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Ms. Sherry Boothe  
Audit and Attest Standards, File 2691  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, New York 10036-8775

### ***Consideration of Fraud in a Financial Statement Audit Exposure Draft***

Dear Ms. Boothe:

On behalf of the Association of Government Accountants (AGA), the Financial Management Standards Board (FMSB) appreciates the opportunity to provide comments on the AICPA Auditing Standards Board's (Board's) Exposure Draft (ED) of a proposed Statement on Auditing Standards (SAS), *Consideration of Fraud in a Financial Statement Audit*.

The FMSB not only believes that this ED is a significant improvement over the existing guidance in SAS No. 82, similarly entitled *Consideration of Fraud in a Financial Statement Audit*, but it also fully supports the Board's broader long-term program to address the growing concerns about fraudulent financial reporting. In addition, the FMSB agrees that the Board's proposed implementation process, including the development of appropriate continuing education material, is vital to the success of this project. The FMSB's two general comments and recommendations and 11 specific comments and recommendations regarding the ED are presented on the following pages. However, our comments and recommendations do not necessarily represent positions of individual FMSB members or the organizations they represent.

The FMSB, comprised of 21 members with accounting and auditing backgrounds in federal, state, and local government, academia, and public accounting, reviews and responds to proposed standards and regulations of interest to AGA members. Local AGA chapters and individual members are encouraged to comment separately.

#### **General Comments and Recommendations**

1. The ED is clear that the Board's intent is that auditors are only responsible for finding fraud that has a *material* effect on the financial statements, and that the Board is applying a



quantitative definition of materiality. The FMSB believes it would be helpful if the ED also contained clarifying guidance on the auditor's responsibilities to detect fraud that is *immaterial* in a quantitative sense (e.g., William Aramony's defrauding the United Way of America a decade ago), but nevertheless is adverse to the viability and future of the entity (e.g., reduced credibility and contributions). Because materiality in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, is not defined quantitatively, the FMSB recommends that the Board expand the guidance in the final SAS to include such circumstances. We believe that the guidance should be that auditors (1) are not expected to design audits to detect monetarily insignificant frauds that might cause considerable damage to an entity due to adverse publicity and (2) are not responsible for detecting such fraud.

2. Although this ED significantly expands the practical guidance for auditors, some FMSB members are concerned that certain issues may not be appropriately developed and/or emphasized. First, given the recent events within the profession, more detailed fraud guidance related to debt obligations, relationships with debt of related entities, and guarantees of the indebtedness of other entities could be very beneficial to the auditor. Second, because this ED proposes no change to the standard language in the independent auditor's report, users of that report may not be aware of the auditor's heightened emphasis on the consideration of fraud and auditors themselves may not fully appreciate the significance of the changes. For these reasons, the FMSB recommends that the Board ensure that these and any other relevant issues are appropriately considered for inclusion in the final SAS.

### **Specific Comments and Recommendations**

1. Paragraphs 5 through 12, on Pages 18-21, describe fraud and its characteristics. Because an important purpose of this ED is to provide the criteria to be used in judging whether an auditor should be deemed culpable when fraud is not detected during the audit, the FMSB believes the document could be further improved if the Board placed increased emphasis in these paragraphs on the facts that (1) fraud is almost always extremely difficult to detect, because it is, by definition, characterized by deceit, deception, concealment, and hidden intent on the part of the perpetrator, (2) a perpetrator is usually in a position to thwart

(through various and varied concealment techniques) an auditor's attempts to uncover evidence of fraud, (3) after any fraud is discovered through nonaudit means, it becomes easy for critics (e.g., media, plaintiffs, and prosecutors) to work backward to identify evidence that was indicative of the fraud, but probably could not have been readily identified by the auditor due to the complexity of the organization, the sheer number of transactions, and the perpetrator's concealment efforts, and (4) the auditor is rarely in a position to obtain or observe direct (versus circumstantial) evidence of fraud—at best, an auditor can usually only observe evidence of the perpetrator's attempts to conceal the fraud through various means. Also, the FMSB suggests that these paragraphs be expanded to include explicit language, as previous professional standards have contained, that auditing procedures have significant limitations for fraud detection.

