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Fraud – Importance Of Risk Assessment

- SEC proposed guidance
- PCAOB proposed guidance (AS 5)
- IIA practice advisory 1210 –A2.1
- Fraud risk assessment

SEC Proposed Guidance

Top-down risk based approach

I/C Framework – Generally COSO

Consider the vulnerability of the entity to fraudulent activity (fraudulent financial reporting, misappropriation of assets, corruption)

SAB 99 materiality

PCAOB Proposed Guidance

AS5¶12: Smaller companies – "Risk of management override" and "segregation of duties"

AS5¶ 18 "Management override" and "risk assessment process"

AS5¶21 & 22: Some JE and financial reporting requirements from SAS 99

AS5¶ 26: Risk factors to consider in selecting significant accounts - "Susceptibility of misstatement due to errors or fraud"

PCAOB Proposed Guidance

AS5¶34: "For each significant process … auditor should …"

- Identify points within process at which a misstatement including misstatement due to fraud could arise ...
- Identify controls management has implemented …
- Identify controls management has implemented over prevention or timely detection of [material] unauthorized acquisition, use or disposition of … assets …

AS5¶45 "… The Auditor should test the company's programs and controls that address identified risks of material misstatement due to fraud as well as controls intended to address the risk of management override of other controls."

IIA Practice Advisory

IIA adopted changes in June 2006 to two fraud-related practice advisories – PA 1210.A2-1 & PA 1210.A2-2

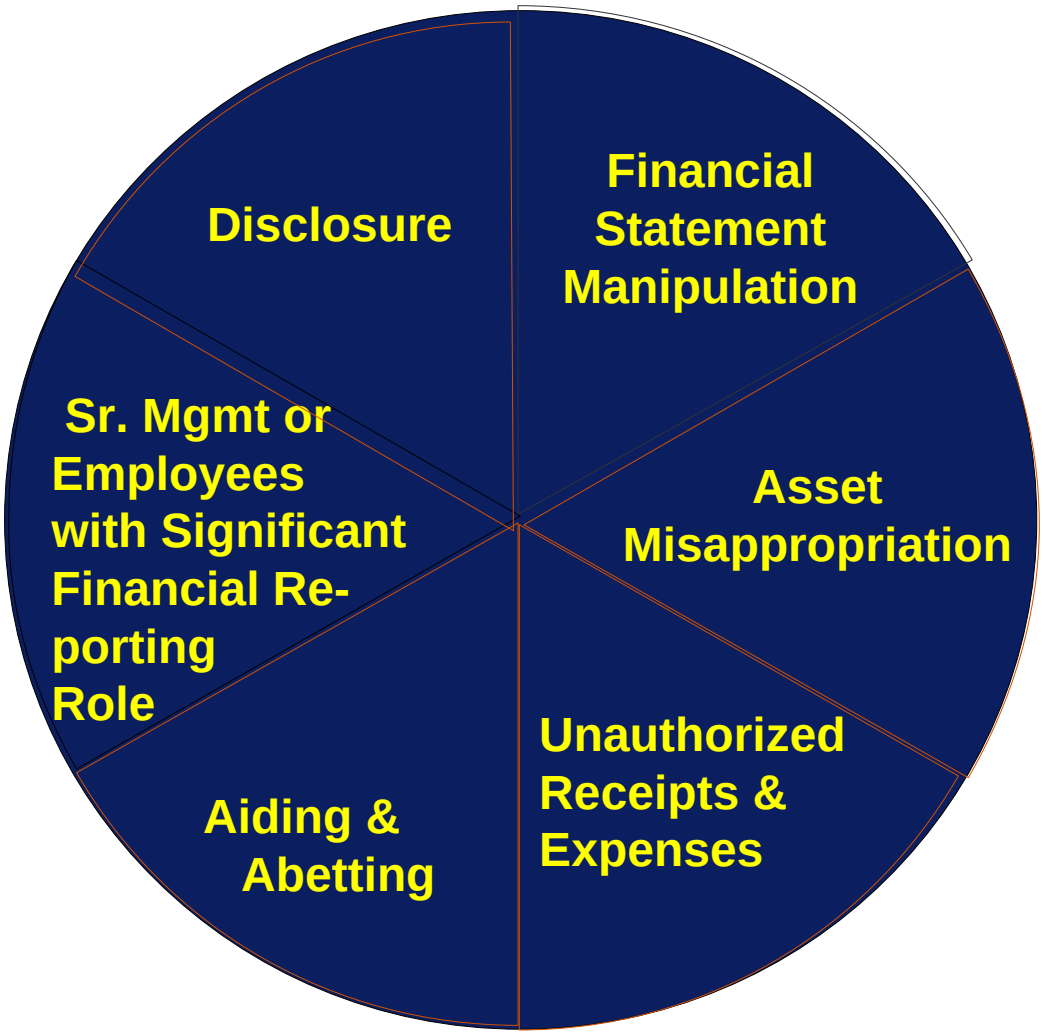
Key points:

