## STANDARDS AND EMERGING ISSUES ADVISORY GROUP MEETING

## DISCUSSION – FRAUD CONSIDERATIONS

## NOVEMBER 2, 2022

### INTRODUCTION

The PCAOB's standard-setting agenda includes a project to consider how the existing fraud requirements,[1] including AS 2401, *Consideration of Fraud in a Financial Statement Audit*, ("existing requirements") should be revised to better align an auditor's responsibilities for addressing intentional acts that result in material misstatements in financial statements ("fraud") with the auditor's risk assessment, including addressing matters that may arise from developments in the use of technology.

At the November 2022 meeting, members of the Standards and Emerging Issues Advisory Group (SEIAG) will discuss their views and experiences regarding topics relating to the auditor's consideration of fraud. In addition, the Board would be interested in SEIAG member views regarding data sources for evaluating economic impact and academic research papers or external reports of which the Board should be aware regarding this fraud topic.

This briefing paper is intended to facilitate a focused SEIAG discussion regarding these matters by providing background information and describing: (i) antifraud programs and controls and improvements in corporate governance; (ii) lessons learned from other professions, including forensic consultants; (iii) auditor knowledge, skills, and ability; (iv) changes in the use of data and technology in the audit; and (v) considering whether the existing requirements could be strengthened or improved.

[1] The auditor's responsibilities regarding fraud are contained in several PCAOB standards, including AS 2401, *The Auditor's Consideration of Fraud in a Financial Statement Audit*, AS 2110, *Identifying and Assessing Risks of Material Misstatement*, AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and AS 2810, *Evaluating Audit Results*.

## BACKGROUND

Corporate scandals can undermine investor confidence and result in significant losses for investors.[2] Some companies that experience fraud can go bankrupt or suffer reputational losses. Investors could also suffer losses from frauds that are not widely known and could go undetected for long periods.[3]

Existing standards define fraud as an intentional act that results in a material misstatement in financial statements that are the subject of an audit.[4] Two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.[5]

Other audit standard setters and regulators have recently updated or are now considering, improving their standards regarding fraud. For example:

- The International Auditing and Assurance Standards Board (IAASB) has a current project to update and revise its analogous auditing standard on fraud. The IAASB anticipates issuing an exposure draft for comment in June 2023.[6]

- In 2021, the UK's Financial Reporting Council (FRC) updated its auditing standards to improve the auditor's consideration of fraud. The improvements include, among other things, a requirement to describe in the audit report to what extent the audit was considered capable of detecting irregularities, including fraud.[7] Also, beginning in 2022, the Netherlands Authority for the Financial Markets (AFM) will require auditors to discuss their responses to fraud risks in the auditor's report.[8]

  Note: The European Union's (EUs) 2014 statutory audit legislation contains similar requirements for statutory audits of public interest entities.[9]

- In 2013, Japan's Business Accounting Council (BAC) issued a standard to address risks of fraud in an audit to require, for example, that auditors be familiar with fraud schemes that are

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[2] *See, e.g.,* Statement by Paul Munter SEC Acting Chief Accountant, *The Auditor's Responsibility for Fraud Detection* (October 11, 2022). *See also*, Association of Certified Fraud Examiners (ACFE) *Occupational Fraud 2022: A Report to the Nations* and Cornerstone Research *Accounting Class Action Filings and Settlements 2021 Review and Analysis*.

[3] *See generally, OCC Bulletin 2019-37 Operational Risk: Fraud Risk Management Principles* (July 24, 2019) and ACFE *Occupational Fraud 2022: A Report to the Nations*.

[4] *See* AS 2401.05.

[5] *See* AS 2401.06.

[6] *See* IAASB project page.

[7] *See* UK FRC ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

[8] *See, e.g.*, Royal Netherlands Institute of Chartered Accountants, *MANDATORY REPORTING ON FRAUD AND GOING CONCERN IN THE AUDITOR'S REPORT TO THE ANNUAL ACCOUNTS What does this mean for you, as a client?* (Oct. 2021).

