United States Courts
Southern District of Texas
FILED
MAY 0 8 2002
Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION - This Document Relates To: MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, - against - ENRON CORP., et al., Defendants,	§ § § § § § § § § § § § § § § § § §	Civil Action No. H-01-3624 (Consolidated)
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, - against - KENNETH L. LAY, et al., Defendants.	§ § § § § § § § § § § § § § § §	

DECLARATION OF ANDREW RAMZEL IN SUPPORT OF
DEFENDANT ARTHUR ANDERSEN LLP AND
THE INDIVIDUAL ANDERSEN DEFENDANTS'
MOTIONS TO DISMISS

652

1. I, Andrew Ramzel, am an attorney representing Arthur Andersen L.L.P. ("Andersen") and certain of the Individual Andersen Defendants in the above-captioned action. I am an attorney licensed to practice law in the State of Texas and before this Court. I am competent to make this declaration, and it is based on my personal knowledge. I make this declaration in support of Andersen and all of the Individual Andersen Defendants' Motions to Dismiss.

2. Attached to my declaration are the following true and correct copies of the documents listed below.

Exhibit	Description
A.	Memorandum by James A. Hecker re Client Accounting Inquiry dated August 21, 2001.
B.	Excerpts from February 19, 2002 Deposition of Thomas Bauer, Newby v. Enron Corp., C.A. No. H-01-3624 (Consolidated Class Action), Tittle v. Enron Corp., C.A. No. H-01-3913 (and Consolidated Cases) (S.D. Tex.).
C.	American Institute of Certified Public Accountants, Auditing Standards § 230 (2001)
D.	American Institute of Certified Public Accountants, Auditing Standards § 316 (2001)
E.	American Institute of Certified Public Accountants, Auditing Standards § 9312 (2001)

3. I declare under penalty of perjury that the foregoing is true and correct. Executed on May 8, 2002.

Andrew Ramzel

CERTIFICATE OF SERVICE

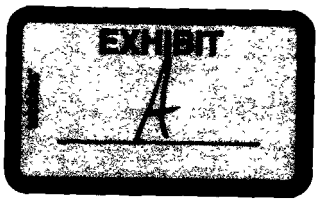
I hereby certify that on this 8 day of May, 2002, the forgoing pleading was served pursuant to the Court's April 5, 2002 Order.

Andrew Ramzel

Copies To:

Debra A. Cash
David B. Duncan
Michael M. Lowther
Michael C. Odom
William E. Swanson

Just recently received word to issue. Thank you. J.Hecker



Memo

ANDERSEN

To The Files

From James A. Hecker

Date August 21, 2001

Subject Client Accounting Inquiry

Yesterday I received an ostensibly social call from Sherron Smith Watkins, a Houston office alum who works in the CFO's group at our large audit client, Enron. After some small talk about current events such as the job market and last week's CEO resignation at Enron, she asked me if I knew much about some of Enron's recent structured transactions. I told her I did not, having never worked on the Enron job, but that I had general knowledge about many of the related issues from my work on other marketing and trading clients. Although she seemed initially reluctant to get into the details with me, an Arthur Andersen audit partner, she obviously wanted a "sounding board" with whom she could discuss certain of her concerns related to a set of Enron transactions, and I told her I'd be happy to listen.

Sherron then told me she was concerned about the propriety of accounting for certain related-party transactions. The transactions in question were, based on our discussions, with an entity with a name something like "LJM", which was at the time of the transactions at least partly owned by Andy Fastow, Enron's CFO (and her current boss). She later told me that Fastow's interest in "LJM" has since been sold to Michael Copper, an Enron alum. I also understood by her tone that the potentially sensitive transactions were done within the last couple of years. Sherron seemed even more agitated about the transactions' accounting because she perceived the related footnote disclosures in the company's consolidated financial statements were difficult to understand and did not tell the "whole story".

After some investigative work since her return to Fastow's group, she reportedly had discussed some of her concerns with Enron's general counsel office (she did not name the individual). That individual had assured her that AA and Enron's external counsel (Vinson &Elkins) had reviewed the transactions' accounting and financial statement disclosures and that they were sure there was no impropriety. At that point, I mentioned to Sherron that many people inside and outside the company assume we have seen every small transaction and OK'd the accounting, which for many reasons, potentially including immateriality, is often not true. Sherron understood this, but assured me the dollars involved (approximately $500 million) were material, even to (a company as large as) Enron. Based both on the type and size of the transactions, Sherron told me she was concerned enough about these issues that she was going to discuss them with Ken Lay, Enron's Chairman, on Wednesday, August 22, 2001

Based on our following discussions, her perceptions and concerns were:

- In summary, Sherron couldn't understand how Enron could, with its own capital stock, repeatedly add to the collateral underlying an obligation owed to Enron from a related party without recognizing in its financial statements either a) the related Enron stock distributions or contributions to that related party or b) the high-tech investment losses such related-party obligation was supposedly protecting against.
- LJM, an investment company formerly owned at least partially by Andy Fastow (CFO of Enron), was formed to enter into various structured transactions with Enron. I understood from Sherron that one such transaction involved the hedging of certain of Enron's investments in high-tech companies. Since these high-tech investment values have declined, Enron's hedge from LJM has increased in value, thus putting LJM on the hook for a potentially large liability to Enron. Supporting this hedging arrangement, Sherron described to me that LJM was initially capitalized in large part with Enron stock, which has also significantly declined in value since yearend 2000. Well after LJM's formation, and in response to this resulting reduction in total LJM asset value, her investigative inquiries had pieced together a very troublesome scenario. She perceived that Enron was putting additional Enron stock into LJM (the exact mechanism – sales, contributions, exchanges or otherwise –wasn't clear from our conversation), primarily to bolster LJM's perceived ability to repay obligations that will be owed to Enron at some future date. However, according to Sherron, these additional Enron stock contributions/issuances to LJM did not appear to be recorded on Enron's books. I informed Sherron I could not comment because I was obviously unfamiliar with the facts behind both the formation and ongoing operations of LJM.
- She asserted that the Enron financial-statement disclosures related to the Fastow investment-company relationships and transactions were (putting it kindly) hard to understand and incomplete. A $500 million gain from the LJM contract(s) was purportedly identified in interim financial disclosures. However, according to Sherron, it was not clear in the disclosures that the $500 million gain on Enron's books from the Fastow agreement (through LJM) actually offset other losses on Enron's investments in various high-tech investments. The potential collateralization/collectibility issues behind the LJM obligation that Sherron perceived are a problem were also not spelled out. I did not attempt to confirm these disclosure assertions by pulling Enron's Form 10-K or 10-Q's (but see documentation of engagement team discussions below).
- She also asserted that, at the time of the recent sale to Mr. Copper, she had mentioned to others that LJM must have had "very limited" stockholders' equity and must have been an unsuccessful investment for its owner(s). I inferred that she thought Mr. Copper's purchase price must have been relatively small, for one or more of the following reasons: a) LJM owed so much to Enron, or b) the company had so few other assets or c) it only had assets such as Enron stock that had declined so much in value since LJM's inception. However, she also asserted that she had been told that most, if not all, of LJM's equity had been distributed to its shareholder(s) [including Fastow and CIBC, an independent banking organization unrelated to Enron] concurrently, or shortly after, its original formation.

