CENDROWSKI SELECKY P.C.

# NEW REVIEW STANDARD:
## check your malpractice insurance

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The AICPA recently released an exposure draft for a proposed Standard for Accounting and Review Services (SSARS) that will revise SSARS 1 (Compilation and Review of Financial Statements) to expand previous guidance on analytical procedures, inquiries and other review procedures. If adopted, the proposed revisions will be effective for reviews of financial statements for periods ending on or after December 15, 2004. The proposed statement also, with a tip of the hat to SAS 99, revises SSARS 1 to provide inquiries regarding fraud in a review engagement. The additional guidance on analytical procedures, inquiries, and other review procedures should help the accountant improve the review product. However, the guidance for inquiries regarding fraud in a review engagement opens a Pandora's Box of issues, pitfalls, and risks for the accountant. If adopted as proposed, accountants performing review engagements will need to identify fraud indicators in different business processes, understand the potential impacts of that fraud on the financial statements, and be able to identify additional inquiries or analytical procedures required based on the potential for fraud within the organization. In short, the accountant will need to develop a fraud awareness and deterrence mindset in order to manage the risk associated with the performance of a review engagement.

**"the guidance for inquiries regarding fraud in a review engagement opens a Pandora's Box of issues, pitfalls, and risks for the accountant"**

The proposed standard reiterates that a Review Engagement "does not contemplate obtaining an understanding of internal control or assessing control risk", however, the accountant is "required to obtain a basis for communicating whether he or she is aware of any material modifications that should be made to the financial statements for them to be in conformity with generally accepted accounting principles. The specific inquiries made and the analytical and other procedures performed should be tailored to the engagement based on the accountant's knowledge of the entity's business." This basis for communication will now include specific inquiries around the existence of fraud within the organization, and inquiries regarding specific internal control procedures within the business processes. The management representation letter will now include acknowledgement of management's responsibilities to prevent and detect fraud (AR 100.32 c), and disclosure of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements (AR 100.32 d). Additionally, the proposed standard notes that "the accountant should consider the reasonableness and consistency of management's responses in light of the results of other review procedures, and the accountant's knowledge of the entities' business." (AR 100.30)

In essence, the new standard for reviews *implies* a responsibility for understanding the internal controls responsible for the deterrence of fraud within the organization; this is a major practitioner risk area of the new standard.

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According to the new standard, the accountant will be asking management for a representation regarding fraud within the organization, will be making inquiries of management directly related to knowledge of fraudulent activity within the organization, and making inquiries relating directly to the operation of the internal controls for fraud deterrence. The accountant will receive a tremendous amount of information about the operation and adequacy of the internal control structure through the conduct of these inquiries, however, the new standard provides little guidance for action to be taken if fraud is revealed or suspected in the course of a review. If the accountant is not prepared to judge the responses to the inquiries, recognize the warning signs of fraud, and develop appropriate communication to company ownership, they could be exposed to professional liability.

For these reasons, the accountant performing a review will need to be armed with an understanding of the warning indicators of fraud, and the role of internal controls in the deterrence of fraud. This professional competency has been recognized in SAS 99, which defines the auditor's responsibilities to consider the potential for misstatement of the financial statements due to fraud. The proposed revisions to SSAR 1 includes a number of features found in SAS 99, including a management representation about fraudulent activities within the company, and expanded inquiries into the business process controls responsible for fraud deterrence.

Appendix B of the proposed standard includes a number of "illustrative inquiries" which, as noted, "will not necessarily be applicable in every review engagement, nor are these inquiries meant to be all-inclusive." The accountant needs to select the inquiries to be made based on sound professional judgment, given the specific engagement and client situation, however, would also need to be able to explain why a specific inquiry was *not* made. For example, one illustrative inquiry for the inventory cycle asks if adjustments made to agree ledger control accounts to the physical inventory count were significant. If the accountant does not inquire about the significance of the adjustments, and it is later revealed that significant adjustments were made, and the source of the inventory shortage was a fraud or theft, the accountant would most surely be asked why the question was specifically omitted from the inquiries.

A number of the new illustrative inquiries seem to directly assess the operation of internal controls essential for the deterrence of fraud:

| | |
|---|---|
| 3-i. | Is the accounts receivable subsidiary ledger reconciled to the general ledger account balance on a regular basis? |
| 4-j. | Is scrap inventoried and controlled? |
| 7-b. | When was the last time a physical inventory of property and equipment was taken? |
| 14-e. | Has there been any unusual customer or vendor complaints related to purchase or sales transactions? If so, what was the resolution associated with the complaints? |
| 14-f. | Has there been any unusual or unexpected change orders (or other contract changes)? |

Ostensibly, the questions listed in Appendix B are to be asked to identify any modifications that should be made to the financial statements, but these specific questions will reveal additional information that, if not properly addressed, could expose the accountant to risk.

