Appendix to SAS No. 99, Fraud Risk Factors


A.1 This appendix contains examples of risk factors discussed in paragraphs 31 through 33 of the Statement. Separately presented are examples relating to the two types of fraud relevant to the auditor’s consideration that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM FRAUDULENT FINANCIAL REPORTING

A.2 The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

A. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
   - High degree of competition or market saturation, accompanied by declining margins
   - High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
   - Significant declines in customer demand and increasing business failures in either the industry or overall economy
   - Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
   - Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
   - Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
   - New accounting, statutory, or regulatory requirements

B. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
   - Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management itself, for example, overly optimistic press releases or annual report messages
   - Need to obtain additional debt or equity financing to stay competitive including financing of major research and development or capital expenditures
   - Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
   - Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

C. Information available indicates that management or the board of directors’ personal financial situation is threatened by the entity’s financial performance arising from the following:
   - Significant financial interests in the entity
   - Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow
   - Personal guarantees of debts of the entity

D. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

Opportunities

A. The nature of the industry or the entity’s operations provides opportunities to engage in fraudulent
financial reporting that can arise from the following:
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

B. There is ineffective monitoring of management as a result of the following:
- Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
- Ineffective board of directors or audit committee oversight over the financial reporting process and internal control

C. There is a complex or unstable organizational structure, as evidenced by the following:
- Difficulty in determining the organization or individuals that have controlling interest in the entity
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- High turnover of senior management, counsel, or board members

D. Internal control components are deficient as a result of the following:
- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems, including situations involving reportable conditions

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to correct known reportable conditions on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
  - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
  - Dominating management behavior in dealing with the auditor, especially involving attempts
RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM MISAPPROPRIATION OF ASSETS

A.3. Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

A. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

B. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefit plans
- Promotions, compensation, or other rewards inconsistent with expectations

Opportunities

A. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lacking observable identification of ownership

B. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations
- Inadequate job applicant screening of employees with access to assets
- Inadequate recordkeeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

Risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets, are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from misappropriation of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

FOOTNOTES:

1 Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.