

## **FRAUD AND ERROR – WHY, WHAT AND HOW?**

### **1. How would you define fraud?**

Fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

### **2. What is the difference between fraud and error?**

The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. Error refers to an unintentional misstatement in the financial statements, including the omission of an amount or disclosure.

### **3. Why is fraud important to us?**

Misstatements in the financial statements can arise from fraud or error. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

We should consider the risk of misstatement from fraud or error of each significant account balance, recognizing the material classes of transactions included therein, in order to identify specific risk.

In addition, if a material misstatement is found due to the possibility of fraud, it may cause us to question management's integrity and the reliability of evidence obtained from management in other areas of the audit.

### **4. What is the difference between management and employee fraud?**

Management fraud involves one or more members of management or those charged with governance.

Those charged with governance - "Governance" is the term used to describe the role of persons entrusted with the supervision, control, and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions. <IAA>

Employee fraud involves only employees of the entity.

Fraud may also involve third parties outside the entity through collusion by management, those charged with governance or employees.

5. We are concerned with two types of misstatements in our consideration of fraud – misstatements resulting from fraudulent financial reporting and those arising from misappropriation of assets.

#### **a. What do we mean by fraudulent financial reporting?**

Fraudulent financial reporting involves intentional misstatements, or omissions of amounts or disclosures in financial statements to deceive financial statement users.

**b. How can fraudulent financial reporting be accomplished?**

Fraudulent financial reporting may be accomplished through:

- i. Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- ii. Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information.
- iii. Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

**c. What is asset misappropriation?**

Misappropriation of assets involves the theft of an entity's assets.

**d. How can the misappropriation of assets be accomplished?**

Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received). It is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

**6. Fraud involves the motivation to commit fraud and a perceived opportunity to do so**

**– what do we mean by this?**

Individuals might be motivated to misappropriate assets, for example, because the individuals are living beyond their means.

Fraudulent financial reporting may be committed because management is under pressure, from sources outside and inside the entity, to achieve an expected (and perhaps unrealistic) earnings target – particularly since the consequences to management of failing to meet financial goals can be significant.

A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

**7. Why is fraud easily missed or not detected by us?**

An audit does not guarantee that all material misstatements will be detected due to the inherent limitation of an audit. Therefore, we can obtain only reasonable assurance that material misstatements in the financial statements will be detected.

The risk of not detecting a material misstatement due to fraud is higher than that of not detecting misstatements resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority involved.

The risk of not detecting management fraud is greater than that of not detecting employee fraud, because management and those charged with governance are often in a position that assumes their integrity and enables them to override the formally established control procedures.

## **CLASSIC EXAMPLES OF FRAUD**

It is important to study both past and current frauds so we can learn how they occurred and what to look for on our engagements. Below are some classic examples of how fraud was perpetrated.

### **The Great Salad Oil Swindle<sup>1</sup>**

In the early 1950's, the United States ("U.S") had a surplus of vegetable and other edible oils; therefore, they created a program whereby the U.S. government would provide subsidies to exporters of these oils. Tino De Angelis formed the Allied Crude Vegetable Oil Co. ("Allied") to participate in the program and export vegetable oil. Five years after it was established, Allied held 75% of the export market for vegetable oil and had sales of approximately \$200 million.

Allied began to have some problems towards the end of the 1950's, including:

- a Charges were brought against Allied for \$1.5 million in tax evasion and using false shipping documents to extract money from the U.S. government. Allied was temporarily removed from the U.S. program, and was reinstated upon a government review and payment of damages.
- b The U.S. Congress complained about the delivery of a sub-standard product by Allied worth \$70 million.
- c The company was banned from doing business with certain institutions.

Although aware of these problems, American Express invested in Allied.

