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STANDING ADVISORY GROUP MEETING

CONSIDERATION OF OUTREACH AND RESEARCH REGARDING THE AUDITOR'S APPROACH TO DETECTING FRAUD

NOVEMBER 15-16, 2012

Introduction

At the November 2012 meeting, members of the Standing Advisory Group ("SAG") will be asked for views on whether the Public Company Accounting Oversight Board ("PCAOB" or the "Board") should conduct outreach or research regarding the auditor's approach to the detection of material misstatements of financial statements due to fraud ("financial statement fraud"). Outreach could include formation of a task force or other alternative means, such as roundtables. Research could be conducted by the Board's staff or by academic researchers. The SAG also will discuss potential areas of focus in conducting such outreach or research.

The November 2012 discussion follows up on an earlier discussion of this topic that took place at the May 17, 2012, SAG meeting. At that meeting, SAG members discussed the possible creation of a task force of the SAG that could explore issues regarding the auditor's approach to the detection of financial statement fraud, including consideration of possible enhancements to the PCAOB's auditing standards. During that discussion, many SAG members expressed support for such a task force. Some SAG members suggested that a task force could be a useful vehicle to identify and consider ways to improve auditing practices for fraud detection, such as increasing the use of forensic auditing procedures. Other SAG members who expressed support for a task force observed that outreach could explore the techniques and methods used by analysts and short-sellers that have uncovered recent frauds with access only to public information regarding a company. Some SAG members suggested that if a task force is formed, the task force should have clear objectives and direction.

This briefing paper is intended to facilitate a focused SAG discussion regarding matters for the Board to consider in deciding whether to conduct outreach or research regarding the auditor's approach to the detection of financial statement fraud. After a brief introduction of the topic, SAG members and observers will form break-out groups to discuss specific questions regarding the topic. On the second day of the meeting, PCAOB staff will present a summary of the break-out group discussions, and SAG members will have an opportunity to provide additional commentary.

Background

Under PCAOB auditing standards, 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.[1/] As early as 1940, the SEC held the position that an audit can be expected to detect certain kinds of fraud,[2/] and, over time, the auditing standards in this area have been enhanced and clarified.

Throughout its history, the PCAOB has devoted substantial attention to the auditor's responsibilities regarding financial statement fraud. Some specific PCAOB activities related to the auditor's responsibilities for detecting financial statement fraud include:

- Issuance of a Division of Registration and Inspections general inspection report on fraud, entitled *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud.*[3/] In this report, inspectors reported many observations related to

[1/] *See, e.g.*, paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*. *See also* the Appendix to this briefing paper.

[2/] *See* SEC, *In the Matter of McKesson & Robbins, Inc.* Accounting Series Release No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940) ("…accountants can be expected to detect gross overstatements of assets and profits whether resulting from collusive fraud or otherwise").

[3/] *See Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud,* PCAOB Release 2007-001 (Jan. 22, 2007) at 3-6, available at http://pcaobus.org/Inspections/Documents/2007_01-22_Release_2007-001.pdf.

the procedures performed by auditors that are relevant to an auditor's responsibilities regarding fraud, including:

- o Fraud procedures were performed as a mechanical exercise and with a check-the-box mentality;
- o Auditors were not holding required fraud "brainstorming" sessions or holding the sessions late;
- o Auditors were not making the required inquiries of key company personnel, audit committee members, and others; and
- o Auditors were not responding appropriately to identified fraud risk factors.

PCAOB inspections staff continues to identify auditing deficiencies related to auditors' planning and execution of audit procedures for detecting material misstatements due to fraud. For example, inspectors have noted that some auditors' procedures for examinations of journal entries were not sufficient to obtain evidence of possible material misstatement due to fraud.

- Inclusion in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements,* of specific requirements related to the risk of fraud related to an audit of internal control over financial reporting.

- Issuance of the Board's risk assessment standards in 2010,[4/] which incorporated and strengthened the requirements in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for identifying and responding to the risks of material misstatement due to fraud ("fraud risks") and evaluating audit results into the entire audit process.

