Introduction

The Auditing Standards Board has promulgated standards that address an auditor’s understanding and evaluation of journal entries and other adjustments. For example, in SAS 94, The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit, the Auditing Standards Board expanded the auditor’s required understanding of the automated and manual procedures an entity uses to prepare its financial statements and related disclosures to include procedures an entity uses to (a) enter transaction totals into the general ledger, (b) initiate, record and process journal entries in the general ledger, and (c) record recurring and non-recurring adjustments, such as consolidating adjustments, report combinations and reclassifications, that are not reflected in formal journal entries.

In addition, SAS 99 – Consideration of Fraud in a Financial Statement Audit states, “Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting by (a) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) made in the preparation of the financial statements.”

SAS 99 further states, “Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity’s internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity’s internal controls. Accordingly, the auditor should con-
sider placing additional emphasis on identifying and testing items processed outside of the normal course of business.”

In response to the risk of management override, SAS 99, which will be effective for audits of calendar year 2003 financial statements, requires the auditor, in all audits, to (a) obtain an understanding of the entity’s financial reporting process and controls over journal entries and other adjustments, (b) identify and select journal entries and other adjustments for testing, (c) determine the timing of the testing, and (d) inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries or other adjustments.

The purpose of this Practice Alert is to provide auditors with guidance regarding the design and performance of audit procedures to fulfill the responsibilities outlined in SAS 99 regarding journal entries and other adjustments.

**Obtaining an understanding of the entity’s financial reporting process and its controls over journal entries and other adjustments**

SAS 99 states, “An entity may have implemented specific controls over journal entries and other adjustments. For example, an entity may use journal entries that are preformatted with account numbers and specific user approval criteria, and may have automated controls to generate an exception report for any entries that were unsuccessfully proposed for recording or entries that were recorded and processed outside of established parameters. The auditor should obtain an understanding of the design of such controls over journal entries and other adjustments and determine whether they are suitably designed and have been placed in operation”.

An entity’s financial reporting system also includes the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as business combinations, or a nonrecurring estimate such as an asset impairment. Additionally, nonstandard entries include consolidation entries, reclassification entries, and spreadsheet or other worksheet adjustments. Because of the risk of misstatements (intentional or unintentional) oftentimes linked to nonstandard journal entries and other adjustments, the engagement team needs to obtain a thorough understanding of the entity’s controls surrounding this aspect of the financial reporting process.

Obtaining an understanding of the entity’s financial reporting process helps the auditor to identify important information such as:

- The entity’s written and unwritten policies and procedures regarding the initiation, recording and processing of standard and nonstandard journal entries and other adjustments;
- The sources of significant debits and credits to an account;
- Individuals responsible for initiating entries to the general ledger, transaction processing systems, or consolidation;
- Approvals and reviews required for such entries and other adjustments;
- The mechanics for recording journal entries and other adjustments (for example, whether entries are initiated and recorded online with no physical evidence, or created in paper form and entered in batch mode);
- Controls, if any, designed to prevent and detect fictitious entries and unauthorized changes to journals and ledgers; and
- Controls over the integrity of the process used to generate reports used by the auditors.

**Assessing the risk of material misstatement resulting from journal entries and other adjustments**

Although SAS 99 requires the auditor to test journal entries and other adjustments regardless of the risk assessment, the nature, timing, extent and focus of the testing will be influenced by the auditor’s risk assessments. The auditor should assess the nature and risk of management’s incentive to manipulate earnings or financial ratios through financial statement misstatement. That assessment should be made in conjunction with the interim reviews as well as the year-end audit. For example, if a client has loan covenant ratios that depend on earnings, and net income is close to causing covenant violations, then the auditor may assess the risk of material misstatement as higher. The auditor may also assess the risk of material misstatement as higher when executive compensation is tied to earnings thresholds and earnings are close to the threshold. Additionally, market expectations in many cases have led to earnings manipulations. In those cases where the auditor determines that the risk of fraudulent journal entries is high due to questions regarding the integrity of management, the auditor should reassess his or her client acceptance/continuance decision.

