Fraud from an Audit Planning Perspective

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What is the Definition of Fraud?

Fraud Definition Varies widely

The simplest and clearest definition is from https://www.myaccountingcourse.com/accounting-dictionary/fraud

"Corporate fraud means intentional deceitful acts designed to profit from unknowing individuals."

Some Common Types of Fraud

In simple terms:

- Invoice/Accounts receivable fraud
- Accounts Payable fraud
- Tax fraud
- Financial Statement/Financial Reporting fraud
- Misuse/Theft of assets

Common Responses to Fraud

When a fraud surfaces, the first response of entities and investors is often:

— Where were the Auditors?

— Why didn't the audit catch this?

— How did *YOU* miss this?

— What are we paying YOU for?

How Fraud is Really Discovered

The Association of Certified Fraud Examiners issued a 2016 report summarizing how fraud was actually uncovered:

— Tips from employees and others – 39%
  - Hotline was most common method – 40%
  - E-mail – 34%
  - Web based/online - 24%

— Internal audits – 17%

— Management reviews – 14%

— Accident – 6%

— **External Audit – 4%**

— Other methods – 20%

Client and investor responses are often inconsistent with reality!

What's an Auditor to do?

Educate your clients – Management and Board

— Discuss the Responsibilities of
  - Management and Board
  - Internal Audit
  - External Audit

Key Messages

— *Lack of internal controls is the most prominent organizational weakness that contributes to fraud*

— The vast majority of fraud is not discovered by external auditors

— External auditors are not part of an entity's system of internal control

— Clear misunderstanding of Auditors, Audit and the Audit Process
  - We are financial statement auditors, not forensic auditors – who often are engaged <u>to look for fraud</u>
  - We test on a sample of transactions
  - We do not look at 100% of the transactions
  - We plan and perform an audit to obtain <u>reasonable assurance</u> about whether the financial statements are free of material misstatement
  - We don't guarantee the absence of fraudulent activities

Is anyone listening?

Example #1

Accountant Suspended for Failing to Spot Fraud in Company Audit

— The SEC's order finds that during the audits of Example Co, CPA Firm failed to perform sufficient procedures to detect the fraudulent sales in the company's financial statements. CPA Firm also failed to obtain sufficient audit evidence over revenue recognition and accounts receivable, identify related party transactions, investigate management representations that contradicted other audit evidence, perform procedures to resolve and properly document inconsistencies, and exercise due professional care.

  - "Auditors are supposed to act as **gatekeepers to protect the integrity of our markets**, but CPA Firm failed to live up to their professional obligations," said David Glockner, Director of the SEC's Chicago Regional Office

Example #2

Accountant Suspended for Failing to Spot Fraud in Company Audit

— It turns out that the owners of Example Co. had been cooking the books for years, while the auditors seemingly looked the other way. The CPA Firm (Canada) detected irregularities in the reporting of Example Co.'s profit, but did not report them correctly and instead took management's explanation for the irregularity — this was a mistake.

— After the $118-million judgement, CPA Firm's position was that Example Co.'s recovery of damages should be barred by the defense or reduced because of contributory fault for their executives' actions. In addition, CPA Firm asserted that because Example Co.'s own executives perpetrated the fraud, they had no right to sue. The judge disagreed, stating that it would create a dangerous precedent that would undermine the fraud system if auditors were not held accountable for their actions.

— The takeaways? According to the court, auditors have a **legal responsibility to drill down whenever there is something that looks <u>at all</u> suspicious or unusual**. <u>Taking management at their word will not protect auditors from legal exposure — they must instead gather corroborating evidence and perform their auditing responsibilities.</u> The court further concluded that hiding behind legal considerations whenever there is a fraud involving company management is not an option

