


AUDITING FRAUD RISK- A PRACTITIONER'S ACTION PLAN



Life Without Worry.

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HEAD OF RISK AND COMPLIANCE

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Definition of Fraud

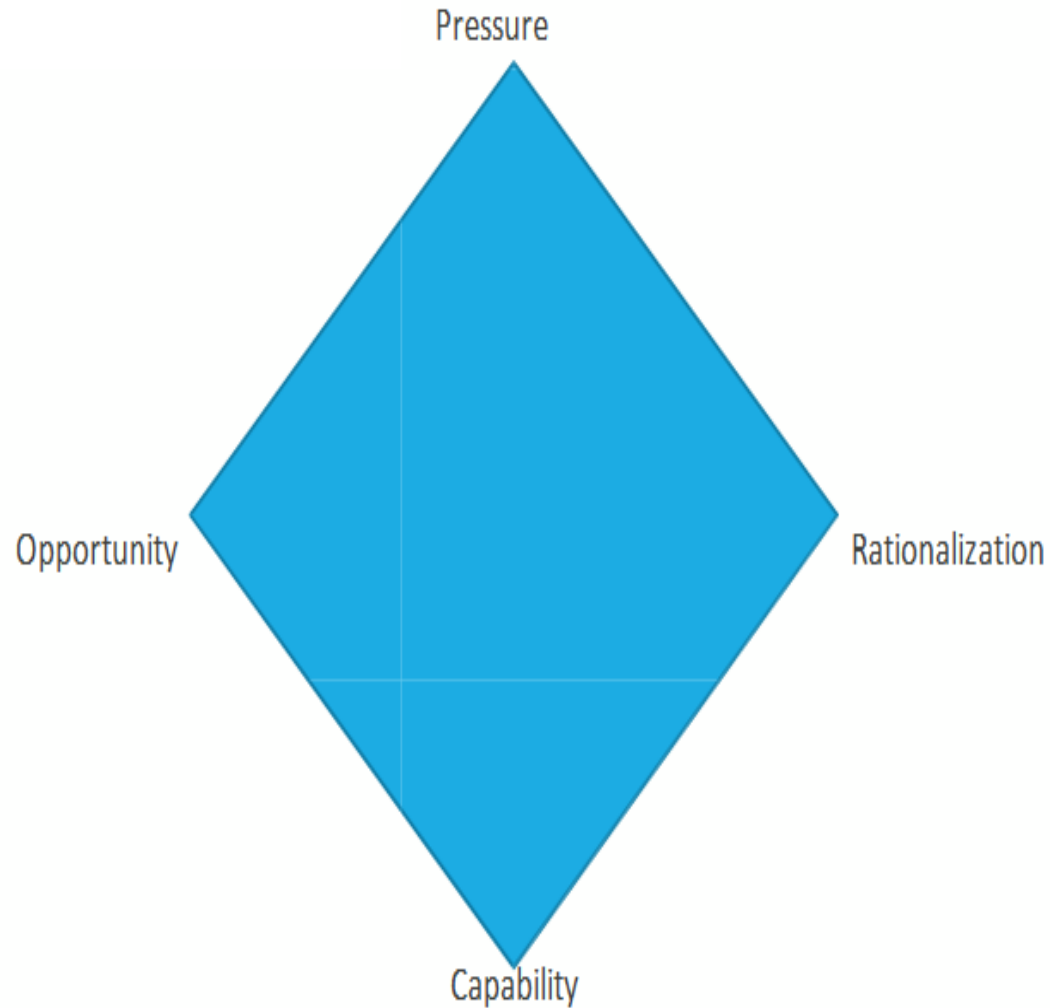
Fraud is generally defined in the law as an intentional misrepresentation of a material existing fact made by one person to another with knowledge of its falsity and for the purpose of inducing the other person to act, and upon which the other person relies.

Consequently should be an intentional or deliberate act to deprive another of property by deception, or other unfair means.

Classification of Fraud

- ❖ **Asset misappropriation**-High frequency with low impacts
- ❖ **Financial Statement Fraud**-Less frequency with high impacts
- ❖ **Bribery and Corruption**: Difficult to prove

The Fraud Triangle/Diamond



Pressure

- ❖ Pressure is what causes a person to commit fraud.
- ❖ Personal or organization driven-Complaining Accountant or pressure to deliver on sales people and its impact on receivables. Regulatory and Industry pressures
- ❖ Often this need/problem is non-sharable in the eyes of the fraudster. That is, the person believes, for whatever reason, that their problem must be solved

Rationalization

- ❖ Rationalization is a crucial component in most frauds.
- ❖ It involves a person reconciling his/her behavior (stealing) with the commonly accepted notions of decency and trust.
- ❖ The person believes committing fraud is justified to save a family member or loved one.
- ❖ The person believes they will lose everything
- ❖ The person labels the theft as “borrowing”, and fully intends to pay the stolen money back at some point.

