CHAPTER 11

CONSIDERING THE RISK OF FRAUD

Accounting Scandal Rocks Public Trust

The accounting profession was under fire. Throughout the long, hot summer, newspapers were filled with new details of a corporate accounting scandal. One of the largest, most respected companies in the United States had been caught inflating earnings and assets through blatant manipulation of the accounting rules. Thousands of investors and employees had suffered. Congressional hearings were called to examine and understand the fraud, and everyone asked, "Where were the auditors?" The accounting profession was under immense political pressure from reform-minded lawmakers, and the negative publicity surrounding the perceived audit failure cast all CPAs in the most unfavorable light.

The year was 1938. The corporate accounting scandal was McKesson-Robbins, and it arguably had a greater impact on the way audits are performed than any subsequent scandal, including Enron and WorldCom.

In 1924, Philip Musica, a high-school dropout with fraud convictions and a prison record, reinvented himself as F. Donald Coster and awarded himself a medical degree. "Dr. Coster" took control of McKesson-Robbins and embarked on a massive fraud to inflate its share price. McKesson-Robbins inflated assets and earnings by $19 million through the reporting of non-existent inventory and fictitious sales. Coster duped McKesson's auditors, and the investing public, into believing that the company had a huge drug inventory, worth multimillions of dollars, that didn't exist. Coster created phony purchase orders, sales invoices, and other documents, all of which McKesson's auditors dutifully reviewed as evidence of the imaginary inventory. The fraud succeeded because the auditing standards of the day permitted auditors to confine themselves to reviewing documents and talking to management. They were not required to physically observe and verify inventories.

During an emergency board meeting, hastily called after the fraud came to light, word was received that Coster had committed suicide. An investment bank partner who served as a McKesson outside director, concerned about his responsibilities, responded to the news by exclaiming, "Let's fire him anyway!"

Sources: 1. Michael Ramos, *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide*, AICPA (2003), p. ix; 2. Presentation by PCAOB Board Member Daniel L. Goelzer at Investment Company Institute's 2003 Tax & Accounting Conference, September 15, 2003 (www.pcaobus.org/News).

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **11-1** Define fraud and distinguish between fraudulent financial reporting and misappropriation of assets.
- **11-2** Describe the fraud triangle and identify conditions for fraud.
- **11-3** Understand the auditor's responsibility for assessing the risk of fraud and detecting material misstatements due to fraud.
- **11-4** Identify corporate governance and other control environment factors that reduce fraud risks.
- **11-5** Develop responses to identified fraud risks.
- **11-6** Recognize specific fraud risk areas and develop procedures to detect fraud.
- **11-7** Understand interview techniques and other activities after fraud is suspected.

The classic fraud at McKesson-Robbins illustrates that financial statement fraud is not just a recent occurrence. In the wake of that scandal, the auditing profession responded by setting the first formal standards for auditing procedures. Those standards required confirmation of receivables and observation of physical inventory, procedures that are standard today, plus guidance on the auditor's responsibilities for detecting fraud.

In response to more recent frauds, Congress passed the Sarbanes–Oxley Act in 2002 and the AICPA developed specific auditing standards to deal with fraud risk assessment and detection. In this chapter we will discuss the auditor's responsibility to assess the risk of fraud and detect material misstatements due to fraud and describe major areas of fraud risk, as well as controls to prevent fraud and audit procedures to detect fraud.

TYPES OF FRAUD

OBJECTIVE 11-1

Define fraud and distinguish between fraudulent financial reporting and misappropriation of assets.

As a broad legal concept, fraud describes any intentional deceit meant to deprive another person or party of their property or rights. In the context of auditing financial statements, fraud is defined as an intentional misstatement of financial statements. The two main categories are fraudulent financial reporting and misappropriation of assets, which we introduced when defining the auditor's responsibilities for detecting material misstatements in Chapter 6.

Fraudulent Financial Reporting

Fraudulent financial reporting is an intentional misstatement or omission of amounts or disclosures with the intent to deceive users. Most cases involve the intentional misstatement of amounts, rather than disclosures. For example, WorldCom capitalized as fixed assets billions of dollars that should have been expensed. Omissions of amounts are less common, but a company can overstate income by omitting accounts payable and other liabilities.

While most cases of fraudulent financial reporting involve an attempt to overstate income—either by overstatement of assets and income or by omission of liabilities and expenses, companies also deliberately understate income. At privately held companies, this may be done in an attempt to reduce income taxes. Companies may also intentionally understate income when earnings are high to create a reserve of earnings or "cookie jar reserves" that may be used to increase earnings in future periods. Such practices are called income smoothing and earnings management. **Earnings management** involves deliberate actions taken by management to meet earnings objectives. **Income smoothing** is a form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings. One technique to smooth income is to reduce the value of inventory and other assets of an acquired company at the time of acquisition, resulting in higher earnings when the assets are later sold. Companies may also deliberately overstate inventory obsolescence reserves and allowances for doubtful accounts to counter higher earnings.

Although less frequent, several notable cases of fraudulent financial reporting involve inadequate disclosure. For example, a central issue in the Enron case was whether the company adequately disclosed obligations to affiliates known as special-purpose entities. E. F. Hutton, a now defunct brokerage firm, was charged with intentionally overdrawing accounts at various banks to increase interest earnings. These overdrafts were included as liabilities on the balance sheet, but the balance sheet description of the obligations did not clearly state the nature of the liabilities.

Misappropriation of Assets

Misappropriation of assets is fraud that involves theft of an entity's assets. In many cases, but not all, the amounts involved are not material to the financial statements. However, the theft of company assets is often a management concern, regardless of the materiality of the amounts involved, because small thefts can easily increase in size over time.

The term misappropriation of assets is normally used to refer to theft involving employees and others internal to the organization. According to estimates of the Association of Certified Fraud Examiners, the average company loses five percent of

FRAUDULENT FINANCIAL REPORTING STATISTICS

A recent study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) analyzes fraudulent financial reporting by U.S. public companies over the period 1998–2007. The study updates an earlier study that analyzed fraudulent financial reporting for the period 1987–1997.

There were 347 alleged cases of fraudulent financial reporting from 1998–2007, compared to 294 cases from 1987–1997. The size of the companies and magnitude of the frauds were much larger in the later period. The companies alleged to have engaged in fraud had median assets and revenues of almost $100 million in the period 1998–2007. In contrast, the companies in the 1987–1997 period had median assets and revenues of under $16 million. The median fraud increased from $4.1 million in the earlier period to $12.1 million in the 1998–2007 period. The average fraud soared from $25 million in the earlier period to almost $400 million in the later period, influenced by the major frauds at companies such as Enron and WorldCom.

The most common fraud technique continued to be improper revenue recognition, representing 60% of the cases from 1998–2007 and 50% of the cases from 1987–1997. Eighty-nine percent of the fraud cases involved the chief executive officer (CEO) and/or the chief financial officer (CFO), compared to 83% in the earlier period.

Consequences of these frauds were significant. Initial news of the alleged fraud resulted in an average abnormal decline in the stock price of 16.7%. Companies engaged in fraud often filed for bankruptcy, were delisted from stock exchanges, or had material assets sales following the discovery of the fraud.

Sources: 1. *Fraudulent Financial Reporting: 1998–2007, An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission, New York, 2010 (www.coso.org); 2. *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission, New York, 1999 (www.coso.org).

its revenues to fraud, although much of this fraud involves external parties, such as shoplifting by customers and cheating by suppliers.

Misappropriation of assets is normally perpetrated at lower levels of the organization hierarchy. In some notable cases, however, top management is involved in the theft of company assets. Because of management's greater authority and control over organization assets, embezzlements involving top management can involve significant amounts. In one extreme example, the former CEO of Tyco International was charged by the SEC with stealing over $100 million in assets. A fraud survey conducted by the Association of Certified Fraud Examiners found that asset misappropriations are the most common fraud scheme, although the size of the fraud is much greater for fraudulent financial reporting.

CONDITIONS FOR FRAUD

OBJECTIVE 11-2

Describe the fraud triangle and identify conditions for fraud.

Three conditions for fraud arising from fraudulent financial reporting and misappropriations of assets are described in the auditing standards. As shown in Figure 11-1 (p. 356), these three conditions are referred to as the **fraud triangle**.

1. *Incentives/Pressures.* Management or other employees have incentives or pressures to commit fraud.
2. *Opportunities.* Circumstances provide opportunities for management or employees to commit fraud.
3. *Attitudes/Rationalization.* An attitude, character, or set of ethical values exists that allows management or employees to commit a dishonest act, or they are in an environment that imposes sufficient pressure that causes them to rationalize committing a dishonest act.

Risk Factors for Fraudulent Financial Reporting

An essential consideration by the auditor in uncovering fraud is identifying factors that increase the risk of fraud. Table 11-1 (p. 356) provides examples of these **fraud risk factors** for each of the three conditions of fraud for fraudulent financial reporting. In the fraud triangle, fraudulent financial reporting and misappropriation of assets share the same three conditions, but the risk factors differ. We'll first

FIGURE 11-1 **The Fraud Triangle**

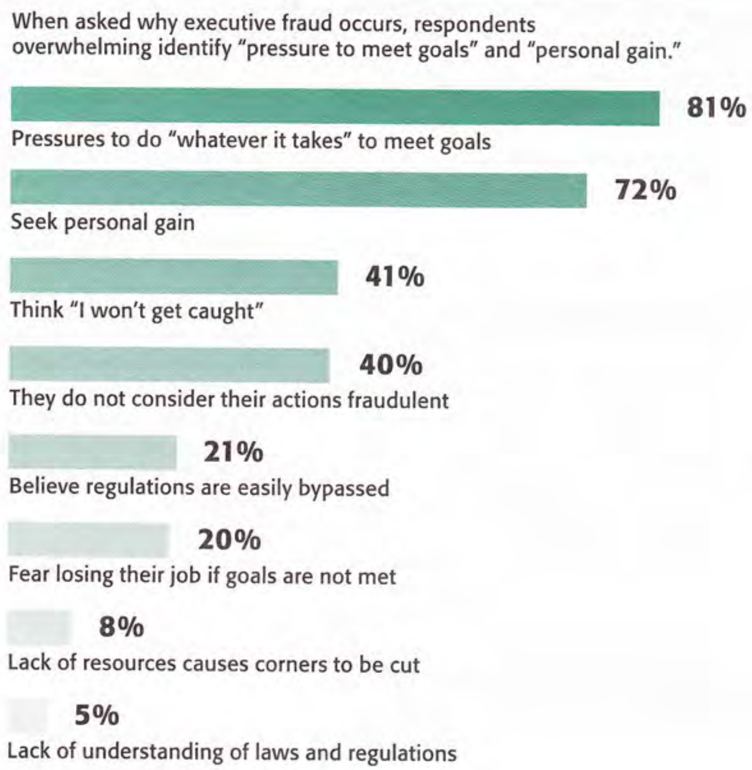
address the risk factors for fraudulent financial reporting, and then discuss those for misappropriation of assets. Later in the chapter, the auditor's use of the risk factors in uncovering fraud is discussed.

Incentives/Pressures A common incentive for companies to manipulate financial statements is a decline in the company's financial prospects. For example, a decline in earnings may threaten the company's ability to obtain financing. Companies may also manipulate earnings to meet analysts' forecasts or benchmarks such as prior-year earnings, to meet debt covenant restrictions, to achieve a bonus target based on earnings, or to artificially inflate stock prices. In some cases, management may manipulate earnings just to preserve their reputation. Figure 11-2 highlights an

TABLE 11-1 **Examples of Risk Factors for Fraudulent Financial Reporting**

THREE CONDITIONS OF FRAUD		
Incentives/Pressures	**Opportunities**	**Attitudes/Rationalization**
Management or other employees have incentives or pressures to materially misstate financial statements.	*Circumstances provide an opportunity for management or employees to misstate financial statements.*	*An attitude, character, or set of ethical values exists that allows management or employees to intentionally commit a dishonest act, or they are in an environment that imposes sufficient pressure that causes them to rationalize committing a dishonest act.*
Examples of Risk Factors	**Examples of Risk Factors**	**Examples of Risk Factors**
Financial stability or profitability is threatened by economic, industry, or entity operating conditions. Examples include significant declines in customer demand and increasing business failures in either the industry or overall economy. Excessive pressure for management to meet debt repayment or other debt covenant requirements. Management or the board of directors' personal net worth is materially threatened by the entity's financial performance.	Significant accounting estimates involve subjective judgments or uncertainties that are difficult to verify. Ineffective board of director or audit committee oversight over financial reporting. High turnover or ineffective accounting, internal audit, or information technology staff. Weak internal controls. Significant related-party transactions.	Inappropriate or ineffective communication and support of the entity's values. Known history of violations of securities laws or other laws and regulations. Management's practice of making overly aggressive or unrealistic forecasts to analysts, creditors, and other third parties.

FIGURE 11-2 **Reasons Why Fraud Occurs**



Source: From the *2007 Oversight System Report on Corporate Fraud*, Oversight Systems, Inc., 2007.

Oversight Systems, Inc., survey finding that the pressure to do "whatever it takes" to meet goals and the desire for personal gain are often cited as primary incentives to engage in fraudulent actions.