Based on our discussion, I told her she appeared to have some good questions. I emphasized that I was uninvolved in the issues or client and therefore unable to give her any definitive advice or conclusions on these matters, especially without knowing all the facts, which she understood. However, I encouraged her to discuss these issues with anyone in the company who could satisfy her about the accounting and disclosures related to these transactions. I told her that I admired her "stand-up" attitude and that corporate introspection about these sorts of accounting and reporting issues often was very healthy and should not be surpressed. She neither committed to update me about her discussions with Ken Lay nor requested anything further from me.

Immediately after my discussion with Sherron on August 20, I relayed the essence of her asserted concerns to Bill Swanson (ABA practice director), Dave Duncan (Enron engagement partner) and Deb Cash (a partner on several of the trading segments at Enron). On August 21, we all added Mike Odom, practice director, to the discussions, and agreed to consult with our firm's legal advisor about what actions to take in response to Sherron's discussion of potential accounting and disclosure issues with me.

Copies To:

Debra A. Cash
David B. Duncan
Michael M. Lowther
Michael C. Odom
William E. Swanson

CERTIFIED COPY

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

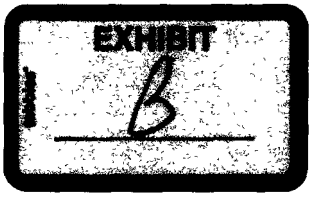
MARK NEWBY, ET AL, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED,	)	
Plaintiffs,	)	C.A. No. H-01-3624 (Consolidated) Class Action
vs.	)	
ENRON CORP., ET AL, Defendants.	)	

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

PAMELA M. TITTLE, ON BEHALF OF HERSELF AND A CLASS OF PERSONS SIMILARLY SITUATED, ET AL,	)	
Plaintiffs,	)	C.A. No. H-01-3913 (And Consolidated Cases)
vs.	)	
ENRON CORP., AN OREGON CORPORATION, ET AL, Defendants.	)	

ORAL VIDEOTAPED DEPOSITION
THOMAS BAUER
February 19, 2002

ORAL VIDEOTAPED DEPOSITION OF THOMAS BAUER, produced as a witness at the instance of the Plaintiffs and duly sworn, was taken in the



1 above-styled and numbered cause on the 19th day of
2 February, 2002, from 9:09 a.m. to 1:52 p.m., before
3 Vickie G. Hildebrandt, Certified Shorthand Reporter
4 in and for the State of Texas, reported by
5 computerized stenotype machine at The Houstonian,
6 111 North Post Oak Lane, Houston, Texas, pursuant to
7 the Federal Rules of Civil Procedure and the
8 provisions stated on the record or attached hereto.
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1 Q. Hear it discussed? 09:50
2 A. No, sir. 09:50
3 Q. Do you know to whom it was directed? 09:50
4 A. I -- as I recall, it was directed to the 09:50
5 other assistants, but I'm -- I'm not certain. 09:50
6 Q. And without any pejorative use here, when 09:50
7 you say "assistants," are we -- 09:50
8 A. I'm sorry. 09:50
9 Q. -- talking secretaries? 09:50
10 A. Yes, sir. 09:50
11 Q. Between the 23rd of October and the 9th of 09:50
12 November, did you delete or destroy any documents or 09:50
13 data related to Enron? 09:50
14 A. Yes. 09:50
15 Q. What kind of documents in that time period 09:50
16 did you delete or destroy? 09:50
17 A. I would have -- in -- in connection with my 09:50
18 normal policy, I would have deleted or destroyed any 09:50
19 documents related to the '01 audit that I was working 09:50
20 on including drafts of reports or -- or work that we 09:51
21 were conducting for that year. 09:51
22 Q. And the '01 audit would be for fiscal 2001? 09:51
23 A. That's correct. 09:51
24 Q. And when you say "drafts of reports," what 09:51
25 kind of reports would you do in the course of an 09:51

1 audit for 2001? 09:51
2 MR. SCHREIBER: Again, you're getting 09:51
3 a little bit into the -- into the substance, but by 09:51
4 way of background, I'll give you a little leeway here 09:51
5 in explaining sort of what it is he's doing for the 09:51
6 '01 audit. 09:51
7 Q. (BY MR. HOWES) My question is -- I'm just 09:51
8 trying to figure out what kind of things you would 09:51
9 have deleted. 09:51
10 A. Yes, sir. As I recall, they would be 09:51
11 drafts of -- of reports on control projects that we 09:51
12 have done, you know, many throughout the year and I 09:51
13 keep the final draft but not the intermediate 09:51
14 version, so I would have deleted those during the 09:51
15 course of the year. I also believe I deleted a -- 09:51
16 earlier drafts of a price risk management policy that 09:52
17 the company was adopting and -- and had given to me 09:52
18 for review, and I kept the final version. I don't 09:52
19 believe I kept the earlier drafts of that. 09:52
20 Q. This price risk management policy, the 09:52
21 final, would that have gone in the central file? 09:52
22 A. I believe so. 09:52
23 Q. And did you still have a copy of it when 09:52
24 your documents were collected? 09:52
25 A. I don't recall. If I -- if I did, I would 09:52