- Differentiate the internal auditor's role in 'auditing for fraud' vs. involvement in 'fraud investigations'
- Auditors should understand fraud schemes and scenarios
- COSO ERM – Suggested as a useful framework
- Fraud risk assessment is included as an element of an effective fraud-prevention program

Roles And Responsibilities

Board	Management	External Auditor
Oversight of fraud risk assessment Management override of controls Investigation of alleged and suspected fraud Sarbanes §301 – Whistleblower hotline	Enterprise and fraud risk assessment Control environment Controls to address items that can have a > inconsequential effect on financials Monitoring Compliance (USSG, FCPA)	Plan and perform to obtain reasonable assurance SAS 99: • Brainstorming • Fraud risk assessment • Inquiries • Journal entry testing • Unpredictable procedures

Fraud Risk Assessment



Types Of Fraud To Consider

Foreign Corrupt Practices Act

Last year, 15 new investigations were reported, up from eight in 2005, and it was not just a one-year anomaly.
Shearman & Sterling

There are currently 47 open investigations of alleged overseas bribery incidents. The vast majority involve U.S.-based corporations

Financial Times – March 2007

Foreign Corrupt Practices Act

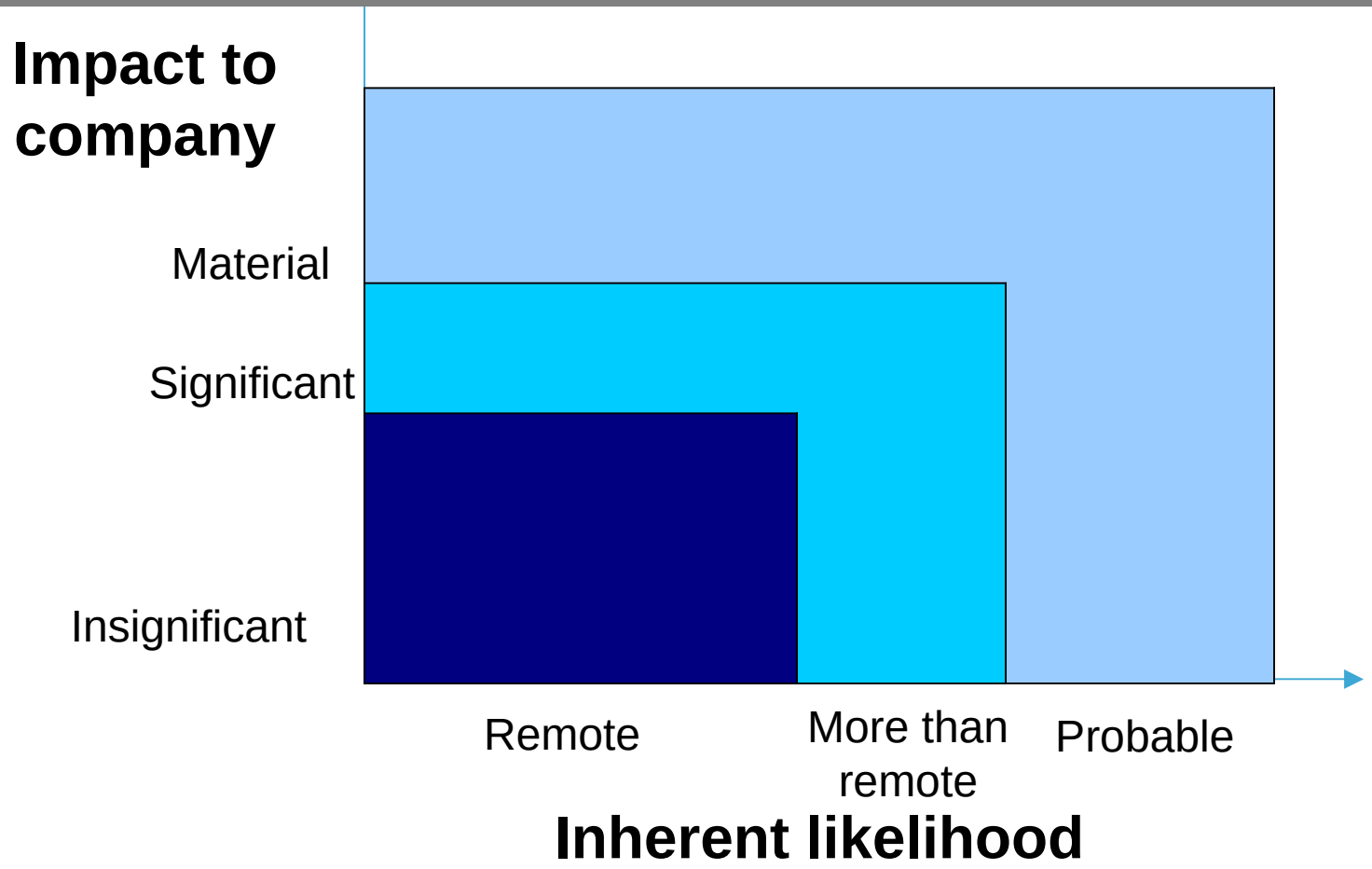
Accounting requirement

- Reasonably detailed and accurate records of payments and transactions
- Internal controls system that provides reasonable assurance that management controls the use of business assets

Anti-bribery provision

- Prohibits U.S. entities, their foreign subsidiaries and others from bribing foreign government officials, either directly or indirectly, to obtain or retain business

Fraud Risk Assessment



Fraud Risk Assessment

Business Unit, Process or Objective	Fraud Category	Fraud Scenario	Antifraud Controls	
			Preventative	Detective
Revenue recognition	Fraudulent financial reporting	Improper change in pricing	Access to make changes to pricing is restricted Establishment and changes to price lists are approved by authorized personnel	Reporting to monitor changes to the master file Management review and approval required for orders with pricing overrides

SAS No. 99 *Consideration of Fraud in a Financial Statement Audit* – An Overview

Issued October 2002 – Amends SAS No.1

Establishes the auditor's responsibly for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether cased by error or by fraud

SAS No. 99 *Consideration of Fraud in a Financial Statement Audit* – An Overview

SAS No. 99 addresses:

- Description and characteristics of fraud
- Exercising professional skepticism
- Audit team discussion of risk of material misstatement due to fraud