The company operations consisted of borrowing funds to purchase salad oil and then using the oil as collateral for the financing. The salad oil was taken to the American Express warehouse subsidiary, or another warehousing company, where the oil was stored. The warehouse issued receipts confirming they had the oil. The oil was then sold and exported overseas. What the lenders did not know was that the storage tanks were actually filled mainly with seawater with just enough oil on top to fool everyone. The warehouse staff relied on Allied to help in checking the oil inventory, so whenever the tanks were checked, Allied would pump oil from one tank to another.

The scandal was brought to light in 1963. Allied was unable to fulfill a major contract with its current stock, therefore they purchased futures. However, problems arose when Allied lost money on the futures and was unable to pay its lenders. He had caused \$120 million to disappear. De Angelis was sentenced to seven years in prison.

<sup>1</sup> Based upon information published in "A Blast from the Past", by Schon G. Condon, *Revive* (Issue No. 12 February 1998 and Issue No. 13 May 1998); "Salad Oil Scandal Still Smells", by Albert S. Frank, LL.B., *The Bottom Line* (May 2001 Issue); and "High and Mighty Crooked", by Peter Carlson, *Washington Post* (February 10, 2002; page F01).

### *Warning Signs*

- a American Express received complaints from creditors about Allied.
- b American Express received anonymous messages about Allied's accounting and operations. American Express sent out investigators to follow up on these messages; however, most of the investigators spoke with De Angelis, or staff members he directed them to.
- c An American Express inspector found discrepancies between the paperwork and inventory.
- d A funding exporter sent an inspector to Allied who conducted spot checks and found a shortage. The only action taken was to require American Express warehouse receipts for any oil pledged as collateral.
- e The American Bureau of Statistics reported that the tonnage of edible oils handled by Allied was greater than the entire edible oil production of the U.S.

### *Lessons Learned*

- a If you are to confirm the existence or ownership of an asset, ensure the verification is done independently of the client.
- b Take the warning signs seriously and investigate them promptly.
- c Investigate discrepancies.
- d Just because a company is profitable and successful does not mean there is not a possibility of fraud.

### **The South Sea Bubble<sup>2</sup>**

The South Sea Company ("the Company"), founded in 1711, was given a monopoly of all English trade with Spain's colonies in the West Indies and South America, in exchange for assuming a portion (£9 million) of the government's public debt at a 6% interest rate. Holders of the public debt were then required to exchange their government securities for shares in the Company. Investors accepted the shares with hopes that the Company's ships would return with valuable goods at the end of the War of the Spanish Succession, resulting in unimaginable profits to the shareholders.

To raise working capital, the Company borrowed against the security of debt due from the government. In 1713, the War ended with a treaty that favored England, but not to the extent expected. The English government announced that it had been given trading rights to four ports in South America, however the King of Spain informed everyone that he was only willing to let one ship in each year. The first voyage of that ship did not take place until 1717.

With the war between England and Spain, which began in 1718, trade was stopped. In 1719, the directors of the Company proposed to assume the entire government debt, £31 million. The proposal was accepted in April 1720. The debt was to be converted voluntarily to Company shares with a fee from the Company of £7.5 million for the privilege of making the conversion.

Speculators believed that there were future prospects in trading with Spain. The Company used this to its benefit to raise cash through the issue of share subscriptions and allowed investors the

option of paying in installments. Then the Company announced that its cash position was so strong that they could lend investors the money needed to purchase Company shares and use the shares as security. The directors also got involved by buying shares when the price was low and then selling as the price increased. The Company continued the circle, thereby driving up its share price, cash, and raising the cash needed to pay the conversion charge.

On January 1, 1720 the share price was at £128, climbed to £380 by the end of March, £520 by May 29<sup>th</sup>, and then peaked at £1050<sup>3</sup> on June 24. As the credibility of the Company declined and there were rumors of people selling Company shares, slowly the share price began to fall – it was at £135 by the end of September. Many went bankrupt; investors were angry; and the government formed a committee to investigate the Company. The investigation found widespread corruption and fraud among the directors, company officials, and their friends in government. The corruption and fraud found were bribes to government officials and embezzlement by the directors. Unfortunately by this time, some had fled and escaped prosecution while those who remained were investigated and some estates were confiscated.

