1997

Auditor's responsibility for detecting fraud

American Institute of Certified Public Accountants (AICPA)

The Auditor's Responsibility for Detecting Fraud

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Recently, a new standard about the auditor's responsibility for fraud was enacted: Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit.* If the fiscal year for your organization ends on or after December 15, 1997, the independent certified public accountant who is engaged to audit the organization's financial statements will be required to apply this SAS in that audit.

Why SAS No. 82 Was Issued

SAS No. 82 was issued to clarify the auditor's detection responsibility for fraud and to provide expanded operational guidance in carrying out that responsibility. It is expected to strengthen the auditor's ability to fulfill that detection responsibility.

The Auditor's Responsibility for Fraud

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. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that *misstatements,* whether caused by *errors or fraud,* that are material to the financial statements *are detected.* This responsibility applies only to *material* misstatements, not misstatements that are not material to the financial statements.

Under the New SAS, Will Auditors Be Expected to Detect All Kinds of Fraud?

No, this is not the case. The auditor has a responsibility to detect material misstatements of the financial statements that are caused by fraud. The types of fraud that may cause misstatements in financial statements are fraudulent financial reporting and misappropriation of assets. The SAS makes this distinction because many frauds, such as bribery and kickbacks, typically do not cause a misstatement in financial statement amounts.

How Will the New Standard Affect Audit Fees

The effect will vary. Some entities have very strong internal control. In these organizations, management is concerned about fraud and its effects on the entity, and there are controls that are designed to prevent and detect fraud. For these organizations, the effect on audit fees will not be significant. For entities with fraud risk factors that are not effectively addressed by management, the costs will be greater. The AICPA believes that the public-interest benefits outweigh the additional cost. Also, organizations concerned about such costs can take active measures to reduce them by, for example, implementing controls designed to prevent and detect fraud.

In What Other Ways Will the New Standard Affect Entities Under Audit?

The new standard will require the auditor to make certain inquiries of management and consider making certain communications:

- The new standard requires the auditor to ask management about the risk of fraud in the entity and whether management has knowledge of fraud that has been perpetrated on or within the entity.
- If an organization has established a program to prevent, deter, and detect fraud, the auditor will also inquire of those overseeing the program as to whether the program has identified any fraud risk factors.
- When the auditor has identified risk factors that have continuing control implications, the auditor needs to consider whether these risk factors represent reportable conditions that should be communicated to senior management and the audit committee. This is expected to encourage management to improve fraud prevention and detection techniques.

How Does the New Standard Serve the Public Interest?

This new guidance on fraud detection will help auditors better serve the public interest by increasing their ability to detect material misstatements in financial statements caused by fraud. The public interest is served by adding independent assurance to the credibility of financial statements upon which our capital and credit markets depend.

The Auditor's Responsibility for Fraud and Illegal Acts: Their Relationship

The auditor's responsibility for detecting fraud and the responsibility for detecting certain illegal acts by clients are frequently misunderstood by auditors, the financial press, and the general public. Now that the AICPA has published a new SAS on fraud, issues about the auditor's detection responsibility for illegal acts and the relationship of SAS No. 82 to illegal acts are receiving renewed attention. Illegal acts by clients are covered by SAS No. 54, *Illegal Acts by Clients,* which divides illegal acts into two categories.

- **Illegal acts that have a *direct and material effect* on line-item amounts in financial statements.** The auditor has the same detection responsibility for these illegal acts as for material fraud. That is, the auditor should design the audit to provide reasonable assurance that financial statement amounts are free from material misstatement from these direct-effect illegal acts. Examples in SAS No. 54 of direct-effect illegal acts are violations of laws or regulations that affect the amount of revenue accrued under government contracts and violations of laws that affect the amount of expense recognized for the period (for example, income tax expense).

- **Illegal acts that have an *indirect effect* on financial statement amounts.** For this second category of illegal acts, SAS No. 54 says that an audit conducted in accordance with generally accepted auditing standards (GAAS) normally does not include audit procedures specifically designed to detect illegal acts having an *indirect effect* on financial statements. Examples of indirect-effect illegal acts include violations of laws relating to securities trading, occupational safety and health, food and drug administration, environmental protection, or equal employment. The auditor is responsible for evaluating such acts only when information comes to his or her attention, during performance of the audit, suggesting that they may have occurred.

If the auditor becomes aware of information that raises his or her suspicions, he or she is obligated to apply additional procedures to determine whether an illegal act has, in fact, occurred.

Does SAS No. 82 Apply to Compilations and Reviews of Financial Statements?

No, it does not. SAS No. 82 applies only to audits of financial statements conducted in accordance with GAAS.