Opportunities Although the financial statements of all companies are potentially subject to manipulation, the risk is greater for companies in industries where significant judgments and estimates are involved. For example, valuation of inventories is subject to greater risk of misstatement for companies with diverse inventories in many locations. The risk of misstatement of inventories is further increased if those inventories are at risk for obsolescence.

A turnover in accounting personnel or other deficiencies in accounting and information processes can create an opportunity for misstatement. Many cases of fraudulent financial reporting went undetected by ineffective audit committee and board of director oversight of financial reporting.

Attitudes/Rationalization The attitude of top management toward financial reporting is a critical risk factor in assessing the likelihood of fraudulent financial statements. If the CEO or other top managers display a significant disregard for the financial reporting process, such as consistently issuing overly optimistic forecasts, or they are overly concerned about meeting analysts' earnings forecasts, fraudulent financial reporting is more likely. Management's character or set of ethical values also may make it easier for them to rationalize a fraudulent act.

Risk Factors for Misappropriation of Assets

The same three conditions apply to misappropriation of assets. However, in assessing risk factors, greater emphasis is placed on individual incentives and opportunities for theft. Table 11-2 (p. 358) provides examples of fraud risk factors for each of the three conditions of fraud for misappropriation of assets.

TABLE 11-2 **Examples of Risk Factors for Misappropriation of Assets**

THREE CONDITIONS OF FRAUD		
Incentives/Pressures	**Opportunities**	**Attitudes/Rationalization**
Management or other employees have incentives or pressures to misappropriate material assets.	*Circumstances provide an opportunity for management or employees to misappropriate assets.*	*An attitude, character, or set of ethical values exists that allows management or employees to intentionally commit a dishonest act, or they are in an environment that imposes sufficient pressure that causes them to rationalize committing a dishonest act.*
Examples of Risk Factors	**Examples of Risk Factors**	**Examples of Risk Factors**
Personal financial obligations create pressure for those with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between management and employees with access to assets susceptible to theft motivate employees to misappropriate those assets. Examples include the following: • Known or expected employee layoffs. • Promotions, compensation, or other rewards inconsistent with expectations.	Presence of large amounts of cash on hand or inventory items that are small, of high value, or are in high demand. Inadequate internal control over assets due to lack of the following: • Appropriate segregation of duties or independent checks. • An approved vendor list to detect unauthorized or fictitious vendors • Job applicant screening for employees with access to assets. • Mandatory vacations for employees with access to assets.	Disregard for the need to monitor or reduce risk of misappropriating assets. Disregard for internal controls by overriding existing controls or failing to correct known internal control deficiencies.

Incentives/Pressures Financial pressures are a common incentive for employees who misappropriate assets. Employees with excessive financial obligations, or those with drug abuse or gambling problems, may steal to meet their personal needs. In other cases, dissatisfied employees may steal from a sense of entitlement or as a form of attack against their employers.

Opportunities Opportunities for theft exist in all companies. However, opportunities are greater in companies with accessible cash or with inventory or other valuable assets, especially if they are small or easily removed. For example, casinos handle extensive amounts of cash with little formal records of cash received. Similarly, thefts of laptop computers are much more frequent than thefts of desktop systems.

Weak internal controls create opportunities for theft. Inadequate separation of duties is practically a license for employees to steal. Whenever employees have custody or even temporary access to assets and maintain the accounting records for those assets, the potential for theft exists. For example, if inventory storeroom employees also maintain inventory records, they can easily take inventory items and cover the theft by adjusting the accounting records. A lack of controls over payments to vendors, or payroll systems, can allow employees to create fictitious vendors or employees and bill the company for services or time.

Fraud is more prevalent in smaller businesses and not-for-profit organizations because it is more difficult for these entities to maintain adequate separation of

WHY DO THEY STEAL?

A controller in a large company was well compensated and participated in bonus and profit-sharing plans. A routine internal audit of petty cash discovered that the controller had stolen approximately $2,000 from petty cash. He was immediately terminated. The amounts identified as stolen were trivial in relation to the controller's annual income. Some employees steal to meet a financial need, but for others the access to company assets is just too great a temptation.

MADOFF CONVICTED IN LARGEST INVESTOR FRAUD

On March 12, 2009, Bernie Madoff pled guilty to the largest investor fraud ever, in a Ponzi scheme with losses estimated at almost $21 billion. By way of comparison, the massive fraud at WorldCom was approximately $11 billion. Madoff was sentenced to a prison term of 150 years.

In a Ponzi scheme, people are enticed to invest by above-market returns that are paid from the investments of additional investors, rather than actual profits on investments. The scheme usually collapses under its own weight because it depends on a continuing supply of new investors. The scheme is named after Charles Ponzi, who used the scheme in the early 1920s. Although he did not invent the Ponzi scheme, it has become associated with his name because of the scale of his operation. Madoff's scandal lasted a long time, particularly for such a large scheme. Investigators believe the fraud may have begun in the 1970s, although Madoff maintains that his fraudulent activities began in the 1990s. Madoff mainly managed money for charities, many of them private foundations. Private foundations are required by IRS regulations to pay out 5% of their funds each year, and Madoff could easily meet these required payouts using investments into the fund.

Madoff was secretive about his trading practices and marketed his funds to an exclusive clientele. Although concerns were raised over the years about the consistency of the returns generated, and the SEC investigated Madoff several times, his scheme was not revealed until the market plunge in 2008 triggered investor withdrawals from the firm. The market downturn revealed what several critics had alleged, that Madoff was running an elaborate Ponzi scheme.

Sources: 1. Robert Frank, Amir Efrati, Aaron Luchetti, and Chad Bray, "Madoff Jailed After Admitting Epic Scam," *The Wall Street Journal* (March 13, 2009); 2. Securities and Exchange Commission Litigation Complaint, December 11, 2008 (www.sec.gov/litigation).

duties. However, even large organizations may fail to maintain adequate separation in critical areas. Barings Bank collapsed after incurring losses in excess of $1 billion from the activities of one trader because of inadequate separation of duties.

Attitudes/Rationalization Management's attitude toward controls and ethical conduct may allow employees and managers to rationalize the theft of assets. If management cheats customers through overcharging for goods or engaging in high-pressure sales tactics, employees may feel that it is acceptable for them to behave in the same fashion by cheating on expense or time reports.

ASSESSING THE RISK OF FRAUD

OBJECTIVE 11-3

Understand the auditor's responsibility for assessing the risk of fraud and detecting material misstatements due to fraud.

Auditing standards provide guidance to auditors in assessing the risk of fraud. Auditors must maintain a level of professional skepticism as they consider a broad set of information, including fraud risk factors, to identify and respond to fraud risk. As we discussed in Chapter 6, the auditor has a responsibility to respond to fraud risk by planning and performing the audit to obtain reasonable assurance that material misstatements, whether due to errors or fraud, are detected.

Professional Skepticism

Auditing standards state that, in exercising **professional skepticism**, an auditor "*neither assumes that management is dishonest nor assumes unquestioned honesty*."[1] In practice, maintaining this attitude of professional skepticism can be difficult because, despite some recent high-profile examples of fraudulent financial statements, material frauds are infrequent compared to the number of audits of financial statements conducted annually. Most auditors will never encounter a material fraud during their careers. Also, through client acceptance and continuance evaluation procedures, auditors reject most potential clients perceived as lacking honesty and integrity.

Questioning Mind Auditing standards emphasize consideration of a client's susceptibility to fraud, regardless of the auditor's beliefs about the likelihood of fraud and management's honesty and integrity. During audit planning for every audit, the

[1]Source: Copyright by American Institute of CPAs. All rights reserved. Used with permission.

engagement team must discuss the need to maintain a questioning mind throughout the audit to identify fraud risks and critically evaluate audit evidence. There is always a risk that even an honest person can rationalize fraudulent actions when incentives or pressures become extreme.

Critical Evaluation of Audit Evidence Upon discovering information or other conditions that indicate a material misstatement due to fraud may have occurred, auditors should thoroughly probe the issues, acquire additional evidence as needed, and consult with other team members. Auditors must be careful not to rationalize or assume a misstatement is an isolated incident. For example, say an auditor uncovers a current-year sale that should properly be reflected as a sale in the following year. The auditor should evaluate the reasons for the misstatement, determine whether it was intentional or a fraud, and consider whether other such misstatements are likely to have occurred.

Sources of Information to Assess Fraud Risks

Figure 11-3 summarizes the information used to assess fraud risk. The five sources of information to assess these fraud risks on the top of the figure are discussed further in this section.

Communications Among Audit Team Auditing standards require the audit team to conduct discussions to share insights from more experienced audit team members and to "brainstorm" ideas that address the following:

1. How and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud. This should include consideration of known external and internal factors affecting the entity that might:
   - create an incentive or pressure for management to commit fraud.
   - provide the opportunity for fraud to be perpetrated.
   - indicate a culture or environment that enables management to rationalize fraudulent acts.
2. How management could perpetrate and conceal fraudulent financial reporting.
3. How anyone might misappropriate assets of the entity.
4. How the auditor might respond to the susceptibility of material misstatements due to fraud.

These discussions about fraud risks will likely take place at the same time as discussions about the susceptibility of the entity's financial statements to other types of material misstatement, which was addressed in Chapter 8.

Inquiries of Management Auditing standards require the auditor to make specific inquiries about fraud in every audit. Inquiries of management and others within the company provide employees with an opportunity to tell the auditor information that

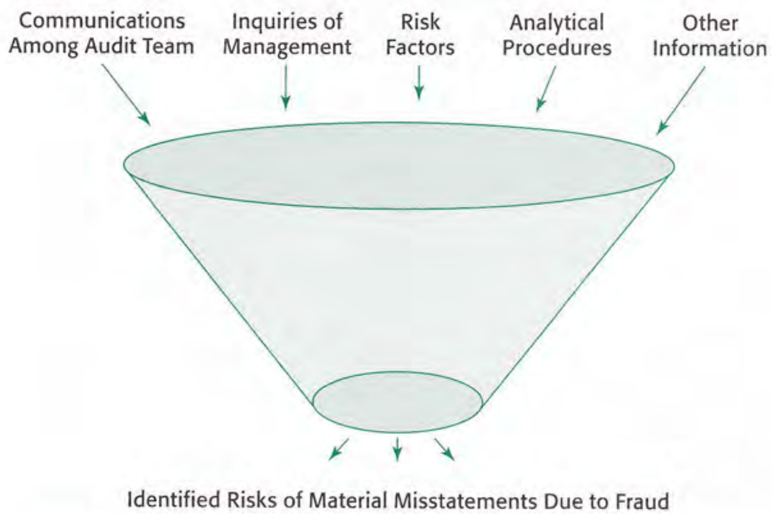
IT PAYS TO BLOW THE WHISTLE ON FRAUD

In an effort to combat fraud, Congress included a monetary reward for being a whistleblower in the Dodd–Frank Wall Street Reform and Consumer Protection Act. The whistleblower program, which went into effect in August 2011 and is overseen by the SEC, provides a monetary reward to anyone providing information about a violation of a federal securities law that leads to a successful enforcement action resulting in at least $1 million in sanctions. The reward is between 10% and 30% of the amount recovered by the SEC. Tips can be anonymous and do not even have to be from a direct observation of the fraudulent activity. In addition, the new provisions strengthen anti-retaliation rules so that penalizing a whistleblower constitutes a violation of the securities laws.

According to the first annual report of the SEC whistleblower office, they received 334 tips in the first seven weeks of the program, for an average of over 47 complaints per week. The most common categories of complaints related to market manipulations (16%), corporate disclosures and financial statements (15%), and securities offering fraud (16%).

Source: U.S. Securities and Exchange Commission Annual Report on the Dodd–Frank Whistleblower Program: Fiscal Year 2011 (November 2011) (www.sec.gov).

FIGURE 11-3 **Sources of Information Gathered to Assess Fraud Risks**



otherwise might not be communicated. Moreover, their responses to the auditor's questions often reveal information on the likelihood of fraud.

The auditor's inquiries of management should address whether management has knowledge of any fraud or suspected fraud within the company. Auditors should also inquire about management's process of assessing fraud risks, the nature of fraud risks identified by management, any internal controls implemented to address those risks, and any information about fraud risks and related controls that management has reported to the audit committee.

The audit committee often assumes an active role in overseeing management's fraud risk assessment and response processes. The auditor must inquire of the audit committee or others charged with governance about their views of the risks of fraud and whether they have knowledge of any fraud or suspected fraud. For entities with an internal audit function, the auditor should inquire about internal audit's views of fraud risks and whether they have performed any procedures to identify or detect fraud during the year.

Auditing standards also require the auditor to make inquiries of others within the entity whose duties lie outside the normal financial reporting lines of responsibility. When coming into contact with company personnel, such as the inventory warehouse manager or purchasing agents, the auditor may inquire about the existence or suspicion of fraud. Throughout the audit, inquiries of executives and a wide variety of other employees provide opportunities for the auditor to learn about risks of fraud. When responses are inconsistent, the auditor should obtain additional audit evidence to resolve the inconsistency and to support or refute the original risk assessment.

