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OBSERVATIONS ON AUDITORS' IMPLEMENTATION OF PCAOB STANDARDS RELATING TO AUDITORS' RESPONSIBILITIES WITH RESPECT TO FRAUD

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This report focuses on aspects of the Board's interim auditing standards that address the auditor's responsibility with respect to fraud, principally AU § 316, *Consideration of Fraud in a Financial Statement Audit*.[1/] The Board is not, in this report, changing or proposing to change any existing standard, nor is the report meant to provide a new interpretation of any aspect of existing standards. The Board has, however, identified certain observations, made in the course of Board inspections, that are sufficiently important or arise with sufficient frequency to warrant discussion in a public report, both for the purpose of generally focusing auditors on being diligent about these matters and for the purpose of providing information that audit committees may find useful in working with auditors.[2/]

The auditor's responsibility with respect to the detection of a material misstatement caused by fraud is an important focus of the Board. The Board's standards state that the auditor has a responsibility to plan and perform the audit to

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[1/] On April 16, 2003, the Board adopted certain pre-existing auditing standards as its interim auditing standards to be used on an initial, transitional basis. PCAOB Rule 3200T describes the auditing standards that the Board adopted and requires registered public accounting firms and their associated persons to comply with these auditing standards to the extent not superseded or amended by the Board. See www.pcaobus.org/standards.

[2/] The inspection observations described in this report reflect information reported to the Board by its inspection staff and do not reflect or constitute any determinations by the Board as to whether any firms or persons have engaged in any conduct for which the Board could sanction them through the Board's disciplinary process.

obtain reasonable assurance about whether the financial statements are free of material misstatement, including misstatements caused by fraud.[3/] Although any financial statement audit entails some risk that the auditor will not detect a material misstatement even when the audit has been conducted in accordance with the standards of the PCAOB,[4/] the risk of nondetection is likely to be higher for misstatements caused by fraud than for misstatements caused by error, since fraud usually involves deliberate concealment and may involve collusion with third parties. The auditor should, therefore, assess risks and apply procedures directed specifically to the detection of a material, fraudulent misstatement of the financial statements.

Using observations from certain Board inspections as a focal point, this report discusses aspects of procedures relevant to an auditor's consideration of fraud.[5/] The discussion is organized around the following topics:[6/]

- Auditor's Overall Approach to the Detection of Financial Fraud
- Brainstorming Sessions and Fraud-Related Inquiries
- Auditor's Response to Fraud Risk Factors

3/ See paragraph .01 of AU § 316, *Consideration of Fraud in a Financial Statement Audit*.

4/ See AU § 316.12.

5/ Information received or prepared by the Board in connection with any inspection of a registered public accounting firm is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Act. Under the Board's Rule 4010, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such published report may identify the firm or firms to which any quality control criticisms in the report relate.

6/ This report's focus on certain topics should not be understood to suggest any relatively lesser degree of importance of topics that are not addressed. Topics are included in this report because of the nature and frequency of deficiencies that Board inspectors have observed concerning these points in certain of their inspections.

- Financial Statement Misstatements
- Risk of Management Override of Controls
- Other Areas to Improve Fraud Detection

Auditor's Overall Approach to the Detection of Financial Fraud

The auditor is to make various judgments about the nature, timing, and extent of tests to perform to address specifically identified risks of material misstatement due to fraud.[7/]

PCAOB inspection teams have observed, however, that auditors often document their consideration of fraud merely by checking off items on standard audit programs and checklists. PCAOB standards require additional documentation evidencing the actual performance of certain of the procedures outlined in those programs and checklists.[8/]

In addition, in audits performed by multi-person audit engagement teams, the lack of such additional documentation makes it difficult for senior members of the audit team to supervise engagement team members properly and to review the procedures performed with respect to the consideration of fraud. In certain instances involving such engagement teams, PCAOB inspection teams have observed that engagement teams' documentation did not contain any such additional evidence of the actual performance of the procedures, suggesting that there may not be sufficient involvement of senior members in supervising and reviewing the engagement team's application of the provisions of AU § 316.

In addition, PCAOB inspection teams have, in some cases, observed that auditors failed to expand audit procedures when addressing identified fraud risk factors. In those cases, it appeared that auditors might be performing the procedures required in AU § 316 mechanically, without using those procedures to develop insights on the risk

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7/ See AU § 316.52.

