**FRAUD**

Fraud is big business and the real scale may be unknown. Incorporated bodies are especially prone to frauds in part due to the agency conflicts, and their sheer size, and weak regulations. Frauds arise when ‘things go wrong’ and this has implications for the system of internal control. 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. Although fraud is a broad legal concept, for the purposes of generally accepted auditing standards (GAAS), the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. Fraud may involve:

* Creation of fictitious revenues.
* Understatement/ overstatement of assets.
* Understatement of expenses e.g. by capitalizing them. (Note that occasionally, expenses can be inflated, and this is still fraud).
* Fraudulent encashment of payable instruments.
* Misappropriation of cash.
* Theft of assets.
* Works services projects e.g. kickbacks in roads construction.
* Travel and subsistence.
* Instruments of payment received on false documents.
* False claims for hours worked.

Some of the main risk areas for employee fraud include:

* Revenue
* Debtors
* Cash
* Payroll
* Large capital contracts
* Major computer acquisitions
* Computer access
* Portable attractive items (e.g. laptops)
* Public sector benefits
* Government grants
* Expenses Stock
* Cheques drawn
* Creditors and payments
* Mortgages Pensions
* Petty cash Recruitment references
* Overtime and employee claims
* Confidential information
* Corporate knowledge
* Employee bonus schemes
* Procurement

**DEFINING FRAUD**

The IIA define fraud as: ‘Any illegal acts characterized by deceit, concealment or violation of trust. These acts are not dependent upon the application of threats of violence or physical force. Fraud is a misrepresentation of fact with the intent of inducing someone to believe the falsehood and act upon it, and thus suffer a loss/ damage. Frauds are perpetrated by individuals, and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage. Fraud is a white collar crime.

**Categories of fraud**

* **Misappropriation of assets:** this may be;
* **Employee fraud:**

This refers to use of fraudulent means by an employee to take money or other property from the employer. It involves falsification of some kind- false documents, lying, exceeding authority or violating company policies.

* **Embezzlement**

This is a type of fraud involving employees or non-employees wrongfully taking money or property entrusted to their care, custody and control, often accompanied by false accounting entries and other forms of cover-up/ lying.

* **Management fraud/ fraudulent financial reporting**

Fraudulent financial reporting is an intentional misstatement or omission of amounts or disclosures with the intent to deceive users. Most cases involve the intentional misstatement of amounts, rather than disclosures. For example, WorldCom capitalized as fixed assets billions of dollars that should have been expensed. Omissions of amounts are less common, but a company can overstate income by omitting accounts payable and other liabilities. While most cases of fraudulent financial reporting involve an attempt to overstate income—either by overstatement of assets and income or by omission of liabilities and expenses, companies also deliberately understate income. At privately held companies, this may be done in an attempt to reduce income taxes. Companies may also intentionally understate income when earnings are high to create a reserve of earnings or “cookie jar reserves” that may be used to increase earnings in future periods. Such practices are called income smoothing and earnings management. **Earnings management** involves deliberate actions taken by management to meet earnings objectives. **Income smoothing** is a form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings. One technique to smooth income is to reduce the value of inventory and other assets of an acquired company at the time of acquisition, resulting in higher earnings when the assets are later sold. Companies may also deliberately overstate inventory obsolescence reserves and allowances for doubtful accounts to counter higher earnings. Although less frequent, several notable cases of fraudulent financial reporting involve inadequate disclosure. For example, a central issue in the Enron case was whether the company adequately disclosed obligations to affiliates known as special-purpose entities.

**TYPES OF FRAUD**

There is no legal definition of fraud. The fraud may be carried out by insiders or outsiders and an organization may carry out fraud by, say, overstating its earnings. The various offences associated with fraud are:

***Theft*** This includes obtaining property by deception and false accounting.

***Bribery and corruption;*** *A*ny money, gift or consideration paid or received shall be deemed to have been paid or received corruptly as an inducement or reward unless the contrary is proved’.