Risk Factors Auditing standards require the auditor to evaluate whether fraud risk factors indicate incentives or pressures to perpetrate fraud, opportunities to carry out fraud, or attitudes or rationalizations used to justify a fraudulent action. Tables 11-1 (p. 356) and 11-2 (p. 358) outline examples of the fraud risk factors auditors consider. The existence of fraud risk factors does not mean fraud exists, but that the likelihood of fraud is higher. Auditors should consider these factors along with any other information used to assess the risks of fraud.

Analytical Procedures As we discussed in Chapter 8, auditors must perform analytical procedures during the planning and completion phases of the audit to help

FIGURE 11-4 **Horizontal Analysis of Income Statement**

HILLSBURG HARDWARE COMPANY HORIZONTAL ANALYSIS OF INCOME STATEMENT (in thousands)	Year Ended December 31			
	2013	2012	Change	% Change
Net sales	$143,086	$131,226	$11,860	9.0%
Cost of sales	103,241	94,876	8,365	8.8%
Gross profit	39,845	36,350	3,495	9.6%
Selling, general, and administrative expenses	32,475	29,656	2,819	9.5%
Operating income	7,370	6,694	676	10.1%
Other income and expense				
Interest expense	2,409	2,035	374	18.4%
Gain on sale of assets	(720)	–	(720)	N/A
Total other income/expense (net)	1,689	2,035	(346)	−17.0%
Earnings before income taxes	5,681	4,659	1,022	21.9%
Provision for income taxes	1,747	1,465	282	19.2%
Net income	$ 3,934	$ 3,194	$ 740	23.2%

identify unusual transactions or events that might indicate the presence of material misstatements in the financial statements. When results from analytical procedures differ from the auditor's expectations, the auditor evaluates those results in light of other information obtained about the likelihood of fraud to determine if fraud risk is heightened.

In addition to the ratio analysis described in Chapter 8, the auditor may perform horizontal and vertical analysis of the financial statements. In **horizontal analysis**, the account balance is compared to the previous period, and the percentage change in the account balances for the period is calculated. Figure 11-4 is an example of horizontal analysis applied to the condensed income statement for Hillsburg Hardware. For example, sales increased $11,860 (in 000's) from the prior year, which represents a 9.0% increase ($11,860/$131,226). In **vertical analysis**, the financial statement numbers are converted to percentages. The common-size financial statement in Figure 8-7 on p. 247 is an example of vertical analysis applied to the detailed income statement for Hillsburg Hardware, with each income statement amount calculated as a percentage of sales. In vertical analysis of the balance sheet, balances are calculated as a percentage of total assets.

Because occurrences of fraudulent financial reporting often involve manipulation of revenue, auditing standards require the auditor to perform analytical procedures on revenue accounts. The objective is to identify unusual or unexpected relationships involving revenue accounts that may indicate fraudulent financial reporting. By comparing the sales volume based on recorded revenue with actual production capacity, for example, the auditor can reveal revenues beyond the entity's production capabilities. The auditor may review monthly sales in the general ledger and may also review quarterly or monthly sales by product line. By reviewing sales trends, the auditor may identify unusual sales activity. For example, at one company the reversals of improperly recorded sales resulted in negative sales for a month.

Other Information Auditors should consider all information they have obtained in any phase or part of the audit as they assess the risk of fraud. Many of the risk

GUIDANCE FOR MANAGING FRAUD RISK

The American Institute of CPAs, The Institute of Internal Auditors, and the Association of Certified Fraud Examiners jointly created *Managing the Business Risk of Fraud: A Practical Guide*, to assist boards, senior management, and internal auditors in their management of fraud risk within organizations. The guide defines the following five principles for fraud risk management:

Principle 1: As part of an organization's governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

Principle 2: Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

Principle 3: Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

Principle 4: Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

Principle 5: A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

The guide describes how organizations of all sizes can establish their own fraud risk management programs and includes examples of key program components and resources that organizations can use as a starting point to develop an effective and efficient fraud risk management program.

Source: Based on *Managing the Business Risk of Fraud: A Practical Guide*, The Institute of Internal Auditors, The American Institute of Certified Public Accountants, and the Association of Certified Fraud Examiners, 2011.

assessment procedures that the auditor performs during planning to assess the risk of material misstatement may indicate a heightened risk of fraud. For example, information about management's integrity and honesty obtained during client acceptance procedures, inquiries and analytical procedures done in connection with the auditor's review of the client's quarterly financial statements, and information considered in assessing inherent and control risks may lead to auditor concerns about the likelihood of misstatements due to fraud.

Documenting Fraud Assessment

Auditing standards require that auditors document the following matters related to the auditor's consideration of material misstatements due to fraud:

- The discussion among engagement team personnel in planning the audit about the susceptibility of the entity's financial statements to material fraud.
- Procedures performed to obtain information necessary to identify and assess the risks of material fraud.
- Specific risks of material fraud that were identified and a description of the auditor's response to those risks.
- Reasons supporting a conclusion that there is not a significant risk of material improper revenue recognition.
- Results of the procedures performed to address the risk of management override of controls.
- Other conditions and analytical relationships indicating that additional auditing procedures or other responses were required, and the actions taken by the auditor.
- The nature of communications about fraud made to management, the audit committee, or others.

After fraud risks are identified and documented, the auditor should evaluate factors that reduce fraud risk before developing an appropriate response to the risk of fraud. Corporate governance and other control factors that reduce fraud risks are discussed in the next section.

CORPORATE GOVERNANCE OVERSIGHT TO REDUCE FRAUD RISKS

OBJECTIVE 11-4

Identify corporate governance and other control environment factors that reduce fraud risks.

Management is responsible for implementing corporate governance and control procedures to minimize the risk of fraud, which can be reduced through a combination of prevention, deterrence, and detection measures. Because collusion and false documentation make detection of fraud a challenge, it is often more effective and economical for companies to focus on fraud prevention and deterrence. By implementing antifraud programs and controls, management can prevent fraud by reducing opportunity. By communicating fraud detection and punishment policies, management can deter employees from committing fraud.

Guidance developed by the AICPA identifies three elements to prevent, deter, and detect fraud:

1. Culture of honesty and high ethics
2. Management's responsibility to evaluate risks of fraud
3. Audit committee oversight

Let's examine these elements closely, as auditors should have a thorough understanding of each to assess the extent to which clients have implemented fraud-reducing activities.

Culture of Honesty and High Ethics

Research indicates that the most effective way to prevent and deter fraud is to implement antifraud programs and controls that are based on core values embraced by the company. Such values create an environment that reinforces acceptable behavior and expectations that employees can use to guide their actions. These values help create a culture of honesty and ethics that provides the foundation for employees' job responsibilities. Creating a culture of honesty and high ethics includes six elements.

Setting the Tone at the Top Management and the board of directors are responsible for setting the "tone at the top" for ethical behavior in the company. Honesty and integrity by management reinforces honesty and integrity to employees throughout the organization. Management cannot act one way and expect others in the company to behave differently. Through its actions and communications, management can show that dishonest and unethical behaviors are not tolerated, even if the results benefit the company.

A "tone at the top" based on honesty and integrity provides the foundation upon which a more detailed code of conduct can be developed to provide more specific guidance about permitted and prohibited behavior. Table 11-3 provides an example of the key contents of an effective code of conduct.

EVERYDAY VALUES: THE HARLEY-DAVIDSON CODE OF BUSINESS CONDUCT

The Harley-Davidson Motor Company, founded over 100 years ago, has grown to be recognized as one of the leading U.S. companies. Both *Fortune* and *Forbes* magazines have named Harley-Davidson several times as one of their most admired companies. The company has an incredible following of avid motorcycle enthusiasts, often referred to as "H.O.G.s."

The company places tremendous emphasis on preserving the Harley-Davidson legacy. To help its employees make the right decisions on the job, management developed a detailed guide, *Everyday Values: The Harley-Davidson Code of Business Conduct*, which applies to the board of directors and all employees of the company. The guide is built around these five basic Harley-Davidson values:

- Tell the truth
- Be fair
- Keep your promises
- Respect the individual
- Encourage intellectual curiosity

The guide is intended to promote honest and ethical conduct, and it addresses a wide range of activities and situations in which employees may need to make decisions.

Source: Based on Harley-Davidson, Inc., *Everyday Values: The Harley-Davidson Code of Business Conduct* (www.harley-davidson.com).

TABLE 11-3	Example Elements for a Code of Conduct
Code of Conduct Element	**Description**
Organizational Code of Conduct	The organization and its employees must at all times comply with all applicable laws and regulations, with all business conduct well above the minimum standards required by law.
General Employee Conduct	The organization expects its employees to conduct themselves in a businesslike manner and prohibits unprofessional activities, such as drinking, gambling, fighting, and swearing, while on the job.
Conflicts of Interest	The organization expects that employees will perform their duties conscientiously, honestly, and in accordance with the best interests of the organization and will not use their positions or knowledge gained for private or personal advantage.
Outside Activities, Employment, and Directorships	All employees share a responsibility for the organization's good public relations. Employees should avoid activities outside the organization that create an excessive demand on their time or create a conflict of interest.
Relationships with Clients and Suppliers	Employees should avoid investing in or acquiring a financial interest in any business organization that has a contractual relationship with the organization.
Gifts, Entertainment, and Favors	Employees must not accept entertainment, gifts, or personal favors that could influence or appear to influence business decisions in favor of any person with whom the organization has business dealings.
Kickbacks and Secret Commissions	Employees may not receive payment or compensation of any kind, except as authorized under organizational remuneration policies.
Organization Funds and Other Assets	Employees who have access to organization funds must follow prescribed procedures for recording, handling, and protecting money.
Organization Records and Communications	Employees responsible for accounting and record keeping must not make or engage in any false record or communication of any kind, whether external or internal.
Dealing with Outside People and Organizations	Employees must take care to separate their personal roles from their organizational positions when communicating on matters not involving the organization's business.
Prompt Communications	All employees must make every effort to achieve complete, accurate, and timely communications in all matters relevant to customers, suppliers, government authorities, the public, and others within the organization.
Privacy and Confidentiality	When handling financial and personal information about customers and others with whom the organization has dealings, employees should collect, use, and retain only the information necessary for the organization's business; internal access to information should be limited to those with a legitimate business reason for seeking that information.

Source: AICPA, *"CPA's Handbook of Fraud and Commercial Crime Prevention."*

Creating a Positive Workplace Environment Research shows that wrongdoing occurs less frequently when employees have positive feelings about their employer than when they feel abused, threatened, or ignored. A positive workplace can generate improved employee morale, which may reduce employees' likelihood of committing fraud against the company.

Employees should also have the ability to obtain advice internally before making decisions that appear to have legal or ethical implications. Many organizations, including all U.S. public companies, have a whistleblowing process for employees to report actual or suspected wrongdoing or potential violations of the code of conduct or ethics policy. The vignette on page 360 describes how public companies are required to have whistleblower hotlines, which are often directed to or monitored by an ethics officer or other trusted individual responsible for investigating and reporting fraud or illegal acts.

Hiring and Promoting Appropriate Employees To be successful in preventing fraud, well-run companies implement effective screening policies to reduce the likelihood of hiring and promoting individuals with low levels of honesty, especially those who hold positions of trust. Such policies may include background checks on individuals being considered for employment or for promotion to positions of trust. Background checks verify a candidate's education, employment history, and personal references, including references about character and integrity. After an employee is hired, continuous evaluation of employee compliance with the company's values and code of conduct also reduces the likelihood of fraud.

Training All new employees should be trained about the company's expectations of employees' ethical conduct. Employees should be told of their duty to communicate actual or suspected fraud and the appropriate way to do so. In addition, fraud awareness training should be tailored to employees' specific job responsibilities with, for example, different training for purchasing agents and sales agents.

Confirmation Most companies require employees to periodically confirm their responsibilities for complying with the code of conduct. Employees are asked to state that they understand the company's expectations and have complied with the code, and that they are unaware of any violations. These confirmations help reinforce the code of conduct policies and also help deter employees from committing fraud or other ethics violations. By following-up on disclosures and non-replies, internal auditors or others may uncover significant issues.

Discipline Employees must know that they will be held accountable for failing to follow the company's code of conduct. Enforcement of violations of the code, regardless of the level of the employee committing the act, sends clear messages to all employees that compliance with the code of conduct and other ethical standards is important and expected. Thorough investigation of all violations and appropriate and consistent responses can be effective deterrents to fraud.

Management's Responsibility to Evaluate Risks of Fraud

Fraud cannot occur without a perceived opportunity to commit and conceal the act. Management is responsible for identifying and measuring fraud risks, taking steps to mitigate identified risks, and monitoring internal controls that prevent and detect fraud.