2. Paragraph 13, on Page 21, addresses the discussion among engagement personnel regarding the risks of material misstatement due to fraud. The FMSB has two concerns with this paragraph. First, the third sentence states that “Professional judgment should be used in determining which audit team members should be included in the discussion, how it should occur, and the extent of the discussion.” This sentence could be interpreted to mean that only the more senior members of the engagement team should be involved in the discussion. Because the more junior members of the engagement team will likely collect the bulk of the primary audit evidence and would directly benefit from the discussion, the FMSB suggests that Paragraph 13 be expanded to include a sentence, such as “In most instances, such discussions should include nearly all members of the engagement team to ensure they understand the risk factors related to the potential for material misstatement due to fraud.” Second, the last two sentences indicate that it may be useful to include specialists assigned to the engagement team in the discussion. Because under certain circumstances, it may also be beneficial to include a member(s) from the prior audit engagement team in the discussion, the FMSB suggests that the Board expand the last two sentences of Paragraph 13 to include consideration of both specialists and previous audit engagement team members.
3. The first sentence in Paragraph 14, also on Page 21, and the last sentence in Paragraph 73, on Page 41, refer to “the auditor with

final responsibility for the audit.” Because this term is ambiguous and could include professionals ranging from a management-level administrator up to and including the managing partner or the appointed/elected government auditor, the FMSB suggests that the Board more clearly define the term “the auditor with final responsibility for the audit.”

4. Paragraphs 43 through 77, on Pages 29-42, describe how the auditor should respond to the results of the assessment and how the auditor should evaluate audit test results when anomalous transactions are found or when anomalous test outcomes occur. However, these paragraphs do not provide clear guidance on how far the auditor should pursue the response or how much additional testing is sufficient to fulfill the objectives of the proposed SAS. For this reason, the FMSB suggests that the Board expand the guidance at the end of both Paragraphs 66 and 77 to explicitly state that (1) the auditor’s responsibility is to apply professional judgment in determining the extent of response or additional testing that is needed to provide reasonable assurance that fraud has occurred that has a material effect on the financial statements, and (2) absolute assurance in that regard is not possible. The FMSB believes this additional language will assist the auditor in defending his/her work in cases where undetected fraud is later revealed through other means.
5. Paragraph 49, on Pages 31-32, provides examples of ways to modify the nature, timing, and extent of tests in response to identified risks of material misstatement due to fraud. Paragraph 50, on Pages 32-34, provides additional examples of responses to identified risks of material misstatements relating to fraudulent financial reporting. However, we noticed that these paragraphs appear to be somewhat redundant. For example, the second paragraph under *Revenue recognition* in Paragraph 50 discusses performing substantive analytical procedures using disaggregated data. This type of testing is also discussed in the fourth bullet under Paragraph 49. As a second example, the first paragraph under *Inventory quantities* in Paragraph 50 discusses observing inventory counts on an unannounced basis, and conducting inventory counts at the end of the reporting period to minimize the risk of manipulation during the period between the count and the end of the reporting period. These types of tests are also discussed in the first and second bullets under Paragraph 49. Because this is already a lengthy document, and because

redundancy could confuse the auditor, the FMSB suggests that the Board review these and other paragraphs to ensure that redundancy is minimized in the final SAS.