1 have produced it. 09:52
2 Q. And without too much of a tutorial, the 09:52
3 control project -- 09:52
4 A. Yes, sir. 09:52
5 Q. -- what -- what does that mean? 09:52
6 MR. SCHREIBER: I'll let the witness 09:52
7 respond a little bit to give you some background. 09:52
8 MR. HOWES: And I don't need much. 09:52
9 MR. SCHREIBER: I understand. 09:52
10 A. I understand. 09:52
11 We would -- we would audit the 09:52
12 company's compliance with certain control policies 09:52
13 and procedures throughout the year, and then we 09:52
14 would -- rather than prepare a management letter, 09:52
15 just at the conclusion of the year, we would issue 09:53
16 project reports on our findings throughout the year, 09:53
17 so we may issue 30 or so reports in the area that I'm 09:53
18 working on which would be -- you may be more familiar 09:53
19 with it in terms of -- or in context of a management 09:53
20 report on recommendations on improvements in controls 09:53
21 or observations on the controls of the company. 09:53
22 Q. (BY MR. HOWES) And did you keep the finals 09:53
23 of those? 09:53
24 A. Yes, sir. 09:53
25 Q. And do you believe that when your documents 09:53

1 were collected, the final of the control project or 09:53
2 the final of the price risk management policy were 09:53
3 documents that were collected from you? 09:53
4 A. Yes, sir. 09:53
5 Q. Would those final copies have been placed 09:53
6 in any central repository other than in your office? 09:53
7 A. They would be placed and become part of the 09:53
8 audit work papers. 09:53
9 Q. Which would be in the central files? 09:53
10 A. Yes, sir. 09:53
11 Q. Is the deletion or destruction of documents 09:53
12 that you've told us about between the 23rd of October 09:54
13 and the 9th of November, then, deletion or 09:54
14 destruction that would have been in the normal course 09:54
15 of how you did business? 09:54
16 A. It would have been in the normal course. 09:54
17 Q. And had you maintained those practices 09:54
18 throughout your time as an engagement partner for 09:54
19 Enron? 09:54
20 A. I did. 09:54
21 Q. Did you destroy anything, Mr. Bauer, or 09:54
22 delete anything after the 9th of November? 09:54
23 A. No, sir. 09:54
24 Q. Why not? 09:54
25 A. I understood we were under subpoena at that 09:54

AU Section 230

Due Professional Care in the Performance of Work[*]

Sources: SAS No. 1, section 230; SAS No. 41; SAS No. 82.

Issue date, unless otherwise indicated: November, 1972.

.01 The third general standard is:

> Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.[1]

[As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.02 This standard requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.03 *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[2]

[As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.04 The matter of due professional care concerns what the independent auditor does and how well he or she does it. The quotation from *Cooley on Torts*

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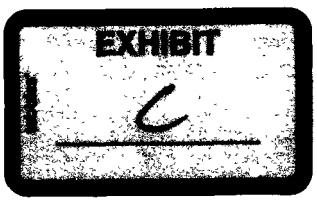
[*] [Title amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[1] This amendment revises the third general standard of the ten generally accepted auditing standards. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[2] D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932). [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]



provides a source from which an auditor's responsibility for conducting an audit with due professional care can be derived. The remainder of the section discusses the auditor's responsibility in the context of an audit. [As amended, April 1982, by Statement on Auditing Standards No. 41 (see section 339). As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.05 An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence" (that is, with due professional care). [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.06 Auditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining. The auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client.[3] The auditor with final responsibility is responsible for the assignment of tasks to, and supervision of, assistants.[4] [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Professional Skepticism

.07 Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.08 Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.09 The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Reasonable Assurance

.10 The exercise of due professional care allows the auditor to obtain *reasonable assurance* that the financial statements are free of material mis-

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[3] See section 311, *Planning and Supervision*, paragraph .07. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[4] See section 311.11. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

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statement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.11 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work.[5] As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.[6] [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.12 Because of the characteristics of fraud, particularly those involving concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material misstatement. For example, an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. Also, auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among client personnel and third parties or among management or employees of the client. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.13 Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (*a*) failure to obtain reasonable assurance, (*b*) inadequate planning, performance, or judgment, (*c*) the absence of due professional care, or (*d*) a failure to comply with generally accepted auditing standards. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[The next page is 221.]

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[5] See section 342, *Auditing Accounting Estimates*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[6] See section 326, *Evidential Matter*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

AU Section 316

Consideration of Fraud in a Financial Statement Audit

(Supersedes SAS No. 53)

Source: SAS No. 82.

Effective for audits of financial statements for periods ending on or after December 15, 1997.

Introduction

.01 Section 110, *Responsibilities and Functions of the Independent Auditor*, states that "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] This section provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards. Specifically, this section—

- Describes fraud and its characteristics (see paragraphs .03 through .10).
- Requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors to be considered in the auditor's assessment (see paragraphs .11 through .25).
- Provides guidance on how the auditor responds to the results of the assessment (see paragraphs .26 through .32).
- Provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud (see paragraphs .33 through .36).
- Describes related documentation requirements (see paragraph .37).
- Provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others (see paragraphs .38 through .40).

.02 While this section focuses on the auditor's consideration of fraud in an audit of financial statements, management is responsible for the prevention

[1] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in section 317, *Illegal Acts by Clients*. For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors (see section 312, *Audit Risk and Materiality in Conducting an Audit*) or fraud.

EXHIBIT D

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and detection of fraud.[2] That responsibility is described in section 110.03, which states, "Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions consistent with management's assertions embodied in the financial statements."

Description and Characteristics of Fraud

.03 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional.[3] Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.[4] These two types of misstatements are described in the following paragraphs.

.04 *Misstatements arising from fraudulent financial reporting* are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

.05 *Misstatements arising from misappropriation of assets* (sometimes referred to as defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented in conformity with generally accepted accounting principles.[5] Misappropriation can be accomplished in various ways, including embezzling receipts, stealing assets,

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[2] In its October 1987 report, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, noted that "The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management—starting with the chief executive officer—sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start with the reporting company."