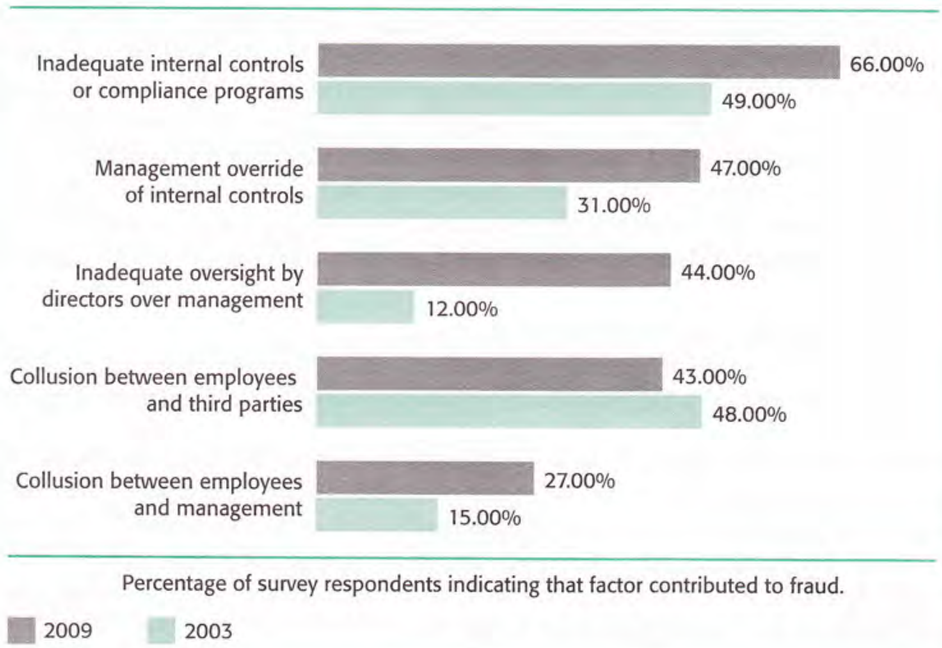
Identifying and Measuring Fraud Risks Effective fraud oversight begins with management's recognition that fraud is possible and that almost any employee is capable of committing a dishonest act under the right circumstances. This recognition increases the likelihood that effective fraud prevention, deterrence, and detection programs and controls are implemented. Figure 11-5 summarizes factors that management should consider that may contribute to fraud in an organization.

Mitigating Fraud Risks Management is responsible for designing and implementing programs and controls to mitigate fraud risks, and it can change business activities and processes prone to fraud to reduce incentives and opportunities for fraud. For example, management can outsource certain operations, such as transferring cash collections from company personnel to a bank lockbox system. Other programs and controls may be implemented at a company-wide level, such as the training of all employees about fraud risks and strengthening employment and promotion policies.

Monitoring Fraud Prevention Programs and Controls For high fraud risk areas, management should periodically evaluate whether appropriate antifraud programs and controls have been implemented and are operating effectively. For example, management's review and evaluation of results for operating units or subsidiaries increases the likelihood that manipulated results will be detected.

Internal audit plays a key role in monitoring activities to ensure that antifraud programs and controls are operating effectively. Internal audit activities can both deter and detect fraud. Internal auditors assist in deterring fraud by examining and evaluating internal controls that reduce fraud risk. They assist in fraud detection by performing audit procedures that may uncover fraudulent financial reporting and misappropriation of assets.

FIGURE 11-5 **Organizational Factors Contributing to Risk of Fraud**



Sources: *Fraud Survey 2003* and *Fraud Survey 2009*, KPMG Forensics. Copyright © 2003 and 2009 KPMG, LLP. Reprinted with permission.

Audit Committee Oversight

The audit committee has primary responsibility to oversee the organization's financial reporting and internal control processes. In fulfilling this responsibility, the audit committee considers the potential for management override of internal controls and oversees management's fraud risk assessment process, as well as antifraud programs and controls. The audit committee also assists in creating an effective "tone at the top" about the importance of honesty and ethical behavior by reinforcing management's zero tolerance for fraud.

Audit committee oversight also serves as a deterrent to fraud by senior management. For example, to increase the likelihood that any attempt by senior management to involve employees in committing or concealing fraud is promptly disclosed, oversight may include:

- Direct reporting of key findings by internal audit to the audit committee
- Periodic reports by ethics officers about whistleblowing
- Other reports about lack of ethical behavior or suspected fraud

Because the audit committee plays an important role in establishing a proper tone at the top and in overseeing the actions of management, PCAOB Standard 5 requires the auditor of a public company to evaluate the effectiveness of the board and audit committee as part of the auditor's evaluation of the operating effectiveness of internal control over financial reporting. As part of the evaluation, the auditor might consider the audit committee's independence from management and the level of understanding between management and the audit committee regarding the latter's responsibilities. An external auditor may gather insights by observing interactions between the audit team, the audit committee, and internal audit regarding the level of audit committee commitment to overseeing the financial reporting process. PCAOB Standard 5 notes that ineffective oversight by the audit committee may be a strong indicator of a material weakness in internal control over financial reporting.

RESPONDING TO THE RISK OF FRAUD

OBJECTIVE 11-5

Develop responses to identified fraud risks.

When risks of material misstatements due to fraud are identified, the auditor should first discuss these findings with management and obtain management's views of the potential for fraud and existing controls designed to prevent or detect misstatements. As described in the last section, management may have programs designed to prevent, deter, and detect fraud, as well as controls designed to mitigate specific risks of fraud. Auditors should then consider whether such antifraud programs and controls mitigate the identified risks of material misstatements due to fraud or whether control deficiencies increase the risk of fraud. Auditor responses to fraud risk include the following:

1. Change the overall conduct of the audit
2. Design and perform audit procedures to address fraud risks
3. Design and perform procedures to address management override of controls

Change the Overall Conduct of the Audit

Auditors can choose among several overall responses to an increased fraud risk. If the risk of misstatement due to fraud is increased, more experienced personnel may be assigned to the audit. In some cases, a fraud specialist may be assigned to the audit team.

Fraud perpetrators are often knowledgeable about audit procedures. For this reason, auditing standards require auditors to incorporate unpredictability in the audit strategy. For example, auditors may visit inventory locations or test accounts that were not tested in prior periods. Auditors should also consider tests that address misappropriation of assets, even when the amounts are not typically material.

Design and Perform Audit Procedures to Address Fraud Risks

The appropriate audit procedures used to address specific fraud risks depend on the account being audited and type of fraud risk identified. For example, if concerns are raised about revenue recognition because of cutoff or channel stuffing, the auditor may review the sales journal for unusual activity near the end of the period and review the terms of sales. Later in this chapter, procedures for specific fraud risk areas are discussed.

Auditors should also consider management's choice of accounting principles. Careful attention should be placed on accounting principles that involve subjective measurements or complex transactions. Because auditors presume fraud risk in revenue recognition, they should also evaluate the company's revenue recognition policies.

Design and Perform Procedures to Address Management Override of Controls

The risk of management override of controls exists in almost all audits. Because management is in a unique position to perpetrate fraud by overriding controls that are otherwise operating effectively, auditors must perform procedures in every audit to address the risk of management override. Three procedures must be performed in every audit.

Examine Journal Entries and Other Adjustments for Evidence of Possible Misstatements Due to Fraud Fraud often results from adjustments to amounts reported in the financial statements, even when effective internal controls exist over the rest of the recording processes. The auditor should first obtain an understanding of the entity's financial reporting process, as well as controls over journal entries and other adjustments, and inquire of employees involved in the financial reporting process about inappropriate or unusual activity in processing journal entries and other adjustments. In some organizations, management uses spreadsheet software to make adjustments to financial information generated by the accounting system. These "top-side adjustments" have been used to manipulate financial statements. Auditing standards require testing of journal entries and other financial statement adjustments. The extent of testing is affected by the effectiveness of controls and results of the inquiries.

Review Accounting Estimates for Biases Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates.

Auditing standards require the auditor to consider the potential for management bias when reviewing current-year estimates. The auditor is required to "look back" at significant prior-year estimates to identify any changes in the company's processes or management's judgments and assumptions that might indicate a potential bias. For example, management's estimates may have been clustered at the high end of the range of acceptable amounts in the prior year and at the low end in the current year.

Accounting standards increasingly require that assets be recorded at fair value. Although market value is readily determinable for some assets, determining fair value often depends on estimates and judgment, creating opportunities for manipulation.

Evaluate the Business Rationale for Significant Unusual Transactions Auditing standards emphasize understanding the underlying business rationale for significant unusual transactions that might be outside the normal course of business for the company. The auditor should gain an understanding of the purposes of significant transactions to assess whether transactions have been entered into to engage in fraudulent financial reporting. For example, the company may engage in financing transactions to avoid reporting liabilities on the balance sheet. The auditor should determine whether the accounting treatment for any unusual transaction is appropriate in the circumstances, and whether information about the transaction is adequately disclosed in the financial statements.

Update Risk Assessment Process

The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit and coordinated with the auditor's other risk assessment procedures. Auditors should be alert for the following conditions when doing the audit:

- Discrepancies in the accounting records
- Conflicting or missing audit evidence
- Problematic or unusual relationships between the auditor and management
- Results from substantive or final review stage analytical procedures that indicate a previously unrecognized fraud risk
- Responses to inquiries made throughout the audit that are vague or implausible or that produce evidence that is inconsistent with other information

SPECIFIC FRAUD RISK AREAS

OBJECTIVE 11-6

Recognize specific fraud risk areas and develop procedures to detect fraud.

Depending on the client's industry, certain accounts are especially susceptible to manipulation or theft. Specific high-risk accounts are discussed next, including warning signs of fraud. But even when auditors are armed with knowledge of these warning signs, fraud remains extremely difficult to detect. However, an awareness of warning signs and other fraud detection techniques increases an auditor's likelihood of identifying misstatements due to fraud.

Revenue and Accounts Receivable Fraud Risks

Revenue and related accounts receivable and cash accounts are especially susceptible to manipulation and theft. A study sponsored by the Committee of Sponsoring Organizations (COSO) found that more than half of financial statement frauds involve revenues and accounts receivable. Similarly, because sales are often made for cash or are quickly converted to cash, cash is also highly susceptible to theft.

Fraudulent Financial Reporting Risk for Revenue As a result of the frequency of financial reporting frauds involving revenue recognition, the AICPA and SEC issued guidance dealing with revenue recognition. Auditing standards specifically require auditors to identify revenue recognition as a fraud risk in most audits.

Several reasons make revenue susceptible to manipulation. Most important, revenue is almost always the largest account on the income statement, therefore a misstatement only representing a small percentage of revenues can still have a large effect on income. An overstatement of revenues often increases net income by an

ASSET MISAPPROPRIATION AND COLLUSION AT KOSS CORPORATION

Fraud is more difficult to uncover and often goes undetected for a longer period of time when there is collusion among the perpetrators. Koss Corporation, a manufacturer of headphones located in Milwaukee, and their auditors found this out the hard way when the company was notified by American Express that their vice president of finance, secretary, and principal accounting officer had been wiring funds from Koss Corporation's account into her personal American Express account to fund her lavish lifestyle. Over a five-year period, she embezzled more than $31 million, which she used to purchase personal items such as cars, fur coats, and expensive jewelry, and to fund travel to exotic locations and extensive home improvements.

The principal accounting officer colluded with two other accounting personnel in order to conceal the fraud. The three together overrode existing internal controls over the processing of payments, and concealed the fraud from management and the auditors. The embezzlement was hidden in the financial statements by overstating assets, expenses and cost of sales, and understating liabilities and sales. When Koss Corp. ultimately restated their financial statements, their gross profit was actually higher than originally reported.

The principal accounting officer pled guilty to six counts of wire fraud, was sentenced to 11 years in prison, and was required to pay $34 million in restitution. It was a classic case where a trusted, long-time employee was able to commit and conceal fraud for an extended period of time.

Because of the size of the company's market capitalization, Koss was not subject to the Sarbanes–Oxley (SOX) Section 404(b) requirement to obtain their auditor's opinion on the effectiveness of internal control over financial reporting. Some may argue that this is a prime example of why SOX 404(b) audits of internal controls over financial reporting should also be required for non-accelerated filers. If Koss had been subject to an integrated audit, the fraud may have been prevented or at least detected sooner.

Source: Based on Bill Singer, "Sachdeva fraud: Another lost soul without a Wales," *Forbes.com* (January 14, 2011).

equal amount, because related costs of sales are usually not recognized on fictitious or prematurely recognized revenues. Revenue growth is often a key performance indicator for analysts and investors, providing an even greater incentive to inflate revenue. Another reason revenue is susceptible to manipulation is the difficulty of determining the appropriate timing of revenue recognition in many situations.

Three main types of revenue manipulations are:

1. Fictitious revenues
2. Premature revenue recognition
3. Manipulation of adjustments to revenues

Fictitious Revenues The most egregious forms of revenue fraud involve creating fictitious revenues. You may be aware of several recent cases involving fictitious revenues, but this type of fraud is not new. The 1931 *Ultramares* case described in Chapter 4 (p. 105) involved fictitious revenue entries in the general ledger.

Fraud perpetrators often go to great lengths to support fictitious revenue. Fraudulent activity at Equity Funding Corp. of America, which involved issuing fictitious insurance policies, lasted nearly a decade (from 1964 to 1973) and involved dozens of company employees. The perpetrators held file-stuffing parties to create the fictitious policies.

Premature Revenue Recognition Companies often accelerate the timing of revenue recognition to meet earnings or sales forecasts. **Premature revenue recognition**, the recognition of revenue before accounting standards requirements for recording revenue have been met, should be distinguished from cutoff errors, in which transactions are inadvertently recorded in the incorrect period. In the simplest form of accelerated revenue recognition, sales that should have been recorded in the subsequent period are recorded as current period sales.