### *Lessons Learned*

- a Be skeptical. Does it make sense that a company could be profitable when it had one year of activity and Spain was allowing only one ship per year into South America?
- b As with MiniScribe Corp, we see that the share price increased significantly over a short
- c period of time. We should ask questions and investigate further when there are rapid
- d changes in profits, revenues, and cash or share prices.
- e We must remain independent and objective, even if the government, public, or media are supportive of the organization or venture.
- f<sup>3</sup> To provide a perspective on how much this was, a middle-class family could live very comfortably at the time on £200 per year.

<sup>2</sup> Based upon information published in “The South Sea Bubble: A Short Sketch of Events”, found on the website of *The Bubble Project*, coordinated by David McNeil, Dalhousie University (October 11, 1996); “The Damn’d South Sea”, by Christopher Reed, *Harvard Magazine* (May – June 1999 Issue); and “The South Sea Bubble”, found on the website of the *History House Magazine*, which is based on Charles MacKay’s book, *Extraordinary Popular Delusions and the Madness of Crowds*, Crown, 1841.

## FRAUD RISK FACTORS

### Fraud Risk Factors Present at Miniscribe

<i><b>Fraud Risk Factor</b></i>	<i><b>Case Information Indicating Risk</b></i>
<p>Management's compensation is represented by bonuses and stock options, the value of which is contingent on the entity achieving specific targets.</p>	<p>Bonuses depended on MiniScribe meeting financial targets. Management was also provided with incentive stock options related to performance. Financial results were the sole determinant of whether bonuses were awarded.</p>
<p>Management commits to achieving what appear to be aggressive forecasts.</p>	<p>Wiles forecasted 1998 sales at \$660 million, an 82% increase over 1987 sales of \$362 million.</p>
<p>Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.</p>	<p>Wiles had a reputation as someone who expected performance. He showed he was in control by firing people and criticizing them in front of their peers.</p> <p>One director was concerned over MiniScribe's financial results, but there is no info if others were.</p>
<p>Management sets aggressive financial targets and expectations for operating personnel.</p>	<p>Wiles told employees the numbers they wanted to hit each quarter, and they came very close to achieving them.</p>
<p>There is a high turnover of management, counsel, or board members.</p>	<p>In this case, there was some turnover of management. However, there was a lot of change and reorganization with employees holding several positions within the company.</p>

<b><i>Fraud Risk Factor</i></b>	<b><i>Case Information Indicating Risk</i></b>
There is a strained relationship between management and the current auditor, including: z Frequent disputes on accounting, auditing or reporting matters. z Unreasonable demands on auditor. z Domineering management behavior in dealing with auditor, especially in attempts to influence the scope of work.	Relations between Coopers and MiniScribe were becoming tense, especially before a bond offering. Executives were putting pressure on auditors to boost revenue. Wiles became upset when Coopers raised issues of what was a sale. When Coopers proposed a \$1.48 million adjustment to reduce earnings, MiniScribe executives went above the engagement partner with offsetting adjustments just two days before the deadline.
A declining industry with increasing business failures and significant declines in customer demand.	MiniScribe lost its biggest customer. Disk drive sales began to fall in the industry. While others in the industry were laying off employees, MiniScribe was reporting record-breaking earnings.
Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.	MiniScribe manufactured computer disk drives, which could become obsolete very quickly.
Inability to generate cash flows from operations while reporting earnings and earnings growth.	MiniScribe reported positive earnings from 1986 to 1988, yet was fully extended on their revolving credit with Bank of America. A report to the Board indicated MiniScribe's cash flows were negative, yet they reported earnings on the fourth quarter financials.
Unusually high dependence on debt.	MiniScribe was fully extended on its \$35 million revolving credit and could not get further credit from the Bank. Then they were given \$90 million in credit from SCB.