8/ See AU § 316.83 and paragraph 6 of PCAOB Auditing Standard No. 3, *Audit Documentation*.

of fraud or with a view toward identifying ways to modify the audit plan in order to address the risk. If used properly, firm programs and checklists can be useful tools for achieving the objectives of AU § 316. Mechanical implementation of the standard is unlikely to be very effective in detecting fraud.

Brainstorming Sessions and Fraud-Related Inquiries

The auditor's planning should include consideration of how the issuer's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how the issuer's assets could be misappropriated.[9/] In audits involving multi-person audit teams, the audit team should hold what the standard refers to as a "brainstorming session" to discuss those issues. This discussion allows the audit team to be alerted to how fraud might be perpetrated and concealed based on the general and client-specific knowledge of key members of the audit team and the expertise of the more experienced members of the team. This brainstorming session also reinforces the concept that the detection of a material misstatement in the financial statements caused by fraud is an essential element of an audit.

During this stage of planning the audit, AU § 316.15 states the auditor should set "aside any prior beliefs the audit team members may have that management is honest and has integrity." The emphasis at this stage is on the issuer's vulnerability to fraud, if management and employees were inclined to perpetrate it,[10/] and not solely on the likelihood that fraud has occurred. To be most effective, this stage of planning the audit, including an audit team's brainstorming discussion, should occur during the early stages of audit planning so that auditors can consider the issuer's vulnerability to fraud when developing an overall strategy for the expected scope and conduct of the audit. To most effectively identify fraud risk factors, an audit team's brainstorming session should involve key members of the audit team, including, for example, information technology ("IT"), tax, and other specialists, when they are key members of the audit engagement team.[11/]

9/ See AU § 316.14.

10/ See AU § 316.15.

11/ See AU § 316.17.

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Despite the importance of this planning stage to an effective audit, PCAOB inspection teams have noted instances of failures to comply with this aspect of the standard. In particular, PCAOB inspectors have (1) identified audits in which the audit team was unable to demonstrate that brainstorming sessions were held; (2) identified audits in which the audit teams' brainstorming sessions occurred after planning and after substantive fieldwork had begun; and (3) identified audits in which key members of the audit team did not attend the brainstorming sessions.

To appropriately discharge the auditor's responsibility with respect to the detection of a material misstatement caused by fraud, the auditor should make inquiries of the audit committee, management, and others about their knowledge of alleged or suspected fraud and fraud risks within the organization.[12/] In some engagements, however, inspection teams have found no evidence in the audit documentation that the auditor made required inquiries of the audit committee, management, or others about their knowledge of fraud and fraud risks.

Auditor's Response to Fraud Risk Factors

Auditors respond to the assessment of the risks of material misstatement due to fraud by using a combination of overall and specific responses.[13/] The auditor should evaluate whether the fraud risk assessment can be linked to individual accounts or classes of transactions and related assertions.[14/] Linking in this manner assists the auditor in designing the appropriate audit procedures.[15/] An overall response involves a general consideration of how the audit is to be conducted and involves procedures such as modifying the assignment of personnel and the extent of supervision and incorporating an element of unpredictability into the selection of auditing procedures to be performed.[16/] For specifically identified risks of material misstatement due to fraud, such as significant related-party transactions not in the ordinary course of business, the

[12/] See AU §§ 316.20-.27.

[13/] See AU § 316.48.

[14/] See AU § 316.38.

[15/] Ibid.

[16/] See AU § 316.50.

auditor generally responds by changing the nature, timing, and/or extent of auditing procedures.[17/]

PCAOB inspection teams have observed instances of auditors failing to respond appropriately to identified fraud risk factors. Inspection teams also observed instances in which auditors examined transactions warranting further fraud risk consideration, but for which there was no evidence that the auditors had considered any associated fraud risk factors.

Financial Statement Misstatements

When the auditor's procedures identify misstatements in the financial statements, the auditor should document the nature and effect of the misstatements[18/] and consider whether the misstatements might be indicative of fraud.[19/] The auditor's evaluation of misstatements may influence the auditor's conclusion about the materiality of those misstatements.[20/] Qualitative considerations related to indications of fraud may mean that misstatements of relatively small amounts are material.[21/] Although intent might be difficult to ascertain, that difficulty does not relieve the auditor of the responsibility to consider whether misstatements might be indicative of fraud.[22/] In addition, the auditor's ongoing assessment of the risk of material misstatement due to fraud should take into account, among other things, any last-minute adjustments significantly affecting financial results.[23/]

17/ See AU § 316.52.