One method of fraudulently accelerating revenue is through violating accounting rules related to "bill-and-hold" sales. Sales are normally recognized at the time goods are shipped, but in a bill-and-hold sale, the goods are invoiced before they are shipped. These types of sales can be legitimate depending on the contract terms, but can violate accounting standards if the required terms are not met. Another method involves issuing side agreements that modify the terms of the sales transaction. For example, revenue recognition is likely to be inappropriate if a major customer agrees to "buy" a significant amount of inventory at year-end, but a side agreement provides for more favorable pricing and unrestricted return of the goods if not sold by the customer. In some cases, as a result of the terms of the side agreement, the transaction does not qualify as a sale under accounting standards.

Two notable examples of premature revenue recognition involve Bausch and Lomb and Xerox Corporation. In the Bausch and Lomb case, items were shipped that were not ordered by customers, with unrestricted right of return and promises that the goods did not have to be paid for until sold. The revenue recognition issues at Xerox were more complex. Capital equipment leases include sales, financing, and service components. Because the sales component is recognized immediately, Xerox attempted to maximize the amount allocated to this aspect of the transaction.

Manipulation of Adjustments to Revenues The most common adjustment to revenue involves sales returns and allowances. A company may hide sales returns from the auditor to overstate net sales and income. If the returned goods are counted as part of physical inventory, the return may increase reported income. In this case, an asset increase is recognized through the counting of physical inventory, but the reduction in the related accounts receivable balance is not made.

Companies may also understate bad debt expense, in part because significant judgment is required to determine the correct amount. Companies may attempt to reduce bad debt expense by understating the allowance for doubtful accounts. Because the required allowance depends on the age and quality of accounts receivable, some companies have altered the aging of accounts receivable to make them appear more current.

Warning Signs of Revenue Fraud Many potential warning signals or symptoms indicate revenue fraud. Two of the most useful are analytical procedures and documentary discrepancies.

Analytical Procedures Analytical procedures often signal revenue frauds, especially gross margin percentage and accounts receivable turnover. Fictitious revenue overstates the gross margin percentage, and premature revenue recognition also overstates gross margin if the related cost of sales is not recognized. Fictitious revenues also lower accounts receivable turnover, because the fictitious revenues are also included in uncollected receivables. Table 11-4 includes comparative sales, cost of sales, and accounts receivable data for Regina Vacuum, including the year before the fraud and the two fraud years. Notice how both a higher gross profit percentage and lower

TABLE 11-4 **Example of the Effect of Fictitious Receivables on Accounting Ratios Based on Regina Vacuum Company**

	Year Ended June 30		
	1988	1987	1986
Sales	$181,123	$126,234	$76,144
Cost of sales	(94,934)	(70,756)	(46,213)
Gross profit	86,189	55,478	29,931
Gross profit percentage	47.6%	43.9%	39.3%
Year-end accounts receivable	51,076	27,801	14,402
Accounts receivable turnover[a]	3.55	4.54	5.29

[a]Accounts receivable turnover calculated as Sales/Ending accounts receivable

POCKETING PARKING CASH

Sam Ralston was in charge of a university parking lot. He was supposed to place a parking receipt on the dash of the car when he received cash from the driver, but he would often collect the cash and wave the driver in without a receipt, particularly for sporting events. The university considered it too expensive to have two employees handle parking, and it was difficult to count the paid vehicles in a lot because some cars were parked by university employees with passes.

After several years, the university rotated Sam to another lot. An astute employee in the accounting office noticed that revenues collected from the lot seemed to increase after Sam's departure. Further investigation revealed that average revenues declined at the new lot to which Sam had been assigned. Confronted with the evidence, Sam confessed and was terminated from employment.

accounts receivable turnover ratio in the most recent two years that include the fraud helped signal fictitious accounts receivable.

In some frauds, management generated fictitious revenues to make analytical procedures results, such as gross margin, similar to the prior year. In frauds like this, analytical procedures are typically not useful to signal the fraud.

Documentary Discrepancies Despite the best efforts of fraud perpetrators, fictitious transactions rarely have the same level of documentary evidence as legitimate transactions. For example, in the well-known fraud at ZZZZ Best, insurance restoration contracts worth millions of dollars were supported by one- or two-page agreements and lacked many of the supporting details and evidence, such as permits, that are normally associated with these types of contracts.

Auditors should be aware of unusual markings and alterations on documents, and they should rely on original rather than duplicate copies of documents. Because fraud perpetrators attempt to conceal fraud, even one unusual transaction in a sample should be considered to be a potential indicator of fraud that should be investigated.

Misappropriation of Receipts Involving Revenue Although misappropriation of cash receipts is rarely as material as fraudulent reporting of revenues, such frauds can be costly to the organization because of the direct loss of assets. A typical misappropriation of cash involves failure to record a sale or an adjustment to customer accounts receivable to hide the theft.

Failure to Record a Sale One of the most difficult frauds to detect is when a sale is not recorded and the cash from the sale is stolen. Such frauds are easier to detect when goods are shipped on credit to customers. Tracing shipping documents to sales entries in the sales journal and accounting for all shipping documents can be used to verify that all sales have been recorded.

It is much more difficult to verify that all cash sales have been recorded, especially if no shipping documents exist to verify the completeness of sales, and no customer account receivable records support the sale. In such cases, other documentary evidence is necessary to verify that all sales are recorded. For example, a retail establishment may require that all sales be recorded on a cash register. Recorded sales can then be compared to the total amount of sales on the cash register tape. If the sale is not included in the cash register it is almost impossible to detect the fraud.

Theft of Cash Receipts After a Sale is Recorded It is much more difficult to hide the theft of cash receipts after a sale is recorded. If a customer's payment is stolen, regular billing of unpaid accounts will quickly uncover the fraud. As a result, to hide the theft, the fraud perpetrator must reduce the customer's account in one of three ways:

1. Record a sales return or allowance
2. Write off the customer's account
3. Apply the payment from another customer to the customer's account, which is also known as lapping

Warning Signs of Misappropriation of Revenues and Cash Receipts Relatively small thefts of sales and related cash receipts are best prevented and detected by

TABLE 11-5 **Example of the Effect of Fictitious Inventory on Inventory Turnover Based on Crazy Eddie, Inc.**

	Year Ended March 1, 1987	Year Ended March 2, 1986	9 Months Ended March 3, 1985
Sales	$352,523	$262,268	$136,319
Cost of sales	(272,255)	(194,371)	(103,421)
Gross profit	80,268	67,897	32,898
Gross profit percentage	22.8%	25.9%	24.1%
Year-end inventories	109,072	59,864	26,543
Inventory turnover[a]	2.50	3.20	5.20[b]

[a]Inventory turnover calculated as Cost of sales/Ending inventory.
[b]Inventory turnover calculated based on annualized Cost of sales.

internal controls designed to minimize the opportunity for fraud. For detecting larger frauds, analytical procedures and other comparisons may be useful.

Inventory Fraud Risks

Inventory is often the largest account on many companies' balance sheets, and auditors often find it difficult to verify the existence and valuation of inventories. As a result, inventory is susceptible to manipulation by managers who want to achieve certain financial reporting objectives. Because it is also usually readily saleable, inventory is also susceptible to misappropriation.

Fraudulent Financial Reporting Risk for Inventory Fictitious inventory has been at the center of several major cases of fraudulent financial reporting. Many large companies have varied and extensive inventory in multiple locations, making it relatively easy for the company to add fictitious inventory to accounting records.

While auditors are required to verify the existence of physical inventories, audit testing is done on a sample basis, and not all locations with inventory are typically tested. In some cases involving fictitious inventories, auditors informed the client in advance which inventory locations were to be tested. As a result, it was relatively easy for the client to transfer inventories to the locations being tested.

Warning Signs of Inventory Fraud Similar to deceptions involving accounts receivable, many potential warning signals or symptoms point to inventory fraud. Analytical procedures are one useful technique for detecting inventory fraud.

Analytical Procedures Analytical procedures, especially gross margin percentage and inventory turnover, often help uncover inventory fraud. Fictitious inventory understates cost of goods sold and overstates the gross margin percentage. Fictitious inventory also lowers inventory turnover. Table 11-5 is an example of the effects of fictitious inventory on inventory turnover based on the Crazy Eddie fraud. Note that the gross profit percentage did not signal the existence of fictitious inventories, but the significant decrease in inventory turnover was a sign of fictitious inventories.

Purchases and Accounts Payable Fraud Risks

Cases of fraudulent financial reporting involving accounts payable are relatively common although less frequent than frauds involving inventory or accounts receivable. The deliberate understatement of accounts payable generally results in an understatement of purchases and cost of goods sold and an overstatement of net income. Significant misappropriations involving purchases can also occur in the form of payments to fictitious vendors, as well as kickbacks and other illegal arrangements with suppliers.

Fraudulent Financial Reporting Risk for Accounts Payable Companies may engage in deliberate attempts to understate accounts payable and overstate income.

This can be accomplished by not recording accounts payable until the subsequent period or by recording fictitious reductions to accounts payable.

All purchases received before the end of the year should be recorded as liabilities. This is relatively easy to verify if the company accounts for prenumbered receiving reports. However, if the receiving reports are not prenumbered or the company deliberately omits receiving reports from the accounting records, it may be difficult for the auditor to verify whether all liabilities have been recorded. In such cases, analytical evidence, such as unusual changes in ratios, may signal that accounts payable are understated.

Companies often have complex arrangements with suppliers that result in reductions to accounts payable for advertising credits and other allowances. These arrangements are often not as well documented as acquisition transactions. Some companies have used fictitious reductions to accounts payable to overstate net income. Therefore, auditors should read agreements with suppliers when amounts are material and make sure the financial statements reflect the substance of the agreements.

Misappropriations in the Acquisition and Payment Cycle The most common fraud in the acquisitions area is for the perpetrator to issue payments to fictitious vendors and deposit the cash in a fictitious account. These frauds can be prevented by allowing payments to be made only to approved vendors and by carefully scrutinizing documentation supporting the acquisitions by authorized personnel before payments are made. In other misappropriation cases, the accounts payable clerk or other employee steals a check to a legitimate vendor. Documentation related to the purchase is then resubmitted for payment to the vendor. Such fraud can be prevented by canceling supporting documents to prevent their use as support for multiple payments.

Other Areas of Fraud Risk

Although some accounts are more susceptible than others, almost every account is subject to manipulation. Let's examine some other accounts with specific risks of fraudulent financial reporting or misappropriation.

Fixed Assets Fixed assets, a large balance sheet account for many companies, are often based on subjectively determined valuations. As a result, fixed assets may be a target for manipulation, especially for companies without material receivables or inventories. For example, companies may capitalize repairs or other operating expenses as fixed assets. Such frauds are relatively easy to detect if the auditor examines evidence supporting fixed asset additions. Nevertheless, prior cases of fraudulent financial reporting, such as WorldCom, have involved improper capitalization of assets.

Because of their value and salability, fixed assets are also targets for theft. This is especially true for fixed assets that are readily portable, such as laptop computers. To reduce the potential for theft, fixed assets should be physically protected whenever possible, engraved, or otherwise permanently labeled, and should be periodically inventoried.

Payroll Expenses Payroll is rarely a significant risk area for fraudulent financial reporting. However, companies may overstate inventories and net income by recording excess labor costs in inventory. Company employees are sometimes used to construct fixed assets. Excess labor cost may also be capitalized as fixed assets in these circumstances. Material fringe benefits, such as retirement benefits, are also subject to manipulation.

Payroll fraud involving misappropriation of assets is fairly common, but the amounts involved are often immaterial. The two most common areas of fraud are the creation of fictitious employees and overstatement of individual payroll hours. The existence of fictitious employees can usually be prevented by separation of the human resource and payroll functions. Overstatement of hours is typically prevented by use of time clocks or approval of payroll hours.

RESPONSIBILITIES WHEN FRAUD IS SUSPECTED

OBJECTIVE 11-7

Understand interview techniques and other activities after fraud is suspected.

