APPENDIX B

AUDITING AND THE RISK ASSESSMENT PROCESS

Detecting Fraud, Illegal Acts, Errors and Abuse

AICPA Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* and Statement on Auditing Standards No. 54, *Illegal Acts by Clients* provide guidance on the auditor's responsibility to detect fraud and illegal acts.

The *Audit Manual* and the Contract to Audit Accounts require the auditor to immediately report in writing to the Comptroller of the Treasury any evidence of fraud, such as defalcation, misappropriation, misfeasance, malfeasance, embezzlement, or other illegal acts.

AICPA Statements on Auditing Standards (SAS) Nos. 104 through 111, provide guidance concerning the auditor's responsibility to assess the risk of material misstatements of the financial statements due to error or fraud. The basic foundational concepts of the risk assessment standards are as follows:

A. <u>A Low Level of Audit Risk</u> - The auditor must perform the audit so that audit risk (the risk of not discovering material misstatements due to fraud or error and appropriately modifying the opinion) is reduced to a low level in his or her judgment (SAS 104).

B. <u>A High Level of Assurance to Readers of the Financial Statements</u> - The term "reasonable assurance" as used in the independent auditor's report should be understood as high level of assurance (but not absolute assurance) that the financial statements are free of material misstatement from either fraud or error based on our audit procedures (SAS 104).

C. <u>A Risk Based Approach to the Audit</u> - The auditor should utilize a risk based approach following guidance in SAS 99 and SASs 104-111. Accordingly, the auditor must obtain a sufficient understanding of the entity and its environment, including all five components of internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures (SAS 105).

D. <u>Relating Risks to Materiality at the Assertion Level</u> – The auditor should assess the risk of material misstatement for each relevant assertion for classes of transactions, account balances, and presentation of disclosures in sufficient detail to form a basis for the design and performance of further audit procedures (SAS 106).

<u>Additional Yellow Book Requirements:</u>

The auditor has additional responsibilities for audits performed under Yellow Book Standards (Generally Accepted Government Auditing Standards – GAGAS). In general, GAGAS incorporate the AICPA standards but include additional detection and reporting standards. Under both the AICPA standards and GAGAS, auditors should plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error, fraud, or illegal acts. Some of the more important additional requirements under GAGAS are as follows:

A. To plan and perform the audit to provide reasonable assurance of detecting material misstatements resulting from violations of provisions of contracts or grant agreements that could have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.

B. To be alert to situations or transactions that could be indicative of abuse. Abuse involves behavior that is deficient or improper when compared with behavior a prudent person would consider a reasonable and necessary business practice given the facts and circumstances. Abuse does not necessarily involve fraud, illegal acts, violations of grant provisions, and contracts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.

The Department of Audit conducts special-purpose examinations of governmental entities previously audited by certified public accounting firms and conducts working paper reviews of government audits performed by certified public accounting firms. These examinations and reviews often result in the discovery of fraud that was not detected by the previously performed audits. The Comptroller of the Treasury has identified several areas, summarized below, where undetected fraud has occurred most often. Auditors should consider these areas when performing risk assessment procedures and designing the nature, timing, and extent of further audit procedures. The Department of Audit will determine if these areas were considered when it conducts working paper reviews of governmental audits performed by public accounting firms.

1. Cash Collections

Suggested Procedures - SAS No. 99 requires an audit response to fraud risks that the auditor identifies as representing a risk of material misstatement of the financial statements unless those risks are mitigated by the government’s antifraud programs and internal controls. If the auditor needs to extend audit procedures in response to a risk of material misstatement due to fraud involving cash collections, the Department of Audit has found certain audit procedures to be highly effective in detecting schemes involving misappropriation of cash. The procedures are suggested but not required. If the following procedures are already being performed, consider expanding their extent.

- Review the makeup of deposits and determine that the cash and check ratio agrees with source documents (cash and checks collected).

- Review deposit slips and determine that receipts itemized on the deposit slips are recorded in the receipt books.

- Determine that deposits are being made intact and at least daily. (State law requires that deposits be made within three days of receipt).

- Perform surprise cash counts.

- Send third-party confirmations for significant revenues received in the mail.

2. Unrecorded bank accounts

3. Vending machine revenues

4. Unauthorized or fraudulent cash disbursements

5. Purchasing

6. Travel expenses and reimbursements

7. Credit cards and procurement cards

8. Use of government equipment, labor, materials and supplies

9. Use of government owned vehicles

10. Gasoline usage