- Identification of risks that may result in a material misstatement due to fraud

SAS No. 99 *Consideration of Fraud in a Financial Statement Audit* – An Overview

SAS No. 99 addresses:

- Assessing the identified risks
- Responding to the results of the assessment
- Evaluation of audit evidence
- Communication
- Documentation

PCAOB 4010 Report *Observations on Auditor's Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* – An Overview

Issued Jan. 22, 2007

The report discusses aspects of procedures relevant to an auditor's consideration of fraud. The PCAOB is not changing or proposing to change any existing standard, nor is the report meant to provide a new interpretation of any aspects of the existing standards

PCAOB 4010 Report *Observations on Auditor's Implementation of PCAOB Standards Relating to Auditor's Responsibilities with Respect to Fraud* – An

Observations from PCAOB inspections:

- Auditor's overall approach to detection of financial fraud
- Brainstorming sessions & fraud-related inquiries
- Auditors response to fraud risk factors
- Financial statement misstatements
- Risk of management override of controls
- Other areas to improve fraud detection

SAS No. 99 – "Bridge The Gap And Keep Your Balance"
Introduction

Stakeholders include:

- Regulators and standard setters (e.g. SEC, PCAOB, AICPA, DOJ, states, etc.)
- Companies (e.g. management and directors)
- Investors (e.g. shareholders, creditors, etc.)
- Independent auditors

To bridge the fraud "expectation gap" stakeholders must balance on a "tightrope" of differing responsibilities

SAS No. 99 – "Bridge And Balance" For Regulators Overview

- Uniform standards and guidance
- Public input
- Enforcement

SEC backs eased rules

SARBANES-OXLEY CHANGES TO BE IN PLACE BY JUNE

By Marcy Gordon
Associated Press
Article Launched: 04/05/2007 01:40:29 AM PDT

WASHINGTON - The Securities and Exchange Commission approved a framework Wednesday for changes to rules under a landmark anti-fraud law that would ease requirements for companies and the auditors who pore over their books.

The vote by the five SEC commissioners was unanimous to support building more leeway into the rules, especially rules for auditors being written by the independent board that oversees the accounting industry.

SAS No. 99 – "Bridge And Balance" For Regulators PCAOB Topics

Discussion Topics –

Presentations and discussion may address the following topics –

- Characteristics that distinguish an audit of financial statements from a forensic audit.
- Lessons or best practices from the field of forensic auditing that could improve the quality of financial statement audits.
- The potential objectives of the forensic audits envisioned by the November 2006 Paper.