Opportunity/Capability

- ❖ Capability refers to the personal traits that enable them to perpetrate fraud, beyond the environmental or situational factors of opportunity,
- ❖ Opportunity refers to a person's knowledge of the policies, procedures and controls of the business and, in particular, of the weaknesses there in involvement in and influence over key relationships, either
 - Internal relationships within the business, or
 - External relationships with third parties
- ❖ The necessary psychological traits to commit fraud e.g. self confidence, egotism, etc.

- ❖ **Financial Audit:** An examination by an independent third party of the financial statements of a company resulting in the publication of an independent opinion on whether or not those financial statements are relevant, accurate, complete and fairly presented.
- ❖ **Forensic Audit:** A specialized financial audit performed specifically for the purpose of determining evidence of fraudulent activity and the damages perpetrated by that activity.

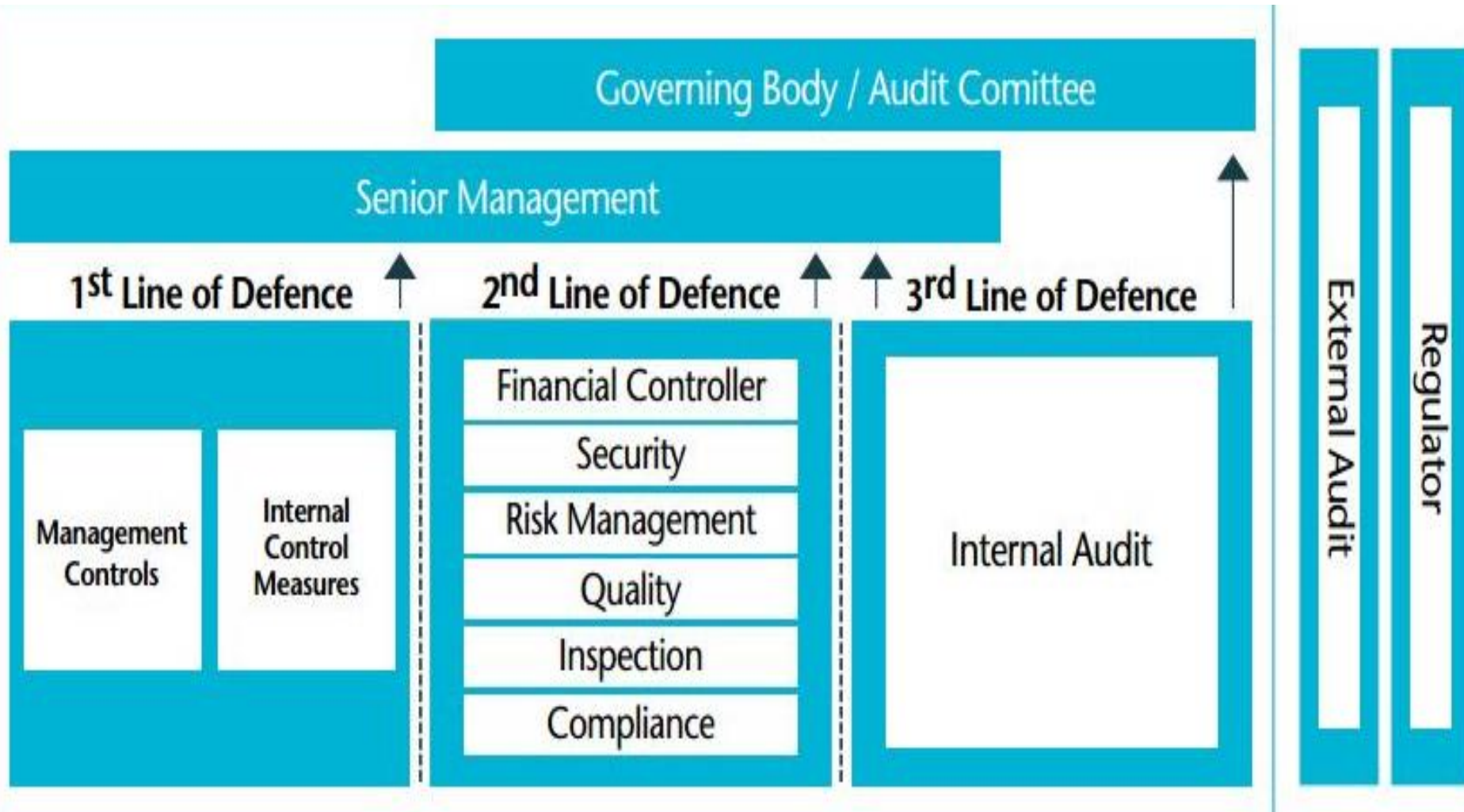
External Auditors role-Cont'd

- ❖ The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement assertion levels-ISA 315
- ❖ Achieved through understanding the **entity and its environment**, including the entity's **internal control**, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Proper Internal Control-C.O.S.O