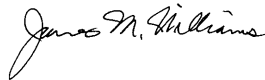
6. The third sentence in Paragraph 55, on Page 35, states, “A not-for-profit organization may face incentives and pressures to achieve a given level of financial performance to satisfy its governing board, contributors, or governmental granting agencies or to meet internal targets.” Although this is a true statement, the FMSB believes that a not-for-profit organization may also face opposite incentives and pressures to appear more “needy” (e.g., under-reporting assets, overstating restrictions on assets) in an effort to secure additional contributions and other support. Therefore, the FMSB suggests that the Board expand the current language in Paragraph 55 to more appropriately recognize that a not-for-profit organization may face incentives and pressures to either overstate or understate its actual financial status and performance.
7. Paragraph 73, on Page 40, states “At or near the completion of the audit, the auditor should....” Because the audit report is typically not issued for several weeks after the fieldwork is completed, and for consistency with other auditing standards (e.g., AU 560.12), the FMSB suggests that the Board revise this sentence to read: “At or near the completion of the audit fieldwork.... ”
8. Paragraphs 78 through 81, on Pages 42-44, provide guidance to the auditor in communicating about possible fraud to management, the audit committee, and others. Although the guidance in these four paragraphs is pertinent and useful, the FMSB believes that implementing the following four suggestions can further enhance it. First, the FMSB suggests that the Board explicitly define the phrase “evidence that fraud may exist.” In particular, Paragraph 78 should explain that “evidence” as traditionally used by auditors is a very broad concept, whereas in a forensic context it has a much narrower meaning. Second, the FMSB suggests that the Board describe and define the two types of forensic evidence (direct evidence and circumstantial evidence), and explain that, although the auditor is rarely in a position to observe or obtain direct evidence, he/she can often find or observe circumstantial evidence. Third, the FMSB suggests that the Board provide additional guidance on *when* the auditor should communicate to

management, the audit committee, and others about possible fraud. Obviously, the auditor would not communicate whenever a single missing document cannot be located. However, the Board might expand the guidance in Paragraphs 78 through 81 to provide a threshold of concern (e.g., possible, probable, more likely than not) that fraud may exist before the auditor is required to initiate communications. Fourth and finally, in addition to the guidance in Footnote 35, the FMSB suggests that the Board clearly alert the auditor to the dangers of stating or implying that fraud has actually occurred. Instead of using terms such as “fraud,” “irregularity,” “misappropriation,” or “defalcation,” auditors should be guided to simply describe the evidence obtained or observed, and to rely on management, the audit committee, or others to discern that the evidence might be indicative of fraud.

9. Footnote 37, on Page 43, further explains the legal and regulatory requirements stated in Paragraph 81a on the same page. To recognize possible regulatory requirements for governmental and not-for-profit organizations, the FMSB suggests that the Board add the following as a third sentence in Footnote 37: “For audits of governmental and not-for-profit organizations, these requirements may also include reports to a state attorney general or other official prescribed by law.”
10. The first bullet under Paragraph 82, on Page 44, discusses the documentation of the discussion among engagement personnel in planning the audit. Because the Board placed significant emphasis on the auditor conducting multiple discussions in differing locations (Paragraph 13, Page 21), the FMSB suggests that the Board add a related sentence to this bullet, such as, “If multiple locations are involved, the discussion at each of the locations should be documented.”
11. The second sentence of Paragraph 83, also on Page 44, states, “Early application of the provisions of this Statement is permissible.” Because the Board clearly indicated, in the first paragraph on Page 7 of the ED Summary, that this Statement was an important initiative of both the Board and its Fraud Task Force, the FMSB believes it should appropriately *encourage* early implementation. Therefore, the FMSB suggests that the Board revise the second sentence of Paragraph 83 to read: “Early application of the provisions of this Statement is encouraged.”

Again, the FMSB appreciates the opportunity to provide comments on this ED. Should you have any questions, or desire further details on the FMSB's position, please contact me at (216) 583-8276 or [james.williams17@ey.com](mailto:james.williams17@ey.com), or Jon Wise, the FMSB facilitator for this project, at (517) 334-8060, Ext. 500, or [WiseJ1@michigan.gov](mailto:WiseJ1@michigan.gov).

Sincerely,



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AGA Financial Management Standards Board

C: Mr. Richard V. Norment, CGFM  
AGA National President