***Forgery*** A person is guilty of forgery if he makes a false instrument with the intention that he or another shall use it to induce someone to accept it as genuine and by reason of so accepting it, to do, or not to do some act to his own or some other person’s prejudice.

***Conspiracy*** This involves the unlawful agreement by two or more persons to carry out an unlawful common purpose or a lawful common purpose by unlawful means. This would cover collusion to override internal controls. There are other actions that fall under the generic category of fraud, including:

• Perjury.

• Concealment (of information).

**Characteristics of fraudsters**

Unlike robbers, fraudsters are least suspected since they look just like everybody else- you and me. They are likely single or married, aged from teens to sixties, educated beyond high school, member of a church, no arrest or criminal record, not tattooed or dreadlocked e.t.c.

**THE FOUR COMPONENTS**

Fraud is an act of deceit to gain advantage or property of another with four main components:

1. **Motive.** There should be a motive for the fraud. This may be that the employee is dissatisfied or is in financial difficulties. In the case of non-employees there should be a reason why the fraud is perpetrated. Good human resource management keeps employees satisfied and lowers non-financial motives for engaging in frauds.
2. **Attraction.** The gain or advantage secured must have an attraction for the perpetrator. This varies and may provide a gain for an associated person, e.g. a mortgage applicant.
3. **Opportunity.** There must be adequate opportunity. Someone may wish to defraud an organization and know exactly what is to be gained, but with no opportunity, it may never occur. Preventive control should be used to guard against the possibility of fraud by reducing opportunities. In fact a report by the University of Nottingham Business School (commissioned by Business Defence Europe) based on a study of 200 firms, claims that middle managers are particularly likely to defraud because they have an in-depth knowledge of how their firms work and know how to cover their tracks.
4. **Concealment.** In contrast to theft, fraud has an element of concealment. It can be by false accounting which is a criminal offence. This makes it difficult to uncover and allows the fraud to be repeated.

**CAUSES OF FRAUD**

The causes of fraud will vary but in terms of reported government fraud the causes of fraud have been listed as:

* Absence of proper control
* Lack of separation of duties
* Collusion with persons outside organization or department
* Failure to observe control procedures
* Collusion within the department

**INDICATORS OF FRAUD**

Frauds are normally found through luck or third-party information while some are discovered during audit reviews, or through controls or by line management. Indicators of fraud are:

• Strange trends where comparative figures move in an unexplained fashion.

• Rewritten and/or amended documents may be evidence of unauthorized alteration to cover up fraud.

• Missing documents may signal a fraud where items are sensitive such as unused cheques or order forms.

• Tipp-Ex (erasing fluid) applied to documents may indicate unauthorized alterations.

• Photocopies substituted for originals can be readily tampered with since the photocopy may make it impossible to uncover alterations to the original.

• Complaints from suppliers that do not tie in with the records should alert one to a potential problem.

**RESPONSIBILITY FOR THE PREVENTION AND DETECTION OF FRAUD**

The primary responsibility for the prevention and detection of fraud rests with both management and those charged with governance of the entity. It is important that management, with the oversight of those charged with governance, places 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. This involves a commitment to creating a culture of honesty and ethical behavior, which can be reinforced by active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts concerning the entity’s performance and profitability.

**FRAUD DETECTION (PRACTICAL: FRAUD DETECTION USING BENFORD’S LAW)**

Fraud can be detected in the following ways: the list is ordered from the most prevalent way of detecting fraud to the least.

1. Tip from employees

2. By accident

3. Internal audit

4. Internal control

5. External audit

6. Tip from customer

7. Anonymous tip

8. Tip from vendor

9. Notification by law enforcement officials.

**SPECIFIC FRAUD RISK AREAS**

**REVENUE**

As a result of the frequency of financial reporting frauds involving revenue recognition standards specifically requires auditors to identify revenue recognition as a fraud risk in most audits. Several reasons make revenue susceptible to manipulation. Most important, revenue is almost always the largest account on the income statement, therefore a misstatement only representing a small percentage of revenues can still have a large effect on income. An overstatement of revenues often increases net income by an equal amount, because related costs of sales are usually not recognized on fictitious or prematurely recognized revenues. Another reason revenue is susceptible to manipulation is the difficulty of determining the appropriate timing of revenue recognition in many situations. Three main types of revenue manipulations are:

1. Fictitious revenues

2. Premature revenue recognition

3. Manipulation of adjustments to revenues

**1. Fictitious Revenues** The most egregious forms of revenue fraud involve creating fictitious revenues. You may be aware of several recent cases involving fictitious revenues.