18/ See paragraph .40 of AU § 312, *Audit Risk and Materiality in Conducting an Audit*.

19/ See AU § 316.75.

20/ Ibid.

21/ See AU §§ 316.74-.75.

22/ See AU §§ 316.05-.12.

23/ See AU § 316.68.

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PCAOB inspectors noted instances in which auditors failed to properly calculate planning materiality and/or the threshold for posting proposed audit adjustments to a summary schedule. As a result, certain uncorrected misstatements were not evaluated, or were not evaluated appropriately, both individually and in the aggregate, with other misstatements because the summary schedule was incomplete. The inspection teams also observed that some auditors did not fulfill their responsibility to investigate identified departures from generally accepted accounting principles to determine whether such departures were indicative of fraud.

In addition, PCAOB inspectors noted instances in which auditors did not post all proposed audit adjustments in excess of the posting threshold to the summary schedule, thus rendering the summary incomplete. Inspectors also noted instances in which auditors had netted the effects of known misstatements that individually met the posting threshold. The net effect of those particular misstatements was lower than the posting threshold for the summary of unadjusted differences. As a result, those misstatements were improperly excluded from the evaluation of potential misstatements. Furthermore, inspection teams observed that some auditors did not adequately scrutinize late adjustments, significantly affecting financial results, that were proposed by management and that partially or completely offset adjustments previously proposed by the auditors.

Risk of Management Override of Controls

AU § 316.08 recognizes that "[m]anagement has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and to present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively." To address the risk of management override of controls, AU § 316 requires an auditor to perform certain procedures, such as the examination of journal entries and other adjustments for evidence of possible material misstatements due to fraud [24/] and the review of accounting estimates for biases that similarly could result in material misstatements due to fraud.[25/]

[24/] See AU § 316.58.

[25/] See AU § 316.63.

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PCAOB inspection teams noted instances in which it did not appear that the auditor had performed adequate procedures with respect to evaluating the risk of management override of controls. More specifically, in some instances it did not appear that the auditor had appropriately addressed the risk of management override of controls with respect to journal entries and accounting estimates.

Journal Entries

Management has often used journal entries to perpetrate or conceal fraudulent financial reporting by recording inappropriate or unauthorized amounts in the accounting records, including computer records, or by making adjustments directly to draft financial statements in post-closing or consolidating entries. Accordingly, auditors should understand the company's financial reporting process and the controls over journal entries and evaluate these areas.[26/]

To identify, select, and test specific entries and other adjustments and to determine the appropriate method of examining the underlying support for these entries, auditors should consider several important issues, for example:

- Fraud risk factors that might help identify specific classes of journal entries for testing, such as entries made by unauthorized personnel or personnel who do not ordinarily enter journal entries, or entries that lack detailed explanations or other supporting documentation,

- The characteristics of fraudulent entries, including entries made at unusual times, such as nights, weekends, or holidays, and entries made to intercompany or suspense accounts, and

- Nonstandard journal entries that might not be subjected to the same level of internal control as recurring journal entries, for instance, entries at the close of quarterly and annual reporting periods and those that are part of the post-closing process.[27/]

[26/] See AU § 316.58a.

[27/] See AU § 316.61.

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PCAOB inspection teams identified certain audit engagements in which auditors performed tests of journal entries, but failed to demonstrate that they had appropriately assessed the completeness and integrity of the population of journal entries obtained from the issuer. The inspection teams also noted instances in which there was no evidence in the audit documentation, and no persuasive other evidence, that an appropriate examination and evaluation of journal entries was performed. In addition, inspection teams noted the exclusion of journal entries with lower dollar amounts from the examination. Setting the scope in such a manner fails to appropriately address the risk of fraud occurring as a result of the frequent use of low-dollar entries.