#### **Fraud Risk Factors Present at Allfirst**

<b><i>Fraud Risk Factor</i></b>	<b><i>Case Information Indicating Risk</i></b>
Management's compensation is represented by bonuses, stock options or other incentives, the value of which is contingent on the entity	Senior employees received compensation based on the bank's profitability. In addition, Rusnak received an annual bonus

<b><i>Fraud Risk Factor</i></b>	<b><i>Case Information Indicating Risk</i></b>
achieving specific targets.	that was directly related to his net trading profits.
Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.	<p>AIB chose to allow the subsidiary to manage independently by Allfirst having its own management team and board of directors, with minority representation from AIB.</p> <p>Cronin reported to the CEO, who did not have experience with the treasury operations, instead of the CFO who could better monitor the treasury operations.</p>
Management does not monitor significant controls adequately.	<p>Cronin relied on Ray to monitor Rusnak's activities, yet Ray did not focus significant attention on Rusnak's trading.</p> <p>The credit exception report indicated that Rusnak exceeded the foreign exchange credit line, yet there was no follow-up on the overage.</p> <p>There was no supervision to ensure that the employee responsible for independently checking the calculation of the VaR.</p>
Management fails to correct known material weaknesses in internal control on a timely basis.	<p>The risk assessment analyst discovered that independent prices were not being used in July 2000; however, the problem was not corrected until October 2001.</p> <p>Back office complained of the lack of confirmations on Rusnak's transactions several times over 3 years. Rusnak's activities were temporarily suspended, but the lack of the confirmations was not investigated until 2001, which resulted in Allfirst discovering the fraud.</p>
Management continues to employ ineffective accounting, information technology, or internal auditing staff.	Internal auditors devoted to treasury operations had little background or training in trading activities. The manager of these auditors appeared to have little trading expertise and done little to supervise the auditors.

<b><i>Fraud Risk Factor</i></b>	<b><i>Case Information Indicating Risk</i></b>
	Also, the treasury risk control employee devoted to measuring trading risk in the foreign exchange portfolio was inexperienced and provided with little support or supervision.
The corporate governance structure is weak or ineffective, which may be evidenced by little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.	The SEC raised a concern regarding the cash flow related to foreign exchange activity. Allfirst deferred investigation of the concern to the upcoming treasury audit (and above we see they were not effective). Allfirst's 10-K filings showed the level of foreign exchange activity and a manager commented on it, yet there was no investigation.
Significant, unusual, or highly complex transactions.	Rusnak dealt in foreign exchange trading, an area where his supervisor, Ray, had limited experience. Transactions were also significant as noted by a manager - \$1 billion in activity with 100 transactions a day.

## **AUDITOR RESPONSIBILITIES RELATED TO FRAUD AND ERROR**

### **Engagement Team Discussion**

#### **Who should lead these discussions? Who should participate in the discussions? How should these discussions be held?**

In developing our audit plan, the auditor should discuss with the engagement team the susceptibility of the entity to fraud or error resulting in the financial statements not being fairly presented, in all material respects.

These discussions are ordinarily held with each member of the team as a group or on an individual basis. The discussions may take place either in person or using teleconference or videoconference facilities.

#### **What should be discussed? Provide examples.**

Such discussions would involve considering errors that may be more likely to occur, how fraud might be perpetrated within particular account balances or specific identified risks that we identified and documented during the planning phase of the audit. The partner should consider discussing which members of the audit team will conduct certain inquiries or audit procedures, and how the results of those inquiries and procedures will be shared.

**Why should we hold such a meeting? What are the benefits?**

The benefit of discussions include the engagement team members gaining a better understanding of the potential for material misstatements in the financial statements resulting from fraud or error in the audit of the potential errors and account balances assigned to them, and how the results of the audit procedures that they perform may affect other aspects of the audit.

**When should we hold this meeting?**

This meeting should be held prior to commencing fieldwork. We may wish to hold this meeting after discussions with management on their assessment of the entity's risk of misstatement and our assessment of engagement risk, as these may contribute to the meeting.

