

Consideration of Fraud in a Financial Statement Audit

Supersedes Statement on Auditing Standards No. 82, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 316); and amends SAS No. 1, Codification of Auditing Standards and Procedures (AICPA, Professional Standards, vol. 1, AU sec. 230, “Due Professional Care in the Performance of Work,” and SAS No. 85, Management Representations (AICPA, Professional Standards, vol. 1, AU sec. 333).

Introduction and Overview

1. Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02, “Responsibilities and Functions of the Independent Auditor”), states, “The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. [footnote omitted]”¹ This Statement establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).²

2. The following is an overview of the organization and content of this statement:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs 5 through 12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph 13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity’s financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs 14 through 18.)

1. The auditor’s consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). For those illegal acts that are defined in that Statement as having a direct and material effect on the determination of financial statement amounts, the auditor’s responsibility to detect misstatements resulting from such illegal acts is the same as that for errors (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]), or fraud.

2. Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Chapter 1, “Attest Engagements,” of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), as amended, and the Statement on Standards for Consulting Services, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by

- a. Inquiring of management and others within the entity about the risks of fraud. (See paragraphs 20 through 27.)
 - b. Considering the results of the analytical procedures performed in planning the audit. (See paragraphs 28 through 30.)
 - c. Considering fraud risk factors. (See paragraphs 31 through 33, and the Appendix, “Examples of Fraud Risk Factors.”)
 - d. Considering certain other information. (See paragraph 34.)
- ***Identifying risks that may result in a material misstatement due to fraud.*** This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs 35 through 42.)
 - ***Assessing the identified risks after taking into account an evaluation of the entity’s programs and controls.*** This section requires the auditor to evaluate the entity’s programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)
 - ***Responding to the results of the assessment.*** This section emphasizes that the auditor’s response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. (See paragraph 46 through 49.) The section requires the auditor to respond to the results of the risk assessment in three ways:
 - a. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned. (See paragraph 50.)
 - b. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed. (See paragraphs 51 through 56.)
 - c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls. (See paragraphs 57 through 67.)
 - ***Evaluating audit evidence.*** This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs 68 through 74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs 75 through 78.)
 - ***Communicating about fraud to management, the audit committee, and others.*** This section provides guidance regarding the auditor’s communications about fraud to management, the audit committee, and others. (See paragraphs 79 through 82.)
 - ***Documenting the auditor’s consideration of fraud.*** This section describes related documentation requirements. (See paragraph 83.)

3. The requirements and guidance set forth in this Statement are intended to be integrated into an overall audit process, in a logical manner that is consistent with the requirements and guidance provided in other Statements on Auditing Standards, including SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311); SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312); and SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended. Even though some requirements and guidance set forth in this Statement are presented in a manner that suggests a sequential audit process, auditing in fact involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly the sequence of the requirements and guidance in this Statement may be implemented differently among audit engagements.

4. Although this Statement focuses on the auditor's consideration of fraud in an audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud.³ That responsibility is described in SAS No. 1 (AU sec. 110.03), which states, "Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements." Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee, board of trustees, board of directors, or the owner in owner-managed entities), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

Description and Characteristics of Fraud

5. Fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. For purposes of the Statement, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.⁴

3. In its October 1987 report, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, noted, "The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management, starting with the chief executive officer, sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start with the reporting company."

4. Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether the misstatement is intentional or not.