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July 9, 2002

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Audit and Attest Standards, File 2691

The New York State Society of Certified Public Accountants, the nation's oldest state accounting association, represents approximately 30,000 CPAs whose audit and attest engagements are affected by the AICPA Auditing Standards Board's (ASB) interpretations and rulings. NYSSCPA thanks ASB for the opportunity to comment on its Exposure Draft on the **Proposed Statement on Auditing Standards,** ***Consideration of Fraud in a Financial Statement Audit.***

The NYSSCPA Accounting and Auditing Oversight Committee contributed to the attached comments, which were drafted by the Auditing Standards and Procedures Committee. If ASB would like additional discussion with the committee, please contact Auditing Standards and Procedures Committee Chair William M. Stocker III, at (212) 503-8800, or NYSSCPA Staff, Robert H. Colson, at (212) 719-8350.

Sincerely,

Jo Ann Golden
President

Attachment

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NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS ON

EXPOSURE DRAFT:

PROPOSED STATEMENT ON AUDITING STANDARDS

Consideration of Fraud in a Financial Statement Audit

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May 31, 2002

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NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
AUDITING STANDARDS AND PROCEDURES COMMITTEE'S COMMENTS

Exposure Draft – Proposed Statement on Auditing Standards
Consideration of Fraud in a Financial Statement Audit

May 31, 2002

General Comments

The exposure draft deals with one of the most important issues that the O'Malley Panel identified for auditors, the consideration of fraud in a financial statement audit. Much of the material in the exposure draft either reiterates the content of SAS 82 or provides more current assessments of what has been learned since SAS 82 about the incentives and opportunities that could lead to fraud in financial statements. The requirements for the audit team to more formally address fraud risk in the audit planning phase and for the auditor to inquire of management about its knowledge of fraud or its risk of occurrence are both extensions of audit standards consistent with the current literature. Some of the committee's general concerns about the content of the exposure draft, however, include the following:

- Much of the narrative of the exposure draft reflects the type of material that the committee would expect to find in a well-prepared audit guide rather than in audit standards.

- Financial statement auditors are generally not trained, and in many cases are not qualified, to detect fraud. Past attempts to develop audit standards for fraud detection have led to the development of check lists that an auditor completes and places in a file to document that fraud has been considered. The committee appreciates that much of the didactic narrative of the proposed standard, which we reference above as comparable to an audit guide, attempts to redress financial statement auditors general lack of preparedness to consider detecting fraud in financial statement audits. Is there a way of including in the audit standard a requirement to attain a level knowledge and continuing training about fraud detection?

- The concepts developed in paragraph 82 should be introduced much earlier in the proposed standard and referenced subsequently throughout the document as appropriate. Referencing the paragraph 82 concepts would be especially helpful as they relate to the discussion of skepticism.

- Emphasize that the rules of confidentiality do not apply to SEC registrants. The committee suggests language such as, " The rules of confidentiality apply, except as modified by the SEC."

- The proposed standard is not likely to prevent failures to detect fraud in financial statement audits unless documentation requirements are clearer. More extensive documentation requirements would result in more work, but it would provide a better benchmark for judging whether or not an auditor did a substandard audit.

- The proposed standards are not clear as to the auditors' responsibility to determine the applicability and extent of the audit risk factors discussed in par. 29 and 30 and in Appendix A. The standard should make clear that it is only necessary for the auditor to consider risk factors identified during the performance of other audit procedures (including other planning procedures) or of which he becomes otherwise aware. The auditor should not be expected to know or find out the information to be considered in the identification of risk factors. For example, the auditor should not be required to obtain information about net worth of directors its relation to their investments in the entity.

- Footnote 12 is a cross-reference concerning analytic procedures in planning discussed in ¶27 and final analytic procedures discussed in ¶69. This footnote link is a poor way to emphasize that analytical procedures should address fraud risk. In practice, even in non-fraud situations this important linkage, which is useful in detecting misstatements, is often overlooked.

- The effective date of the standard should be for audits of fiscal periods beginning after the adoption of the standard with early adoption permitted.

Specific Comments

P. 12 Summary, Commentator Guide, The Risk Assessment Approach, asks if the factors (in Appendix A) to be considered in subsequently determining whether risks, in fact exist are appropriate, and if not how the guidance can be improved.

Appendix A, *Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting, Incentives/Pressures,*

P.46 c. *"Management or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:"*

There is plentiful recent evidence that management and board members could act in their own self-interest when their personal net worth is threatened. The exposure draft could be improved by identifying specific procedures that an auditor could use in determining whether the holdings in the auditee company of a manager or director would threaten their net worth.