[4/] *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), available at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

Incorporating fraud requirements into the foundational risk assessment standards clarifies 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. The risk assessment standards also made certain improvements in the required audit procedures, such as expanding the direction regarding consideration of management bias and including additional requirements for the auditor to assess fraud risks related to omitted, incomplete or inaccurate disclosures.

- Issuance of staff guidance related to fraud risks, including Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, and Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets.*[5/] These staff audit practice alerts provide additional guidance on certain fraud-related topics.

Current PCAOB standard-setting initiatives continue to consider improvements to the audit requirements related to detection of financial statement fraud. For example, the proposed standard, *Related Parties*,[6/] would strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with related parties. In addition, that proposed standard would expand the requirements regarding significant unusual transactions. Both of these enhancements can improve the auditor's ability to detect financial statement fraud.

[5/] *See* Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), and Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* (Oct. 3, 2011), available at http://pcaobus.org/Standards/Pages/Guidance.aspx.

[6/] *See* Proposed Auditing Standard – *Related Parties and Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012), available at http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf.

Alternatives for Outreach or Research

The auditor's responsibility for detecting financial statement fraud continues to be a frequent discussion topic during SAG meetings. For example, from the earliest meetings of the SAG, topics related to the auditor's responsibilities for detecting financial statement fraud have been on the agenda. The SAG has discussed fraud-specific topics in sessions on "forensic auditing" and "PCAOB-related recommendations from the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession ("ACAP")."[7/]

In the course of its standard-setting projects, the Board also considers, among other things, the results of relevant academic research and third-party studies. For example, the release accompanying the proposed auditing standard on related parties and related amendments to PCAOB auditing standards[8/] cites studies by academic researchers, the SEC, and others that are relevant to the Board's proposal.

The Board is considering whether to conduct further outreach or research regarding the auditor's approach to the detection of financial statement fraud.

One form of outreach, as mentioned previously, would be to create a task force. Such a task force could consist of certain SAG members and others who would bring subject matter expertise. Alternatively, the Board or its staff could conduct outreach, including possibly holding one or more public roundtables.

In either scenario, such outreach could include investors, academics, independent auditors, internal auditors, financial executives, and others who might have particular knowledge or other information that would be useful in the Board's consideration of the auditor's approach to the detection of financial statement fraud.

7/ The SAG discussed issues relating to fraud during the "Fraud and Related Topics," "Forensic Audit Procedures," and "Update on U.S. Department of the Treasury's Advisory Committee on the Auditing Profession ("ACAP") Recommendations" segments of the September 8, 2004, February 22, 2007, and April 8, 2010 SAG meetings, respectively. Copies of the respective briefing papers and webcasts archive are available at http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx.

8/ *See* PCAOB Release 2012-001.

Also, PCAOB staff would brief the SAG on the results of the outreach activities and seek the views of the SAG on those results.

Additionally, the Board could consider, separately or in conjunction with the outreach activities discussed above, whether additional research is needed in one or more areas related to the auditor's approach to the detection of financial statement fraud. As mentioned previously, such research could be conducted by the Board's staff or by academic researchers. Examples of financial statement fraud research could include:

- Studies of known financial statement frauds that were not uncovered by auditors to determine why the frauds were not detected (for example, did the auditors not perform the appropriate auditing procedures, did time and fee pressures prevent an in-depth look at uncovered issues, or are additional techniques necessary to uncover the financial statement frauds);

- Studies of financial statement frauds that were uncovered by auditors to determine how these frauds were detected (for example, did specific fraud detection procedures uncover the fraud, or whether it was detected as a result of "normal" audit procedures); or

- Studies on the extent to which, and conditions under which, incentives might result in earnings management through aggressive accounting practices (for example, related to accruals or accounting estimates including fair value measurements).

Potential Areas of Focus for the Outreach or Research

The primary objective of Board outreach or research would be to explore whether improvements are needed to PCAOB standards regarding the auditor's approach to the detection of financial statement fraud. Examples of potential areas of focus for the outreach and research activities include:

- Considering whether the existing requirements and direction in PCAOB auditing standards could be strengthened or improved;

- Considering whether the auditor's responsibilities could be expanded through the incorporation of additional forensic procedures or other types of procedures; and

- Considering whether changes to PCAOB quality control standards and, in turn, changes to firms' quality systems could strengthen auditing practices regarding fraud detection.