[3] Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although the auditor has no responsibility to determine intent, the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement is relevant in either case.

[4] Unauthorized transactions also are relevant to the auditor when they could cause a misstatement in financial statements. When such transactions are intentional and result in material misstatement of the financial statements, they would fall into one of the two types of fraud discussed in this section. Also see the guidance in section 317.

[5] Reference to generally accepted accounting principles includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles as defined in section 623, *Special Reports*, paragraph .04.

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or causing an entity to pay for goods or services not received. Misappropriation of assets may be accompanied by false or misleading records or documents and may involve one or more individuals among management, employees, or third parties.

.06 Fraud frequently involves the following: (*a*) a pressure or an incentive to commit fraud and (*b*) a perceived opportunity to do so. Although specific pressures and opportunities for fraudulent financial reporting may differ from those for misappropriation of assets, these two conditions usually are present for both types of fraud. For example, fraudulent financial reporting may be committed because management is under pressure to achieve an unrealistic earnings target. Misappropriation of assets may be committed because the individuals involved are living beyond their means. A perceived opportunity may exist in either situation because an individual believes he or she could circumvent internal control.

.07 Fraud may be concealed through falsified documentation, including forgery. For example, management that engages in fraudulent financial reporting might attempt to conceal misstatements by creating fictitious invoices, while employees or management who misappropriate cash might try to conceal their thefts by forging signatures or creating invalid electronic approvals on disbursement authorizations. An audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication.

.08 Fraud also may be concealed through collusion among management, employees, or third parties. For example, through collusion, false evidence that control activities have been performed effectively may be presented to the auditor. As another example, the auditor may receive a false confirmation from a third party who is in collusion with management. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false.

.09 Although fraud usually is concealed, the presence of risk factors or other conditions may alert the auditor to a possibility that fraud may exist. For example, a document may be missing, a general ledger may be out of balance, or an analytical relationship may not make sense. However, these conditions may be the result of circumstances other than fraud. Documents may have been legitimately lost; the general ledger may be out of balance because of an unintentional accounting error; and unexpected analytical relationships may be the result of unrecognized changes in underlying economic factors. Even reports of alleged fraud may not always be reliable, because an employee or outsider may be mistaken or may be motivated to make a false allegation.

.10 An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (*a*) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (*b*) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud. Accordingly, because of the above characteristics of fraud and the nature of audit evidence as discussed in section 230, *Due Professional Care in the Performance of Work*, the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements, including misstatements resulting from fraud, are detected.

Assessment of the Risk of Material Misstatement Due to Fraud

.11 Section 311, *Planning and Supervision*, provides guidance as to the level of knowledge of the entity's business that will enable the auditor to plan and perform an audit of financial statements in accordance with generally accepted auditing standards. Section 312, *Audit Risk and Materiality in Conducting an Audit*, provides that determination of the scope of the auditing procedures is directly related to the consideration of audit risk and indicates that the risk of material misstatement of the financial statements due to fraud is part of audit risk.

.12 The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (*a*) misstatements arising from fraudulent financial reporting and (*b*) misstatements arising from misappropriation of assets in each of the related categories presented in paragraphs .16 and .18.[6] While such risk factors do not necessarily indicate the existence of fraud, they often have been observed in circumstances where frauds have occurred.

.13 As part of the risk assessment, the auditor also should inquire of management (*a*) to obtain management's understanding regarding the risk of fraud in the entity and (*b*) to determine whether they have knowledge of fraud that has been perpetrated on or within the entity. Information from these inquiries could identify fraud risk factors that may affect the auditor's assessment and related response. Some examples of matters that might be discussed as part of the inquiry are (*a*) whether there are particular subsidiary locations, business segments, types of transactions, account balances, or financial statement categories where fraud risk factors exist or may be more likely to exist and (*b*) how management may be addressing such risks.

.14 Although the fraud risk factors described in paragraphs .17 and .19 below cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor should use professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.

.15 For example, in a small entity domination of management by a single individual generally does not, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. As another example, there may be little

[6] The auditor should assess the risk of material misstatement due to fraud regardless of whether the auditor otherwise plans to assess inherent or control risk at the maximum (see section 312.29 and .30). An auditor may meet this requirement using different categories of risk factors as long as the assessment embodies the substance of each of the risk categories described in paragraphs .16 and .18. Also, since these risk categories encompass both inherent and control risk attributes, the specific assessment of the risk of material misstatement due to fraud may be performed in conjunction with the assessment of audit risk required by section 312.13 through .33, and section 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .62 through .82. Furthermore, the assessment of audit risk may identify the presence of additional fraud risk factors that the auditor should consider. [Footnote revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

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motivation for fraudulent financial reporting by management of a privately held business when the financial statements audited are used only in connection with seasonal bank borrowings, debt covenants are not especially burdensome, and the entity has a long history of financial success consistent with the industry in which it operates. Conversely, management of a small entity with unusually rapid growth or profitability may be motivated to avoid an interruption in its growth trends, especially compared with others in its industry.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

.16 Risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped in the following three categories:

a. *Management's characteristics and influence over the control environment.* These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

b. *Industry conditions.* These involve the economic and regulatory environment in which the entity operates.

c. *Operating characteristics and financial stability.* These pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

.17 The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting for each of the three categories described above:

a. *Risk factors relating to management's characteristics and influence over the control environment.* Examples include—

- A motivation for management to engage in fraudulent financial reporting. Specific indicators might include—
  - — A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.
  - — An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
  - — A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.
  - — An interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.
- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include—

- An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.
- Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee.
- Inadequate monitoring of significant controls.
- Management failing to correct known reportable conditions on a timely basis.
- Management setting unduly aggressive financial targets and expectations for operating personnel.
- Management displaying a significant disregard for regulatory authorities.
- Management continuing to employ an ineffective accounting, information technology, or internal auditing staff.

- Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
- High turnover of senior management, counsel, or board members.
- Strained relationship between management and the current or predecessor auditor. Specific indicators might include—
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
  - Unreasonable demands on the auditor including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.
  - Formal or informal restrictions on the auditor that inappropriately limit his or her access to people or information or his or her ability to communicate effectively with the board of directors or the audit committee.
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.

b. *Risk factors relating to industry conditions*. Examples include—

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures and significant declines in customer demand.

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- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence

c. *Risk factors relating to operating characteristics and financial stability.* Examples include—

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity—including need for funds to finance major research and development or capital expenditures.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity—such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or individual(s) that control(s) the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- Threat of imminent bankruptcy or foreclosure, or hostile takeover.
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.

- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

.18 Risk factors that relate to misstatements arising from misappropriation of assets may be grouped in the two categories below. The extent of the auditor's consideration of the risk factors in category *b* is influenced by the degree to which risk factors in category *a* are present.

a. *Susceptibility of assets to misappropriation.* These pertain to the nature of an entity's assets and the degree to which they are subject to theft.

b. *Controls.* These involve the lack of controls designed to prevent or detect misappropriations of assets.

.19 The following are examples of risk factors relating to misstatements arising from misappropriation of assets for each of the two categories described above:

a. *Risk factors relating to susceptibility of assets to misappropriation*

- Large amounts of cash on hand or processed
- Inventory characteristics, such as small size, high value, or high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed asset characteristics, such as small size, marketability, or lack of ownership identification

b. *Risk factors relating to controls*

- Lack of appropriate management oversight (for example, inadequate supervision or monitoring of remote locations)
- Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation
- Inadequate recordkeeping with respect to assets susceptible to misappropriation
- Lack of appropriate segregation of duties or independent checks
- Lack of appropriate system of authorization and approval of transactions (for example, in purchasing)
- Poor physical safeguards over cash, investments, inventory, or fixed assets
- Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns)
- Lack of mandatory vacations for employees performing key control functions

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.20 The auditor is not required to plan the audit to discover information that is indicative of financial stress of employees or adverse relationships between the entity and its employees. Nevertheless, the auditor may become aware of such information. Some examples of such information include (*a*) anticipated future employee layoffs that are known to the workforce, (*b*) employees with access to assets susceptible to misappropriation who are known to be dissatisfied, (*c*) known unusual changes in behavior or lifestyle of employees with access to assets susceptible to misappropriation, and (*d*) known personal financial pressures affecting employees with access to assets susceptible to misappropriation. If the auditor becomes aware of the existence of such information, he or she should consider it in assessing the risk of material misstatement arising from misappropriation of assets.

Consideration of Risk Factors in Assessing the Risk of Material Misstatement Due to Fraud

.21 Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor should exercise professional judgment when considering risk factors individually or in combination and whether there are specific controls that mitigate the risk. For example, an entity may not screen newly hired employees having access to assets susceptible to theft. This factor, by itself, might not significantly affect the assessment of the risk of material misstatement due to fraud. However, if it were coupled with a lack of appropriate management oversight and a lack of physical safeguards over such assets as readily marketable inventory or fixed assets, the combined effect of these related factors might be significant to that assessment.

.22 The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant risk factors. For example, in the case of a large entity, the auditor ordinarily would consider factors that generally constrain improper conduct by senior management, such as the effectiveness of the board of directors, the audit committee or others with equivalent authority and responsibility, and the internal audit function. The auditor also would consider what steps had been taken to enforce a formal code of conduct and the effectiveness of the budgeting or reporting system. Furthermore, risk factors evaluated at a country-specific or business segment operating level may provide different insights than the evaluation at an entity-wide level.[7] In the case of a small entity, some or all of these considerations might be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

.23 Section 319, *Consideration of Internal Control in a Financial Statement Audit*, requires the auditor to obtain a sufficient understanding of the entity's internal control over financial reporting to plan the audit. It also notes that such knowledge should be used to identify types of potential misstatements; consider factors that affect the risk of material misstatement; design tests of controls, when applicable; and design substantive tests. The understanding often will affect the auditor's consideration of the significance of fraud risk factors. In addition, when considering the significance of fraud risk factors,

[7] Section 312.18 provides guidance on the auditor's consideration of the extent to which auditing procedures should be performed at selected locations or components.

the auditor may wish to assess whether there are specific controls that mitigate the risk or whether specific control deficiencies may exacerbate the risk. [Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.][8]

.24 If the entity has established a program that includes steps to prevent, deter, and detect fraud, the auditor may consider its effectiveness. The auditor also should inquire of those persons overseeing such programs as to whether the program has identified any fraud risk factors.

.25 The assessment of the risk of material misstatement due to fraud is a cumulative process that includes a consideration of risk factors individually and in combination. In addition, fraud risk factors may be identified while performing procedures relating to acceptance or continuance of clients and engagements,[9] during engagement planning or while obtaining an understanding of an entity's internal control, or while conducting fieldwork.[10] Also, other conditions may be identified during fieldwork that change or support a judgment regarding the assessment—such as the following:

- *Discrepancies in the accounting records*, including—
  - — Transactions not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification, or entity policy.
  - — Unsupported or unauthorized balances or transactions.
  - — Last-minute adjustments by the entity that significantly affect financial results.
- *Conflicting or missing evidential matter*, including—
  - — Missing documents.
  - — Unavailability of other than photocopied documents when documents in original form are expected to exist.
  - — Significant unexplained items on reconciliations.
  - — Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
  - — Unusual discrepancies between the entity's records and confirmation replies.
  - — Missing inventory or physical assets of significant magnitude.
- *Problematic or unusual relationships between the auditor and client*, including—
  - — Denied access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.[11]
  - — Undue time pressures imposed by management to resolve complex or contentious issues.

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[8] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

[9] See Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, paragraphs .14 through 16 [QC section 20.14–.16].

[10] The auditor also obtains written representations from management on information concerning fraud involving (*a*) management, (*b*) employees who have significant roles in internal control, or (*c*) others where the fraud could have a material effect on the financial statements (see section 333, *Management Representations*).

[11] Denial of access to information may constitute a limitation on the scope of the audit that may require the auditor to consider qualifying or disclaiming an opinion on the financial statements (see section 508, *Reports on Audited Financial Statements*, paragraphs .22 through .32).