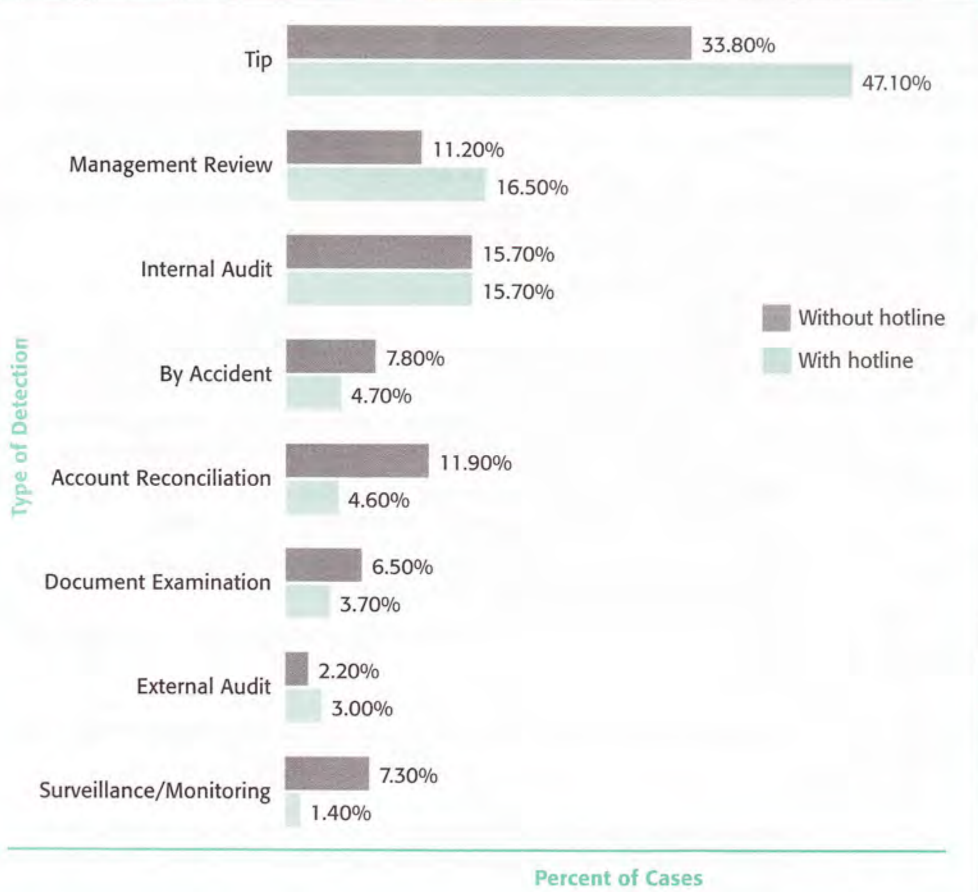
Frauds are often detected through the receipt of an anonymous tip, by management review, internal audit, or by accident. Figure 11-6 highlights the effectiveness of having a whistleblower hotline, with 47% of frauds being detected through a tip when a hotline is available versus 34% without. External auditors detect a relatively small percentage of frauds, but are more likely to detect when the fraud materially impacts the financial statements.

Responding to Misstatements That May Be the Result of Fraud

Throughout an audit, the auditor continually evaluates whether evidence gathered and other observations made indicate material misstatement due to fraud. All misstatements the auditor finds during the audit should be evaluated for any indication of fraud. When fraud is suspected, the auditor gathers additional information to determine whether fraud actually exists. Often, the auditor begins by making additional inquiries of management and others.

Use of Inquiry Inquiry can be an effective audit evidence gathering technique, as we discussed in Chapter 7. Interviewing allows the auditor to clarify unobservable issues and observe the respondent's verbal and nonverbal responses. Interviewing can also help identify issues omitted from documentation or confirmations. The auditor can also modify questions during the interview based on the interviewee's responses.

FIGURE 11-6 **Fraud Detection Methods for Companies With and Without Hotlines**



Source: Data from the *2010 Report to the Nation on Occupational Fraud and Abuse,* Association of Certified Fraud Examiners, 2010.

Inquiry as an audit evidence technique should be tailored to the purpose for which it is being used. Depending on the purpose, the auditor may ask different types of questions and change the tone of the interview. One or more of three categories of inquiry can be used, depending on the auditor's objectives.

Categories of Inquiry An auditor uses **informational inquiry** to obtain information about facts and details that the auditor does not have, usually about past or current events or processes. Auditors often use informational inquiry when gathering follow-up evidence about programs and controls or other evidence involving a misstatement or suspected fraud uncovered during the audit. Auditors can most effectively use informational inquiry by posing open-ended questions about details of events, processes, or circumstances.

An auditor uses **assessment inquiry** to corroborate or contradict prior information. The auditor often starts assessment inquiry with broad, open-ended questions that allow the interviewee to provide detailed responses that can later be followed up with more specific questions. One common use of assessment inquiry is to corroborate management responses to earlier inquiries by asking questions of other employees.

Interrogative inquiry is often used to determine if the individual is being deceptive or purposefully omitting disclosure of key knowledge of facts, events, or circumstances. Often, interrogative inquiry is confrontational, given that subjects may be defensive, as they cover up their knowledge of specific facts, events, or circumstances. When using interrogative inquiry, the auditor often asks specific directed questions that seek either a "yes" or "no" response. Interrogative interviewing should typically be done by senior members of the audit team who are experienced and knowledgeable about the client's affairs.

Evaluating Responses to Inquiry For inquiry to be effective, an auditor needs to be skilled at listening and evaluating responses to questions. Typically, the interviewee's initial response will omit useful information. Effective follow-up questions often lead to better information to assess whether fraud exists. Good listening techniques and observation of behavioral cues strengthen the auditor's inquiry techniques.

Listening Techniques It is critical for the auditor to use effective listening skills throughout the inquiry process. The auditor should stay attentive by maintaining

TABLE 11-6 Observing Verbal Cues During Inquiry

Verbal Cue Examples	Implications
Extensive use of modifiers, such as "generally," "usually," "often," "normally," etc.	Auditors should probe further to determine whether the use of the modifier indicates that there are exceptions to the processes or circumstances being examined.
Frequent rephrasing by the interviewee of the auditor's question.	Skilled auditors recognize that rephrasing often indicates that the interviewee is uncertain about his or her response or is attempting to stall for time.
Filler terms, such as "um," "well," "to tell you the truth," etc.	Auditors should be alert for filler terms, given that they often suggest that the interviewee is hesitant or unable to respond to the inquiry.
Forgetfulness and acknowledgments of nervousness, such as "I'm a bit nervous" or "I just can't remember."	When this continues to occur, auditors should be concerned about the possibility of deception.
Tolerant attitudes, such as "it depends on the circumstances," and overqualified responses, such as "to the best of my memory."	Dishonest people are often tolerant toward someone who may have committed fraud.
Reluctance to end an interview.	Someone who has been honest generally is ready to terminate an interview. Those trying to deceive may try to continue the inquiry process to convince the auditor that they are telling the truth.

Source: Based on "Association of Certified Fraud Examiners (ACFE) Fraud Manual," The Association of Certified Fraud Examiners, www.acfe.org. Reprinted by permission of The Association of Certified Fraud Examiners.

TABLE 11-7	Observing Nonverbal Cues During Inquiry
Nonverbal Cue Examples	**Implications**
Physical Barriers—Interviewees may • Block their mouth with their hands, pens, pencils, papers, etc. • Cross their arms or legs. • Use distracting noises, such as finger tapping or drumming. • Lean away from the auditor, usually toward the door or window, in an effort to create spatial distance.	When the interviewee feels uncomfortable with a specific inquiry, he or she may put up nonverbal barriers to try to keep the auditor at a comfortable distance.
Signs of Stress—Interviewees under stress may • Show signs of having a dry mouth. • Lick lips, swallow, or clear their throats frequently. • Fidget, tap their foot, or shake a leg. • Sweat or become flushed in the face. • Avoid eye contact.	In most people, lying will produce stress, which can manifest itself physically.

Source: Based on Sawyer's Internal Auditing, 5th Edition, copyright 2003.

eye contact, nodding in agreement, or demonstrating other signs of comprehension. Auditors should also attempt to avoid preconceived ideas about the information being provided. Good listeners also take advantage of silence to think about the information provided and to prioritize and review information heard.

Observing Behavioral Cues An auditor who is skilled in using inquiry evaluates verbal and nonverbal cues when listening to the interviewee. Verbal cues, such as those outlined in Table 11-6, may indicate the responder's nervousness, lack of knowledge, or even deceit. In addition to observing verbal cues, the use of inquiry allows the auditor to observe nonverbal behaviors. Expert investigators note that subjects who are uncomfortable providing a response to an inquiry often exhibit many of the nonverbal behaviors shown in Table 11-7.

Of course, not everyone who exhibits these behaviors is uncomfortable responding to the auditor's inquiry. The key is to identify when the individual's behavior begins to change from his or her normal behavior. Less-experienced auditors should be cautious when they start to observe unusual behaviors, and they should discuss their concerns with senior members of the audit team before doing anything in response to those behaviors.

Other Responsibilities When Fraud Is Suspected When the auditor suspects that fraud may be present, auditing standards require the auditor to obtain additional evidence to determine whether material fraud has occurred. Auditors often use inquiry, as previously discussed, as part of that information-gathering process.

Audit Software Analysis Auditors often use audit software such as ACL or IDEA to determine whether fraud may exist. For example, software tools can be used to search for fictitious revenue transactions by searching for duplicate sales invoice numbers or by reconciling databases of sales invoices to databases of shipping records, to ensure that all sales are supported by evidence of shipping. Similarly, these tools provide efficient searches for breaks in document sequences, which may indicate misstatements related to the completeness objective for liabilities and expense accounts. Auditors use audit software, including basic spreadsheet tools such as Excel, to sort transactions or account balances into subcategories for further audit testing. For example, an auditor may use spreadsheet options to sort transactions exceeding a certain size or consisting of other unusual characteristics such as non-standard account numbers or unusual dollar balances (for example, transactions with rounded dollar amounts may be unusual for certain industries).

Auditors also use basic spreadsheet tools, such as Excel, to perform analytical procedures at disaggregated levels. For example, sales can be sorted to disaggregate the data by location, by product type, and across time (monthly) for further analytical procedure analysis. Unusual trends not observable at the aggregate level may be detected when the data is analyzed in greater detail.

Expanded Substantive Testing Auditors may also expand other substantive procedures to address heightened risks of fraud. For example, when there is a risk that sales terms may have been altered to prematurely record revenues, the auditor may modify the accounts receivable confirmation requests to obtain more detailed responses from customers about specific terms of the transactions, such as payment, transfer of custody, and return policy terms. In some instances, the auditor may confirm individual transactions rather than entire account balances, particularly for large transactions recorded close to year-end.

Often the risk of fraud is high for accounts that are based on management's subjective estimation. To respond to heightened risks that management used inappropriate assumptions to estimate account balances, such as the allowance for inventory obsolescence, the auditor may use specialists to assist in evaluating the accuracy and reasonableness of key assumptions. For example, auditors may rely on inventory specialists to assess the obsolescence of electronic parts inventories and business valuation experts to assess the reasonableness of market value assumptions made for certain investments.

Other Audit Implications Auditing standards require the auditor to consider the implications for other aspects of the audit. For example, fraud involving the misappropriation of cash from a small petty cash fund normally is of little significance to the auditor, unless the matter involves higher-level management, which may indicate a more pervasive problem involving management's integrity. This may indicate to the auditor a need to re-evaluate the fraud risk assessment and the impact on the nature, timing, and extent of audit evidence.

When the auditor determines that fraud may be present, auditing standards require the auditor to discuss the matter and audit approach for further investigation with an appropriate level of management, even if the matter might be considered inconsequential. The appropriate level of management should be at least one level above those involved, as well as senior management and the audit committee. If the auditor believes that senior management may be involved in the fraud, the auditor should discuss the matter directly with the audit committee.

The discovery that fraud exists also has implications for the public company auditor's report on internal control over financial reporting. PCAOB Standard 5 states that fraud of any magnitude by senior management is at least a significant deficiency and may be a material weakness in internal control over financial reporting. This includes fraud by senior management that results in even immaterial misstatements. If the fraud by senior management is a material weakness, the auditor's report on internal control over financial reporting will contain an adverse opinion.

Sometimes, auditors identify risks of material misstatements due to fraud that have internal control implications. In some cases, the auditor's consideration of management's antifraud programs and controls identifies deficiencies that fail to mitigate these risks of fraud. The auditor must communicate those items to management and those charged with governance, such as the audit committee, if they are considered significant deficiencies or material weaknesses. When auditing the financial statements of a public company, the auditor should consider those deficiencies when auditing internal controls over financial reporting, as we described in Chapter 10.

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. As described in Chapter 5, such disclosure is prevented by the auditor's professional code of conduct and may violate legal obligations of confidentiality.

The results of the auditor's procedures may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the audit. Withdrawal may depend on management's integrity and the diligence and cooperation of management and the board of directors in investigating the potential fraud and taking appropriate action.

SUMMARY

This chapter examined the two types of fraud considered by auditors when auditing financial statements: fraudulent financial reporting and misappropriations of assets. Auditors are responsible for obtaining reasonable assurance that material misstatements are detected, whether due to errors or fraud. The chapter described the way auditors gather information to assess fraud risk in every audit and develop appropriate responses to identified fraud risks, after considering the effectiveness of management's antifraud programs and controls. Several illustrations of typical fraud techniques highlighted areas subject to greater fraud risk and provided examples of effective audit procedures to address those risk areas.

Once auditors suspect fraud, they gather additional evidence, often through inquiry, and are responsible for making certain communications about suspected or detected fraud to senior management and the audit committee. Auditors of large public companies must consider the implications of their fraud risk assessments, including any suspected fraud, when arriving at their opinion on the operating effectiveness of internal control over financial reporting.