**If we are conducting a multi-location audit, where or how should this meeting be held?**

The auditor of a large multi-location audit may delegate to another audit partner, who has responsibility for the audit in other locations, the discussions with members of the engagement team in that other location, where it is impractical to hold discussions directly between the auditor and the staff members in the other location. In the event that the partner delegates these discussions, the auditor holds appropriate discussions with the other audit partner to whom they have delegated the responsibility.

**Are there any barriers to hold such meetings? How do we overcome these barriers?**

Barriers may include

- a Small engagement, therefore a planning meeting has not been held in the past.
- b Commitment to other clients making it difficult to schedule the planning meeting.
- c Planning of the engagement is not done until the commencement of fieldwork.
- d Tight deadlines.
- e Tight budget.

These barriers may be overcome by:

- a Planning ahead.
- b Scheduling the meeting with sufficient notice.

**Inquiries of Management****What should we ask management? Provide examples.**

We should obtain an understanding of:

The control environment sufficient to assess the overall attitude, awareness, and actions of the directors and management regarding internal control and its importance to the entity.

Management's assessment of the risk that fraud may cause a significant account balance to contain a material misstatement and the accounting and internal control systems management has put in place to address such risk.

Management's understanding regarding the accounting and internal control systems in place to prevent and detect error.

Matters that might be discussed when making these inquiries of management include:

- a whether there are particular branches or locations, business segments, types of transactions, account balances or financial statement categories where the likelihood of error may be greater, or where fraud risk factors may exist, and how they are being addressed by management.
- b whether the entity's internal audit function has identified any fraud or any serious weaknesses in the system of internal control.
- c how management communicates to employees its view on responsible business practices and ethical behavior (e.g., ethics policies, or codes of conduct).

We should inquire of management as to any significant error that has been discovered and whether management is aware of any known fraud that has affected the entity or suspected fraud that the entity is investigating.

### **Why should we make these inquiries of management?**

This understanding will enable us to determine the appropriateness of relying on control activities for a portion of our overall audit assurance.

The control environment is influenced by the attitude of management and management's commitment to systems of control and other processes. Management's commitment to reliable financial reporting can be more thoroughly understood by obtaining an understanding of management's knowledge of the internal control systems and other processes operating in the business. As management is responsible for the entity's accounting and internal control systems and for the preparation of the financial statements, it is appropriate for us to inquire of management as to how it is discharging these responsibilities.

When gaining an understanding of management's commitment to design and maintenance of reliable accounting processes we consider the informed judgments on the nature and extent of the control procedures management chose to implement, and the nature and extent of the risks management is willing to accept. As a result we may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties.

When we inquire of management as to any significant error that has been discovered and whether management is aware of any known or alleged fraud that has affected the entity or suspected fraud that the entity is investigating, we consider whether any errors or frauds discovered or being investigated are factors that may increase the risk of misstatement.

### **When should these inquiries be made?**

Inquiries with management should be made during the planning of the engagement. We may wish to conduct these inquiries prior to completing our assessment of engagement risk, as it will assist us in considering the risk areas of the engagement. We may also wish to make these inquiries prior to our engagement planning meeting to discuss the entity's susceptibility to fraud and error.

### **Who should conduct these inquiries?**

We should likely assign this responsibility to a more senior member of the engagement team, such as the field senior or manager.

### **How do we complete these inquiries if management is reluctant to have these**

## **discussions with us?**

We should inform management the reasons for the discussion and point out how it may benefit them. For example, when asking management about the controls in place to prevent fraud and error, they may find that they don't have adequate controls to minimize the risk. If we find that management is unwilling to cooperate, we may wish to discuss this matter with those charged with governance.

## **Discussions with Those Charged with Governance**

### **What is the role of those charged with governance?**

Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control, and compliance with the law. In entities where corporate governance practices are well developed, those charged with governance play an active role in oversight of how management has discharged its responsibilities.