[9] *See*, REGULATION (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

publicly known and general and industry specific business practices that are likely to be used for fraud.[10]

Prominent corporate scandals were the driving force behind the passage of the Sarbanes-Oxley Act.[11] Throughout its history, the PCAOB has devoted substantial attention to the auditor's responsibilities regarding fraud. For example, the PCAOB's foundational risk assessment standards incorporated the existing requirements for identifying and responding to fraud risks and evaluating audit results into the entire audit process. Incorporating the fraud requirements into the foundational risk assessment standards clarified that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process. This approach is designed to prompt auditors to make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.[12] The Appendix to this briefing paper includes an overview of the auditor's responsibilities under PCAOB standards regarding the consideration of fraud in an audit.

**ANTIFRAUD PROGRAMS AND CONTROLS AND IMPROVEMENTS IN CORPORATE GOVERNANCE**

Companies are responsible for designing and implementing programs and controls to prevent, deter, and detect fraud.[13] Existing PCAOB auditing standards require the auditor to obtain an understanding of and test whether such controls have been implemented, when the auditor identifies a fraud risk.[14] In an integrated audit, the auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment.[15] The maturity of management's antifraud programs and controls impacts the auditor's efforts regarding fraud. Since the Board last updated its existing fraud requirements new developments have occurred with respect to antifraud programs and controls.[16] For example, in 2016, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued its *Fraud Risk Management Guide*, which notes that it can serve as best practices guidance and articulates five principles for "fraud risk management" that are consistent with and parallel the 17 COSO principles, including:

[10] *See* Financial Services Agency provisional translation of the *Opinion on the Standard Setting to Address Risks of Fraud in an Audit*.

[11] *See, e.g.*, Senate Report 107-205, *Report of the Committee on Banking, Housing and Urban Affairs United States Senate to Accompany S.2673 together with additional views* (July 3, 2002) which mentions prominent corporate scandals considered during the passage of the Sarbanes Oxley Act, including Enron, WorldCom, Adelphia and Global Crossing.

[12] *See* *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (Aug. 5, 2010).

[13] *See* AS 2401.04.

[14] *See* AS 2110.72.

[15] *See* paragraph .62 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. *See also* AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*.

[16] *See* DOJ's *Evaluation of Corporate Compliance Programs* (Updated June 2020). (Recent guidance on the *Evaluation of Corporate Compliance Programs* issued by the Department of Justice has been considered by public companies in evaluating their antifraud programs and controls.)

- The organization establishes and communicates a Fraud Risk Management Program that demonstrates the expectations of the board of directors and senior management and their commitment to high integrity and ethical values regarding managing fraud risk.

- The organization performs comprehensive fraud risk assessments to identify specific fraud schemes and risks, assess their likelihood and significance, evaluate existing fraud control activities, and implement actions to mitigate residual fraud risks.

- The organization selects, develops, and deploys preventive and detective fraud control activities to mitigate the risk of fraud events occurring or not being detected in a timely manner.

- The organization establishes a communication process to obtain information about potential fraud and deploys a coordinated approach to investigation and corrective action to address fraud appropriately and in a timely manner.

- The organization selects, develops, and performs ongoing evaluations to ascertain whether each of the five principles of fraud risk management is present and functioning and communicates Fraud Risk Management Program deficiencies in a timely manner to parties responsible for taking corrective action, including senior management and the board of directors.[17]

The maturity of "fraud risk management" across companies can vary greatly. For example, a recent report describes variances in the fraud risk management programs of 16 multinational companies.[18]

The roles and responsibilities of corporate compliance officers (and internal audit) in a company's fraud risk management have become more prevalent. However, existing standards related to fraud do not include any express requirements for the auditor with regards to compliance officers (e.g., inquiring of compliance officer regarding alleged fraud).

**QUESTIONS**:

1. In your experience, in companies where material fraud has occurred which material weaknesses related to management's antifraud programs and controls were central to the fraud occurring?

2. In your experience, what is the state of "fraud risk management" across public companies?

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[17] *See* COSO's *Fraud Risk Management Guide* (2016) (COSO-*Fraud Risk Management Guide*-Executive Summary).