**2. Premature Revenue Recognition** Companies often accelerate the timing of revenue recognition to meet earnings or sales forecasts. **Premature revenue recognition**, the recognition of revenue before accounting standards requirements for recording revenue have been met, should be distinguished from cutoff errors, in which transactions are inadvertently recorded in the incorrect period. In the simplest form of accelerated revenue recognition, sales that should have been recorded in the subsequent period are recorded as current period sales. One method of fraudulently accelerating revenue is a “bill-and-hold” sale. Sales are normally recognized at the time goods are shipped, but in a bill-and-hold sale, the goods are invoiced before they are shipped. Another method involves issuing side agreements that modify the terms of the sales transaction. For example, revenue recognition is likely to be inappropriate if a major customer agrees to “buy” a significant amount of inventory at year-end, but a side agreement provides for more favorable pricing and unrestricted return of the goods if not sold by the customer. In some cases, as a result of the terms of the side agreement, the transaction does not qualify as a sale under accounting standards.

**3. Manipulation of Adjustments to Revenues** The most common adjustment to revenue involves sales returns and allowances. A company may hide sales returns from the auditor to overstate net sales and income. If the returned goods are counted as part of physical inventory, the return may increase reported income. In this case, an asset increase is recognized through the counting of physical inventory, but the reduction in the related accounts receivable balance is not made. Companies may also understate bad debt expense, in part because significant judgment is required to determine the correct amount. Companies may attempt to reduce bad debt expense by understating the allowance for doubtful accounts. Because the required allowance depends on the age and quality of accounts receivable, some companies have altered the aging of accounts receivable to make them appear more current.

**Warning Signs of Revenue Fraud**

Many potential warning signals or symptoms indicate revenue fraud. Two of the most useful are analytical procedures and documentary discrepancies.

**Analytical Procedures** Analytical procedures often signal revenue frauds, especially gross margin percentage and accounts receivable turnover. Fictitious revenue overstates the gross margin percentage, and premature revenue recognition also overstates gross margin if the related cost of sales is not recognized. Fictitious revenues also lower accounts receivable turnover, because the fictitious revenues are also included in uncollected receivables. The table below includes comparative sales, cost of sales, and accounts receivable data for KK Guards, including the year before the fraud and the two fraud years. Notice how both a higher gross profit percentage and lower accounts receivable turnover ratio in the most recent two years that include the fraud helped signal fictitious accounts receivable. In some frauds, management generated fictitious revenues to make analytical procedures results, such as gross margin, similar to the prior year. In frauds like this, analytical procedures are typically not useful to signal the fraud.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Horizontal Analysis of Income Statements | | | | |
| KK Guards Horizontal analysis of income statement (Ksh. 000) | | | | |
|  | Year ended Dec 31 | | Change | Change % |
|  | 2011 | 2010 |  |  |
| Net sales | 143,086 | 131,226 | 11,860 | 9.0% |
| Cost of sales | 103,241 | 94,876 | 8,365 | 8.8% |
| Gross profit | 39,845 | 36,350 | 3,495 | 9.6% |
| Selling, Gen, admin expenses | 32475 | 29656 | 2,819 | 9.5% |
| **Operating income** | **7370** | **6,694** | **676** | **10.1%** |
| **Other income / expenses** |  |  |  |  |
| Interest expense | 2409 | 2035 | 374 | 18.4% |
| Gain on sale of assets | (720) | - | (720) | NA |
| **Total other income/expense (net)** | **1689** | **2035** | **(346)** | **-17.0%** |
| **Earnings before income taxes** | **5681** | **4659** | **1,022** | **21.9%** |
| Provision for income taxes | 1747 | 1465 | 282 | 19.2% |
| **Net income** | **3934** | **3194** | **740** | **23.2%** |