Since the responsibilities of those charged with governance and management may vary by entity, it is important that we understand the nature of these responsibilities within an entity to ensure that the inquiries and communications described above are directed to the appropriate individuals.

### **What should we discuss with those charged with governance? Provide examples.**

We are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management.

In addition, following the inquiries of management we may consider whether there are any matters of governance interest to be discussed with those charged with governance of the entity. Such matters may include:

- Concerns about the nature, extent, and frequency of management's assessments of the accounting and control systems in place to prevent and detect fraud and error, and of the risk that the financial statements may be misstated.
- A failure by management to address appropriately material weaknesses in internal control identified during the prior period's audit.
- Our evaluation of the entity's control environment, including questions regarding management competence and integrity.
- The effect of any matters, such as those above, on the general approach and overall scope of the audit, including additional procedures we may need to perform.

### **Why should we hold such discussions with them?**

Such inquiries may provide insights regarding the susceptibility of the entity to management fraud. This discussion may also provide those charged with governance with the opportunity to bring matters of concern to our attention.

### **Who should conduct these discussions?**

Discussions about matters that would interest those charged with governance should likely be led

by the auditor.

**How do we conduct these discussions if there is no oversight board?**

We consider who the relevant persons charged with governance are in each case. Considerations include the cultural and legal environment in which the entity operates, the organizational structure (including group relationships). If the entity's governance structure is not well defined, or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, we agree with the entity as to whom audit matters of governance interest are to be communicated.

**Assessment of Misstatements as Potential Indicators of Fraud**

**What do we do if circumstances indicate that there may be material misstatements?**

**Provide examples of such circumstances.**

If the results of our tests of controls indicate the existence of fraud or error, we should consider the potential effect on the financial statements. If we believe the indicated fraud or error could have a material effect on the financial statements, we should perform appropriate modified or additional procedures.

We should identify any known and likely misstatements arising from fraud or error and consider the potential effect on the financial statements. If we believe the indicated fraud or error could have a material effect on the financial statements, we should perform appropriate modified or additional procedures.

We should evaluate the results of our substantive analytical procedures to conclude whether we have achieved our desired level of assurance relative to the account balance and related potential error being tested. We should identify known and likely misstatements arising from fraud and error and consider the potential effects on the financial statements. If we believe that the indicated fraud or error could have a material effect on the financial statements, we should perform appropriate modified or additional procedures.

Examples of circumstances are included in ISA 240 – Appendix 3, Examples of Circumstances that Indicate the Possibility of Fraud or Error.

When the auditor encounters such circumstances, the nature, timing, and extent of the procedures to be performed depends on the auditor's judgment as to the type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial statements. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial statements are materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor's report.

We should consider the possible impact on our report and consult within the firm to determine the appropriate course of action in the following circumstances:

- Where suspicion of fraud or error is not dispelled by the results of modified or additional procedures, and/or the matter(s) has not been properly reflected or corrected in the financial statements.
- Where noncompliance with relevant laws and regulations has a material effect on the financial statements, and has not been properly reflected therein.

### **If we identify a misstatement, what should be considered?**

We should consider whether any misstatement we have identified may be indicative of fraud.

If the auditor has determined that a misstatement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organizational position of the person or persons involved. For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material misstatement due to fraud. This is because both the manner of operating the fund, and its size, tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem. In such circumstances, the auditor reconsiders the reliability of evidence previously obtained, since there may be doubts about the completeness and truthfulness of representations made about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management, or third parties when reconsidering the reliability of evidence. If management, particularly at the highest level, is involved in fraud, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements.

### **Why do we complete this assessment?**

The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, considers whether the assessment of the components of audit risk made during planning of the audit may need to be revised and whether the nature, timing and extent of the auditor's other procedures may need to be reconsidered. For example, the auditor considers:

- the nature, timing and extent of substantive procedures;
- the assessment of the effectiveness of internal controls if control risk was assessed below high; and
- the assignment of audit team members that may be appropriate in the circumstances.
- We also consider the implications of fraud and significant error in relation to other aspects of the audit, particularly the reliability of management representations.