[18] *See* *The State of Fraud Risk Management*, Business Ethics Leadership Alliance (BELA) Fraud Risk Management Working Group (March 30, 2022). The working group members assessed the maturity of their fraud risk management programs, noting varying levels of maturity. While the majority of members rated their fraud risk management programs at a middle maturity level, some still remained at a lower level of maturity (e.g., they are currently engaging in initial fraud risk assessments, developing consistent processes, and convening key stakeholders to create a more formalized approach).

3. In your view what should be done to improve the auditor's understanding and evaluation of management's antifraud programs and controls?

**LESSONS LEARNED FROM OTHER PROFESSIONS, INCLUDING FORENSIC CONSULTANTS**

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.[19] Existing PCAOB auditing standards require that auditors perform procedures to specifically address the risk of management override of internal controls, including: (i) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud; (ii) reviewing accounting estimates for biases that could result in material misstatement due to fraud; and (iii) evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud.[20] These procedures were in response to recommendations from the "Panel on Audit Effectiveness" to incorporate a "forensic-type fieldwork phase" during which the auditor performed specific procedures to detect management override of internal control.[21]

Existing requirements also contain examples of audit procedures that could be performed to respond to fraud risks relating to fraudulent financial reporting and asset misappropriation.[22] Forensic consultants and other professions (e.g., internal audit, short sellers, analysts) may have additional tools and techniques for identifying fraud that could be performed during audits. Studies identifying how fraud is detected often note successes of forensic consultants at identifying fraud.[23] Improving the auditors understanding of the tools and techniques used by other disciplines for detecting fraud could assist auditors in designing responses to assessed fraud risks.

Questions:

4. In your experience, what tools or techniques are used by other disciplines (e.g., forensic consultants, internal audit, short sellers) to detect fraud? For example, are there other procedures that could specifically address management override of controls?

5. What differences in mindset are there between auditors and other disciplines (e.g., forensic consultants) that are known to detect fraud?

**AUDITOR KNOWLEDGE, SKILL, AND ABILITY**

The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.[24] Engagement team members should be assigned to tasks commensurate with their level of knowledge, skill, and ability

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[19] *See* AS 2401.08.

[20] *See* AS 2401.58-67A.

[21] *See* Public Oversight Board, *The Panel on Audit Effectiveness, Report and Recommendations* (Aug. 31, 2000).

[22] *See* AS 2401.52-.56.

[23] *See, e.g.*, ACFE *Occupational Fraud 2022: A Report to the Nations*.

[24] *See* AS 2301.05.

so that they can evaluate the audit evidence they are examining.[25] Further, PCAOB standards require auditors to consider whether specialized skills or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.[26]

PCAOB standards require the auditor to use due professional care, including applying professional skepticism, in performing the audit.[27] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. PCAOB standards also state that the auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.[28]

While fraud has a significant effect on investors, some auditors may not have dealt with fraud on their audit engagements. However, auditors are required to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud.[29]

Some standard setters have created specific requirements regarding auditor competencies. For example, in 2013, Japan's BAC issued a standard to address risks of fraud in an audit to require, among other things, that auditors be familiar with fraud schemes that are publicly known and general and industry specific business practices that are likely to be used for fraud.[30]

**QUESTIONS**:

6. Are there specialized skills or knowledge that auditors might need to be able to detect fraud?

7. In your experience, how might auditor mindset, attitudes, and cognitive biases have an impact on the detection of fraud in an audit?

## CHANGES IN THE USE OF DATA AND TECHNOLOGY IN THE AUDIT

The development of automated and technology-based tools can affect the auditor's consideration of fraud. Improvements in technology can affect both how fraud is perpetrated and how fraud might be detected.[31] For example, the use of data analytics by auditors has the potential to assist the auditor in responding to assessed fraud risks.[32] Further, changes in the workplace due to the COVID-19 pandemic

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[25] *See* paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

[26] *See* paragraph .16 of AS 2101, *Audit Planning*.

[27] *See generally* AS 1015.

[28] *See* AS 2301.07. Examples of the application of professional skepticism in response to assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

[29] *See* paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

[30] *See* provisional translation of the *Opinion on the Standard Setting to Address Risks of Fraud in an Audit* of the Business Accounting Council.