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**Example in action:**
Assume for a moment that the accountant makes the following inquiry of the plant manager:

*Accountant*: "Is scrap inventoried and controlled?"

*Plant Manager*: "We do not inventory the scrap per se, but I know where it is. The scrap is accumulated in bins by type, aluminum in one, steel in another, glass in a third. When the bins get full, I call a scrap dealer to take it away, they tell me what it is worth, and give me cash. I give the cash to accounting, and they make a journal when they deposit the cash."

According to SSARS 1, the accountant must decide whether they have achieved limited assurance that there are not material modifications that should be made to the financial statements to be in conformity with GAAP. If they do not have that limited assurance, the accountant may consider making additional inquiries. (AR .24) Given the information provided by the controller, what should the accountant do next?

The accountant could conclude that the scrap is valued when sold by the company, by a party with reasonable knowledge of the value of the scrap, and is recorded within a reasonable time of the sale by accounting. Under these assumptions the accountant might have achieved the limited assurance required, and no further inquiry or additional analytical procedures would be made. Of course, the accountant would be well advised to memorialize those assumptions and judgments in the workpapers.

A different accountant could realize that the company may have no basis to know the true total value of the scrap, and without that knowledge, cannot conclude about the magnitude of any potential modifications to the financial statements. In this scenario, the accountant should consider making additional inquiries or employing additional analytical procedures, or both. Some of the additional inquiries might include:

| Is scrap weighed by the company and recorded prior to sale? |
| --- |
| Does the cost accounting system calculate the expected level of scrap and compare it to actual scrap? |
| How does the company validate the prices offered by the scrap buyer? |
| Does the scrap buyer provide a receipt detailing the materials and quantities purchased to accounting? |

The goal of additional inquiry is to obtain the limited assurance described above, or to be able to report to company ownership more conclusively about the situation within the company. Opening the inquiry into business process controls, without a deliberate conclusion in one manner or the other can expose the accountant to risk. The risk is heightened by a new line in AR sec .24 of the proposed standard which states "the accountant's knowledge of an entity's business influences the inquiries made and analytical procedures performed." In the scrap example, the accountant has knowledge that the company has poorly defined internal controls over certain processes resulting in a sale of assets for cash: the value of the asset is not carried on the books until sold, and the asset custodian (plant manager) has the authority to

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dispose of the asset, and is also responsible for the creation of the transaction to record the sale. Basically, the plant manager described, and the accountant has knowledge of, a situation with a number of conditions to allow fraud. There is nothing in the standards that would allow them to ignore such information, once obtained. While the standard does not specifically state that the accountant needs to expand inquiry to further investigate the potential for fraud, the accountant has already asked management to represent knowledge of any fraud, and has inquired about the state of internal controls for certain processes. Fraudulent acts, therefore, should be within the accountant's area of concern, and misstatement due to fraudulent acts should be explored by the accountant, and the results reported to company ownership.

**"Given this risky environment, what can the accountant do to help mitigate the risk?"**

Knowledge of an entity's business" is somewhat of a definitional problem: what constitutes the clients business. There are a wide variety of businesses that use the same underlying business process to produce different products or results; it is essential to understand the manner in which the client records the business operations. The accountant must gain knowledge of the enterprise, but it doesn't matter specifically what the company does as the accounting standards drive the process. This, however, can be somewhat problematic if a conflict should arise, however, as the opposing expert could focus on the *specific* product produced by the process, rather than the process itself. The accountant should understand the underlying recordkeeping process, and document their experience with such a process. It is not the accountant's job to run the business, however, how results of operations are recorded is essential.

The risk to the accountant highlighted by this new standard is that a fraudulent situation exists within the organization which is not uncovered by the accountant. This is especially troubling given the pervasive nature of fraud, and the crafty means used to conceal fraud. Given this risky environment, what can the accountant do to help mitigate the risk?

**Communicate with management about fraud**. SAS 99 defines the auditor's responsibilities for communicating with company management and ownership about fraud; this is not included in the proposed SSAR, however, is certainly a practice that should be considered by the accountant and one that is strongly recommended by the authors. Since the accountant will be asking management for a representation about fraud within the organization, inquiring about the operation of control processes within the organization, and potentially reporting back about processes considered at risk for fraud, management and ownership will also require a baseline understanding of the risks of fraud. Communication of these issues should provide an opportunity for the accountant to be viewed as a valuable resource to the company. Additionally, the accountant will probably make inquiries about situations discovered within the organization; an understanding of fraud will help management better answer the questions, or refer the accountant to appropriate, independent sources of answers.