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PCAOB
Public Company Accounting Oversight Board

SAS No. 99 – "Bridge And Balance" For Companies Overview

- Fraud risk assessment
  - Move from *compliance* to *management* of risks

- Periodic forensic "audits"
  - Regular basis
  - Random

SAS No. 99 – "Bridge And Balance" For Companies Fraud Risk Assessment

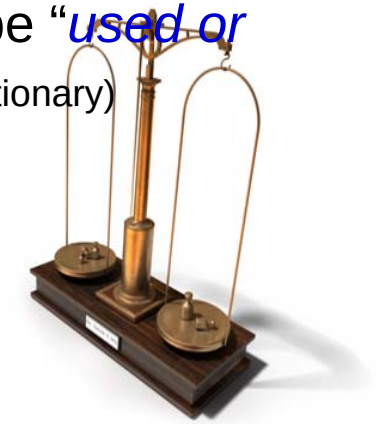
- Integral part of enterprise-wide risk assessment
  - Responsibility of management and board
  - Identify, measure and reduce fraud risks
- Recommended and/or required by:
  - Committee of Sponsoring Organizations of the Treadway Commission ("COSO") *Internal Control – Integrated Framework*
  - Federal and/or state laws and/or regulations

COSO
The Committee of Sponsoring Organizations of the Treadway Commission

SAS No. 99 – "Bridge And Balance" For Companies Forensic Audits

Forensic "audits“

- A financial statement auditor’s responsibility is to plan and perform an audit to obtain *reasonable assurance* about whether the financial statements are free of material misstatements, whether caused by error or fraud
- Forensic procedures are designed and performed to be “*used or suitable in courts of law or public debate*” (Black’s Law Dictionary)



SAS No. 99 – "Bridge And Balance" For Companies Forensic Audit Techniques

Forensic "audits" – 7 basic techniques

- Public document reviews and background investigations
- Interviews of knowledgeable persons
- Use of confidential sources
- Laboratory analysis of physical and electronic evidence
- Physical and electronic surveillance
- Undercover operations
- Analysis of financial transactions

SAS No. 99 – "Bridge And Balance" For Companies Global 6 Views

Subject All Public Companies to a Forensic Audit on a Regular Basis: The most aggressive, but costly and intrusive way of rooting out fraud is to require all public companies to undergo a forensic audit on a regular basis (perhaps every three or five years).

Subject All Public Companies to a Forensic Audit on a Random Basis: A less onerous and costly version of the forensic audit proposal would be to subject a sample of public companies on every exchange to a forensic audit on a random basis. Though such a

Serving Global Capital Markets and the Global Economy: A View from the CEOs of the International Audit Networks November, 2006

SAS No. 99 – "Bridge And Balance" For Investors Overview

- Recognize that an "*expectation gap*" exists
  - Management and board responsibilities
    - Sect. 302 -- Corporate responsibility for financial reports
      - Officers disclose to the auditors and audit committee … *any fraud*, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls
  - Independent auditor responsibilities
    - Defined by professional standards

SAS No. 99 – "Bridge And Balance" For Auditors Overview

- Three broad requirements
  - *Identify* fraud risks
  - *Assess* fraud risks
  - *Respond* to fraud risks

SAS No. 99 – "Bridge And Balance" For Auditors Identify Fraud Risks

- Brainstorming *preceded* by research, fraud analytics and interviews
  - Evaluate company fraud risk assessment
  - Checklists used to locate potential "red flags"
  - Research public filings and comments, backgrounds and other relevant matters
  - Analytically test relevant details
  - Inquiries of management and directors
    - Done by teams
    - Experienced/specialized expertise

SAS No. 99 – "Bridge And Balance" For Auditors Identify And Assess Fraud Risks

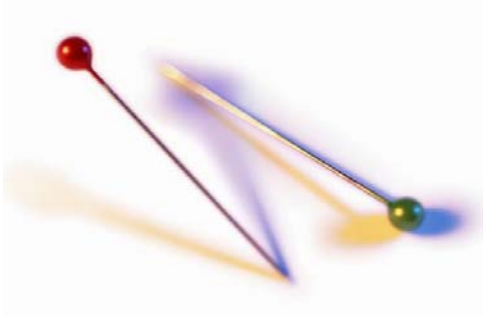
- Robust brainstorming at front end to *identify and assess* significant fraud risks
  - Key team members and specialists
  - Focused on schemes and scenarios
  - Linked to:
    - Individual accounts
    - Classes of accounts
    - Assertions
    - Disclosures