ESSENTIAL TERMS

Assessment inquiry—inquiry to corroborate or contradict prior information obtained

Earnings management—deliberate actions taken by management to meet earnings objectives

Fraud risk factors—entity factors that increase the risk of fraud

Fraud triangle—represents the three conditions of fraud: incentives/pressures, opportunities, and attitudes/rationalization

Horizontal Analysis—analysis of percentage changes in financial statement numbers compared to the previous period

Income smoothing—form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings

Informational inquiry—inquiry to obtain information about facts and details the auditor does not have

Interrogative inquiry—inquiry used to determine if the interviewee is being deceptive or purposefully omitting disclosure of key knowledge of facts, events, or circumstances

Premature revenue recognition—recognition of revenue before accounting standards requirements for recording revenue have been met

Professional skepticism—an attitude of the auditor that neither assumes management is dishonest nor assumes unquestioned honesty

Vertical Analysis—analysis in which financial statement numbers are converted to percentages of a base; also called common-size financial statements

REVIEW QUESTIONS

11-1 (Objective 11-1) Define fraudulent financial reporting and give two examples that illustrate fraudulent financial reporting.

11-2 (Objective 11-1) Define misappropriation of assets and give two examples of misappropriation of assets.

11-3 (Objective 11-2) What are the three conditions of fraud often referred to as "the fraud triangle?"

11-4 (Objective 11-2) Give examples of risk factors for fraudulent financial reporting for each of the three fraud conditions: incentives/pressures, opportunities, and attitudes/rationalization.

11-5 (Objective 11-2) Give examples of risk factors for misappropriation of assets for each of the three fraud conditions: incentives/pressures, opportunities, and attitudes/rationalization.

11-6 (Objective 11-3) What sources are used by the auditor to gather information to assess fraud risks?

11-7 (Objective 11-3) What should the audit team consider in its planning discussion about fraud risks?

11-8 (Objective 11-3) Auditors are required to make inquiries of individuals in the company when gathering information to assess fraud risk. Identify those with whom the auditor must make inquiries.

11-9 (Objective 11-3) The two components of professional skepticism are a questioning mind and a critical assessment of the audit evidence. How do these components help an auditor distinguish an unintentional misstatement from an intentional (fraudulent) misstatement?

11-10 (Objective 11-4) Describe the purpose of corporate codes of conduct and identify three examples of items addressed in a typical code of conduct.

11-11 (Objective 11-4) Discuss the importance of the control environment, or "setting the tone at the top," in establishing a culture of honesty and integrity in a company.

11-12 (Objective 11-4) Distinguish management's responsibility from the audit committee's responsibility for designing and implementing antifraud programs and controls within a company.

11-13 (Objective 11-5) What are the three categories of auditor responses to fraud risks?

11-14 (Objective 11-5) What three auditor actions are required to address the potential for management override of controls?

11-15 (Objective 11-6) Describe the three main techniques used to manipulate revenue.

11-16 (Objective 11-6) You go through the drive-through window of a fast food restaurant and notice a sign that reads, "Your meal is free if we fail to give you a receipt." Why would the restaurant post this sign?

11-17 (Objective 11-7) Name the three categories of inquiry and describe the purpose of each when used by an auditor to obtain additional information about a suspected fraud.

11-18 (Objective 11-7) Identify three verbal and three nonverbal cues that may be observed when making inquiries of an individual who is being deceitful.

11-19 (Objective 11-7) You have identified a suspected fraud involving the company's controller. What must you do in response to this discovery? How might this discovery affect your report on internal control when auditing a public company?

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

11-20 (Objectives 11-2, 11-3) The following questions address fraud risk factors and the assessment of fraud risk.

a. Because of the risk of material misstatements due to fraud (fraud risk), an audit of financial statements in accordance with generally accepted auditing standards should be performed with an attitude of
   (1) professional skepticism.
   (2) independent integrity.
   (3) objective judgment.
   (4) impartial conservatism.

b. Which of the following characteristics is most likely to heighten an auditor's concern about the risk of material misstatements due to fraud in an entity's financial statements?
   (1) The entity's industry is experiencing declining customer demand.
   (2) Employees who handle cash receipts are not bonded.
   (3) Internal auditors have direct access to the board of directors and the entity's management.
   (4) The board of directors is active in overseeing the entity's financial reporting policies.

c. Which of the following circumstances is most likely to cause an auditor to increase the assessment of the risk of material misstatement of the financial statements due to fraud?

(1) Property and equipment are usually sold at a loss before being fully depreciated.
(2) Unusual discrepancies exist between the entity's records and confirmation replies.
(3) Monthly bank reconciliations usually include several in-transit items.
(4) Clerical errors are listed on a computer-generated exception report.

d. Which of the following statements reflects an auditor's responsibility for detecting fraud?
(1) An auditor is responsible for detecting employee errors and simple fraud, but not for discovering fraudulent acts involving employee collusion or management override.
(2) An auditor should plan the audit to detect fraud caused by departures from GAAP.
(3) An auditor is not responsible for detecting fraud unless the application of auditing standards would result in such detection.
(4) An auditor should design the audit to provide reasonable assurance of detecting errors and fraud that are material to the financial statements.

11-21 (Objective 11-5) The following questions concern the auditor's responses to the possibility of fraud.

a. When fraud risk factors are identified during an audit the auditor's documentation should include

	The Risk Factors Identified	The Auditor's Response to The Risk Factors Identified
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

b. If an independent audit leading to an opinion on financial statements causes the auditor to believe that a material misstatement due to fraud exists, the auditor should first
(1) request that management investigate to determine whether fraud has actually occurred.
(2) make the investigation necessary to determine whether fraud has actually occurred.
(3) consider the implications for other aspects of the audit and discuss the matter with the appropriate levels of management.
(4) consider whether fraud was the result of a failure by employees to comply with existing controls.

c. Which of the following is least likely to suggest to an auditor that the client's management may have overridden internal control?
(1) There are numerous delays in preparing timely internal financial reports.
(2) Management does not correct internal control weaknesses that it knows about.
(3) Differences are always disclosed on a computer exception report.
(4) There have been two new controllers this year.

11-22 (Objective 11-6) The following questions address fraud risks in specific audit areas and accounts.

a. Cash receipts from sales on account have been misappropriated. Which of the following acts will conceal this embezzlement and be least likely to be detected by the auditor?
(1) Understating the sales journal.
(2) Overstating the accounts receivable control account.
(3) Overstating the accounts receivable subsidiary records.
(4) Understating the cash receipts journal.

b. An auditor discovers that a client's accounts receivable turnover is substantially lower for the current year than for the prior year. This trend may indicate that
(1) the client recently tightened its credit-granting policies.
(2) employees have stolen inventory just before year-end.
(3) fictitious credit sales have been recorded during the year.
(4) an employee has been lapping receivables in both years.

c. Which of the following internal controls will best detect the theft of valuable items from an inventory that consists of hundreds of different items selling for $1 to $10 and a few items selling for hundreds of dollars?
   (1) Maintain a perpetual inventory of only the more valuable items, with frequent periodic verification of the validity of the perpetual inventory records.
   (2) Have an independent auditing firm examine and report on management's assertion about the design and operating effectiveness of the control activities relevant to inventory.
   (3) Have separate warehouse space for the more valuable items, with sequentially numbered tags.
   (4) Require an authorized officer's signature on all requisitions for the more valuable items.

DISCUSSION QUESTIONS AND PROBLEMS

11-23 (Objective 11-2) During audit planning, an auditor obtained the following information:

1. The company's controller works very hard, including evenings and weekends, and has not taken a vacation in two years.
2. The company's board of directors includes a majority of directors who are independent of management.
3. Assets and revenues are based on significant estimates that involve subjective judgments and uncertainties that are hard to corroborate.
4. The company is marginally able to meet exchange listing and debt covenant requirements.
5. The company's financial performance is threatened by a high degree of competition and market saturation.
6. New accounting pronouncements have resulted in explanatory paragraphs for consistency for the company and other firms in the industry.
7. The company has experienced low turnover in management and its internal audit function.
8. Significant operations are located and conducted across international borders in jurisdictions where differing business environments and cultures exist.
9. There are recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.

Required

a. Indicate whether the information indicates an increased risk for fraud.

b. If the information indicates an increased risk of fraud, indicate which fraud condition (incentives/pressures, opportunities, or attitudes/rationalization) is indicated.

11-24 (Objectives 11-1, 11-2, 11-3) Assessing the risk of fraud in a financial statement audit is a difficult audit judgment. Auditing standards require the auditor to perform several audit procedures to accumulate information to assess the risk of fraud. You are the in-charge auditor responsible for planning the financial statement audit of Spencer, Inc. Two new staff auditors are assisting you with the initial audit planning and have asked you the following questions.

Required

Briefly summarize your response to these staff auditor questions:

a. What is the purpose of the audit team's brainstorming session?

b. Who should attend the brainstorming session and when should the session be held?

c. What is the role of the two staff auditors in the brainstorming session?

d. What is the auditor's responsibility under auditing standards for detecting fraud?

11-25 (Objectives 11-2, 11-6) The Art Appreciation Society operates a museum for the benefit and enjoyment of the community.

When the museum is open to the public, two clerks who are positioned at the entrance collect a $5.00 admission fee from each nonmember patron. Members of the Art Appreciation Society are permitted to enter free of charge upon presentation of their membership cards.

At the end of each day, one of the clerks delivers the proceeds to the treasurer. The treasurer counts the cash in the presence of the clerk and places it in a safe. Each Friday afternoon, the treasurer and one of the clerks deliver all cash held in the safe to the bank and receive an authenticated deposit slip that provides the basis for the weekly entry in the accounting records.

The Art Appreciation Society board of directors has identified a need to improve its internal controls over cash admission fees. The board has determined that the cost of installing turnstiles, sales booths, or otherwise altering the physical layout of the museum will greatly exceed any benefits. However, the board has agreed that the sale of admission tickets must be an integral part of its improvement efforts.

Smith has been asked by the board of directors of the Art Appreciation Society to review the internal control over cash admission fees and provide suggestions for improvements.

Required

a. Indicate deficiencies in the existing internal controls over cash admission fees that Smith should identify, and recommend one improvement for each of the deficiencies identified. Organize the answer as indicated in the following illustrative example.*

Deficiencies	Recommendation
1. There is no basis for establishing the number of paying patrons.	1. Prenumbered admission tickets should be issued upon payment of the admission fee.

b. Indicate which of the deficiencies, if any, increase the likelihood of misappropriation of assets.

c. Indicate which of the deficiencies, if any, increase the likelihood of fraudulent financial reporting.

11-26 (Objectives 11-1, 11-2, 11-3, 11-4) The chapter vignette on page 370 highlights the fraud at Koss Corporation where the principal accounting officer, Sujata ("Sue") Sachdeva, embezzled approximately $31 million over 5 years to fund her lavish lifestyle. This was a material amount in relation to Koss Corporation's reported net income ($1,976,668 for 2009 and $4,494,289 for 2008). The fraud was not detected by the external auditors. Ms. Sachdeva used wire transfers from the company's account to her American Express account, cashier's checks, manual checks, and traveler's checks drawn on the company's account to fund her purchases. The embezzlement was concealed by overstating assets, expenses, and cost of sales and understating liabilities and sales, through the collusion of two employees in the accounting department. At the time Ms. Sachdeva was arrested, more than 22,000 items were confiscated from her home that had been purchased using Koss Corporation funds. Below are just a few examples taken from the court complaint filed against her of purchases Ms. Sachdeva made on her American Express charge card that was later paid for by wire-transferring money from Koss Corp. to American Express as payment:

1. $127,400 from A.C. Zuckennan Jewelers;
2. $670,000 from Au Courant, a women's clothing store;
3. $12,500 from Channel BTQ #16;
4. $14,000 from Georgio-Armani;
5. $40,000 from Holzman's Furs;
6. $255,000 from Karat 22 Jewelers;
7. $1,358,322 from Valentina Boutique, a women's clothing store.

Required

a. Is this fraud an example of asset misappropriation or fraudulent financial reporting?

b. Ms. Sachdeva came from a wealthy family, so the theft was not necessary for her to live comfortably. What incentive and attitude/rationalization do you believe drove Ms. Sachdeva to embezzle? Would there have been behavioral red flags that should have alerted auditors to the fraud?

c. Koss Corporation designs, manufactures, and sells stereo headphones and related accessories. Do you think it would be normal for a manufacturing company to have recurring disbursements to American Express or more than 100 cashier's checks written per year? How could auditors have used audit software to detect these disbursements?

d. What internal controls could Koss Corporation have had in place to prevent employee collusion in the first place or detect the fraud after it began?

e. Ms. Sachdeva avoided using wire transfers during the month of June because she knew this was the month the auditors would review the bank records. What could the auditors have done differently to detect the fraud?

f. Do you believe auditors should be held liable for not detecting fraud when management attempts to hide the fraud and there is employee collusion? Does it matter whether the amounts are material or immaterial to the financial statements?

11-27 (Objectives 11-1, 11-4, 11-6) The following misstatements are included in the accounting records of the Jasmine Manufacturing Company:

1. Several key-entry mistakes resulted in the exclusion of three invoices.
2. A customer complained when he received a bill, saying he has already paid. He produced a receipt, but there was no record of the payment in the books.
3. A shipment to a customer was not billed because of the loss of the bill of lading.
4. Merchandise was shipped to a customer, but no bill of lading was prepared. Because billings are prepared from bills of lading, the customer was not billed.
5. Commercial and residential customers are not differentiated on bills of lading.
6. Sales generated through the company's Web site are recorded at the point the customers submit the orders online.
7. A shipment of goods was recorded as being paid at the end of the year, but was recorded as unpaid at the beginning of the next year.
8. Several invoices were lost when the office moved to a new location.