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**Act as if you will need to defend yourself.**
A major risk to accountants is that hindsight is often the yardstick for adherence to professional standards. Operationally, it often quite hard to judge the actions that should be taken during the conduct of a specific engagement, however, it is quite easy to do so in hindsight. Additionally, after the fact, anyone coming into contact with the facts of the engagement will already know that a problem existed within the organization – vital knowledge not known to the accountant during the engagement. The accountant should plan and execute the professional service with a sense of professional skepticism, independence, and awareness that risks lie with every judgment and resulting action taken. Preparing for a high level of scrutiny is essential if such scrutiny materializes, and such preparation and diligence will result in a better work product in any case.

**Fully document the engagement activities.**
The new standard tends to raise the level of professional judgment to be exercised by the accountant, and professional judgment is always questioned in hindsight. Matters of judgment are not negligence, and selection of alternatives in an engagement is a matter of judgment. Judgment by definition is not automatically wrong, however, it is important to document the underlying questions, responses, assumptions, and actions taken to derive that judgment. Some positions are arguably so grossly wrong that they constitute no judgment at all, and could be considered negligent. Documentation is essential to demonstrate that the judgments made were reasonable given the situation at the time the judgment was made. It will be more vital to record in the workpapers the thought process by which the accountant exercises judgment.

Additionally, the workpapers must record the questions raised by the accountant, the source of answers, and the answers given. The professional judgment exercised by the accountant must also include obtaining independent information to answer the questions raised; the accountant should note where assigned duties do not appropriately separate incompatible authorities, and beware of answers provided related to transactions controlled by those authorities. If the accountant raises a question to the owner, and is told to ask the bookkeeper, that instruction should be documented. If the accountant provides advice to management about a situation, and that advice is rejected, document, document, document. The accountant becomes negligent when issues are raised and not documented, or are not addressed independently with management.

**Obtain value from the management representation letter.**
The new standard increases the content in the management representation letter, however, one of the shortcomings of practicing accountants is failure to make sure clients understand what the management representation letter actually means. Management needs to understand the purpose of the letter, and how the content of the letter can affect the engagement activities. Representations required by the proposed standard include management's responsibility for fraud prevention, and knowledge of fraudulent activities. If management understands the importance of such representations, and answers honestly, it should affect the judgment of the accountant. If management indicates they do little to prevent fraud, or fraud has been discovered within the organization, it should heighten the awareness of the accountant and their obligation to review additional materials.

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The representations should help define the engagement, however, review standards require that the management representation letter is signed near the report date. This unfortunately means that many engagements seek the representation letter too late in the process: by the time you get to the end of the engagement, it is too late to change engagement activities based on any management representations. Real value can be generated by helping management understand and mitigate their own risks while you work to manage the engagement risk.

The topics of the representation letter should become the starting point for a *dialog* with management about governance, management's responsibility for internal controls, and fraud deterrence. Given the current high-risk environment, management will need to understand those topics to appropriately manage their own internal risk. Sit and review the representations with the client at the beginning of the engagement, make sure they understand what the representations mean, and formulate how you will modify your work program based on those representations. And, of course, document those discussions with management as well as any issues raised. At the end of the engagement, have management commit those understandings to writing in the form of the representation letter.

**Have an exit plan.**
The proposed review standard places the accountant in a position to discover fraud in the course of a review, however, does not provide guidance for actions to be taken if fraud is actually uncovered. The profession still needs to develop better guidance about how to respond to fraud when discovered. If the accountant discovers a situation which has the appearance of fraud, or even discovers a large number of red flags, they should be prepared to seek appropriate professional advice from a fraud counselor, elevate the engagement, or resign from the engagement. These actions would also be appropriate if the accountant felt management was not providing appropriate diligence and input to the process to allow the engagement scope to be achieved. Where concerns about the organization are pervasive, the accountant should understand the impacts of additional work steps on the engagement budget, and be prepared to end the engagement if necessary, and begin a new, more detailed engagement if desired. The requirements and risks of the proposed standard will tend to raise the cost of review engagements to more closely approach audit fees than compilation fees.

**Develop required skill sets.**
Many aspects of the new standard require increased professional judgments by the accountant, especially related to fraud indicators. Accountants performing review engagements should be well educated in fraud risk factors, and the relating controls to mitigate fraud risks. In this manner, they will be better prepared to deal with the risks of the new standard, and also better prepared to defend their judgments as reasonable, if ever questioned. Many professional organizations provide education programs related to fraud; a few offer professional designations in fraud related areas. Accountants should consider a robust understanding of fraud a vital tool when providing review services under the proposed standard.

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