overall evaluation based on accumulated information may provide additional insight into the risk of material misstatement due to fraud, and whether

additional or different audit procedures should be performed.

When audit results identify misstatements in the financial statements, the auditor needs to consider whether such misstatements indicate fraud. If fraud is present, yet the related misstatement in not material to the fair presentation of the financial statements, the auditor still should consider the implications of the fraud, primarily in connection with the organizational position of the person(s) involved. If the matter involves higher level management, however immaterial the impact to the financial statements, the auditor should reevaluate the risk assessment related to material misstatement due to fraud.

Auditor's Response to Risk Assessment Results

The risk of material misstatement due to fraud is **always** present. The auditor's response to this reality is affected by the nature and significance of those factors or indicators identified as present. The auditor may conclude that procedures already in place are sufficient to respond to those factors, or the auditor may conclude that those conditions imply a need to change the planned procedures. The type of response may be an overall response, or one that is specific to a particular account balance, class of transactions or assertion, or both. Or, the auditor may decide that withdrawal from the engagement is the most appropriate response.

Overall type responses include increased professional skepticism, such as increased sensitivity in the selection of documentation examined in support of transactions, and increased awareness of the need to corroborate information provided by management regarding material matters. The auditor may also take a closer look at the accounting principles and policies adopted by management, as related to revenue recognition, asset valuation, and asset capitalization, and determine whether these policies are being applied in an inappropriate manner to create a material misstatement of the financial statements. The auditor might also change the nature, timing and extent of the audit procedures as an overall response to risk indicators that are present.

Specific responses to an auditor's assessment of the risk of material misstatement due to fraud vary depending on the specific risk factor identified. The following are a few examples of specific responses:

- Contacting major vendors, lenders, and debtors orally in addition to written confirmation.
- Performing detailed review of year end adjusting journal entries, and investigating those that appear unusual.
- Performing substantive analytical procedures at a detailed level.
- Conducting interviews of personnel in areas where risk assessment is considered high.

Documenting Risk Assessment

The documentation of risk assessment by an auditor is twofold: First, the auditor should document the risk factors that are identified as present, and his response to those risk factors, either individually, or combined. Additionally, the auditor should document any fraud risk factors or other conditions that were identified in the performance of the audit that cause the auditor to believe that an additional response is required. The auditor is also required to inform the board of directors of any reportable conditions (weaknesses) in internal control, and should write a management letter in regard to other non-reportable conditions to the board with various suggestions on improving the nature of operations in general.

Communicating Findings of Fraud, and Significant Risk Factors

Whenever an auditor has discovered the evidence of fraud in an entity, the matter should always be brought to the attention of the appropriate level of management, regardless of how inconsequential it may be considered, or how low the level of the employee. Fraud committed by management, or fraud that has a material impact on the financial statements should be reported directly to the audit committee.

When an auditor has identified risk factors that involve continuing internal controls, or lack thereof, the auditor should determine whether or not these factors represent reportable conditions. The disclosure of possible fraud to parties other than management and the board is generally not the auditor's responsibility, and is generally precluded by ethical standards and legal obligations of confidentiality, unless reflected in the report. However, an auditor may be required to disclose the existence of fraud to outside parties in the following circumstances:

- To comply with legal and regulatory requirements.
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 7
- In response to a subpoena
- To a funding agency or other specified agency in accordance with requirements for audits of entities that receive governmental financial assistance.

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