Considering existing requirements

Existing PCAOB auditing standards require the auditor to, among other things, (1) perform procedures to identify fraud risks; (2) plan and perform audit procedures to address those risks, including certain specified procedures to address the risk of management override of controls; and (3) consider fraud in evaluating the results of the audit.[9/] Outreach and research activities could explore whether there is a need to change existing PCAOB auditing standards to improve the requirements or provide more specific direction for the auditor. For example, in the past, some SAG members have suggested establishing a presumption for the auditor that certain audit areas (such as fair value measurements and accounting for unusual accruals) should be considered higher risk audit areas.

Considering forensic procedures or other types of audit procedures

Another potential focus area relates to whether to expand audit requirements to incorporate additional forensic procedures or other types of procedures for detecting financial statement fraud. In 2000, *The Panel on Audit Effectiveness Report and Recommendations*[10/] recommended that "…auditing standards should create a "forensic-type" fieldwork phase of all audits." In response, the American Institute of Certified Public Accountants' Auditing Standards Board required, in Statement of Auditing Standard No. 99,[11/] that auditors perform: (1) journal entry testing, (2) retrospective review of significant accounting estimates, and (3) evaluation of the

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[9/] *See generally*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, Auditing Standard No. 14, *Evaluating Audit Results*, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[10/] Public Oversight Board, The Panel on Audit Effectiveness, *Report and Recommendations* (Aug. 31, 2000) at x, available at http://www.pobauditpanel.org/download.html.

[11/] Adopted by the PCAOB as interim auditing standard AU sec. 316 in April 2003.

business rationale for significant unusual transactions. This area of focus could explore whether additional forensic procedures or other types of procedures should be required and the circumstances in which they might be required. Also, this area could explore tools and techniques used by other professionals to identify fraud that could be applied by independent auditors, and whether or when to apply such tools.

Considering quality control standards

A third potential area of focus relates to PCAOB quality control standards. Outreach and research activities could explore whether to change quality control requirements related to:

- Enhancing the auditor's use of professional skepticism; and
- Ensuring that firm personnel have the necessary training and competencies to design and perform audit procedures to detect financial statement fraud.

Considerations for Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") gave the Board oversight of the audits of brokers and dealers registered with the SEC.[12/] On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.[13/]

An important aspect of the audit of a broker or dealer is the auditor's consideration of and response to the risk of misappropriation of customer assets. The Board has given significant consideration to the auditor's responsibilities in this area. For example, the Board's proposed attestation standards for broker and dealer compliance and exemption reports under the SEC's proposed amendments that include

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[12/] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

[13/] SEC, *Broker-Dealer Reports,* Exchange Act Release No. 64676 (June 15, 2011), available at http://www.sec.gov/rules/proposed/2011/34-64676.pdf.

specific requirements regarding the risk of fraud, particularly the risk of misappropriation of customer assets.[14/]

Outreach or research could explore whether to make changes to PCAOB auditing standards as they relate to audits of brokers and dealers.

Discussion Questions

1. Should the Board conduct outreach regarding the auditor's approach to the detection of financial statement fraud? If so, what form of outreach should the Board consider and why?

2. Are there particular types of organizations or types of individuals that the Board should consider reaching out to as part of its outreach efforts (for example, forensic investigators, fraudsters, whistleblowers, short-sellers, or others)?

3. Is research needed regarding the auditor's approach to the detection of financial statement fraud?

4. What should be the areas of focus for the outreach and research activities and why?

5. Should the scope of this outreach and research include consideration of issues relating to broker-dealer audits, or should those issues be considered as a separate outreach effort by the Board?

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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.

[14/] *See Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-004 (July 12, 2011), available at http://pcaobus.org/Rules/Rulemaking/Docket035/PCAOB_Release_2011-004.pdf.

