FRAUD ATTENTION GRABBERS CHECKLIST
(Source: 2003-2004 Audit Risk Alert)

Recognizing Circumstances That Should Get Your Attention

How to use the checklist:

1. Review this checklist towards end on an engagement with all profession staff that worked on engagement.
2. Each answer identifies an area that may require attention.

Attention Grabber		Attention Grabber Exists?		
Ref.	**Question (Note: each "yes" answer identifies a potential problem!)**	Yes	No	N/A
1.	**Is there a culture of arrogance and management entitlement within the company?** Management that engages in deceptive accounting practices or fraudulent financial reporting often exhibits high levels of arrogance, pride, greed, and hubris. They often have a reputation for being unusually aggressive, taking high risks, living close to the edge, and swinging for the fences in business dealings. In some cases, management may believe that they are entitled to financial success and rewards no matter how they are achieved because they created the company and its past successes. Effective internal control starts with a proper "tone at the top." Culture and values are critical elements of control because all other controls are derived from them. Culture drives behavior. A few bad apples will flourish in a culture of arrogance, excessive risk taking, and little accountability. And a few bad apples can cause a company to come crashing down.			
2.	**Do accounting policies rely heavily on management's judgment or seem too aggressive?** The manner in which accounting principles are selected and applied affects the accuracy, transparency, understandability, and usefulness of the financial statements. If the accounting methodology for a transaction or event involves different alternatives or a good degree of estimating and judgment, or represents an evolving area in accounting, or is unclear, unusual, or not fully supportable, then management has the tools and the temptation to manipulate financial reporting. These tools, stemming from the selection and application of accounting principles, can be used to tweak earnings and manipulate other accounts and transactions to report the financial results desired by management and conceal critical information. Abusing the selection and application of accounting principles can lead to a situation in which an entity's financial statements do not reflect the underlying economic condition. The accounting principles selected by management should enhance the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.			
3.	**Is the audit committee and/or the board of governance ineffective?** The audit committee is the ultimate monitor of the financial reporting process. It therefore stands to reason that an ineffective committee or its equivalent, or the lack of one, can seriously undermine proper financial reporting. Be on the lookout for audit committees that are not independent of the company, meet infrequently, lack adequate financial expertise, do not hear *directly* from internal auditors, and do not closely monitor sensitive company programs, such as a corporate loan program for senior management.			
4.	**Does management have an obsession with meeting earnings targets and expectations?** In today's business reality, failing to meet the earnings expectations of Wall Street, creditors, and others, even by a small amount, can create serious repercussions, including a nosedive in a company's stock price. Faced with such pressure, management may attempt to meet those earnings targets at all costs and commit fraud, stretch accounting rules, or follow inappropriate accounting methodologies.			
5.	**Is there difficulty in explaining how the company actually makes money?** Simply put, it may be unclear exactly how a company derives its profits and its cash. Or, at the end of the day, it may be the case that a company just does not make very much money. In some cases, an entity may be involved in numerous businesses and complicated operations, and yet after looking at all that activity, one is hard pressed to explain how the entity generates cash.			

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6.	**Is there an overly centralized control over financial reporting?** If one member of senior management or a small group of senior management holds a tight grip over the financial reporting process and goes to extremes to exclude prying eyes, internal control suffers and the opportunity for fraudulent or questionable financial reporting emerges.			
7.	**Do ratios and benchmarks differ significantly from industry averages?** An auditor needs to ask why an entity's financial results are markedly different from other entities in its industry. This kind of benchmarking research and analysis may not be readily available or apparent. However, this kind of information can point to a possible business failure or going concern problem or to the manipulation of the accounting and financial reporting process.			
8.	**Do cash flows from operations bear little relationship to reported earnings?** If reported earnings do not correspond to the actual cash flowing into an entity, auditors should take note. If management is manipulating the accounting process to manage earnings, it may show up in the disparity between operating cash flow and income statement earnings. When cash flow from operations falls below net income, it may be indicative of serious business trouble insofar as the company is not generating enough cash from routine operations, but instead is fueling earnings by borrowing money, selling assets, or other nonoperational activities. Companies go bankrupt because they run out of cash. Keep an eye on the cash flow statement when assessing an entity's ability to continue as a going concern.			
9.	**Are compensation plans geared toward enriching executives rather than generating profits?** With their own compensation tied to operating or financial targets, management can push hard on personnel throughout the company to meet what may be overly optimistic goals. A high-pressure environment can create an incentive to adopt practices that may be too aggressive or inconsistently applied. At some point, the motivation driving earnings management can be strong enough to encourage individuals with the right opportunity to move beyond acceptable practices. Don't underestimate greed. If greed is evident and management is focused on how much money they are going to make, auditors should heighten their sense of professional skepticism and adjust their audit procedures accordingly.			
10.	**Is there significant insider trading?** A significant sell-off of company stock by senior management may indicate that they believe the stock is overvalued, the financial reporting does not portray the true economic value of the entity, or that the company may be heading toward failure.			
11.	**Are predictions my management at odds with industry trends?** Management may base their assumptions, estimates, accounting principles, business decisions, and explanations to auditors on predictions, forecasts, and beliefs about the current and future business environment that contradict actual industry trends, credible research, and what other entities in the industry are doing or predicting.			
12.	**Is there undisciplined growth through acquisitions?** Senior management may acquire businesses and assets more for the sake of accumulating assets than for the overall good of the company. Acquisition growth can help management hide and ignore serious weaknesses and failings of a company. Acquiring businesses and assets too rapidly can lead to many challenges and risks, including integrating disparate operations, melding internal control processes, and meeting expanded financing needs. In addition, rapid acquisition growth may outstrip the ability of a company's financial systems to remain under effective internal control. If management cares more about acquiring new assets than about making the existing ones perform properly, serious business, liquidity, and financial reporting problems can arise.			
13.	**Have there been any departures of key senior management personnel?** If key people leave a company suddenly or a number of senior management personnel have resigned, this may be a warning sign of possible trouble at the entity. Are these resignations unexplained? Is the suddenness or number of resignations unusual? Do these key people know something about the company's financial future that is causing them to jump ship? An auditor needs to pay attention to significant or unusual management departures.			

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14.	**Are the relationships and credibility with customers, creditors, and other third parties declining?** Information pointing to deterioration in a company's business relationship with its customers, creditors, suppliers, or other parties may signal financial difficulties or inappropriate activities at the company.			
15.	**Has there been a prolonged period of success?** Yes, even too much success can be a dangerous thing. Many big-name companies that have experienced difficulties ran into trouble after long periods of financial success and business growth. As the years of prosperity add up, management may become set in its ways. Assumptions about the future of the industry and the company may be severely clouded by the past experience of uninterrupted success. Management may let its guard down and become incapable of envisioning an environment of subsiding financial prosperity. Does management face reality or merely explain it away or ignore it? Assumptions and estimates used in financial reporting and business decisions need to be questioned and examined with a clear perception of the true conditions of the economy, the industry, and the company.			