[31] *See*, e.g., KPMG *Global Profiles of the Fraudster* (May 2016).

[32] *See*, e.g., *May 2020 Spotlight – Data and Technology Research Project Update* and *May 2021 Spotlight – Data and Technology Research Project Update*, which note, among other things, that technology based tools could assist the auditor with regards to evaluating management bias.

has the potential to affect the auditor's ability to detect fraud (e.g., remote work arrangements for management and remote audit procedures).[33]

**QUESTIONS**:

8. How have advances in automated and technology-based tools affected fraud detection (e.g., have improvements in technology been effective in detecting fraud?)

9. What are the advantages and disadvantages of the increased use of automated and technology-based tools in an audit? For example, could the increased use of automated and technology-based tools influence the auditor's exercise of professional skepticism?

**CONSIDERING WHETHER THE EXISTING REQUIREMENTS COULD BE STRENGTHENED OR IMPROVED**

The Appendix to this briefing paper includes an overview of the auditor's responsibilities under PCAOB standards regarding the consideration of fraud in an audit. Existing PCAOB auditing standards require the auditor to, among other things: (i) perform procedures to identify fraud risks; (ii) plan and perform audit procedures to address those risks, including certain specified procedures to address the risk of management override of controls; and (iii) consider fraud in evaluating the results of the audit.[34]

Other standard setters are exploring improvements (or have improved their standards). For example, the aims of the current IAASB project on fraud include:

- Clarifying the role and responsibilities of the auditor for fraud in an audit of financial statements.

- Promoting consistent behavior and facilitating effective responses to identified risks of material misstatement due to fraud through establishing more robust requirements and enhancing and clarifying application material.

- Reinforcing the importance, throughout the audit, of the appropriate exercise of professional skepticism in fraud-related audit procedures.

- Enhancing transparency on fraud-related procedures where appropriate, including strengthening audit committee communications and the reporting requirements.[35]

**QUESTIONS**:

10. Are there differences between how users of audit reports view the auditor's responsibilities regarding fraud and how the auditors view their responsibilities regarding fraud? For example, is more transparency needed about the auditor's work in relation to fraud in an audit of financial statements?

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[33] *See*, e.g., *PCAOB Staff Observations and Reminders during the COVID-19 Pandemic (Dec. 2020)*.

[34] *See generally* AS 2110, AS 2301, AS 2401, and AS 2810.

[35] *See* IAASB Fraud Project Page.

11. In your experience, when has an audit been effective in detecting fraud? When have audits not been effective in detecting fraud? Are there specific changes in the auditor's responsibilities that you would recommend?

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

## APPENDIX

## OVERVIEW OF THE AUDITOR'S RESPONSIBILITIES UNDER PCAOB STANDARDS REGARDING THE CONSIDERATION OF FRAUD IN AN AUDIT

### General Requirements

Under PCAOB standards, the auditor is required to plan and perform the audit of the financial statements to obtain reasonable assurance, which is a high level of assurance, about whether the financial statements are materially misstated due to error or fraud.[1] As this wording suggests, these auditor responsibilities are focused on fraud that results in material inaccuracies in, or omissions from, the financial statements.[2]

PCAOB standards describe two categories of fraud that can result in material misstatement of the financial statements ("financial statement fraud"): (1) fraudulent financial reporting and (2) misappropriation of assets.

As the Board emphasized with the adoption of its risk assessment standards, the auditor's responsibilities with respect to the consideration of fraud is an integral part of the audit. PCAOB standards require the auditor to consider fraud throughout the course of the audit, as discussed in the next section below.