In reviewing journal entries, auditors should obtain an understanding of the financial reporting process related to the initiation, recording, and processing of journal entries;[28/] the procedures used to record recurring and nonrecurring adjustments; and the controls over journal entries and similar adjustments. Auditors might need to use IT specialists and computer-assisted audit techniques to assist them in this process to ensure the integrity and completeness of the population of journal entries and to assist in the selection of journal entries for testing.[29/]

Accounting Estimates

Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates.[30/] Financial frauds have been committed by management intentionally biasing assumptions and judgments used to estimate account balances. In certain cases, management also has used significant or unusual accounting estimates to intentionally distort results of operations by, for example, failing to recognize losses due to the impairment of assets or intentionally overstating estimates in one period so that the estimates can be reversed in future periods to manage earnings in those periods. Such accounting estimates include allowances for bad debts, accruals for merger-related expenses in connection with business combinations, and so-called restructuring reserves.

28/ See AU §§ 316.58-.59 and .61.

29/ See AU § 316.61.

30/ See AU § 316.63.

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Auditors, in complying with AU § 316, should consider the possibility of management bias in developing estimates by considering whether the differences between the estimates best supported by the audit evidence and the estimates included in the financial statements indicate a possible management bias.[31/] For example, if each individual accounting estimate included in the financial statements was reasonable and, at the same time, the effect of the difference between each management estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.[32/] Moreover, auditors should perform a retrospective review of significant accounting estimates reflected in the prior year's financial statements to determine whether management's judgments and assumptions relating to estimates indicate a possible bias on the part of management.[33/] If the auditor identifies a possible bias, he or she should evaluate whether the circumstances producing such a bias represent a risk of material misstatement due to fraud.[34/]

PCAOB inspection teams observed that some auditors have failed to test, or failed to document their testing of, management's assumptions and other aspects of issuers' accounting estimates. The inspection teams also noted that some auditors failed to assess, or failed to include in their audit documentation evidence that they had assessed, whether the overstatement or understatement of accounting estimates indicated a bias in management's estimates that could result in material misstatements due to fraud.

Other Areas to Improve Fraud Detection

Improvement in auditors' performance in the areas described below also may better position auditors to detect possible misstatements due to fraud.[35/]

[31/] Ibid.

[32/] See AU § 312.36.

[33/] See AU § 316.64.

[34/] See AU § 316.65.

[35/] Each of the areas described in this section has significant relevance to aspects of an audit other than an auditor's responsibilities with respect to fraud. The

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Analytical Procedures

Although analytical procedures alone are not well-suited for detecting fraud,[36/] they can be an effective diagnostic tool, depending on the reliability of the data used to develop the expected results. For example, auditors can use analytical procedures on information that management is less able or less likely to manipulate, such as operating statistics maintained by operating personnel or audited information.

PCAOB inspection teams have noted numerous deficiencies in auditors' performance of analytical procedures that were intended to be substantive analytical procedures. These deficiencies include the failure to test the underlying data used in the analytical procedures as well as the failure to disaggregate the data in order to improve the precision of the analytical procedures when such disaggregation was appropriate. In addition, inspection teams noted that, when the analytical procedures were intended to be substantive tests, some auditors failed to establish expectations, establish thresholds for identifying significant differences, or investigate differences from the expectations that were greater than the established thresholds. Moreover, some auditors failed to obtain corroboration of management's explanations for differences in excess of the established thresholds.

Confirmation Process

AU § 316.41 states that auditors ordinarily should presume that revenue recognition is a fraud risk, thus requiring the auditor to respond with appropriate audit procedures. Numerous financial frauds have been perpetrated by management through premature or fictitious revenue recognition schemes.

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discussion of any inspection observations in this section should not be understood to mean that any observed deficiencies in these areas have been addressed with the particular firm specifically in relation to detection of fraud. These matters are included in this report because appropriate attention to these areas may play a role in helping the auditor detect material misstatements caused by fraud.

[36/] See paragraph .09 of AU § 329, *Analytical Procedures*, as amended by the *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements."*

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The recognition of fictitious revenue often results in complementary false and uncollectible receivables. Historically, one of the most widely used substantive tests for determining the existence of receivables and similar assets and, perhaps, for detecting revenue-related fraud as a result, has been direct communication by the auditor with the issuer's customers and others. That audit procedure is based on the premise that audit evidence obtained from third parties will provide the auditor with higher quality audit evidence than is typically available from within the entity.[37/]

PCAOB auditing standards permit the use of either positive or negative confirmation requests.[38/] With positive confirmation requests, audit evidence is obtained when the auditor receives completed confirmations from the issuer's customers or other intended recipients[39/] or, in the absence of such responses, when the auditor performs alternative procedures, such as the examination of shipping documents and cash receipts.[40/] (Recipients of negative confirmations are requested to respond only if they disagree with the stated information.) The interim auditing standards caution auditors to use negative confirmations only when certain conditions are present, one of which is that the combined assessed level of inherent and control risk is low.[41/] When auditors do not request confirmation of accounts receivable or do not receive responses to positive confirmation requests, they should apply alternative procedures to obtain the evidence necessary to reduce audit risk to an acceptably low level.