Required

a. Identify whether each misstatement is an error or fraud.

b. For each misstatement, list one or more controls that should have prevented it from occurring on a continuing basis.

c. For each misstatement, identify evidence the auditor can use to uncover it.

11-28 (Objectives 11-2, 11-4, 11-6) Appliances Repair and Service Company bills all customers rather than collecting in cash when services are provided. All mail is opened by Tom Gyders, treasurer. Gyders, a CPA, is the most qualified person in the company who is in the office daily. Therefore, he can solve problems and respond to customers' needs quickly. Upon receipt of cash, he immediately prepares a listing of the cash and a duplicate deposit slip. Cash is deposited daily. Gyders uses the listing to enter the financial transactions in the computerized accounting records. He also contacts customers about uncollected accounts receivable. Because he is so knowledgeable about the business and each customer, he grants credit, authorizes all sales allowances, and charges off uncollectible accounts. The owner is extremely pleased with the efficiency of the company. He can run the business without spending much time there because of Gyders' effectiveness.

Imagine the owner's surprise when he discovers that Gyders has committed a major theft of the company's cash receipts. He did so by not recording sales, recording improper credits to recorded accounts receivable, and overstating receivables.

Required

a. Given that cash was prelisted, went only to the treasurer, and was deposited daily, what internal control deficiency permitted the fraud?

b. What are the benefits of a prelisting of cash? Who should prepare the prelisting and what duties should that person not perform?

c. Assume that an appropriate person, as discussed in part b., prepares a prelisting of cash. What is to prevent that person from taking the cash after it is prelisted but before it is deposited?

d. Who should deposit the cash, given your answer to part b.?

11-29 (Objectives 11-2, 11-4, 11-6) The Kowal Manufacturing Company employs about 50 production workers and has the following payroll procedures.

The factory foreman interviews applicants and on the basis of the interview either hires or rejects them. When applicants are hired, they prepare a W-4 form (Employee's

Withholding Exemption Certificate) and give it to the foreman. The foreman writes the hourly rate of pay for the new employee in the corner of the W-4 form and then gives the form to a payroll clerk as notice that the worker has been employed. The foreman verbally advises the payroll department of rate adjustments.

A supply of blank time cards is kept in a box near the time clock at the entrance to the factory. Each worker takes a time card on Monday morning, fills in his or her name, and punches the time clock upon their daily arrival and departure. At the end of the week, the workers drop the time cards in a box near the door to the factory.

On Monday morning, the completed time cards are taken from the box by a payroll clerk. One of the payroll clerks then enters the payroll transactions into the computer, which records all information for the payroll journal that was calculated by the clerk and automatically updates the employees' earnings records and general ledger. Employees are automatically removed from the payroll when they fail to turn in a time card.

The payroll checks that are not directly deposited into employees' bank accounts are manually signed by the chief accountant and given to the foreman. The foreman distributes the checks to the workers in the factory and arranges for the delivery of the checks to the workers who are absent. The payroll bank account is reconciled by the chief accountant, who also prepares the various quarterly and annual payroll tax reports.

Required

a. List the most important deficiency in internal control and state the misstatements that are likely to result from the deficiency.

b. For each deficiency that increases the likelihood of fraud, identify whether the likely fraud is misappropriation of assets or fraudulent financial reporting.*

11-30 (Objectives 11-2, 11-3, 11-4, 11-6) Fateen Shakran, store supervisor, is responsible for creating a summary of the store's transactions at the end of each day. He is also responsible for checking the register tape against the credit slips and cash in the register, and then depositing the money in the morning. Fateen recently took on a new role as head bookkeeper, when the former one retired. Fateen would occasionally change a transaction on the register and pocket the extra money. Now, he waits until the end of the year for the store manager to go on holiday break. He writes a check for himself in the amount of an invoice, then cancels the check originally written to pay for the invoice. He cashes the check for himself, and waits a few weeks before resubmitting the invoice. When the owner writes the second check, Fateen records this in the cash disbursements journal, and then deposits the check. He then files it with all other paid invoices. Fateen has been following this practice successfully for several years and feels confident that he has developed a foolproof method to earn some extra income.

Required

a. What is the auditor's responsibility for discovering this type of embezzlement?

b. What deficiencies exist in the client's internal control?

c. What evidence can the auditor use to uncover the fraud?

11-31 (Objectives 11-5, 11-6) The following are various potential frauds in the sales and collection cycle:

1. The company engaged in channel stuffing by shipping goods to customers that had not been ordered.
2. The allowance for doubtful accounts was understated because the company altered the aging of accounts receivable to reduce the number of days outstanding for delinquent receivables.
3. The accounts receivable clerk stole checks received in the mail and deposited them in an account that he controlled. He issued credit memos to the customers in the amount of the diverted cash receipts.
4. The company contacted a major customer and asked them to accept a major shipment of goods before year end. The customer was told that they could return the goods without penalty if they were unable to sell the goods.
5. A cashier stole cash receipts that had been recorded in the cash register.

6. The company recorded "bill-and-hold sales" at year-end. Although the invoices were recorded as sales before year-end, the goods were stored in the warehouse and shipped after year-end.
7. The company did not record credit memos for returns received in the last month of the year. The goods received were counted as part of the company's year-end physical inventory procedures.
8. A cashier stole cash receipts by failing to record the sales in the cash register.
9. The CFO recorded fictitious credit sales at the end of the year without recording the associated cost of sales and reduction in inventory.

Required

a. Indicate whether the fraud involves misappropriation of assets or fraudulent financial reporting.

b. For those frauds that involve misappropriation of assets, state a control that would be effective in preventing or detecting the misappropriation.

c. For those frauds that involve fraudulent financial reporting, state an audit procedure that would be effective in detecting the fraud.

11-32 (Objectives 11-6, 11-7) The following audit procedures are included in the audit program because of heightened risks of material misstatements due to fraud.

1. Use audit software to search cash disbursement master files for missing check numbers.
2. Search the accounts receivable master file for account balances with missing or unusual customer numbers (e.g., "99999").
3. Use audit software to create a list of all credits to the repair and maintenance expense account for follow-up testing.
4. Engage an actuarial specialist to examine management's assumptions about average length of employment and average life expectancy of retirees used in pension accounting decisions.
5. Send confirmations to customers for large sales transactions made in the fourth quarter of the year to obtain customer responses about terms related to the transfer of title and ability to return merchandise.
6. Use audit software to search purchase transactions to identify any with non-standard vendor numbers or with vendor names reflecting related parties.
7. Search sales databases for missing bill of lading numbers.
8. Use audit software to search for journal entries posted to the sales revenue account from a non-standard source (other than the daily sales journal).

Required

For each audit procedure:

a. Describe the type of fraud risk that is likely associated with the need for this audit procedure.

b. Identify the related accounts likely affected by the potential fraud misstatement.

c. Identify the related audit objective(s) that this procedure addresses.

CASE

11-33 (Objectives 11-2, 11-3, 11-4) Yosef, CPA, is engaged for the financial statement audit of Gilgamesh Goods, an online antiquities dealer. Gilgamesh Goods has been in business since 2005; however, this is the second time Yosef's firm has dealt with the company. Waseem, CPA, is Yosef's supervisor.

Yosef: Have you had a chance to look over my report for Gilgamesh yet?

Waseem: Yes, but I think that your worries about that supplier are unfounded.

Yosef: I tried mailing a confirmation of charges to the supplier, but I never heard back. There is an answering service for the phone system, but no one returns my call. And they always charge the same amount, but there is no record of the exact goods or services they provide.

Waseem: We noticed the same thing last year, too. But the owner, Saul, put a call through for us last year, and the supplier confirmed the amounts.

Yosef: I think it's a bit suspicious. The owner's salary is average enough, but the fact that no one gets bonuses is surprising.

Waseem: Maybe, but remember that this is a fairly new business. They've invested in the company.

Yosef: What about the fact that the company doesn't seem to have a permanent address?

Waseem: Well, it's possible that online companies might not need a permanent address.

Yosef: Still, I think that we need to bring up the issue with the auditing committee. They probably ran into similar issues when they were preparing the internal audit and reviewing statements.

Waseem: Before you start implying that you think the company is a fake, remember that Saul and the store manager are both on the committee. There might be five other people in the meetings, but Saul and the store manager have the most power in the group. They're the only ones who are closely checking the books.

Yosef: I think that if we present the material to the group, it might feel less confrontational. Also, we could ask for a meeting with the accountants of the other company, as well as a copy of the company's invoices. That way, we could be absolutely sure it's just a matter of a few discrepancies and misstatements.

Waseem: If you cause a stir, I'm sure Saul and the other committee members will agree to cooperate and get us the necessary information. But they might not choose our firm for next year's audit, and the company seems to be doing well. We want to keep our clients happy.

Yosef: I think the integrity of our company should be equally important, though. Besides, the employees of the company have a right to know if something is amiss at work.

Waseem: Business is booming right now, so the employees would probably be irritated that you're trying to frame their employer for fraud.

Yosef: I know, but if this continues, they're the ones who will end up hurt by any repercussions of the theft. Remember, they have stock and an interest in the company, too. I think they have a right to know of this, even if it ends up being nothing.

Required

a. Describe the fraud risk factors that are indicated in the dialogue above.

b. Describe Waseem's misconceptions regarding the consideration of fraud in the audit of Gilgamesh's financial statements that are contained in the preceding dialogue, and explain why each is a misconception.

c. Describe an auditor's audit documentation requirements regarding the assessment of the risk of material misstatement due to fraud.

INTEGRATED CASE APPLICATION — PINNACLE MANUFACTURING: PART IV

11-34 (Objectives 11-2, 11-3) In Parts I (pp. 263–265) and II (pp. 305–306) of this case you performed preliminary analytical procedures and assessed acceptable audit risk and inherent risk for Pinnacle Manufacturing. In Part III (pp. 350–352) of the case, you obtained an understanding of internal control and assessed control risk for acquisition and cash disbursement transactions.

The auditor also assesses fraud risk as part of risk assessment procedures performed during audit planning. You have been invited by the audit partner on the Pinnacle engagement to participate in the fraud brainstorming session conducted as part of audit planning. The purpose of Part IV is to identify fraud risks and the response to these fraud risks in the audit of Pinnacle Manufacturing.

Required

a. Use the fraud triangle and information from Parts I through III of this case to identify incentives/pressures, opportunities, and attitudes/rationalizations for Pinnacle to engage in fraudulent financial reporting.

b. Identify one or more fraud risks that you believe exist due to the nature of Pinnacle's industry. Indicate the accounts most likely to be affected by the identified fraud risks.

c. Auditors must generally identify a fraud risk for revenue recognition. Indicate at least two ways that Pinnacle might engage in revenue recognition fraud. Identify the specific nature of the potential fraud and an audit procedure that you would perform to determine whether fraud is occurring.

d. In Part I of this case you performed preliminary analytical procedures on Pinnacle's financial statements. Identify changes in account balances or ratios that you believe indicate the potential for fraud, and describe the nature of the potential fraud.

e. Part II of the case includes 11 situations that you encountered in audit planning. For each situation, describe whether it indicates a potential fraud risk. For each potential fraud risk, identify the related fraud risk triangle element(s).

ACL PROBLEM

11-35 (Objective 11-6) This problem requires the use of ACL software, which is included in the CD attached to the text. Information about installing and using ACL and solving this problem can be found in Appendix, pages 850–854. You should read all of the reference material preceding the instructions about "Quick Sort" before locating the appropriate command to answer questions a. through f. For this problem use the Metaphor_APTrans_2002 file in ACL_Demo. The suggested command or other source of information needed to solve the problem requirement is included at the end of each question.

Required

a. Total the Invoice Amount column for comparison to the general ledger. (Total Field)

b. Recalculate unit cost times quantity and identify any extension misstatements. (Filter)

c. Products that Metaphor purchases should not exceed $100 per unit. Print any purchases for subsequent follow-up where unit cost exceeded that amount. (Filter)

d. Identify the three vendors from which the largest total dollar accounts payable transactions occurred in 2002. (Summarize and Quick Sort)

e. For each of the three vendors in question d., list any transactions that exceeded $15,000 for subsequent follow-up. Include the vendor number, invoice number, and invoice amount. (Filter)

f. Vendor numbers 10134 and 13440 are related parties to Metaphor. Print any accounts payable transactions with those two vendors. (Filter) Also, determine the total amount of transactions with vendor 10134. (Total Field)

RESEARCH PROBLEM 11-1: GLOBAL FRAUD SURVEY

Companies and auditors now operate in a global environment and need to be aware of potential risks that stem from subsidiaries, business partners, and network firms located outside the U.S. In the past decade, we have witnessed increasing fraud around the world due to multiple factors. Using the Internet, search for PwC Global Economic Crime Survey 2011 and answer the following questions related to fraud around the world.

Required

a. What are the four most common types of fraud identified in the 2011 survey?

b. What percentage of organizations reported in the 2011 survey that they had experienced economic crime? Why has there been an increase in fraudulent activity since the last survey?

c. What is "cybercrime"? What can companies do to protect themselves from cybercrime?

d. What is "suspicious transaction monitoring," and how effective is it at detecting fraud?