THREE LINES OF DEFENSE-C.O.S.O FREWORK



- ❖ Misstatements in the financial statements can arise from either fraud or error.
- ❖ The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- ❖ Audit plans and tests however should incorporate reviews with consideration on opportunities and likely pressures that can lead to financial misstatements-where was the auditor?

- ❖ The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
- ❖ It is the role of those charged with governance to place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment.

- ❖ An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.
- ❖ Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs especially high level financial misreporting.
- ❖ Examples: Two databases for financial reporting, Skimming,

Objectives of the Auditor

The objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement of the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to fraud or suspected fraud identified during the audit.

Objectives of the Auditor

- ❖ If financial audits reveal specific factors for a high risk profile or indicate an actual higher risk of fraud or illegal acts, involvement of a Forensic specialist should be considered.
- ❖ Forensic specialists may play a role in assisting the audit team with respect to fraud, principally assisting audit professionals in the identification and evaluation of and response to financial statement fraud risks.

Fraud Prevention and Detection



Fraud prevention and detection are related

- ❖ Prevention encompasses policies and processes, training, and communication that stop fraud from occurring;
- ❖ Detection focuses on activities and techniques that promptly recognize timely whether fraud has occurred
- ❖ Prevention should be promoted from the board down throughout the organization and awareness of the fraud risk management program, including the types of fraud that may occur.
- ❖ Audit work plan should have from risk assessments procedures to test and review prevention and detection of fraud.

Fraud Risk Factors Considerations

- ❖ Pressure to meet budgets with unrealistic forecasts
- ❖ Operating in jurisdictions that are perceived as potentially unethical or higher risk including payments to sales agents in those jurisdictions
- ❖ Involved in a rapidly changing and distress industry
- ❖ Significant use of sales agents/business consultants to procure business.
- ❖ Involved in a cash based business/industry.

Fraud Risk factors

- ❖ Review of capability at the top/ capability management
- ❖ Any history of prior-year adjustments due to management judgments
- ❖ Accounting records of low quality or sufficiency of financial or operational to fundamental errors Profits sensitive
- ❖ Insufficient or inexperienced accounting staff Weak internal control structure
- ❖ Reviews of roles and Functions with their segregation-signing is it a control
- ❖ Reviews of adequacy and effectiveness of system capabilities and trails-incapable guardian
- ❖ Reviews of Directors account

Fraud Risk factors-Cont'd

- ❖ Discrepancies in the accounting records, including late adjustment of balances
- ❖ Conflicting or missing evidence.
- ❖ Problematic or unusual relationships between the auditor and management
- ❖ Inaccurate accounting and critical judgment by management
- ❖ Unusual balances e.g. marketing expenses and directors account changes

Response to fraud Risk

- ❖ Auditor should always maintain Professional Skeptism to high risk areas
- ❖ Review and carry out substantive tests on Abnormal analytical results
- ❖ Consider involving a forensic team in the assignment especially for high risk areas
- ❖ Involve an element of surprise especially for asset misappropriation and sampling methodology
- ❖ Document all significant risks in relation to fraud risk
- ❖ Consider withdrawing from the assignment if the review is a likely indicators of fraud-Check on reporting

- ❖ Communicate to those charged with Governance:

The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity.

Certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law in certain cases where management and those charged with governance fail to take corrective action then the auditor should report this to regulatory bodies.

- ❖ Communication with the regulatory bodies involved

Anti-fraud Consideration in Audit Program



Prevention	Detection	Response
	Board/audit committee oversight Executive and line management functions Internal audit, compliance and monitoring functions	
<ul style="list-style-type: none">❖ Fraud and misconduct risk assessment❖ Code of conduct and related standards❖ Employee and third-party due diligence❖ Communication and training❖ Write off on debts❖ Allocation of amounts to specific buyers❖ Cancelled receipts❖ Process-specific fraud risk controls	<ul style="list-style-type: none">◆ Hotlines and whistle-blower mechanisms◆ Auditing and monitoring◆ Proactive forensic data analysis	<ul style="list-style-type: none">◆ Internal investigation protocols◆ Enforcement and accountability protocols◆ Disclosure protocols◆ Remedial action protocols



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