### **Who should complete this assessment?**

When a misstatement is detected, all members of the engagement team have a responsibility to consider whether the misstatement is indicative of fraud. Assistants on the engagement should consult with the engagement field senior, or manager, when evaluating if misstatements indicate fraud.

If we believe the indicated fraud or error could have a material effect on the financial statements, we should perform appropriate modified or additional procedures. The field senior, in consultation with the manager, should determine what additional or modified procedures should be completed. All members of the engagement team are then responsible for ensuring these procedures are carried out.

### **When should this assessment be completed?**

We should evaluate the results of our test of controls prior to performing substantive procedures. This way we are able to incorporate the results of our test of controls into our planned substantive procedures and modify them as necessary.

We should consider the effect of misstatements on the financial statements and if they indicate fraud as the misstatements are detected. We should not wait until the completion of the engagement to evaluate the misstatements, as it may be inefficient to do this if we had needed to revise our planned procedures.

### **Management Representations**

#### **What management representations should be obtained, specifically in relation to fraud and error?**

We should obtain specific written representations from management:

- On management's acknowledgement of its responsibility for the implementation and operations of accounting and internal control systems that are designed to prevent and detect fraud and error.
- On management's belief that the effects of those uncorrected financial statement misstatements aggregated during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
- On the completeness of information provided regarding all significant facts relating to any frauds, alleged frauds, or suspected frauds known to management that may have affected the entity. Where appropriate, the management representation may include details of each fraud, or suspected fraud, management has identified and has communicated to us.
- On the completeness of information provided regarding the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

#### **Why do we obtain such representations?**

We obtain these representations because:

- Management is responsible for the financial statements and systems designed to prevent and detect fraud and error.
- Management is responsible for adjusting the financial statements to correct material misstatements. We seek agreement from management that the misstatements aggregated by us during the audit are in fact misstatements. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements, are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items...and...constitute misstatements because [*description of reasons*]."
- The nature of fraud, and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, may preclude us from detecting fraud.

**What should be included in the summary included with the representation letter? Be specific on what types of misstatements should be in the summary, how we go about completing the summary, where we obtain the information from, and who should prepare the summary.**

The management representation on the uncorrected misstatements should include a list of the uncorrected misstatements to evidence the misstatements that management has considered and assessed as being immaterial.

We should use the Evaluation of Misstatements Workbook to determine which misstatements to include in the summary. The summary should include:

- All likely and known uncorrected misstatements detected by us during the current year.
- Known misstatements detected in the prior year that were not corrected in the prior year and have been carried forward to the current year.

Individual known and likely uncorrected misstatements less than two percent of pretax monetary precision need not be aggregated for the Evaluation of Misstatements, nor the summary included with the management representation letter. The auditor may determine that a de minimis threshold less than two percent of pretax monetary precision is appropriate. This de minimis threshold should not exceed two percent of pretax monetary precision. The misstatements that fall below the determined threshold should be evaluated for qualitative considerations. If it is determined that the misstatement is qualitatively material, even though it is quantitatively below the threshold, the misstatement should be accumulated for the Evaluation of Misstatements. All misstatements detected (including those below the threshold) should be brought to management's attention and the disposition of such items documented in our working papers.

The field senior or manager on the engagement should likely prepare the summary to be included with the management representation letter. It is not appropriate to simply attach a copy of our Evaluation of Misstatements to the management representation letter, as this is an internal document. The most effective form of communication may be a three-column presentation of condensed financial statements showing (1) as reported, (2) the uncorrected misstatements by financial statement line item, and (3) as if the misstatements were corrected. An explanation of the misstatements should also be provided to facilitate in understanding the nature of such items.