**Documentary Discrepancies** Despite the best efforts of fraud perpetrators, fictitious transactions rarely have the same level of documentary evidence as legitimate transactions. For example, in the well-known fraud at ZZZZ Best, insurance restoration contracts worth millions of dollars were supported by one or two page agreements and lacked many of the supporting details and evidence, such as permits, that are normally associated with these types of contracts. Auditors should be aware of unusual markings and alterations on documents, and they should rely on original rather than duplicate copies of documents. Because fraud perpetrators attempt to conceal fraud, even one unusual transaction in a sample should be considered to be a potential indicator of fraud that should be investigated.

**Misappropriation of Receipts Involving Revenue** Although misappropriation of cash receipts is rarely as material as fraudulent reporting of revenues, such frauds can be costly to the organization because of the direct loss of assets. A typical misappropriation of cash involves failure to record a sale or an adjustment to customer accounts receivable to hide the theft.

**Failure to Record a Sale** One of the most difficult frauds to detect is when a sale is not recorded and the cash from the sale is stolen. Such frauds are easier to detect when goods are shipped on credit to customers. Tracing shipping documents to sales entries in the sales journal and accounting for all shipping documents can be used to verify that all sales have been recorded. It is much more difficult to verify that all cash sales have been recorded, especially if no shipping documents exist to verify the completeness of sales, and no customer account receivable records support the sale. In such cases, other documentary evidence is necessary to verify that all sales are recorded. For example, a retail establishment may require that all sales be recorded on a cash register. Recorded sales can then be compared to the total amount of sales on the cash register tape. If the sale is not included in the cash register it is almost impossible to detect the fraud.

**Theft of Cash Receipts After a Sale is Recorded** It is much more difficult to hide the theft of cash receipts after a sale is recorded. If a customer’s payment is stolen, regular billing of unpaid accounts will quickly uncover the fraud. As a result, to hide the theft, the fraud perpetrator must reduce the customer’s account in one of three ways:

1. Record a sales return or allowance

2. Write off the customer’s account

3. Apply the payment from another customer to the customer’s account, which is also known as lapping

**Warning Signs of Misappropriation of Revenues and Cash Receipts** Relatively small thefts of sales and related cash receipts are best prevented and detected by internal controls designed to minimize the opportunity for fraud. For detecting larger frauds, analytical procedures and other comparisons may be useful.

**INVENTORY**

Inventory is often the largest account on many companies’ balance sheets, and auditors often find it difficult to verify the existence and valuation of inventories. As a result, inventory is susceptible to manipulation by managers who want to achieve certain financial reporting objectives. Because it is also usually readily saleable, inventory is also susceptible to misappropriation.

**Fraudulent Financial Reporting Risk for Inventory** Fictitious inventory has been at the center of several major cases of fraudulent financial reporting. Many large companies have varied and extensive inventory in multiple locations, making it relatively easy for the company to add fictitious inventory to accounting records. While auditors are required to verify the existence of physical inventories, audit testing is done on a sample basis, and not all locations with inventory are typically tested. In some cases involving fictitious inventories, auditors informed the client in advance which inventory locations were to be tested. As a result, it was relatively easy for the client to transfer inventories to the locations being tested.

**Warning Signs of Inventory Fraud**

Similar to deceptions involving accounts receivable, many potential warning signals or symptoms point to inventory fraud. Analytical procedures are one useful technique for detecting inventory fraud.

