How Auditors Can Detect Financial Statement Misstatement

BY HOWARD GROVEMAN

The most frequent causes of audit failure appear to be inappropriate audit team reactions to various warning signals, according to cases reported to the American Institute of CPAs' quality control inquiry committee (QCIC)—the group SEC practice section members must report to about litigation involving public companies. These warning signals call attention to problem areas auditors have long recognized as sources of potential financial statement difficulties. The inexperience of many young staff members and their lack of familiarity with these signals is a recurring theme, as are repeated instances in which audits were not conducted in an atmosphere of appropriate professional skepticism. More so than any confusion caused by high-tech products or complex financial instruments, these problems appear to be the primary causes of audit failure. The purpose of this article is to reemphasize the need for audit skepticism and to focus additional attention on potential warning signs.

ROFESSIONAL SKEPTICISM

When planning a financial statement audit, auditors design procedures to provide reasonable assurance of detecting possible material misstatements. In performing such procedures, the audit team must always bear in mind that although most misstatements are the result of unintentional mistakes (errors), they occasionally result from employee embezzlement or deliberate management manipulation (irregularities) or from the commission of an illegal act.

Accordingly, auditors must ensure that audits are conducted with an attitude of skepticism. While auditors should not assume client management personnel are dishonest, they should not unquestioningly expect honesty.

> About one-third of cases reported to the AICPA quality control inquiry committee each year are deemed to be frivolous and are therefore closed by the committee following its analysis.

Rather, an audit team must objectively evaluate observed conditions and audit evidence and follow up any potentially material negative indicators to determine whether or not financial statements are free of material misstatement.

The Financial Executives Institute has observed: "Audit teams must understand not only accounting and auditing issues, but also the risks and nature of the business and the economic reality of its transactions. A key ingredient... is an audit team that is broadly trained and has sufficient experience to relate seemingly unrelated items. The overall reality check appears to be a missing test in some of the recent audit failures. One cannot develop guidelines for a 'smell test.'"

OVERSTATEMENT OF INVENTORIES

In recent years, the financial press has reported a rash of allegedly fraudulent financial statements attributed to significant inventory misstatements, such as Leslie Fay, Phar-Mor and Crazy Eddie. A December 1992 Wall Street Journal article, "Inventory Cheating Tempts More Firms, Fools More Auditors," cited the "recent rise in inventory fraud" as "one of the biggest single reasons for the proliferation of accounting scandals." Other abuses also have been reported:

- Auditors who showed up at plants were fresh out of college, there was little continuity of assigned staff.
- Partners or managers rarely attended audit team observance of inventory counts.
AUDITING

Be alert for inventory that appears not to have been used for some time or that is stored in unusual locations or fashions.

- Auditors were fooled because they checked only small samples of management's tallies.
- Auditors permitted company officials to follow them and record where they made test counts, making it easy for officials to falsify counts for inventory not being tested.
- Auditors who identified a situation indicating possible fraud—such as a barrel filled with floor sweepings whose contents management had valued at thousands of dollars—forced the company to subtract the amount from inventory but never recognized the possibility of intentional and pervasive fraud.
- Auditors gave a client advance notice of specific locations where they would observe the inventory count. As a result, the client refrained from making adjustments at locations where it knew the inventories would be observed and instead made fraudulent adjustments at other locations.

To help prevent or detect such abuses, the auditor's inventory observation procedures should follow these guidelines:

1. The audit team assigned to observe inventories should be led by capable, experienced personnel who are familiar with the client and its operations: the greater the risk, the greater the experience needed. When less-experienced personnel participate, they should be adequately supervised and encouraged to bring anything out of the ordinary to the attention of the partner, manager or other auditor in charge at that location.
2. If neither the partner nor manager can be present, one should be reachable in case problems arise. A preobservation planning meeting can help ensure an inexperienced staff will pay appropriate attention to potentially significant matters.
3. When observing the counts:
   - If using a substantive test approach, make certain audit test counts focus on high value items and will, in the aggregate, encompass a sufficient proportion of the inventory being counted.
   - If not all locations will be visited, or if counts are made cyclically, make certain the locations and cycles do not follow an easily predictable pattern and advise the client as late as possible about locations or cycles to be observed.
   - Be skeptical of large or unusual test count differences or of client personnel taking notes or displaying particular interest in audit procedures or test counts. If there are more than occasional differences, ensure that they are not systematic, or worse, systemic.
- Be alert for inventory that appears not to have been used for some time or that is stored in unusual locations or fashions. If not already so identified, such conditions may indicate damage, obsolescence or excess quantities.
- Ensure that intercompany and interplant movement is kept to an absolute minimum. Establish control of the inventory before you leave—satisfy yourself any items added to it after the count is completed are proper and reasonable.