PCAOB standards require the auditor to use due professional care, including applying professional skepticism, in performing the audit.[3] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. PCAOB standards also state that the auditor's responses to the assessed risks of material misstatement, particularly risks of material misstatement due to fraud ("fraud risks"), should involve the application of professional skepticism in gathering and evaluating audit evidence. Examples of the application of professional skepticism in response to assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.[4]

PCAOB standards require auditors to consider financial statement fraud throughout the course of the audit from the earliest stages of engagement acceptance and planning the audit through performing risk assessment procedures; performing tests of controls, accounts, and disclosures; and evaluating the

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[1] *See, e.g.*, paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

[2] Under Sections 10A(a)-(f) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j-1(a)-(f)), the auditor of an issuer's financial statements generally is required, among other things: (1) to perform procedures designed to obtain reasonable assurance of detecting illegal acts, including fraud, that would have a direct and material effect on the financial statements, (2) when becoming aware of information indicating an illegal act has or may have occurred, to determine whether it is likely that an illegal act has occurred and, if so, its possible effects on the financial statements, and (3) to report illegal acts that come to the auditor's attention to various parties based on criteria in the statute, unless the act is clearly inconsequential. Also, the auditor's responsibilities under PCAOB standards regarding illegal acts generally are set forth in AS 2405, *Illegal Acts by Clients* and AS 1301, *Communications with Audit Committees*, requiring the auditor to make certain inquiries of the audit committee about violations or possible violations of laws and regulations.

[3] *See, e.g.*, AS 1015, *Due Professional Care in the Performance of Work*.

[4] Paragraph .07 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

results of the audit to form the opinions to be expressed in the auditor's report. The following paragraphs discuss some of those procedures.

*Client Acceptance and Retention Evaluation*. Auditors are directed to consider risks related to financial statement fraud even before commencing an audit. PCAOB quality control standards state that firms should establish policies and procedures for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized.[5] The auditor should evaluate whether information obtained from the client acceptance and retention evaluation process is relevant to identifying risks of material misstatement.[6] This evaluation includes information that could raise concerns about management's integrity.

*Audit Planning*. Planning the audit encompasses such matters as establishing the strategy for the audit and determining the audit procedures to be performed. As part of audit planning, the auditor is required to evaluate certain matters, including the auditor's preliminary judgments about risks, which include fraud risks.[7]

*Risk Assessment Procedures*. PCAOB standards require auditors to perform risk assessment procedures that are sufficient to provide a reasonable basis for assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. The risk assessment procedures required by PCAOB standards are intended to direct the auditor to identify external and company-specific factors that affect risks due to error or fraud, such as, factors that create pressures to manipulate the financial statements. The types of risk assessment procedures to be performed are:

- Obtaining an understanding of the company and its environment;
- Obtaining an understanding of internal control over financial reporting;
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;
- Performing analytical procedures;
- Conducting a discussion among engagement team members regarding the risks of material misstatement; and
- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.[8]

Some required risk assessment procedures are directed specifically to identifying and assessing fraud risks, such as:

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[5] Paragraph .14 of QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

[6] Paragraph .41 of AS 2110, *Identifying and Assessing Risks of Material Misstatements*.

[7] *See* paragraph .07 of AS 2101, *Audit Planning*, and AS 1101, *Audit Risk*.

[8] AS 2110.05.

- Conducting a discussion among the engagement team members of the potential for material misstatement due to fraud;[9]

- Inquiring of the audit committee, management, internal auditors, and others about fraud risks;[10]

- Performing analytical procedures relating to revenue for the purpose of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud;[11]

- Considering factors relevant to identifying fraud risks, including in particular, fraud risks related to improper revenue recognition, management override of controls, and risk that fraud could be perpetrated or concealed through omission of disclosures or presentation of incomplete or inaccurate disclosures;[12] and

- Evaluating the design of controls that address fraud risks.[13]

A substantial number of the other required risk assessment procedures also can provide evidence that indicates potential fraud risks. For example, the following risk assessment procedures that are performed to obtain an understanding of the company and its environment can provide evidence of potential fraud risks:

- Obtaining an understanding of relevant industry, regulatory, and other external factors[14] can identify external conditions that place incentives or pressures for management to manipulate the financial statements.

- Obtaining an understanding of the nature of the company encompasses matters such as the organization structure and operating characteristics of the company, its sources of funding and earnings, and financial relationships and transactions with executive officers,[15] which can highlight potential pressures, incentives, and opportunities for management to manipulate the financial statements.

- Understanding the company's selection and application of accounting principles, including related disclosures,[16] could reveal areas in which management might employ aggressive accounting principles that could be used to create management bias in the financial statements or otherwise commit fraudulent financial reporting.

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[9] AS 2110.49-53.