Appendix

Overview of the Auditor's Responsibilities Under PCAOB Standards Regarding the Consideration of Fraud in an Audit

Over the years, a variety of views have been expressed by auditors and others about the auditor's responsibilities with respect to fraud in an audit (which is sometimes described as an "expectations gap"), and some parties may not fully understand the auditor's existing responsibilities under PCAOB standards.

This appendix provides an overview of the auditor's responsibilities under existing PCAOB standards regarding the consideration of fraud in an audit. The appendix was developed to facilitate discussion among members of the Standing Advisory Group ("SAG"). It does not address all of the audit requirements in PCAOB standards regarding the auditor's consideration of fraud in an audit, is not a substitute for PCAOB standards, and does not express any legal positions on any issues related to auditors' responsibilities under the securities laws or PCAOB standards.

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/]

1/ *See, e.g.*, paragraph .02 of AU sec. 110, *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 auditors 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 AU sec. 317, *Illegal Acts*. And Auditing Standard No. 16, *Communications with Audit Committees*, 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/]

<u>Consideration of Financial Statement Fraud in Planning and Performing Audit Procedures</u>

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 results of the audit to

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requires the auditor to make certain inquiries of the audit committee about violations or possible violations of laws and regulations.

[3/] *See, e.g.*, AU sec. 230, *Due Professional Care in the Performance of Work.*

[4/] Paragraph 7 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

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 errors 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;

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

[6/] Paragraph 41 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatements*.

[7/] *See* paragraph 7 of Auditing Standard No. 9, *Audit Planning*, and Auditing Standard No. 8, *Audit Risk*.

- 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:

- 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

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[8/] Paragraph 5 of Auditing Standard No. 12.

[9/] *See* paragraphs 49-53 of Auditing Standard No. 12.

[10/] *See* paragraphs 56-58 of Auditing Standard No. 12.

[11/] *See* paragraph 47 of Auditing Standard No. 12.

[12/] *See* paragraphs 65-69 of Auditing Standard No. 12 and paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

- 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 compensation arrangements with senior management,[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.

- 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

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[13] *See* paragraphs 72-73 of Auditing Standard No. 12.

[14] *See* paragraph 9 of Auditing Standard No. 12.

[15] *See* paragraphs 10-11 of Auditing Standard No. 12.

[16] *See* paragraphs 12-13 of Auditing Standard No. 12.

[17] *See* paragraphs 14-15 of Auditing Standard No. 12.

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. 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:

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[18] *See* paragraphs 16-17 of Auditing Standard No. 12.

[19] *See* paragraphs 18-40 of Auditing Standard No. 12.

[20] *See* paragraphs 3-4 of Auditing Standard No. 13.

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud; and
- Evaluating the business rationale for significant unusual transactions.[21/]

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;[22/]
- Observation of inventories;[23/] and
- Procedures to identify and examine transactions with related parties.[24/]

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.[25/] 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:

21/ *See, e.g.*, paragraph 15 of Auditing Standard No. 13 and paragraphs .54-.67 of AU sec. 316.

22/ *See generally,* AU sec. 330, *The Confirmation Process.*

23/ *See generally,* AU sec. 331, *Inventories.*

24/ *See generally,* AU sec. 334, *Related Parties*. The Board has proposed an auditing standard that would replace AU sec. 334. *See* PCAOB Release 2012-001.

25/ Paragraph 3 of Auditing Standard No. 14.

- 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;[26/]
- Evaluating whether identified misstatements might be indicative of fraud and performing additional procedures as necessary;[27/]
- Evaluating potential management bias in the amounts and disclosures in the financial statements;[28/] and
- 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.[29/]

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

26/ Paragraphs 6.b. and 9 of Auditing Standard No. 14.

27/ Paragraphs 19-23 of Auditing Standard No. 14.

28/ *See, e.g.*, paragraphs 24-27 of Auditing Standard No. 14.

29/ Paragraphs 28-29 and Appendix C of Auditing Standard No. 14.

- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.[30/]

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.[31/]

[30/] Paragraph 14 of Auditing Standard No. 5.

[31/] Paragraph 15 of Auditing Standard No. 5. *See also*, paragraphs 65-69 of Auditing Standard No. 12.