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— Unusual delays by the entity in providing requested information.
— Tips or complaints to the auditor about fraud.

The Auditor's Response to the Results of the Assessment

.26 A risk of material misstatement due to fraud is always present to some degree. The auditor's response to the foregoing assessment is influenced by the nature and significance of the risk factors identified as being present. In some cases, even though fraud risk factors have been identified as being present, the auditor's judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors. In other circumstances, the auditor may conclude that the conditions indicate a need to modify procedures.[12] In these circumstances, the auditor should consider whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transactions or assertion, or both. The auditor also may conclude that it is not practicable to modify the procedures that are planned for the audit of the financial statements sufficiently to address the risk. In that case withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action (see paragraph .36).

Overall Considerations

.27 Judgments about the risk of material misstatement due to fraud may affect the audit in the following ways:

- *Professional skepticism.* Due professional care requires the auditor to exercise professional skepticism—that is, an attitude that includes a questioning mind and critical assessment of audit evidence (see section 230.07 through .09). 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 (*a*) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (*b*) 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.
- *Assignment of personnel.* The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk of the engagement (see section 210, *Training and Proficiency of the Independent Auditor*, paragraph .03). In addition, the extent of supervision should recognize the risk of material misstatement due to fraud and the qualifications of persons performing the work (see section 311.11).
- *Accounting principles and policies.* The auditor may decide to consider further management's selection and application of significant

[12] Section 312 requires the auditor to limit audit risk to a low level that is, in the auditor's professional judgment, appropriate for expressing an opinion on the financial statements.

accounting policies, particularly those related to revenue recognition, asset valuation, or capitalizing versus expensing. In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements.

- *Controls.* When a risk of material misstatement due to fraud relates to risk factors that have control implications, the auditor's ability to assess control risk below the maximum may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity's internal control sufficient to plan the audit (see section 319). In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the identified fraud risk factors. However, this consideration also would need to include an added sensitivity to management's ability to override such controls.

.28 The nature, timing, and extent of procedures may need to be modified in the following ways:

- The *nature* of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more evidential matter may be needed from independent sources outside the entity. Also, physical observation or inspection of certain assets may become more important. (See section 326, *Evidential Matter*, paragraphs .19 through .22.)
- The *timing* of substantive tests may need to be altered to be closer to or at year end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive testing should be performed near or at year end because it would not otherwise be possible to control the incremental audit risk associated with that risk factor. (See section 313, *Substantive Tests Prior to the Balance-Sheet Date*, paragraph .06.)
- The *extent* of the procedures applied should reflect the assessment of the risk of material misstatement due to fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate. (See section 350, *Audit Sampling*, paragraph .23, and section 329, *Analytical Procedures*.)

Considerations at the Account Balance, Class of Transactions, and Assertion Level

.29 Specific responses to the auditor's assessment of the risk of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified and the account balances, classes of transactions, and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas should be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the risk factors or conditions identified. The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis—for example, observing inventory at locations where auditor

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attendance has not been previously announced or counting cash at a particular date on a surprise basis.

- Request that inventories be counted at a date closer to year end.
- Alter the audit approach in the current year—for example, contacting major customers and suppliers orally in addition to written confirmation, sending confirmation requests to a specific party within an organization, or seeking more and different information.
- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year end, investigate (*a*) the possibility of related parties and (*b*) the sources of financial resources supporting the transactions.[13]
- Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to auditor-developed expectations.[14]
- Conduct interviews of personnel involved in areas in which a concern about the risk of material misstatement due to fraud is present, to obtain their insights about the risk and whether or how controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement due to fraud resulting from transactions and activities among these components is adequately addressed.
- If the work of a specialist becomes particularly significant with respect to its potential impact on the financial statements, perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or engage another specialist for that purpose. (See section 336, *Using the Work of a Specialist*, paragraph .12.)

Specific Responses—Misstatements Arising From Fraudulent Financial Reporting

.30 Some examples of responses to the auditor's assessment of the risk of material misstatements arising from fraudulent financial reporting are—

- ***Revenue recognition.*** If there is a risk of material misstatement due to fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements—inasmuch as the appropriate accounting is often influenced by such terms or agree-

[13] Section 334, *Related Parties*, provides guidance with respect to the identification of related-party relationships and transactions, including transactions that may be outside the ordinary course of business (see section 334.06).

[14] Section 329, *Analytical Procedures*, provides guidance on performing analytical procedures used as substantive tests.

ments.[15] For example, acceptance criteria, delivery and payment terms and the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

- ***Inventory quantities.*** If a risk of material misstatement due to fraud exists in inventory quantities, reviewing the entity's inventory records may help to identify locations, areas, or items for specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis (see paragraph .29). In addition, where the auditor has a concern about the risk of material misstatement due to fraud in the inventory area, it may be particularly important that the entity counts are conducted at all locations subject to count on the same date. Furthermore, it also may be appropriate for the auditor to apply additional procedures during the observation of the count—for example, examining more rigorously the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Finally, additional testing of count sheets, tags or other records, or the retention of copies may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

Specific Responses—Misstatements Arising From Misappropriations of Assets

.31 The auditor may have identified a risk of material misstatement due to fraud relating to misappropriation of assets. For example, the auditor may conclude that such a risk of asset misappropriation at a particular operating location is significant. This may be the case when a specific type of asset is particularly susceptible to such a risk of misappropriation—for example, a large amount of easily accessible cash, or inventory items such as jewelry, that can be easily moved and sold. Control risk may be evaluated differently in each of these situations. Thus, differing circumstances necessarily would dictate different responses.

.32 Usually the audit response to a risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in paragraphs .29 and .30 may apply in such circumstances, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, obtaining an understanding of the control activi-

[15] Section 330, *The Confirmation Process*, provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. Among other considerations, that guidance discusses the types of respondents from whom confirmations may be requested, and what the auditor should consider if information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity comes to his or her attention (section 330.27). It also provides that the auditor maintain control over the confirmation requests and responses in order to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses (section 330.28). Further, when confirmation responses are other than in written communications mailed to the auditor, additional evidence, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender, may be required to support their validity (section 330.29).