**Analytical Procedures** Analytical procedures, especially gross margin percentage and inventory turnover, often help uncover inventory fraud. Fictitious inventory understates cost of goods sold and overstates the gross margin percentage. Fictitious inventory also lowers inventory turnover. The table below is an example of the effects of fictitious inventory on inventory turnover. Note that the gross profit percentage did not signal the existence of fictitious inventories, but the significant decrease in inventory turnover was a sign of fictitious inventories. Cases of fraudulent financial reporting involving accounts payable are relatively common although less frequent than frauds involving inventory or accounts receivable. The deliberate understatement of accounts payable generally results in an understatement of purchases and cost of goods sold and an overstatement of net income. Significant misappropriations involving purchases can also occur in the form of payments to fictitious vendors, as well as kickbacks and other illegal arrangements with suppliers.

|  |  |  |  |
| --- | --- | --- | --- |
| Example of the effect of fictitious inventory on inventory turnover | | | |
|  | Year ended Dec 31, 2011 | Year ended Dec 31, 2010 | 9 months to Sep 30, 2009 |
| Sales | 352,523 | 262,268 | 136,319 |
| Cost of sales | (272,255) | (194,371) | (103,421) |
| Gross profit | 80,268 | 67,897 | 32,898 |
| Gross profit percentage | 22.8% | 25.9% | 24.1% |
| Year end inventories | 109,072 | 59,864 | 26,543 |
| Inventory turnover | 2.50 | 3.20 | 5.20 |

**FRAUDULENT FINANCIAL REPORTING RISK FOR ACCOUNTS PAYABLE**

Companies may engage in deliberate attempts to understate accounts payable and overstate income. This can be accomplished by not recording accounts payable until the subsequent period or by recording fictitious reductions to accounts payable. All purchases received before the end of the year should be recorded as liabilities.

This is relatively easy to verify if the company accounts for pre-numbered receiving reports. However, if the receiving reports are not pre-numbered or the company deliberately omits receiving reports from the accounting records, it may be difficult for the auditor to verify whether all liabilities have been recorded. In such cases, analytical evidence, such as unusual changes in ratios, may signal that accounts payable are understated. Companies often have complex arrangements with suppliers that result in reductions to accounts payable for advertising credits and other allowances. These arrangements are often not as well documented as acquisition transactions. Some companies have used fictitious reductions to accounts payable to overstate net income. Therefore, auditors should read agreements with suppliers when amounts are material and make sure the financial statements reflect the substance of the agreements.

**OTHER RISK AREAS**

**Misappropriations in the Acquisition and Payment Cycle** The most common fraud in the acquisitions area is for the perpetrator to issue payments to fictitious vendors and deposit the cash in a fictitious account. These frauds can be prevented by allowing payments to be made only to approved vendors and by carefully scrutinizing documentation supporting the acquisitions by authorized personnel before payments are made. In other misappropriation cases, the accounts payable clerk or other employee steals a check to a legitimate vendor. Documentation related to the purchase is then resubmitted for payment to the vendor. Such fraud can be prevented by canceling supporting documents to prevent their use as support for multiple payments. Although some accounts are more susceptible than others, almost every account is subject to manipulation. Let’s examine some other accounts with specific risks of fraudulent financial reporting or misappropriation.

**Fixed Assets** Fixed assets, a large balance sheet account for many companies, are often based on subjectively determined valuations. As a result, fixed assets may be a target for manipulation, especially for companies without material receivables or inventories. For example, companies may capitalize repairs or other operating expenses as fixed assets. Such frauds are relatively easy to detect if the auditor examines evidence supporting fixed asset additions. Nevertheless, prior cases of fraudulent financial reporting, such as WorldCom, have involved improper capitalization of assets. Because of their value and salability, fixed assets are also targets for theft. This is especially true for fixed assets that are readily portable, such as laptop computers. To reduce the potential for theft, fixed assets should be physically protected whenever possible, engraved, or otherwise permanently labeled, and should be periodically inventoried.