SAS 99 states, “Members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include… an exchange of ideas or “brainstorming” among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity’s financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.”

Journal entries and other adjustments oftentimes exist only in electronic form, which requires extraction of the desired data by an auditor with information technology (IT) knowledge and skills or the use of an IT specialist. In audits of entities with complex IT systems, the IT auditors and/or IT specialists should be included in the brainstorming session. In the brainstorming session, the auditors...
normally will discuss the following:

- The various ways in which management could originate and post inappropriate journal entries or other adjustments.
- The kinds of unusual combinations of debits and credits that the engagement team should be looking for.
- The types of journal entries or other adjustments that could result in a material misstatement that would not likely be detected by standard audit procedures.

**Inquiries of individuals involved in the financial reporting process**

SAS 99, paragraph 24, states, “The auditor should inquire of others within the entity about the existence or suspicion of fraud. The auditor should use professional judgment to determine those others within the entity to whom inquiries should be directed and the extent of such inquiries. In making this determination, the auditor should consider whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud—for example, others who may have additional knowledge about or be able to corroborate risks of fraud identified in the discussions with management… or the audit committee.” Where practical, regardless of the fraud risk assessment, the auditor should inquire of the entity’s accounting and data entry personnel about whether those individuals were requested to make unusual entries during the audit period. The auditor should also consider asking selected programmers and IT staff about the existence of unusual and/or unsupported entries and specifically inquire about these entries, including whether any were initiated directly by top management outside the normal accounting process. The auditor should not expect client personnel to volunteer information about known or suspected fraud. However, those same individuals may be more likely to provide information if asked directly.

**Assessment of completeness of journal entry and other adjustments sources**

It is important in testing journal entries and other adjustments that the auditor be aware of and consider the entire population of journal entries and other adjustments. The auditor’s ability to detect fraud is adversely affected if he or she is not assured of access to all of the journal entries posted and other adjustments made during the audit period. The auditor should be aware that journal entries and other adjustments may be made outside of the general ledger and should obtain a complete understanding as to how the various general ledgers are combined and the accounts are grouped to create the consolidated financial statements. For example, at large, multinational companies, multiple general ledgers are utilized, adjustments are made to convert from local GAAP to U.S. GAAP, and translation and other adjustments are made before the numbers are combined (perhaps at more than one level of sub-consolidation) and become subject to further elimination and adjusting entries. Appropriate procedures should be applied to all of the various sources of information from which journal entries and other adjustments are selected for testing to assist the auditor in assessing completeness. The nature and extent of these procedures will depend on the engagement risk assessments and the client’s systems for recording transactions.

**Identification and selection of journal entries and other adjustments for testing**

After the auditor has made his or her assessment of the risk of fraudulent journal entries and other adjustments and has performed appropriate procedures to assess completeness, he or she should design procedures, based on that assessment, to test the appropriateness of the journal entries and other adjustments from the various sources previously identified including (a) journal entries recorded in the general ledger, and (b) top side consolidation or report entries that are not actually posted to the general ledger. The auditor should test the appropriateness of selected journal entries and other adjustments in all engagements—including those in which the risk of fraudulent journal entries is assessed as low. Those tests are performed to confirm that entries are appropriately approved by management, are adequately supported and reflect the underlying events and transactions. Such tests should be designed to detect inappropriate entries.

After considering the identified population of journal entries and other adjustments, the auditor should use professional judgment to determine the nature, timing and extent of the testing of journal entries and other adjustments. SAS 99 requires that the auditor consider:

- The auditor’s assessment of the risk of material misstatement due to fraud.
- The effectiveness of controls that have been implemented over journal entries and other adjustments.
- The entity’s financial reporting process and the nature of the evidence that can be examined.
- The characteristics of fraudulent entries or adjustments.
- The nature and complexity of the accounts.
- Journal entries or other adjustments processed outside the normal course of business.

