Fraud Auditing

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1. BACKGROUND

Today's demanding marketplace expects auditors to take responsibility for fraud detection, and this expectation is buoyed by such legislation enacted in USA as the Sarbanes-Oxley Act and the Auditing Standard, which requires increased performance on the part of the auditor to find material financial statement fraud.

2. CONCEPT OF FRAUD AUDITING

A fraud audit is a meticulous review of financial documents, while one searches for the point where the numbers and/or financial statements do not mesh. Fraud audits are done when fraud is suspected. Some companies do them as a precaution to prevent fraud from happening and to catch it before the offender takes too much money. There is more to a fraud audit, however-.

- **Fraud Auditing is not an Investigation**

- Fraud auditing is used to identify fraudulent transactions, not to figure out how they were created. It is a common mistake that many people make believing that audit and investigation are the same process. The auditor simply traces every transaction performed by the company, looking for the one that is fraudulent, if any. A regular auditor simply checks the numbers for accuracy.

- **Looking at All of the Records**

- Fraud auditors often go outside the ledger of accounts to find fraudulent transactions. This may include reviewing receipts, not only from the company, but from customers as well. Any inconsistencies in these numbers could help uncover an act of fraud. These auditors also interview employees, customers and sometimes clients to find out if a fraud has taken place.

- **Patterns**

o There are patterns to every fraud case--these help fraud auditors uncover illegal activity. Many criminals perpetrating a fraud will believe that he is too good to be caught or that the scheme is original. In fact, all fraud has the same indicators that aid the criminal in his crime and the auditor in his search for the same. These include tax management, history of unethical behavior, document tampering and disregard of procedure. These patterns are found wherever there is a fraud crime in progress. Some patterns are less obvious than others, but they are still present.

- **Types of Fraud**

  - Fraud auditing is designed to look for six types of fraud, according to Business Network's "Recognizing Fraud Indicators." These are embezzling, bribes, stealing, extortion, "fictitious transactions," kickbacks and conflict of interest. Although not all fraud cases can be easily classified, they will always---at the very least---involve one of these categories. Fraud auditors are trained to look specifically for indicators to any of these fraud types.

3. AUDIT PROCEDURES FOR FRAUD

In business, fraud is the deliberate attempt to use false information or mislead individuals for personal profit or gain.

SA- 240 says, “When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present.” As a practical matter, the application of SA-230, relating to audit planning should allow the auditor to identify the broad categories of fraud risks related to incentive/pressure and opportunity.

Regarding fraud risk factors relating to attitude/rationalization, you cannot possibly know with certainty a person’s ethical standards and beliefs. However, during the course of your engagement, you may become aware of circumstances that indicate the possible presence of an attitude or ability to rationalize that you consider being a fraud risk. For example, a recurring attempt by management to justify marginal, inappropriate accounting on the basis of materiality and a strained relationship between management and the current or predecessor auditor are fraud risks relating to fraudulent financial reporting.

4. RESPONSIBILITY FOR FRAUD DETECTION

The new fraud standard, SA- 240, Consideration of Fraud in a Financial Statement Audit, is the cornerstone of the ICAI’s comprehensive antifraud and corporate responsibility programme. The goal of the programme is to rebuild the confidence of investors in our capital markets and reestablish audited financial statements as a clear picture window into corporate India.

An Auditor will enter a much expanded arena of procedures to detect fraud as they implement SA- 240. The new standard aims to have the auditor’s consideration of fraud seamlessly blended into the audit process and continually updated until the audit’s completion. SA- 240 describes a process in which the auditor (1) gathers information needed to identify risks of material misstatement due to fraud, (2) assesses these risks after taking into account an evaluation of the entity’s programs and controls and (3) responds to the results. Under SA-240, you will gather and consider much more information to assess fraud risks than you have in the past.

5. PROFESSIONAL SKEPTICISM

SA- 240 reminds auditors they need to overcome some natural tendencies—such as overreliance on client representations—and biases and approach the audit with a skeptical attitude and questioning mind. Also essential: The auditor must set aside past relationships and not assume that all clients are honest. The new standard provides suggestions on how auditors can learn how to adopt a more critical, skeptical mind-set on their engagements, particularly during audit planning and the evaluation of audit evidence.

6. FRAUD RISK FACTORS

A fraud risk factor is an event or condition that tracks the three conditions of the fraud triangle. Although fraud risk factors do not necessarily indicate that fraud exists, they often are warning signs where it does. This standard lists numerous illustrative fraud risk factors to help the auditor in considering whether fraud risks are present. However, in SA- 240, these illustrative fraud risk factors have been reorganized to track the fraud triangle.

Auditors are cautioned not to think that these fraud risk factors are all-inclusive. In fact, research has found that auditors who used open-ended questions that encouraged them to develop their own fraud risk factors outperformed those who relied on a checklist based on looking only for the illustrated fraud risk factors.

7. IDENTIFY AND ASSESS FRAUD RISKS

The key to designing effective audit tests is to perform an effective synthesis of the identified risks. Synthesis is defined as "the assembling of a complex whole from originally separate parts." That is what you must do after you identify risks. SA- 240 requires auditors to assess fraud risks, but one of the problems practitioners have had with the previous standard on fraud is that they mistakenly believed "assessment" to mean they should describe the risk as high, medium or low. That is not how "assessment" is meant to be interpreted in SA- 240. The following illustration maps the audit process from risk identification to audit test design. "Synthesis" is the element that links the two ends of the process.