[10] AS 2110.56-58.

[11] AS 2110.47.

[12] AS 2110.65-69 and paragraph .85 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*.

[13] AS 2110.72-73.

[14] AS 2110.09.

[15] AS 2110.10-11.

[16] AS 2110.12-13.

- Obtaining an understanding of company objectives, strategies, and related business risks,[17] can identify business risks that create pressures to commit fraudulent financial reporting or misappropriation of assets.

- Obtaining an understanding of company performance measures can highlight measures that create incentives or pressures for management of the company to manipulate certain accounts or disclosures to achieve certain performance targets (or conceal a failure to achieve those targets).[18]

Similarly, obtaining an understating of the company's internal control over financial reporting[19] can help the auditor identify control deficiencies that provide opportunities to commit or conceal financial statement fraud or conditions or situations in which controls might be overridden to commit or conceal financial statement fraud.

*Responding to Fraud Risks, including Performing Tests of Accounts and Disclosures*. Auditors are required to design and implement audit responses that address the risks of material misstatement, including fraud risks. PCAOB standards establish requirements for two types of responses – overall responses that have an overall effect on how the audit is conducted, and responses involving the performance of audit procedures.[20]

In addition to the application of professional skepticism, two required overall audit responses are especially relevant to addressing fraud risks:

- Incorporating an element of unpredictability in the selection of audit procedures to be performed, such as, selecting items for testing that are outside customary selection parameters or performing procedures on an unannounced basis; and

- Evaluating whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions, are indicative of bias that could lead to material misstatement of the financial statements.

Regarding audit procedures, PCAOB standards require auditors to perform substantive procedures (that is, tests of accounts and disclosures), including tests of details, that are specifically responsive to the identified fraud risks.[21] PCAOB standards provide examples of ways to modify audit procedures and respond to specific types of fraud risks. In addition, auditors are required to perform the following procedures to specifically address the risk of management override of controls:

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;

[17] AS 2110.14-15.

[18] AS 2110.16-17.

[19] AS 2110.18-40.

[20] AS 2301.03-04.

[21] AS 2301.13.

- Reviewing accounting estimates for biases that could result in material misstatement due to fraud; and

- Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud.[22]

It should be noted that several PCAOB standards include requirements regarding audit procedures that are relevant to addressing fraud risks. Examples of such audit procedures include:

- Confirmation of accounts receivable;[23]

- Observation of inventories;[24] and

- Evaluating a company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.[25]

*Evaluating Audit Results*. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, PCAOB standards require the auditor to take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.[26] The procedures the auditor is required to perform in evaluating the results of the audit include several procedures that relate to the consideration of financial statement fraud. Examples of such procedures include the following:

- In the overall review of the financial statements, evaluating whether unusual or unexpected transactions, events, amounts, or relationships indicate fraud risks that were not identified previously;[27]

- Evaluating whether identified misstatements might be indicative of fraud and performing additional procedures as necessary;[28]

- Evaluating potential management bias in the amounts and disclosures in the financial statements;[29] and

[22] AS 2301.15 and AS 2401.54-.67A.

[23] AS 2310, *The Confirmation Process*.

[24] AS 2510, *Auditing Inventories*.

[25] *See generally*, AS 2410, *Related Parties*.

[26] Paragraph .03 of AS 2810, *Evaluating Audit Results*.

[27] AS 2810.06.b. and .09.

[28] AS 2810.19-23.

[29] AS 2810.24-27.

- Evaluating whether the accumulated results of auditing procedures and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks.[30]

**Additional Fraud Considerations in Audits of Internal Control Over Financial Reporting**

PCAOB standards require the auditor to take into account the results of his or her fraud risk assessments when planning and performing the audit of internal control over financial reporting. As part of identifying and testing entity-level controls and selecting other controls to test, the auditor should evaluate whether the company's controls sufficiently address identified fraud risks and controls intended to address the risk of management override of other controls. Controls that might address these risks include:

- Controls over significant unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.[31]

If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit.[32]

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[30] AS 2810.28-29 and Appendix C.

[31] Paragraph .14 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[32] AS 2201.15. *See also*, AS 2110.65-69.