Inventory overstatement also can be detected through other auditing procedures. Exhibit 1, page 85, lists indicators that should direct the audit team's attention to possible overstatement and provides pertinent detection procedures CPAs might apply.

OVERLY AGGRESSIVE ACCOUNTING

A key indicator, indeed an alarm bell, is an entity's use of very aggressive accounting principles or practices in audit areas such as income recognition, capitalization and deferral of costs, depreciation and amortization. The use of such principles

EXECUTIVE SUMMARY

- THE MOST FREQUENT AUDIT FAILURES appear to result from inappropriate audit team reactions to warning signals. In cases reported to the American Institute of CPAs quality control inquiry committee, problems also include inexperienced staff assigned to audits and a lack of professional skepticism.
- TO MAINTAIN THE APPROPRIATE DEGREE of skepticism, auditors should not assume client management is dishonest but also should not unquestioningly expect honesty. The audit team should evaluate evidence objectively to determine whether financial statements are free of material misstatement.
- INVENTORY MISSTATEMENTS HAVE caused numerous financial statement problems. To prevent or detect inventory abuses, the inventory observation team should include experienced personnel; a partner or manager should be present or easily reached.
- AN ENTITY'S USE OF AGGRESSIVE accounting practices may indicate management is more concerned with the portrayal of favorable financial results than with the reality. All practices should be acceptable under generally acceptable accounting principles and the financial statements should make overall business sense.
- OTHER POTENTIAL PROBLEM AREAS auditors may encounter include inappropriate revenue recognition, inadequate loss reserves, understated costs and expenses and unusual or related party transactions or balances.

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If the audit team concludes it is likely management is not acting in good faith, the auditors usually should resign.

### Exhibit 1: Possible Inventory Overstatement

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Procedures</th>
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<tbody>
<tr>
<td>1) Unusually large quantities of high-cost items in the summarized inventory</td>
<td>Trace items back to applicable test counts or of the quantities, if available. (Note: if not covered by inventory test counts, consider why.) If the quantities are derived from other sources, scrutinize the underlying documents and obtain explanations as to the business reasons. In some situations, test the quantities by considering sales (in addition to examining purchasing or manufacturing records in conjunction with pricing tests) or by current observation coupled with examination of subsequent period sales.</td>
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<tr>
<td>2) Unclear or ineffective cutoff procedures or indications of possible inclusion in inventory of merchandise sold or for which purchases are not recorded.</td>
<td>Perform procedures such as expanding cutoff tests and reviewing subsequent period entries and obtaining confirmation from major suppliers.</td>
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<tr>
<td>3) Few or no writedowns to market or provisions-for obsolescence where there have been changes in product lines or technology or rapid declines in sales or markets.</td>
<td>Products believed to be affected by such changes should be compared with recent and subsequent period sales activity; explanations should be obtained from management and available documentation (such as correspondence and sales returns) should be examined.</td>
</tr>
<tr>
<td>4) Questionable procedures for determining or aggregating inventory costs or indications that erroneous or insupportable costs have been applied.</td>
<td>Additional pricing tests should be performed. Management should be asked to justify any questionable determinations that could have a significant effect.</td>
</tr>
<tr>
<td>5) A gross profit percentage higher than expected or that should be lower in the circumstances. (Inventory dollar levels and ratios will be similarly affected.)</td>
<td>Perform analytical comparisons and follow up on variances; these are key procedures for detecting inventory misstatements. It is essential such procedures be performed by personnel with requisite background and experience.</td>
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may indicate management is overly concerned with the portrayal, rather than the reality, of favorable financial results.

