

Palomar College

Statement of Auditing Standards 99

Why is it important to become familiar with the content of Statement on Auditing Standards (SAS) No. 99?

The answer begins with a few questions ...

1. How would you feel if fraud were discovered in an area under your responsibility and that fraud had been going on for five or ten years?
2. Given the scenario described in Item 1, how do you think others would perceive things?

While fraud can never be completely eliminated, steps can be taken toward detecting it in a timely manner. Becoming familiar with the risk factors and conditions outlined in SAS No. 99 will place employees in a better position to recognize situations which are associated with the commission of fraudulent acts. In addition, management personnel should consider the risk factors listed in SAS No. 99, especially those under "Opportunities" and "Attitudes / Rationalizations", when developing internal controls for their areas of responsibility. For example, inadequate or missing controls related to the approval of payroll transactions will increase the likelihood that fraud could occur and not be detected in a timely manner. To mitigate the likelihood of fraud occurring in payroll, internal controls would be implemented to ensure that all payroll transactions are properly approved.

Background Information

SAS No. 99 establishes standards and provides guidance to external auditors in fulfilling their responsibility as it relates to fraud in an audit of the College's financial statements. SAS No. 99 supersedes SAS No. 82 which had the same title. It is effective for audits of financial statements for periods beginning on or after December 15, 2002 with earlier implementation permissible.

SAS No. 99 covers a number of issues, including, but not limited to, the following:

- Describes fraud and its characteristics, including the aspects of fraud particularly relevant to an audit of financial statements
- Requires, as part of planning the audit, that there be a discussion among the audit team members to consider the susceptibility of the

entity's financial statements to material misstatement due to fraud and to reinforce the importance of having a mindset of [professional skepticism](#): An attitude that includes a questioning mind and critical assessment of audit evidence. Some examples demonstrating the application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud include

...

- increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and
- increased recognition of the need to corroborate management explanations or representations concerning material matters, such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity.
- Requires the auditor to gather the information necessary to identify the risks of material misstatement due to fraud, by the following ...
- Making inquiries of management and others within the entity
 - Considering the results of analytical procedures performed in planning the audit
 - Considering [fraud risk factors](#)
 - Considering certain other information
- Requires the auditor to use the information gathered above to identify risks that may result in a material misstatement due to fraud
- Requires the auditor to evaluate the entity's programs and controls that address the identified risk of material misstatement
- Requires antifraud programs and controls be put in place by management under three fundamental activities:
 - Creating an ethical institutional culture
 - Implementing antifraud processes and controls
 - Developing an effective program oversight process

It should be noted that all of the risk factors indicated in SAS No. 99 are not applicable to higher education.

Selected Risk Factors Identified in SAS No. 99

The risk factors indicated in SAS No. 99 are grouped in the following categories:

Misstatements Arising From Fraudulent Financial Reporting	Misstatements Arising From Misappropriation of Assets
Incentives / Pressures	Incentives / Pressures
Opportunities	Opportunities
Attitudes / Rationalizations	Attitudes / Rationalizations

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

Risk factors related to misstatements arising from fraudulent financial reporting are as follows:

Fraudulent Financial Reporting - Incentives / Pressures

- Threatened financial stability or profitability (may be economic, industry, or entity operating conditions)
 - High degree of competition or market saturation, along with declining margins
 - High vulnerability to rapid changes (e.g. in technology, product obsolescence, or interest rates)
 - Significant declines in customer demand
 - Increasing business failures in either the overall economy or specific industry
 - Operating losses (e.g. through the threat of foreclosure, bankruptcy, or hostile takeover)
 - Recurring negative cash flows from operations
 - Inability to generate cash flows from operations while reporting earnings and earnings growth
 - Rapid growth or unusual profitability, especially when compared to other companies in the same industry
 - New accounting, regulatory or statutory requirements
- Excessive third party pressures that exist for management, including the following:

- Profitability or trend expectations from investment analysts, institutional investors, significant creditors, or other external parties, especially when those expectations are unduly aggressive or unrealistic
 - Includes expectations created by management (e.g. press releases or annual report messages)
- Need to obtain debt or equity financing to stay competitive (e.g. the financing of major research and development or capital expenditures)
- Ability to meet debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, (e.g. business combinations or contract awards)
- Personal net worth of management or the board of directors' is threatened by the entity's financial performance arising from the following situations:
 - Large concentrations of their personal net worth in the business or organization
 - Significant portions of their compensation contingent upon achieving aggressive on operating results, financial position, cash flow, or stock price
 - Compensation may include bonuses, stock options, etc,
 - Personal guarantees of the debt of the business or organization that are significant to their personal net worth
- Excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management

Fraudulent Financial Reporting - Opportunities

- The nature of an industry and the entity's operations may provide opportunities to engage in fraudulent financial reporting arising from the following:
 - Significant related-party transactions
 - Significant estimates of assets, liabilities, revenues, or expenses that involve subjective judgments and/or uncertainties that are difficult to confirm
 - Significant, unusual, or highly complex transactions, especially close to year end transactions involving "substance over form" issues
 - Significant operations located or conducted across international borders