**Payroll Expenses** Payroll is rarely a significant risk area for fraudulent financial reporting. However, companies may overstate inventories and net income by recording excess labor costs in inventory. Company employees are sometimes used to construct fixed assets. Excess labor cost may also be capitalized as fixed assets in these circumstances. Material fringe benefits, such as retirement benefits, are also subject to manipulation. Payroll fraud involving misappropriation of assets is fairly common, but the amounts involved are often immaterial. The two most common areas of fraud are the creation of fictitious employees and overstatement of individual payroll hours. The existence of fictitious employees can usually be prevented by separation of the human resource and payroll functions. Overstatement of hours is typically prevented by use of time clocks or approval of payroll hours.

**FRAUD PREVENTIVE TECHNIQUES**

The investigative process is reactive in that it is initiated as a result of an alleged fraud. Steps may be taken to guard against fraud. The importance of establishing sound controls cannot be overemphasized as most frauds could have been avoided with proper controls. We must also question an organization which fully resources the investigation of fraud while ignoring the control implications.

Unfortunately those charged with performing these investigations may have little incentive to push the control angle if it will result in less work being available for them. Key controls include:

* Good recruitment procedures
* Independent checks over work
* Supervision
* Regular staff meetings
* System of management accounts
* An employee code of conduct.
* Up-to-date accounts
* Good management information systems
* Clear lines of authority
* Publicized policy on fraud
* Controlled profit margins
* Good documentation
* Good staff discipline procedures
* Financial procedures
* Management trails
* Good communications
* Good controls over cash income
* Segregation of duties
* Stores/equipment control
* Anti-corruption measures
* Fraud hotline
* Good all-round systems of control
* Well-trained and alert management

Fraud risk management is now a major issue and, under its consulting arm, internal audit may need to spend some time helping managers ensure that the risk of fraud is properly understood and mitigated wherever possible. Note that any such activity should be carried out in conjunction with the corporate anti-fraud policy.

**FRAUD AWARENESS AUDITING**

Fraud examination combines the expertise of auditors and criminal investigators. Fraud detection is most likely as a result of voluntary confessions by perpetrators, tips, accident or luck on the part of auditors. Internal and external auditors detect around 20% of frauds. In fraud audits, you should:

* Float a mindset of sensitivity to the unusual, where nothing is standard.
* Note errors and omissions and FOCUS on exceptions, oddities, and patterns of conduct.
* “Think like a crook” to imagine ways controls may be subverted for fraudulent purposes.
* Examine cumulative materiality.

**AUDITORS RESPONSIBILTY REGARDING FRAUD**

* Auditors should understand fraud, assess fraud risks, design audit procedures to provide reasonable assurance of detecting material management fraud and employee fraud that could have material effect on financial statements and report on findings to management, directors, users of financial statements (at times), and outside agencies.
* Keep track of management estimates and closest reasonable estimates supported by audit evidence. This is because a lot of fraud involves manipulation of accounting estimates e.g. bad debts provisions.

**GATHERING EVIDENCE WHERE FRAUD IS SUSPECTED**

**Use of Inquiry**

Inquiry can be an effective audit evidence gathering technique, as we discussed earlier. Interviewing allows the auditor to clarify unobservable issues and observe the respondent’s verbal and nonverbal responses. Interviewing can also help identify issues omitted from documentation or confirmations. The auditor can also modify questions during the interview based on the interviewee’s responses. Inquiry as an audit evidence technique should be tailored to the purpose for which it is being used. Depending on the purpose, the auditor may ask different types of questions and change the tone of the interview. One or more of three categories of inquiry can be used, depending on the auditor’s objectives.

**Categories of Inquiry** An auditor uses **informational inquiry** to obtain information about facts and details that the auditor does not have, usually about past or current events or processes. Auditors often use informational inquiry when gathering follow-up evidence about programs and controls or other evidence involving a misstatement or suspected fraud uncovered during the audit. Auditors can most effectively use informational inquiry by posing open-ended questions about details of events, processes, of circumstances.

An auditor uses **assessment inquiry** to corroborate or contradict prior information. The auditor often starts assessment inquiry with broad, open-ended questions that allow the interviewee to provide detailed responses that can later be followed up with more specific questions. One common use of assessment inquiry is to corroborate management responses to earlier inquiries by asking questions of other employees.