Auditors should ensure that any such practice is acceptable under generally accepted accounting principles and that they have appropriately documented the entity’s rationale for its use and the basis for the auditors’ conclusion. In addition, auditors should be aware that management’s aggressiveness may affect other audit areas, such as those involving the use of estimates. Particular skepticism is called for if aggressive principles or practices are being applied in more than one area. These matters should be viewed from a business perspective. In other words, the financial statements should make overall business sense.

In addition—and this applies equally to all indicators—if the members of the audit team conclude it is likely management is not acting in good faith, the auditors usually should resign. Generally accepted auditing standards were not designed to uncover the machinations of a dishonest management.

### OTHER LIKELY AREAS OF MISSTATEMENT

Among other financial statement areas that could give rise to material misstatement, the ones auditors should focus on include:

- Inappropriate revenue recognition.
- Inadequate collectibility (loss) reserves.
- Understated costs and expenses.
- Unusual or related party transactions or balances.

Exhibit 2, page 86, lists indicators of problems in the above areas as well as the procedures customarily applied in such circumstances.

### IMPROVING DETECTION

This article doesn’t provide a complete list, but it does include the most common situations that may give rise to material misstatements. Senior audit personnel should not only direct appropriate attention to these matters themselves but also should ensure that less-experienced staff are familiar with them. Many, perhaps most, errors and irregularities (including frauds) can be detected only by examining the underlying detailed records (such as invoices, correspondence and shipping documents). This work usually is performed by staff assistants, and it is essential that they appreciate the importance of the duties they are assigned and have an informed understanding of the potential significance of all matters discovered.

All audit personnel should bear in mind that the indicators discussed here should be called to the attention of others in the firm with the background and authority to help deal with them, such as more senior members of the audit team.

Business realities and human nature being what they are, it is unlikely unintentional or deliberate financial statement misstatements can be eliminated entirely. However, skepticism, coupled with a thorough understanding of the indicators, will improve the likelihood of auditor detection.
### Exhibit 2: Other Likely Areas of Misstatement

