CAQ ALERT

December 2017

B/D Alert #8: Risks of Material Misstatement Due to Fraud

This alert is intended to provide certain auditing considerations that may be relevant for audit and attestation engagements for brokers and dealers registered with the US Securities and Exchange Commission (SEC). The alert discusses some of the more judgmental or complex areas of the audit and attestation engagements, including some of those identified by the Public Company Accounting Oversight Board (PCAOB). [1]

While the alert highlights certain areas and questions for consideration, it should not be relied upon as definitive or all-inclusive, and should be read in conjunction with applicable rules, standards, and guidance in their entirety. The questions posed in this alert are a mixture of (1) questions applicable to all audits of brokers and dealers and (2) questions that may require further action if certain circumstances are present at the broker or dealer.

Please see previously issued CAQ Alert #2017-05, *Select Auditing Considerations for the 2017 Audit Cycle for Brokers and Dealers* where additional areas of the audit and attestation engagements are highlighted for consideration.[2]

Developing and Performing Auditing Procedures

Assessing and responding to risks of material misstatement due to error or fraud is a critical component of an audit or attestation engagement. Auditors must have an appropriate response to their assessed risks of material misstatement due to fraud related to management override of controls, including examining journal entries for evidence of possible material misstatement due to fraud. The two types of material misstatements due to fraud can be the result of fraudulent financial reporting or misappropriation of assets, including customer assets.[3] The auditor should refer to the following resources.

- AS 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110) outlines the following procedures, among others:

[1] See PCAOB Staff Inspection Brief: *Information about 2017 Inspection of Auditors of Brokers and Dealers* and PCAOB Staff Inspection Brief: *Preview of Observations from 2016 Inspections of Auditors of Brokers and Dealers.*
[2] CAQ Alert #2017-05 is available at http://www.thecaq.org/caq-alert-2017-05-select-auditing-considerations-2017-audit-cycle-brokers-and-dealers.
[3] See AS 2401.06.

- Inquire of audit committee or equivalent, management, or others within the company about the risks of material misstatement
- Obtain a sufficient understanding of the aspects of internal control over financial reporting, including evaluating the design of the controls intended to address fraud risks
- Obtain a sufficient understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement[4]
- Obtain an understanding of industry, regulatory, and other external factors[5]

- AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (AS 2301) outlines ways in which planned audit procedures may be modified to address assessed fraud risks.[6]
- AS 2401, *Consideration of Fraud in a Financial Statement Audit* (AS 2401) outlines the following procedures, among others:
  - Assess improper revenue recognition as a potential fraud risk or provide documentation or other persuasive evidence indicating how the auditor overcame the presumption that improper revenue recognition is a fraud risk; and appropriately execute auditing procedures related to journal entries testing, such as:
    - obtaining a sufficient understanding of the entity's reporting process and the controls over journal entries and other adjustments,
    - determining appropriate timing of testing,
    - inquiring about inappropriate or unusual activity, and
    - selecting appropriate journal entries for testing.

  AS 2401 also indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

    - examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, as addressed by paragraphs 58–62;
    - reviewing accounting estimates for biases that could result in material misstatement due to fraud, as addressed by paragraphs 63–65; and evaluating whether the business purpose (or lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets ("significant unusual transactions"), as addressed by paragraphs 66–67A.

[4] See AS 2110.07.
[5] See AS 2110.07a.
[6] See AS 2301.14.

Questions to Consider

Consider the following questions when developing and performing audit procedures to address the risks of material misstatement due to fraud:

- Has the auditor assessed the risk of improper revenue recognition as a potential fraud risk?
- If the auditor has concluded that the risk of fraud through improper revenue recognition as a fraud risk has been overcome, are those conclusions documented?
- Do the substantive procedures, planned or performed, include a response to address the risk of fraud in revenue?
- Has the auditor obtained an understanding of the process to record journal entries? As a result of the understanding, has the auditor planned or performed procedures to test journal entries that represent a risk of material misstatement from fraud or error? How have the procedures planned or performed considered the completeness of the journal entry population?
- Has the auditor (1) selected specific journal entries for testing to address fraud risk and (2) obtained sufficient appropriate evidence to support the conclusions reached? Has the auditor considered journal entries recorded based on transactions occurring in back-office brokerage system(s)?

Example Deficiencies

The following are examples of audit deficiencies that have been identified in previous PCAOB inspections related to this area:[7]

- Auditors did not identify improper revenue recognition as a potential fraud risk, or if they have concluded it is not a fraud risk, they did not document their reasons supporting that conclusion.[8]
- Auditors did not perform substantive procedures, including tests of details, specifically responsive to this risk.
- Auditors did not identify and test, or sufficiently test, journal entries.
- Auditors did not test the completeness of the population of journal entries from which they selected a sample for testing.
- Auditors did not test journal entries to address the risk of management override of controls.

[7] As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.
[8] See AS2401.83.