### **Communication with Clients**

#### **What should we communicate with respect to fraud and error?**

We should discuss any misstatements resulting from fraud (whether or not material to the financial statements) that we detect with the client at a level of management that is consistent with the nature and significance of the fraud.

We consider the need to report such matters to those charged with governance if fraud or significant error is found to exist, or we suspect that fraud may exist, even if the potential effect on the financial statements would be immaterial.

We should discuss any material misstatement resulting from error we detect with the appropriate level of management on a timely basis, and consider the need to communicate corrected material misstatements resulting from error with those charged with governance. Corrected material

misstatements are misstatements that would not have been detected except through the audit procedures performed, that management has made corrections in the financial statements.

The discussions with management consider correction of the error, the reasons for the misstatement and the potential impact on our audit.

We should communicate to those charged with governance any uncorrected misstatements identified during the course of our audit, resulting from fraud or error that management has determined to be immaterial, to the financial statements taken as a whole. The communication may be in the form of a report, a letter, or a presentation to a meeting of those charged with governance. Uncorrected misstatements are communicated individually and in the aggregate. A limit may be set below which individual misstatements need not be communicated to those charged with governance.

If we become aware of any audit matters of governance interest in the course of the audit of financial statements, we communicate with those charged with governance of an entity on a timely basis.

In addition, we should communicate the factual findings to the appropriate levels of management as soon as possible, and consider the need to report such matters to those charged with governance, if:

- We suspect that fraud may exist, even if the potential effect on the financial statements would be immaterial, or
- Fraud or significant error is actually found to exist.

We communicate, on a timely basis, any significant findings or observations that we consider audit matters of governance interest to those charged with governance. Audit matters of governance interest are findings or observations from our audit of financial statements that are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process.

Audit matters of governance interest may include such matters as:

- matters Our audit plan, including any expected limitations thereon (e.g., scope limitations), or any additional requirements.
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements.
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements.
- Audit adjustments, whether or not recorded by the entity that have, or could have, a significant effect on the entity's financial statements.
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report.
- Expected modifications to the auditor's report.

- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.
- Any other agreed upon in the terms of the audit engagement.

The determination of which matters are to be communicated to those charged with governance is a matter of professional judgment, and is also affected by any understanding with those charged with governance as to which matters are to be communicated. Ordinarily, such matters include:

- Questions regarding management competence and integrity.
- Fraud involving management.
- Other fraud that results in a material misstatement of the financial statements.
- Material misstatements resulting from error.
- Misstatements that indicate material weaknesses in internal control, including the design or operation of the entity's financial reporting process.
- Misstatements that may cause future financial statements to be materially misstated.

#### **Who should we communicate this to and how do we determine the appropriate level?**

The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, magnitude, and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement or suspected fraud.

The determination of the appropriate level of management is affected by the likelihood of collusion or the involvement of a member of management.

We consider who the relevant persons charged with governance are in each case. Considerations include the cultural and legal environment in which the entity operates, the organizational structure (including group relationships). If the entity's governance structure is not well defined, or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, we agree with the entity as to whom audit matters of governance interest are to be communicated.

We should consider whether there are regulatory or enforcement authorities to whom we need to report any fraud, error, or suspected fraud. <IAA 26.15i> We consider whether there are regulatory or enforcement authorities to whom we need to report any relevant findings from our audit. The requirements to report to regulators and enforcement authorities will differ from country to country.

#### **When should this communication be completed?**

Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take action as necessary.

#### **Why do we communicate these items?**

We communicate these items with management and those charged with governance because:

- Management and those charged with governance are interested in the results of our audit, in particular in receiving an unqualified audit opinion.
- Management and those charged with governance may take action on these items.
- Communication of these items will assist us in minimizing the risk and exposure to the firm.

**Who should do the communication?**

The auditor should conduct the discussions with those charged with governance.

Depending on the nature of the misstatements, the manager or partner should discuss the misstatements with management.