<table>
<thead>
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<tbody>
<tr>
<td>1. Inappropriate revenue recognition</td>
<td>All such transactions should be examined and the audit team satisfied that they are properly accounted for. Be alert to conditions such as those discussed in the following indicator. Consider the need to perform procedures to search for additional unusual transactions. A pattern of such transactions may have the same negative management implications as the use of very aggressive accounting principles.</td>
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<td>2. Large or unusual transactions occurring shortly before the end of an important period such as the balance sheet date or quarterly reporting periods</td>
<td>Such transactions may come to the audit team’s attention as a result of cutoff procedures, accounts receivable confirmations or inventory observation, for example. (Assistants should be alerted to such possibilities.) The audit team should satisfy itself as to the appropriate accounting treatment after scrutinizing the underlying documentation and contacting the customers directly, if necessary. The team also should inquire about any additional transactions of this nature and consider procedures to extend the search. Here too the team should consider the implications of the possible matter.</td>
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<tr>
<td>3. Shipping products before a sale is consummated or indications that customers are not obligated to pay for shipments. Alternatively: Bill-and-hold transactions or other indications that sales are recognized in advance of shipment</td>
<td>Depending on the nature of the questions, the auditor should consider the propriety of the income recognized or of the use of this accounting method and should document such considerations. In some instances, a legal opinion should be obtained. If it is determined the method is acceptable, consideration should be given to the income recognized for the particular contract(s) in question, ensuring that the judgments are reasonable and supported by appropriate audit evidence.</td>
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<tr>
<td>4. Recaptured sales returns and allowances, or provisions that appear low in relation to past experience or the auditor’s knowledge of the business.</td>
<td>These may come to attention in conjunction with accounts receivable confirmations, cutoff testing or other procedures. The auditor should obtain an explanation and consider expansion of confirmation procedures (possibly contacting customers by phone) and out-of-period tests to search for additional transactions.</td>
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<tr>
<td>5. Inadequate collectibility reserves</td>
<td>Management should be asked to explain this, preferably in writing, and to provide supporting evidence. Auditors should examine this evidence and apply procedures such as intensive analytical comparisons and review of subsequent period payments, exercising particular skepticism when the entity employs aggressive accounting principles or practices.</td>
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<tr>
<td>a. Current provisions or aggregate reserves that seem low in relation to past experience or current business conditions</td>
<td>The workpapers should document an understanding of the debtor and the reasons for nonpayment. In addition, the auditor should obtain appropriate evidential matter relating to the collectibility of such receivables.</td>
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<td>6. Large past due receivable balances or large receivables from related parties or unfamiliar sources</td>
<td>All such transactions should be scrutinized. Consideration should be given to whether classification as a receivable is appropriate (and as to the propriety of recognizing any profits based on such transactions).</td>
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<td>c. &quot;Circular transactions&quot;—collectibility depends on funds or continued patronage to be provided by the entity</td>
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<td>8. Large outstanding tax obligations</td>
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<tr>
<td>7. Understated costs and expenses</td>
<td>Cutoff or analytical procedures may trigger this indicator. Auditors would then usually perform procedures such as extending out-of-period tests or obtaining accounts payable confirmations.</td>
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<tr>
<td>a. Failure to record or accrue significant invoices.</td>
<td>Client policies concerning such capitalization and deferrals should be documented and client records supporting such amounts should be audited. Allocations of labor and other costs between amounts to be capitalized and amounts to be expensed should be supported by contemporaneous records. Auditors should examine the client’s support for these positions with an understanding that the burden of proof rests with the client.</td>
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<tr>
<td>b. Improper or insufficiently supported capitalization of costs or deferral of start-up, administrative or advertising costs</td>
<td>The auditor should obtain explanations for such policies, preferably in writing, and be satisfied they are reasonable in the circumstances.</td>
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<tr>
<td>9. Unusually slow depreciation of fixed assets or lengthy amortization periods (For example, a computer leasing company using a 15-year life for operating leases)</td>
<td></td>
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<td>4. Related party transactions or balances</td>
<td>All such transactions and balances should be scrutinized. In some instances, the auditor may wish to perform procedures with respect to the related party’s records. Collectibility of any such receivables is to be supported by appropriate audit evidence.</td>
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Case Study
Pay Attention to Warning Signals

There are clues that should alert CPAs to the possibility—though of course not the certainty—of misstatement or fraud, according to Robert E. Fleming, director of audit and accounting and a shareholder of Urbach Kahn & Werlin, Albany, New York. "At our firm," he said, "we pay particular attention to them."

The firm is especially alert to warning signals in new auditing engagements. For example, Fleming said, "When we replace another CPA firm, we consider the change of auditors as one possible indicator of potential mis-statements or irregularities. Before we accept a replacement engagement, we want to learn as much as possible about the circumstances surrounding the replacement."

The firm contacts the previous auditor and reviews its relationship with the client. "We ask about the client's integrity and discuss in detail any problem areas." During the first year of the audit engagement, the audit staff watches for warning signals.

There are many factors that might increase the risk of fraudulent financial reporting. Fleming said, including an overly complex organizational structure with many subsidiaries, unusually structured partnerships and numerous joint ventures. In such cases, he said, "we pay particular attention to the magnitude and frequency of related party transactions."

Instilling skepticism
Of the firm's 25 partners and 150 professionals, about 20 partners and 110 professionals do audits and the firm hires 8 to 12 new auditors every year. The firm has a diverse range of clients including financial institutions, manufacturers, real estate developers, not-for-profit organizations and government entities.

"In our training program, for each audit level we have a module on professional skepticism." Fleming said. "Using case studies the modules give examples of auditor reaction to particular situations and show how a skeptical attitude might have ferreted out misstatements made by the client."

"We try to emphasize to our younger or less-experienced auditors that they should not be embarrassed about their role as independent auditors," he said. "We stress that one of their functions is to be skeptical and to get independent evidence regarding the client's assertions. That's necessary because it is easy for new auditors to be intimidated by older, more experienced financial personnel at a client company. And they have not yet heard enough stories that clients often tell auditors about the reasons behind transactions. Such experience will come with time, but we try to make them aware of potential problems."