Eliminate risk synthesis from the process step, and the chain is broken—there is no link to risk identification.

Once that link between risk identification and audit test design is eliminated, it is not surprising that the design of audit tests is not effective in helping auditors identify risks

Your goal is to "assess" or to synthesize the identified risks to determine where the entity is most vulnerable to material misstatement due to fraud, the types of frauds that are most likely to occur and how those material misstatements are likely to be concealed.

8. RISK OF MANAGEMENT OVERRIDE OF INTERNAL CONTROL

SA- 240 requires you to perform certain tasks to address the risk of management override of internal control. Executives can perpetrate financial reporting frauds by overriding established control procedures and recording unauthorized or inappropriate journal entries or other post closing modifications (for example, consolidating adjustments or reclassifications). To address such situations, SA- 240 requires you to test the appropriateness of journal entries recorded in the general ledger and other adjustments.

Understanding the financial reporting process. To effectively identify and test nonstandard journal entries, you will need to obtain a good understanding of the entity's financial reporting process. This knowledge is important because it allows you to be aware of what *should* happen in a "normal" situation so you then can identify anomalies. You also should know how journal entries are recorded (for example, directly online or in batch mode from physical documents), be familiar with the design of any controls over journal entries and other adjustments and learn whether those controls have been placed in operation. This information will help you design suitable tests.

Testing journal entries and other adjustments. Your assessment of the risk of material misstatement due to fraud, together with your evaluation of the effectiveness of controls, will determine the extent of your tests. SA- 240 requires that you inspect the general ledger to identify journal entries to be tested and examine the support for those items.

The new standard provides extensive guidance on what to consider when selecting items for testing. Computer-assisted audit techniques may be required to identify entries that exist only electronically.

9. MISSTATEMENTS THAT MAY BE THE RESULT OF FRAUD

SA- 240 describes how you should respond when you determine that a misstatement is, or may be, the result of fraud. If you believe such a misstatement exists, but its effect is not material to the financial statements, you still are required to evaluate the implications of your belief, especially those dealing with the organizational person(s) involved. For example, if you discover that a member of senior management has fraudulently overstated his or her expenses for reimbursement, you will want to reevaluate the integrity of that individual and the impact an untrustworthy person in that position could have on the financial statements and your engagement.

In those instances where the misstatement is or may be the result of fraud, and the effect either is material or cannot be determined, you are required to take the following steps:

■Attempt to obtain additional evidence.

■Consider the implications for other aspects of the audit.

■Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved and with senior management and the audit committee.

■If appropriate, suggest the client consult with legal counsel.

SA- 240 provides guidance on the auditor’s course of action when the risk of material misstatement due to fraud is such that he or she is considering withdrawing from the engagement. It is impossible to definitively describe when withdrawal is appropriate, but in any event you probably will want to consult with your legal counsel.

10. CHANGING ROLE OF INTERNAL AUDITORS

Across the globe, the economic downturn has brought a number of high profile frauds to the surface and in doing so has created a heightened awareness of fraud risk. Senior executives worldwide are increasingly focused on how their companies might be vulnerable to fraud and whether or not they mitigate sufficiently the risks of financial loss and reputational damage. In November 2010, Deloitte UK issued the results of an Internal Audit Fraud Survey that highlighted disconnect between perception and reality in how companies are mitigating fraud risk. Although focused on UK companies, the survey’s findings may be relevant and insightful to similarly-sized companies worldwide.

In the survey of 75 heads of internal audit at businesses with average revenue of £500 million, 63 percent of respondents stated that their vulnerability to fraud had increased in the past 18 months, yet over 50 percent did not consider their internal audit staffing levels to be adequate to cover such risk. Furthermore, the survey highlighted the disparity between approach and levels of appropriate engagement and delivery, with 23 percent saying that economic uncertainty had not generated board level discussions on introducing or enhancing fraud risk monitoring.

Learn more about how UK companies are being impacted by fraud and explore how respondents see internal audit’s role/focus changing over the next 12 months by downloading the survey report below.

11. VIEWS OF THE ICAI ON FRAUD

The Institute of Chartered Accountants of India (ICAI) has recommended strict penal action, including imprisonment, for auditors who are found associated with serious accounting frauds.

The recommendations are part of ICAI’s final report on Satyam scam and the role of Satyam's former statutory auditors from global auditing firm Price Waterhouse Coopers. The report, finalised by ICAI’s highest decision-making council a few days ago, would be submitted to the ministry this week.

According to sources, ICAI has recommended strict action against auditors known to have collided with Satyam’s former promoter Ramalinga Raju in committing fraud. The committee has also recommended fresh scrutiny of the account books of all associate firms and subsidiary companies of the Raju family. ICAI officials confirmed that its apex council had finalised the report on May 13, but declined to provide details.

An ICAI sub-committee, which carried out extensive inquiry into the scam in January this year, submitted its report to the institute’s council. The sub-committee report prima facie found fault with Price Waterhouse auditors S Gopalakrishnan and S Talluri, and recommended disciplinary action, including a professional ban on the two individuals.

The central council of ICAI took time to firm up its views on the report as it wanted the accused auditors to be given a fair chance to present their case.