PCAOB inspection teams have identified instances in which auditors who had not requested confirmations of account balances or had not received responses to positive confirmation requests either failed to obtain, or failed to include evidence in their audit documentation that they had obtained, sufficient other evidence regarding the existence of accounts receivable balances.

37/ See paragraph .34 of AU § 330, *The Confirmation Process*.

38/ See AU § 330.17.

39/ See AU § 330.18.

40/ See AU §§ 330.31-.32.

41/ See AU § 330.20.

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Roll-Forward of Interim Substantive Testing

Auditors usually perform some of their audit work as of an interim date. Interim audit procedures may include confirmation of accounts receivable and observation of physical inventories. PCAOB auditing standards allow auditors to apply substantive tests to the details of asset or liability accounts as of an interim date if additional substantive tests can be designed to cover the remaining period to provide a reasonable basis for extending the audit conclusions at the interim date to the balance sheet date.[42/]

Interim audit work creates a somewhat higher risk that the auditor will not detect fraud because management may record fraudulent transactions in this roll-forward period, believing that the auditors will be less likely to detect them. The auditing standards caution auditors that such interim audit procedures potentially increase the risk that misstatements that exist at the balance sheet date will not be detected by the auditor. Furthermore, audit risk tends to increase as the period from the interim date to the balance-sheet date is lengthened.[43/]

Therefore, in determining audit procedures to be performed from the interim date to the balance-sheet date, auditors should consider the following factors: the length of the period between the interim and balance-sheet dates; any changes in controls; the nature and volume of transactions during this period; the comparability of the items comprising the account balance at the interim and balance-sheet dates; and any misstatements detected as a result of the interim procedures.[44/]

PCAOB inspection teams have observed that some auditors failed to perform, or failed to include evidence in their audit documentation that they had performed, adequate substantive roll-forward procedures to cover the activity from the interim date to the balance sheet date.

42/ See paragraph .03 of AU § 313, *Substantive Tests Prior to the Balance Sheet Date*.

43/ Ibid.

44/ See AU §§ 313.04-.07.

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Review of Interim Financial Information

Financial frauds, including revenue and expense recognition schemes, often originate with the manipulation of quarterly earnings. The SEC requires the auditor to review the issuer's interim financial information before the company files its quarterly report on Form 10-Q or Form 10-QSB with the SEC for each of the first three quarters of the company's fiscal year. In addition, certain issuers, pursuant to item 302(a) of Regulation S-K, are required to include selected quarterly financial data in their annual (and certain other) filings with the SEC. Thus, a review of a company's interim financial information is required for the fourth quarter for those issuers, even though the company does not file a report on Form 10-Q or Form 10-QSB for that quarter. PCAOB inspection teams observed, in some instances, that auditors had failed to perform, or failed to include evidence in their audit documentation that they had performed, sufficient procedures with respect to the review of fourth-quarter financial information for those issuers that were required to disclose selected quarterly financial data.

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The particular inspection observations described in this report gave rise to quality control concerns that were communicated to the firms at which the deficiencies were identified. By law, those quality control criticisms are not made public with respect to any particular firm if the firm addresses the criticism to the Board's satisfaction within 12 months after the issuance of the inspection report on the firm.[45/] No later than the conclusion of this 12-month period, a firm that seeks to keep such criticisms nonpublic must provide the Board with explanation and evidence, which the Board evaluates, concerning how the firm has addressed the criticisms.[46/] To date, the Board's initial experience with the remediation process has been very positive;[47/] the Board will continue to monitor the firms' progress in this important area.

[45/] See Section 104(g)(2) of the Sarbanes-Oxley Act of 2002.

[46/] See generally, PCAOB Release 104-2006-077 (March 21, 2006), *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms In Inspection Reports*.

[47/] See PCAOB Release 104-2006-078 (March 21, 2006), *Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms Within 12 Months After An Inspection Report*.