- Significant bank accounts or subsidiary / branch operations in tax-haven jurisdictions that do not appear to have a clear business justification
- Monitoring of management is ineffective resulting from the following:
 - Domination of management by a single person or small group without compensating controls
 - Ineffective board of directors oversight over the financial reporting process and internal control
 - Ineffective audit committee oversight over the financial reporting process and internal control
- A complex or unstable organizational structure is present, evidenced by the following:
 - Difficulty in determining the controlling interest in the entity
 - Overly complex organizational structure, involving unusual managerial lines of authority
 - High turnover of senior management positions, counsel, and / or board members
- Deficient internal control components, resulting from the following:
 - Inadequate monitoring of controls
 - High turnover rates accounting, internal audit, or information technology staff
 - Employment of ineffective accounting, internal audit, or information technology staff
 - Ineffective accounting and information systems

Fraudulent Financial Reporting - Attitudes / Rationalizations

The following conditions may indicate risk factors that are reflective of the attitudes / rationalizations of those individuals (e.g. board members, management, and other employees) who could engage in and/or justify financial reporting by the entity:

- Entity's values and ethical standards
 - Ineffective communication of the entity's values and ethical standards
 - Ineffective support by management of the entity's values and ethical standards
 - Communication of inappropriate values or ethical standards to the entity's employees
- Excessive participation in or preoccupation with the selection of accounting principles and / or the determination of significant estimates by non-financial management personnel

- Known **history** of violations of various laws and regulations, i.e. history may repeat itself
- Claims against the entity, senior management or board members alleging fraud or violations of laws and regulations, i.e. smoke can suggest fire
- A **practice** by management of committing to achieve aggressive or unrealistic forecasts to third parties
- Management's failure to correct known reportable conditions on a timely basis
- Management's **recurring** attempts to justify marginal or inappropriate accounting on the basis of materiality
- A strained relationship between management and the current or predecessor auditor, as evidenced by the following:
 - Frequent disputes with the auditor (current or predecessor) in regards to accounting, auditing, or reporting issues
 - Unreasonable demands on the auditor (e.g. unreasonable time constraints regarding the completion of the audit)
 - Formal or informal restrictions placed on the auditor that inappropriately limits his or her access to people or information
 - Formal or informal restrictions placed on the auditor that inappropriately limits his or her ability to communicate effectively with the board of directors or audit committee
 - Domineering management behavior in dealing with the auditor, especially involving attempts by management to ...
 - Influence the scope of the auditor's work
 - Influence the selection or continuance of audit personnel assigned to the engagement

Risk Factors Relating to Misstatements Arising From **Misappropriation of Assets**

Risk factors related to misstatements arising from fraudulent financial reporting may overlap those related to misstatements arising from misappropriation of assets. For example, weaknesses in internal control may be present when misstatements due to **either** fraudulent financial reporting **or** misappropriation of assets exists. Risk factors related to misstatements arising from misappropriation of assets are as follows:

Misappropriation of Assets - Incentives / Pressures

- Personal financial obligations may create pressure on management and employees to misappropriate assets, especially when those

individuals have access to cash or other assets that are susceptible to theft

- Adverse relationships between the entity and employees may motivate employees to misappropriate assets, especially when those employees have access to cash or other assets that are susceptible to theft. Adverse relationships can be created by numerous situations, including the following:
 - Future employee layoffs
 - Employee expectations are inconsistent with promotions, compensation, or other rewards

Misappropriation of Assets - Opportunities

- Certain circumstances increase the susceptibility of assets to misappropriation. Opportunities to misappropriate assets increase when there are ...
 - Large amounts of cash on hand
 - Large amounts of cash in processed by the entity
 - Inventory items that are ...
 - Small in size
 - Of a high value
 - In high demand
 - Easily convertible assets, such as ...
 - Bearer bonds
 - Computer chips
 - Fixed assets that are ...
 - Small in size
 - Marketable
 - Lacking observable identification of ownership
- Inadequate internal control over assets increase the susceptibility of assets to misappropriation. Misappropriation of assets may occur when the following internal control weaknesses exist:
 - Inadequate segregation of duties
 - Inadequate management oversight of employees responsible for assets
 - Including remote locations
 - Inadequate job applicant screening of prospective employees that will have access to assets
 - Inadequate record keeping in regards to assets
 - Inadequate system to authorize transactions

- Inadequate system to **approve** transactions
- Inadequate **physical** safeguards over
 - Cash
 - Investments
 - Inventory
 - Fixed assets
- Lack of **timely** and **appropriate** documentation of transactions
- Lack of **mandatory** vacations for employees that perform key internal control functions
- Inadequate understanding of information technology by management personnel
 - Could enable information technology employees to commit a misappropriation
- Inadequate access to controls associated with automated records

Misappropriation of Assets - Attitudes / Rationalizations

The following conditions may indicate risk factors that are reflective of the attitudes of employees (who have access to assets susceptible to misappropriation) that allow them to justify the misappropriation of such assets:

- Disregarding the need to reduce risks related to the misappropriation of assets
- Disregarding internal controls related to the misappropriation of assets by ...
 - Overriding existing controls
 - Failing to correct known internal control deficiencies
- Displaying behavior that indicates ...
 - Dissatisfaction with the company
 - Displeasure with the company's treatment of the employee
- Displaying changes in behavior or lifestyle that may indicate that assets have been misappropriated

Note 1: The above information was obtained from Appendix A of SAS No. 99 [AU Section 316 (Consideration of Fraud in a Financial Statement Audit)], prepared by the American Institute of Certified Public Accountants (AICPA).