Appendix A, *Risk Factors Relating to Misstatements Arising From Misappropriation of Assets, Incentives/Pressures*

P. 49 a. *"Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.*

In general, except for small clients, this scenario is not realistic because an auditor would have to know when a member of management or an employee has personal financial obligations that create pressure to misappropriate assets?

Appendix A, *Risk Factors Relating to Misstatements Arising From Misappropriation of Assets, Opportunities*

P.49 b. *Inadequate internal control over assets…*

The following control weaknesses should be added to the bullet list:

Lack of computer system level audit journal event logging, lack of continuity and integrity of the logs, and lack of independent control and review of the logs.

P. 13, First paragraph, inquiry of the audit committee. Although not the audit committee, we believe that the following questions, which are relevant to the risk factors related to fraud, should be asked regarding the Board of Directors:

- Is the CEO also the Chair of the Board?
- Does the CEO control the Bard?
- Is there institutional ownership, and is it represented on the Board?
- Are there independent Board members?

The Emphasis on Professional Skepticism

Is the added requirement for the audit team to discuss the importance of maintaining an appropriate attitude regarding professional skepticism (¶14 and 16) appropriate and sufficient? If not how may this guidance be improved?

Professional skepticism is a tried and true concept that works best when conveyed through the tone at the top of the organization. In a standard on fraud it is important to discuss it. How it is handled in a team meeting depends on the importance placed on it by senior executives that set the tone at the top. The concept as depicted in the exposure draft should emphasize that fraud detection will not occur if checklist mentality dominates.

How may the commentary regarding the application of professional skepticism in the critical assessment of the competency and sufficiency of audit evidence ¶46) be improved

There should be an emphasis in this paragraph on the need to document observations, conclusions reached, and how procedures were altered to adjust for perceived risk.

OBTAINING THE INFORMATION

Risk Assessment Approach:

Is the approach understandable?

Yes.

How may this approach be improved?

¶18 through ¶66 describe many procedures that the auditor document in the working papers

¶82 discussion of documentation requirements forces the reader of the exposure draft to refer to ¶18 through ¶66, as well as others, to determine what to document and how, a process which is needlessly cumbersome. We recommend placing this paragraph before paragraph 18.

…proposed Statement provides guidance about factors to considered in subsequently determining whether risks, in fact exist. Are these factors appropriate? … how may..guidance be improved?

Factors are appropriate.

Guidance would be improved by reminding auditors to document observations about risk factors in writing.

Considering the Results of Analytical Procedures in Planning the Audit

P.25 ¶ 27. The exposure draft says that in planning the audit, the auditor should perform analytical procedures relating to revenue.

Why limit the guidance to revenue? If that is all the SAS recommends, then that is all auditors may do. The recommendation to perform analytical procedures should be extended to the accounts relevant to the entity's industry; for example loss reserves for banks and insurance companies, warranty expense and estimated product returns for product sales companies, etc.

P.25 ¶28. Lists some limitations of analytical procedures. The guidance also should require the auditor to recognize that the data used for analytical procedures during the planning stage is unaudited and may contain errors or have been intentionally manipulated to deceive the auditor. The guidance should require the auditor to gain a sufficient understand of the controls over the information used for the analytical procedures so that the auditor can recognize whether audit evidence developed from these procedures is credible.

The Classification of the Risk Factors

¶33 Is the guidance directing the auditor to consider these three conditions in the identification of the risks of material misstatement due to fraud appropriate?…how may..guidance be improved?

The auditor should gather and evaluate information concerning risk of financial misstatement due to fraud to be mindful of incentives/pressures; opportunity; and attitudes/rationalizations, since conditions may or may not be apparent. The auditor should be required to make a positive statement concerning whether conditions are or are not apparent.

Identification of Revenue Recognition as a Fraud Risk

¶ 36 Does the guidance provide the appropriate emphasis on the issue of revenue recognition?…how may.. guidance be improved?

The ED should make it clear that revenue recognition can frequently be subject to fraud risk, and that risk is heightened when management has the ability to override controls.

While revenue recognition is a frequent culprit for management override, there are other areas that could also be covered without making this Statement laborious.

In addition, the procedures addressing management overrides related to revenue recognition are detailed at ¶50 but cross-referenced from ¶36. The separation dilutes the reader's concentration, the subject's importance, and emphasis of the procedures.

Are the examples outlining possible auditing procedures in response to a risk of material misstatement due to fraud relating to revenue recognition (¶50) sufficient? Describe other examples… that should be included…?

The examples need to be expanded for revenue recognition and other high-risk areas. Revenue recognition procedures that should be included for example are:

- vouching transactions documents in detail at both year-end and interim periods(those that have balances remaining in ending balance sheet accounts and those that do not).