For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor’s procedures should include selecting, from the various sources of information from which journal entries and other adjustments are posted, specific entries and other adjustments to be tested and examining the support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (“CAATs”) (for example, report writers, software or data extraction tools, or other systems based techniques) to identify the journal entries and other adjustments to be tested. In addition, the CAATs ordinarily are designed to detect the following:

- Entries made at unusual times of day, that is, outside regular business hours.
• Improperly adjust segment reporting.
• Improperly record adjustments to allowances.
• Understate payables through the recording of post-closing journal entries to increase various revenue accounts.
• Improperly decrease accounts payable and general and administrative expenses.
• Improperly capitalize costs as fixed assets or construction in progress instead of expensing those costs as incurred.
• Improperly adjust records to allowances.

In audits of entities that have several locations or components, the auditor should consider the need to select journal entries from locations based on factors set forth in SAS 47 – Audit Risk and Materiality in Conducting an Audit (AU 312.18). Those factors include (a) the nature and amount of assets and transactions executed at the location or component, (b) the degree of centralization of records or information processing, (c) the effectiveness of the control environment, particularly with respect to management’s direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or component, (d) the frequency, timing, and scope of monitoring activities by the entity or others at the location or component, and (e) judgments about materiality of the location or component.

After considering the factors outlined above, as well as the number and monetary amount of journal entries and other adjustments, the auditor should select journal entries and other adjustments from the population and examine documentary evidence indicating that the journal entries are properly supported and approved by management. The selections should include both journal entries recorded in the general ledger and top side or report adjustments that are not actually posted to the general ledger. Because fraudulent journal entries often are made at the end of a reporting period, the auditor’s testing ordinarily should focus on the journal entries made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished, the auditor should consider whether there is also a need to test journal entries throughout the period under audit. Additionally, if entries are used to correct errors in financial statements of a previous period, the auditor should evaluate whether those previously issued financial statements should be restated.

The auditor should introduce an element of unpredictability regarding the dollar amount and types of journal entries and other adjustments tested. Often, companies are able to perpetrate fraud when, over a period covering several engagements, management is able to determine the auditor’s scope and/or strategy and therefore design inappropriate journal entries and other adjustments that have a high probability of not being tested.

SAS 100 – Interim Financial Information, paragraph 23, states, “The accountant performing the review of interim finan-
cial information ordinarily will also be engaged to perform an audit of the annual financial statements of the entity. Certain auditing procedures may be performed concurrently with the review of interim financial information.” SAS 100 is effective for interim periods with fiscal years beginning after December 15, 2002. As a matter of good practice, the auditor should consider auditing journal entries and other adjustments concurrently with the interim reviews. The auditor should especially focus on journal entries and other adjustments that were reversed at the beginning of the subsequent period.

Other adjustments
In many cases, entities utilize spreadsheets to group general ledger accounts and make consolidating adjustments, reclassifications and other adjustments to arrive at financial statement amounts. Those consolidating adjustments, report combinations and reclassifications that are not reflected in formal journal entries should also be tested based on the auditor’s risk assessment. Tests of other adjustments would normally involve comparing the adjustments to underlying supporting information, and considering the rationale underlying the adjustment as well as the reason it was not reflected in a formal journal entry.

Documentation
SAS 96 – Audit Documentation requires that audit documentation be sufficient to show that the accounting records agree or reconcile with the financial statements or other information being reported on. The results of procedures performed relative to the entity’s journal entries and other adjustments should be documented in the appropriate section of the current audit file. This documentation should include:

- The procedures used by the engagement team to assess the completeness of the population of journal entries and other adjustments subject to review and testing.
- The journal entries and other adjustments that were selected for testing and the basis therefore.
- The procedures performed to audit the journal entries and other adjustments.
- The conclusions reached.
- Who performed and reviewed the work.

Past Practice Alerts
The PITF accumulates and considers practice issues, which appear to present accounting and auditing concerns for practitioners. Previously issued Practice Alerts can be obtained from the AICPA Web site (www.aicpa.org/members/div/secps/lit/practice.htm).

Comments or questions on this alert should be directed to Michael Glynn at 201/938–3176.