Michael Green, CPA, is considering audit risk at the financial statement level in planning the audit of National Federal Bank (NFB) Company’s financial statements for the year ended December 31, 20X1. Audit risk at the financial statement level is influenced by the risks of material misstatements (including fraud risks), which may be indicated by a combination of factors related to management, the environment, and the entity. In assessing such factors Green has gathered the following information concerning NFB’s environment.

*Company Profile:*

NFB is a federally insured bank that has been consistently more profitable than the industry average by marketing mortgages on properties in a prosperous rural area that has experienced considerable growth in recent years. NFB packages its mortgages and sells them to large mortgage investment trusts. Despite recent volatility of interest rates, NFB has been able to continue selling its mortgages as a source of new lendable funds.

NFB’s board of directors is controlled by Smith, the majority stockholder, who also acts as the chief executive officer. Management at the bank’s branch offices has authority for directing and controlling NFB’s operations and is compensated based on branch profitability. The internal auditor reports directly to Harris, a minority shareholder, who also acts as chairman of the board’s audit committee.

The accounting department has experienced little turnover in personnel during the five years Green has audited NFB. NFB’s formula consistently underestimates the allowance for loan losses, but its controller has always been receptive to Green’s suggestions to increase the allowance during each engagement.

*Recent Developments:*

During 20X1, NFB opened a branch office in a suburban town 30 miles from its principal place of business. Although this branch is not yet profitable due to competition from several well-established regional banks, management believes that the branch will be profitable by 20X3.

Also during 20X1, NFB increased the efficiency of its accounting operations by installing a new, sophisticated computer system.

*Required:*

Based only on the information above, describe the factors that most likely would have an effect on the risks of material misstatement of the financial statements. Indicate whether each factor increases or decreases the risk. In addition, indicate whether the factor indicates increased risk of fraud. Use the format illustrated on the back of this page.

|  |  |  |
| --- | --- | --- |
| **Factor** | **Effect on Risks of Material Misstatement** | **Creates a Risk of Fraud?** |
| Branch management has authority for directing and controlling operations | Increase | Yes |