Entity's responsibilities

Board and Management

- **<u>Primary</u>** responsibility for the prevention and detection of fraud rests with both the Board and management – not the auditors
  - Board should create a culture of honesty and ethical behavior
    - setting the proper tone;
    - creating a positive workplace environment;
    - hiring, training and promoting appropriate employees;
    - requiring periodic confirmation by employees of their responsibilities; and
    - taking appropriate action in response to actual, suspected or alleged fraud
  - Management should place a strong emphasis on fraud deterrence/prevention, that may reduce opportunities for fraud to take place
    - Commitment to a culture of honesty and ethical behavior;
    - Reinforce culture/expectation by an active oversight
      - Consider the potential for override of controls or other inappropriate influence over the financial reporting process
        - Journal entries
        - Attempts to manage results in order to influence the reporting of the entity's performance
        - Effective use of Internal Audit personnel
- **If a strong internal control environment is established and the environment and internal controls are tested adequately by internal and external auditors, the strength of the environment will help reduce, but not eliminate, the risk of fraud.**

Auditor’s responsibilities

Auditors

— "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud

- Two Key concepts:
  - **Material misstatement:** Auditors are concerned with material items, but can’t ignore immaterial items
  - **Error or fraud:** Auditors are not only concerned with HOW misstatements happened, but must be concerned about WHY they happened
    - **The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is <u>intentional or unintentional</u>**
      - **Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting policies**
- Although we may suspect or identify potential fraud, <u>we do not make legal determinations</u> of whether fraud has actually occurred
- Because of 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 professional standards

Auditor’s responsibilities

Auditors

- Audits of governmental entities and not-for-profit organizations - auditors may have additional responsibilities relating to fraud:
  - as a result of being engaged to conduct an audit in accordance with law or regulation applicable to governmental entities and not-for-profit
  - because of a governmental audit organization's mandate, or
  - because of the need to comply with Government Auditing Standards
- Consequently, auditor responsibilities in an audit of governmental entities and not-for-profit organizations **may not be limited to consideration of risks of material misstatement of the financial statements**, but may also include a broader responsibility to consider risks of fraud
- Accordingly, such audits may require that auditors go beyond the obligations regarding fraud that are established by the AIPCA

Potentially Fraudulent Activities

Potentially Fraudulent Activities

— For the purposes of an audit, we are concerned with fraud that causes a material misstatement in the financial statements. Two types of <u>intentional</u> misstatements are relevant to:

- misstatements resulting from **fraudulent financial reporting**, and misstatements resulting from **misappropriation of assets**

— Potential Fraud, whether fraudulent financial reporting or misappropriation of assets, involves:

- incentive or pressure to commit fraud
- a perceived opportunity to do so, and
- some rationalization of the fraud

— Items to note

- The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud
- The risk of auditors not detecting a material misstatement resulting from management fraud is greater than for employee fraud
  — Management is in a position to:
    - directly or indirectly manipulate accounting records;
    - present fraudulent financial information; or
    - override control procedures designed to prevent frauds by others

Potentially Fraudulent Activities

Fraudulent Financial Reporting

— Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively

— Fraud can be committed by management overriding controls using such techniques as intentionally:

- recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives
- inappropriately adjusting assumptions and changing judgments used to estimate account balances
- omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
- omitting, obscuring or misstating disclosures required by the applicable financial reporting framework, or disclosures that are necessary to achieve fair presentation
- concealing facts that could affect the amounts recorded in the financial statements
- engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity
- altering records and terms related to significant and unusual transactions

Potentially Fraudulent Activities

Fraudulent Financial Reporting

— Fraudulent financial reporting may be accomplished by the following:
  - Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared
  - Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information
  - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

Potentially Fraudulent Activities

Misappropriation of Assets

— Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

— Misappropriation of assets can be accomplished in a variety of ways including:

Misappropriation of assets by...	Example
Embezzling receipts	Misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts.
Stealing physical assets	Stealing equipment for personal use or for sale, stealing scrap for resale, stealing inventory for personal use or for sale.
Causing an entity to pay for goods and services not received	Payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees.
Using an entity's assets for personal use	Using the entity's assets as collateral for a personal loan or a loan to a related party.

— Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

So Why Don’t Audits Find More Fraud?