- detailed cash applications and review of receivable agings, including comparatives, and customer sales activity.
- reading contracts and agreements.
- procedures concerning affiliated entities, especially those that are or might be involved in revenue generating activities.

The Risk of Management Override of Controls

Is the overall approach to how the auditor is required to consider the risk of management override (¶10, ¶38, ¶44, ¶53, ¶54, and ¶55) appropriate and sufficiently reconcilable with the existing audit risk model?… how may it be improved?

The approach is appropriate and reconcilable to the audit risk model; however, the specific paragraphs should emphasize the auditor's need to document observations and conclusions regarding management overrides.

Is the threshold presumption regarding the applicability of the required procedures to consider the risk of management override of controls (¶53 through ¶55) appropriate, including distinction between public and nonpublic entities? If not, describe how this guidance should be modified?

For nonpublic entities, the threshold should require the auditor to conclude that procedures to address the risk of override are unnecessary by making a positive statement why they are unnecessary.

Are the specified procedures to be performed to further address the risk of management override of controls (¶56 through ¶66) appropriate?…sufficiently defined? … suggestions for additional required procedures?

The procedures are appropriate and sufficiently defined.

Should the auditor be required to inquire of the audit committee to obtain its views about the risk of fraud and whether it members have knowledge of any fraud or suspected fraud (¶20)?

Describe any circumstances, where such an inquiry is unnecessary or inappropriate. Describe any other matters that should be included in inquiries to audit committees about fraud?

The auditor should be required to inquire of audit committees. While there might conceivably be circumstances involving shareholder litigation that might make the inquiry difficult, there should be no circumstances where the auditor should not inquire of the audit committee.

Independence and unique relationships with affiliates, customers, suppliers, lenders and officers, shareholders, directors and audit committee members should be a routine part of the auditors inquiry of the audit committee, including transactions and dependencies therewith in both the ordinary course and otherwise.

RESPONDING TO THE RESULTS

Responses to Identified Risks Involving the Nature, Timing, and Extent of Procedures to be Performed

P. 30 ¶48 Discusses changes in the nature, timing, and extent of auditing procedures. The guidance should include a reminder to the auditor that when computer processing is pervasive, and a large portion of the records exist only in electronic form, and when the auditor relies on output from the computer system for other tests, the auditor may have to perform tests of general and applications controls as well as computer aided audit techniques (CAAT) otherwise audit evidence resulting from such tests may lack credibility and conclusions may be erroneous.

Responses to Further Address Risk of Management Override of Controls

P.36 ¶59 Discusses inappropriate or unauthorized journal entries and adjustments as well as examples of their characteristics. Other examples of characteristics that should be included in the SAS are entries made by unusual users, i.e. users that do not typically make journal entries, or entries made at unusual times such as late at night, on weekends, or holidays.

P.36 ¶60 Discusses controls that an entity may have implemented over the financial reporting process. In addition to the examples provided, the SAS should include the need for the auditor to understand the controls over financial statement report generation, for example, who can change report content, and the audit trail of such changes.

P.37 ¶62 Discusses inquiries of individuals involved in the financial reporting process. The SAS should include the recommendation to include inquiries of the client’s IT employees who may have been requested to assist in or concealing unauthorized activity.

Responding to misstatements that may be the result of fraud

P. 41 and 42 ¶76 Discusses what the auditor should do if he or she believes that a misstatements is, or may be the result of fraud, however the guidance does not require the auditor to document the facts and circumstances, nor his or her conclusion. At this point, if the auditor is convinced that fraud has occurred which is material to the financial statements, or is unable to evaluate whether the effect is material, the SAS should include the requirement to document a summary of the facts and circumstances of the fraud as well as the auditor's conclusion.

DOCUMENTING THE AUDITOR'S CONSIDERATION OF FRAUD

Are the documentation requirements(¶82) clear and appropriate? Do you believe they will add assurance regarding effective implementation of the proposed Statement in practice? Describe how….may be improved?

P. 44 ¶82. Discusses the items the auditor should document; however the SAS should also include documenting the results of the procedures. If the auditor believes that fraud has occurred or is suspect, the facts, evidence, and circumstances that indicate that fraud has occurred or is suspect should also be documented.

The documentation discussion seems somewhat thin for the nature of this SAS and its importance. There is no reinforcement of specific objectives, procedures, and conclusions laid out in the other paragraphs of this ED.

EFFECTIVE DATE

- P. 44 ¶83. The effective date is for audits of financial statements for periods beginning on or after December 15, 2002. This means for most audits these procedures will not be performed until 2004. Given the current criticism auditors are facing this implementation date may lead to further erosion of our credibility to self-regulate and further erosion of public confidence in audits and auditors. The effective date of the standard should be for audits of fiscal periods beginning after the adoption of the standard with early adoption permitted.