SAS No. 99 – "Bridge And Balance" For Auditors Communicate Fraud Risks

- Continuous *communication* of fraud risks to audit team members
  - Expectation-setting for audit team
  - Documentation
    - SAS 99
    - Work plans
  - Supervision and review

SAS No. 99 – "Bridge And Balance" For Auditors Respond To Fraud Risks

- *Response* to significant fraud risks
  - Expanded and tailored work plan linked to risk areas
  - Nature, timing and extent of testing considered
    - Focus on:
      - Management override of controls
      - Non-standard journal entries
      - Accounting estimates
  - Staffing and supervision considered



SAS No. 99 – "Bridge And Balance" For Auditors Respond To Fraud Risks (cont.)

- *Response* to significant fraud risks
  - Testing performed using
    - Heightened skepticism
    - Experienced/specialized expertise
  - Testing results assessed using
    - Experienced/specialized expertise
  - Risk and materiality reassessed continuously
    - Quantitative & qualitative considerations

SAS No. 99 – "Bridge And Balance"
Bradley J. Preber, CPA, CFE

Biography

Bradley J. Preber, CPA, CFE
Partner, Economic and Advisory Services
Brad is the Partner in Charge of Grant Thornton's Forensic Accounting and Investigative Services practice in the Western United States. Brad is a Certified Public Accountant and Certified Fraud Examiner. He has over twenty-three years experience in public accounting and consulting, including service as an audit partner for one of the largest global accounting firms. Among other areas, Brad specializes in fraud prevention, deterrence, and detection, forensic investigations and the development and implementation of remedial actions in response to fraud. Brad is a subject matter expert for Grant Thornton on SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, recently speaking about forensic audit procedures in Washington, D.C. as an invited guest of the PCAOB. Brad is a frequent speaker, writer and instructor on leadership, accounting and fraud related matters.

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SAS No. 99 and 4010 Report Overview
Curtis Reinhart, CPA

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Partner – Audit and Assurance Business Services
Ernst & Young LLP

Curtis Reinhart is a Partner in E&Y's Audit and Assurance Business Services group with 17 years experience serving clients in the Media & Entertainment industry. His primary areas of focus have been Cable Television, TV and Radio Broadcasting. Curtis' client base includes both private and public companies, with extensive involvement in Sarbanes Oxley matters, and SEC regulations. In addition, Curtis also provides consultation to E&Y's Transaction Advisory Services group on Media & Entertainment industry matters.

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Fraud Risk Assessment
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PricewaterhouseCoopers

Graduate Indiana University Cum Laude BS Accounting 1991. Bill joined Price Waterhouse in 1991 and is currently a director in PwC's Fraud Risk and Controls practice with 16 years of experience in financial statement audits and forensic accounting investigations. His experience includes financial statement audits in the entertainment and media, software, and consumer and industrial products industries and forensic investigations in several industries. As a director in the firm's fraud risk and controls practice, Bill assisted in developing PwC's fraud auditing policy and methodology, and serves as a subject matter expert for numerous audit engagement teams with respect to clients' antifraud programs and controls and our fraud auditing procedures.

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SAS No. 99 – "Bridge And Balance" Resources

- PCAOB
  - www.pcaobus.org
  - www.pcaobus.org/Inspections/Other/2007/01-22_Release_2007-01.pdf (Fraud 4010 Report dated 1/22/07)
  - www.pcoabus.org/News_and_Events/Webcasts.aspx#40 (Standing Advisory Group Fraud discussion 2/22/07)
- COSO
  - www.coso.org
- SEC
  - www.sec.gov/news/openmeetings/2007/openmtg_trans040407.pdf (unofficial transcript of commissioners meeting 4/6/07)
- Global Public Policy Symposium
  - www.globalpublicpolicysymposium.com/CEO_Vision.pdf (November 2006 Global 6 auditing firms white paper)
- AICPA
  - www.antifraud.aicpa.org
  - http://antifraud.aicpa.org/Resources/Auditors/Audit+Procedures/High+Fraud+Risk+Areas/Management+Override+and+Financial+Statement+Fraud.htm
- Open Compliance and Ethics Group
  - www.oceg.org
- Grant Thornton
  - www.grantthornton.com
  - http://www.grantthornton.com/staticfiles/GTCom/files/AboutUs/Corporate%20Governance/CorporateGovernor_white_paper_series/404%20whitepaper_FINAL.pdf
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