The firm's new auditors are closely supervised by a senior accountant for at least the first six months; after that they may work alone on occasion with more indirect supervision, Fleming said. Audits are conducted by teams of 2 to 25 or 30 professionals with an experienced field auditor in charge, as well as with audit management that includes an experienced audit partner. He added an example of special audit procedures: If it is possible, the auditors often make unannounced visits to a client's inventory site.

—Selina Friedman
CASE STUDY

Strong Internal Controls Are Vital

"We rely heavily on the state of the clients' internal controls in assessing the potential for fraud," said Ellen M. G. Long, CPA, president of Long & Edmunds, CPAs, Warrensburg, Missouri. "If we see a weakness in those controls, then we do much more testing."

Long's firm of two partners plus one experienced staff soon-to-be CPA and one accounting student audits mainly government entities, along with a number of not-for-profit organizations. "We deal with numerous compliance issues and state regulations," she said. "We find when we first work with them, many small government units aren't as well informed as they should be about statutory requirements. If something isn't right, it may not be that the clients don't want to comply; they may not be aware of what they should be doing. I see part of our role as making sure they understand what is expected of them."

What the firm looks at

There are several things Long's firm considers during an audit that might warn of misstatements or fraud, including the "way the client's financial staff responds to questions," she said. "For example, if I ask about internal controls and get an unusual or ambiguous response, that may be a clue that something is wrong. If our suspicions are aroused, I start asking around in more depth. I've found that if we ask around discreetly, there is usually someone who can give us information we need."

Other signals that raise her suspicions are improper segregation of duties, with individuals who are related working closely in the same area; poor recordkeeping; a lot of cash activity and transactions using petty cash, rather than checks; and the lack of a bidding process for the purchase of goods or services. While these are not guarantees something is amiss, it is important to look closely at all transactions, she said. "It often is very hard to tell the difference between incompetence and fraud."

"We tell our new auditors to take nothing for granted when they are on an audit, but also not to assume people are doing anything wrong," Long said. "The new auditors are usually recent graduates and they're very conscious of what a proper audit should be like and what an ideal financial report should look like. They tend to notice everything."

"We are a small firm and we don't have a formal training program," she added. The firm sends auditors to a continuing professional education class on fraud sponsored by the Missouri Society of CPAs; there are sections for individuals at varying levels of experience. "We also send them for CPE to learn more about auditing in general as well as government auditing. The rest of their training is on-the-job."

The audit

Before going to the client, the auditor in charge runs the figures from the client's general ledger through a software program (the American Institute of CPAs' Accountant's Trial Balance) to do a variety of tests. "We look at things such as the changes between the prior and current years' figures in all trial balance accounts and the difference between the amount budgeted and actual revenues and expenditures," she said. "For example, I take the range of figures from the software program, using the materiality level to decide which accounts and which transactions to examine."

At the client's offices, the CPA in charge looks at the internal controls, asks questions of the client's financial staff and prepares a list of criteria to be used to test whether the necessary controls are in place—including how many people sign checks and what the oversight procedures are.

The firm's new staff members work under direct supervision and don't speak directly with the client's financial staff concerning significant audit issues, Long said. During the audit they follow the instructions of the senior CPA and, in accordance with the list of criteria, examine the checks, invoices and other papers for the accounts selected and make the necessary calculations to see if the controls are functioning. If there are discrepancies that cannot be resolved, the auditor in charge will discuss these with the client.

For example, Long explained, "If I wanted the staff member with me to do some expense testing, I'd decide how much he or she should test for a particular account, such as office supplies—a routine expenditure. Depending on the materiality level, I might decide to examine the invoices for 80% of the total office supply costs. Our staff member would do that, checking and listing the costs shown against the general ledger figures to be sure there was no disparity. The invoices were approved at the appropriate level of authority and the goods were actually received."

Pairing the junior and senior auditors at an audit gives the newer staff member an opportunity to see how the client's internal controls work and what the firm considers clues to possible misstatement, Long added.

—Selma Friedman