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ties related to the prevention and detection of such misappropriation and testing the operating effectiveness of such controls may be warranted. In certain circumstances, physical inspection of such assets (for example, counting cash or securities) at or near year end may be appropriate. In addition, the use of substantive analytical procedures, including the development by the auditor of an expected dollar amount, at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances.

Evaluation of Audit Test Results

.33 As indicated in paragraph .25, the assessment of the risk of material misstatement due to fraud is a cumulative process and one that should be ongoing throughout the audit. At the completion of the audit, the auditor should consider whether the accumulated results of audit procedures and other observations (for example, conditions noted in paragraph .25) affect the assessment of the risk of material misstatement due to fraud he or she made when planning the audit. This accumulation is primarily a qualitative matter based on the auditor's judgment. Such an accumulation may provide further insight into the risk of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

.34 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud.[16] If the auditor has determined that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss and the custodianship of such funds is normally entrusted to a relatively low-level employee.[17] Conversely, when the matter involves higher level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests of balances or transactions, (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum, and (*c*) the assignment of personnel that may be appropriate in the circumstances.

.35 If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should—

a. Consider the implications for other aspects of the audit (see previous paragraph).

b. Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved and with senior management.

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[16] See footnote 3.

[17] However, see paragraph .38 for a discussion of the auditor's communication responsibilities.

c. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[18]

d. If appropriate, suggest that the client consult with legal counsel.

.36 The auditor's consideration of the risk of material misstatement due to fraud and the results of audit tests may indicate such a significant risk of fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee).[19, 20] Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on the diligence and cooperation of senior management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not possible to describe definitively when withdrawal is appropriate. The auditor may wish to consult with his or her legal counsel when considering withdrawal from an engagement.

Documentation of the Auditor's Risk Assessment and Response

.37 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud (see paragraphs .12 through .14). Where risk factors are identified as being present, the documentation should include (*a*) those risk factors identified and (*b*) the auditor's response (see paragraphs .26 through .32) to those risk factors, individually or in combination. In addition, if during the performance of the audit fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required (paragraph .33), such risk factors or other conditions, and any further response that the auditor concluded was appropriate, also should be documented.

Communications About Fraud to Management, the Audit Committee,[21] and Others[22]

.38 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter

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[18] See section 508 for guidance on auditors' reports issued in connection with audits of financial statements.

[19] Examples of "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities, as appropriate.

[20] If the auditor, subsequent to the date of the report on the audited financial statements, becomes aware that facts existed at that date which might have affected the report had the auditor then been aware of such facts, the auditor should refer to section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, for guidance. Furthermore, section 315, *Communications Between Predecessor and Successor Auditors*, paragraphs .21 and .22, provide guidance regarding communication to the predecessor auditor.

[21] See footnote 19.

[22] The requirements to communicate noted in paragraphs .38 through .40 extend to any intentional misstatement of financial statements (see paragraph .03). However, the communication may utilize terms other than *fraud*—for example, *irregularity, intentional misstatement, misappropriation, defalcation*—if there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms.

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might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the expected nature and extent of communications about misappropriations perpetrated by lower-level employees.

.39 When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee.[23] (See section 325, *Communication of Internal Control Related Matters Noted in an Audit*.) The auditor also may wish to communicate other risk factors identified when actions can be reasonably taken by the entity to address the risk.

.40 The disclosure of possible fraud to parties other than the client's senior management and its audit committee ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the entity may exist:

a. To comply with certain legal and regulatory requirements[24]

b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*[25]

c. In response to a subpoena

d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs .38 through .40 with parties outside the client.

Effective Date

.41 This section is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application of the provisions of this section is permissible.

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[23] Alternatively, the auditor may decide to communicate solely with the audit committee.

[24] These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change under the appropriate securities law on Form 8-K and the fraud or related risk factors constitute a "reportable event" or is the source of a "disagreement," as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in section 10A(b)1 of the Securities Exchange Act of 1934) relating to an illegal act that has a material effect on the financial statements.

[25] In accordance with section 315, communication between predecessor and successor auditors requires the specific permission of the client.

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Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312

1. The Meaning of the Term *Misstatement*

.01 *Question*—Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .04, states that financial statements would be considered materially misstated if "they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles." Section 312.04 also states that misstatements can result from errors or fraud. The term *misstatement* is used throughout generally accepted auditing standards; however, this term is not defined. What is the meaning of the term *misstatement*?

.02 *Interpretation*—In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles.[1] A misstatement may consist of any of the following:

a. A difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under generally accepted accounting principles

b. The omission of a financial statement element, account, or item

c. A financial statement disclosure that is not presented in accordance with generally accepted accounting principles

d. The omission of information required to be disclosed in accordance with generally accepted accounting principles.

.03 Misstatements may be of two types: known and likely. Section 312.35 refers to known misstatements as "the amount of misstatements specifically identified." For example, the failure to accrue an unpaid invoice for goods received or services rendered prior to the end of the period presented would be a known misstatement. Section 312.35 refers to likely misstatements as "the auditor's best estimate of the total misstatements in the account balances or classes of transactions...." Likely misstatements may be identified when an auditor performs analytical or sampling procedures. For example, if an auditor applies sampling procedures to a certain class of transactions that identify a known misstatement in the items sampled, the auditor will then determine the likely misstatement by projecting the known difference identified in the sample to the total population tested. With regard to analytical procedures, section 312.35 states, in part—

> When the auditor tests an account balance or class of transactions and related assertions by an analytical procedure, he or she ordinarily would not specifically identify misstatements but would only obtain an indication of whether

[1] Reference to generally accepted accounting principles includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles as defined in section 623, *Special Reports*, paragraph .04.

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misstatements might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him or her to estimate the likely misstatement in the balance or class.

.04 Likely misstatements also are associated with accounting estimates. Section 312.36 states, in part—

> The risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events. Estimates, such as those for inventory obsolescence, uncollectible receivables, and warranty obligations, are subject not only to the unpredictability of future events but also to misstatements that may arise from using inadequate or inappropriate data or misapplying appropriate data. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements.

[Issue Date: December, 2000.]

2. Evaluating Differences in Estimates

.05 *Question*—Section 312.36 states, in part—

> Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements.