Why DON’T financial statement audits uncover fraud

— Trusting management/employees – insufficient level of skepticism
  - “Per Mary Smith…..”
— Improper/Inappropriate reliance on the “Rep Letter”
  - “Make sure that statement gets put in the “Rep Letter””
— Inadvertent or inappropriate reliance on controls
  - “If it come out of the computer…”
— Audit tests lack variation
  - “We’ll be doing the same thing we did last year”
— Inadequate Sample sizes
  - “Our sampling software told us that we should test 5 items….”
— Auditing for Coverage
  - “We’ll be looking at all transaction over $100,000”
— Materiality
  - “Is that really material?”
— Lack of appropriate testing exception follow up
  - “Just document why the error is ‘an isolated incident’….”
— Lack of basic data testing
  - Footing/recalculating excel spreadsheets
— Inappropriate consideration of red flags and fraud risk factors

How Can Audit Planning Help?

Audit Planning

— Our objectives are:
  - to identify and assess fraud risk factors and fraud risks
  - to obtain sufficient appropriate audit evidence regarding the assessed financial statement level fraud risks and the assessed risk of material misstatement due to fraud through designing and implementing appropriate responses, and
  - to respond appropriately to fraud or suspected fraud identified during the audit

— **#1 - Execute the audit with professional skepticism and unpredictability – Trust but verify!**

How Can Audit Planning Help?

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

- Incentives/Pressures
  - Public reaction – News reports
  - New accounting, statutory, or regulatory requirements – Pension/OPEB
  - Perceived or real adverse effects of reporting poor financial results on significant pending transactions
- Opportunities
  - Opportunities to engage in fraudulent financial reporting that can arise from the following:
    - Significant related-party transactions not in the ordinary course of business
    - Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
  - There is ineffective monitoring of management as a result of the following:
    - Domination of management by a single person or small group without compensating controls
    - Ineffective oversight over the financial reporting process and internal control by those charged with governance
- There is an unstable organizational structure, as evidenced by the following:
  - High turnover of senior management
- Internal control components are deficient as a result of the following:
  - Inadequate monitoring of controls, including automated controls
  - Ineffective accounting and information systems, including situations involving significant deficiencies or material weaknesses in internal control

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How Can Audit Planning Help?

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

- Attitudes/Rationalizations
  - Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
  - Management failing to correct known significant deficiencies or material weaknesses in internal control on a timely basis
  - A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic budgets and forecasts
  - 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 those charged with governance
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

How Can Audit Planning Help?

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

- Incentives/Pressures
  - Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets
  - 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
- Opportunities
  - Opportunities to misappropriate assets increase when there are the following:
    - Large amounts of cash on hand/assets easily convertible to cash,
    - Inventory items that are small in size, of high value, or in high demand
    - Fixed assets that are small in size, marketable, or lacking observable identification of ownership
  - Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets.
    - Inadequate segregation of duties or independent checks
    - Inadequate management oversight of employees responsible for assets
    - Inadequate recordkeeping with respect to assets including the system of authorization and approval of transactions
    - Inadequate physical safeguards
    - Lack of complete and timely reconciliations of assets
    - Lack of mandatory vacations for employees performing key control functions
    - Inadequate management understanding of information technology and automated controls

How Can Audit Planning Help?

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

— Attitudes/Rationalizations
  - 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 entity or its treatment of the employee
  - Sense of entitlement
  - Changes in behavior or lifestyle that may indicate assets have been misappropriated

How Can Audit Planning Help?

Audit Responses

- **Discuss the risks of material misstatement due to fraud among engagement personnel**
- **Obtain the information needed to identify risks of material misstatement due to fraud**
  - **Inquire of management and others within the entity about the risks of fraud**
  - **Consider the results of the analytical procedures performed in planning the audit**
  - **Consider fraud risk factors. Considering certain other information**
  - **Identify risks that may result in a material misstatement due to fraud**
- **Assess the identified risks after taking into account an evaluation of the entity's programs and controls**
- **Respond to the results of the assessment**
  - design and perform procedures to respond to fraud risks
  - test controls to respond to assessed the risk of material misstatement due to fraud
  - design and perform appropriate substantive procedures
  - design and perform procedures that are responsive to the risk of management override of controls and journal entries
- **Evaluate audit evidence**
- **Communicate about fraud to management, those charged with governance, and others**
- **Document the auditor's consideration of fraud and conclusions**

Questions

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