With respect to an estimate, what should the auditor consider in determining the amount of the likely misstatements to be aggregated?

.06 *Interpretation*—In determining the amount of the likely misstatements to be aggregated, the auditor considers the "closest reasonable estimate" which may be a range of acceptable amounts or a point estimate, if that is a better estimate than any other amount.

.07 In some cases the auditor may use a method that produces a range of acceptable amounts to determine the reasonableness of amounts recorded. For example, the auditor's analysis of specific problem accounts receivable and recent trends in bad-debt write-offs as a percent of sales may cause the auditor to conclude that the allowance for doubtful accounts should be between $130,000 and $160,000. If management's recorded estimate falls within that range, the auditor ordinarily would conclude that the recorded amount is reasonable and no difference would be aggregated. If management's recorded estimate falls outside the auditor's range of acceptable amounts, the difference

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between the recorded amount and the amount at the closest end of the auditor's range would be aggregated as a misstatement. For example, if management has recorded $110,000 as the allowance, the amount by which the recorded estimate falls outside the range ($20,000) is aggregated as a misstatement.

.08 In other cases the auditor may determine that a point estimate is a better estimate than any other amount. In those situations, the auditor would use that amount to determine the reasonableness of the recorded amount. The auditor would compare the point estimate to the amount recorded by the client and include any difference in the aggregation of misstatements.[2]

.09 Section 312.36 indicates that the auditor should be alert to the possibility that management's recorded estimates are clustered at either end of the auditor's range of acceptable amounts, indicating a possible bias on the part of management. Section 312.36 states, in part—

> The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole. In these circumstances, the auditor should reconsider whether other recorded estimates reflect a similar bias and should perform additional audit procedures that address those estimates. In addition, the auditor should be alert to the possibility that management's recorded estimates were clustered at one end of the range of acceptable amounts in the preceding year and clustered at the other end of the range of acceptable amounts in the current year, thus indicating the possibility that management is using swings in accounting estimates to offset higher or lower than expected earnings. If the auditor believes that such circumstances exist, the auditor should consider whether these matters should be communicated to the entity's audit committee, as described in section 380, *Communication With Audit Committees*, paragraphs .08 and .11.

[Issue Date: December, 2000.]

3. Quantitative Measures of Materiality in Evaluating Audit Findings

.10 *Question*—Section 312, *Audit Risk and Materiality in Conducting an Audit*, provides guidance to the auditor on evaluating the effect of misstatements on the financial statements under audit. Section 312.10 states, in part—

> The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements.

Section 312.34 further describes the auditor's evaluation of the quantitative aspects of materiality. It states, in part—

> In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should aggregate misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.

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[2] See Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss" of FASB Statement No. 5, *Accounting for Contingencies*.

What factors should the auditor consider in assessing the *quantitative* impact of identified misstatements?

.11 *Interpretation*—The quantitative evaluation of identified misstatements is a matter of professional judgment and should reflect a measure of materiality that is based on the element or elements of the financial statements that, in the auditor's judgment, are expected to affect the judgment of a reasonable person who will rely on the financial statements, considering the nature of the reporting entity. For example, it is generally recognized that after-tax income from continuing operations is, in most circumstances, the measure of greatest significance to the financial statement users of entities whose debt or equity securities are publicly traded. Depending on the entity's particular circumstances, other elements of the financial statements that may be useful in making a quantitative assessment of the materiality of identified misstatements include current assets, net working capital, total assets, total revenues, gross profit, total equity, and cash flows from operations. In all instances, the element or elements selected should reflect, in the auditor's judgment, the measures most likely to be considered important by the financial statement users.

.12 *Question*—An entity's after-tax income or loss from continuing operations may be nominal or may fluctuate widely from year to year due to the inclusion in the results of operations of significant, unusual, or infrequently occurring income or expense items. What other quantitative measures could be considered if after-tax income or loss from continuing operations is nominal or fluctuates widely from period to period?

.13 *Interpretation*—In certain circumstances, a quantitative measure of materiality based on after-tax income from continuing operations may not be appropriate. The auditor may identify another element or elements that are appropriate in the circumstances or may compute an amount of current-year after-tax income from continuing operations adjusted to exclude unusual or infrequently occurring items of income or expense.[3]

.14 The selection of an alternate element or elements for use in assessing a quantitative measure of materiality is a matter of the auditor's professional judgment. In choosing an alternate element or elements, the auditor should evaluate the perceived needs of the financial statement users, the particular circumstances that caused the abnormal results for the current year, the likelihood of their recurrence, and any other matters that, in the auditor's judgment, may be relevant to a quantitative assessment of materiality.

[Issue Date: December, 2000.]

4. Considering the Qualitative Characteristics of Misstatements

.15 *Question*—Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .34, states, in part—

> Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.

What qualitative factors should the auditor consider in assessing whether misstatements are material?

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[3] Paragraph 26 of APB Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, discusses unusual or infrequently occurring items.

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.16 *Interpretation*—Section 312.10 states that the auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person. Section 312.11 states—

> As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Section 508, *Reports on Audited Financial Statements*, paragraph .36, states that the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality. Section 312.10 also makes reference to the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*. FASB Concepts Statement No. 2, paragraphs 123 through 132, includes a discussion about matters that might affect a materiality judgment.

.17 The auditor considers relevant qualitative factors in his or her qualitative considerations. Qualitative factors the auditor may consider relevant to his or her consideration include the following:

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the entity, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole. (See Interpretation No. 4 of section 326, *Evidential Matter*, "Applying Auditing Procedures to Segment Disclosures in Financial Statements" [section 9326.33]).

d. The potential effect of the misstatement on the entity's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items or a misclassification between fundraising costs and program activity costs in a not-for-profit organization.

j. The significance of the misstatement or disclosures relative to known user needs, for example—

- The significance of earnings and earnings per share to public-company investors and the significance of equity amounts to private-company creditors.
- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).
- The effect of misstatements of earnings when contrasted with expectations.

Obtaining the views and expectations of the entity's audit committee and management may be helpful in gaining or corroborating an understanding of user needs, such as those illustrated above.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction—it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph .17(*l*) above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

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