**Interrogative inquiry** is often used to determine if the individual is being deceptive or purposefully omitting disclosure of key knowledge of facts, events, or circumstances. Often, interrogative inquiry is confrontational, given that subjects may be defensive, as they cover up their knowledge of specific facts, events, or circumstances. When using interrogative inquiry, the auditor often asks specific directed questions that seek either a “yes” or “no” response. Interrogative interviewing should typically be done by senior members of the audit team who are experienced and knowledgeable about the client’s affairs.

**Listening Techniques** It is critical for the auditor to use effective listening skills throughout the inquiry process. The auditor should stay attentive by maintaining eye contact, nodding in agreement, or demonstrating other signs of comprehension. Auditors should also attempt to avoid preconceived ideas about the information being provided. Good listeners also take advantage of silence to think about the information provided and to prioritize and review information heard.

**Observing Behavioral Cues** An auditor who is skilled in using inquiry evaluates verbal and nonverbal cues when listening to the interviewee. Verbal cues, such as those outlined in the table below, may indicate the responder’s nervousness, lack of knowledge, or even deceit. In addition to observing verbal cues, the use of inquiry allows the auditor to observe nonverbal behaviors. Expert investigators note that subjects who are uncomfortable providing a response to an inquiry often exhibit many of the nonverbal behaviors shown in the table below. Of course, not everyone who exhibits these behaviors is uncomfortable responding to the auditor’s inquiry. The key is to identify when the individual’s behavior begins to change from his or her normal behavior. Less-experienced auditors should be cautious when they start to observe unusual behaviors, and they should discuss their concerns with senior members of the audit team before doing anything in response to those behaviors.

|  |  |
| --- | --- |
| Observing verbal cues during inquiry | |
| Verbal Cue Examples | Implications |
| Extensive use of modifiers- “Generally”, “Usually”, “often”, “Normally” | Probe further to determine whether the use of the modifier indicates there are exceptions to the circumstances being examined. |
| Frequent rephrasing by the interviewee of the auditor question | Skilled auditors recognize that rephrasing often indicates that the interviewee is uncertain about his or her response or is attempting to stall for time. |
| Filler terms, such as “um,” “well,” “to tell you the truth,” etc. | Auditors should be alert for filler terms, given that they often suggest that the interviewee is hesitant or unable to respond to the inquiry. |
| Forgetfulness and acknowledgments of nervousness, such as “I’m a bit nervous” or “I just can’t remember.” | When this continues to occur, auditors should be concerned about the possibility of deception. |
| Tolerant attitudes, such as “it depends on the circumstances,” and overqualified responses, such as “to the best of my memory.” | Dishonest people are often tolerant toward someone who may have committed Fraud |
| Reluctance to end an interview. | Someone who has been honest generally is ready to terminate an interview. Those trying to deceive may try to continue the inquiry process to convince the auditor that they are telling the truth. |

**AUDITOR INDEPENDENCE**

Auditors’ independence from company management is essential for a successful audit because it enables them to approach the audit with the necessary professional skepticism. To help protect their independence, external auditors report to a company’s audit committee, who oversee the auditors’ work and monitor any disagreements between management and the auditor regarding financial reporting. In the past, auditors often were hired by and reported to company management with varying levels of audit committee involvement. Many observers believed that relationship made it more difficult to maintain independence leading to high profile frauds.

**ASSESSING FRAUD RISK**

SAS 99 provides guidance to auditors in assessing the risk of fraud. Auditors must maintain a level of professional skepticism as they consider a broad set of information, including fraud risk factors, to identify and respond to fraud risk. The auditor has a responsibility to respond to fraud risk by planning and performing the audit to obtain reasonable assurance that material misstatements, whether due to errors or fraud, are detected. Auditing standards state that, in exercising professional skepticism, an auditor “neither assumes that management is dishonest nor assumes unquestioned honesty.” In practice, maintaining this attitude of professional skepticism can be difficult because, despite some recent high-profile examples of fraudulent financial statements, material frauds are infrequent compared to the number of audits of financial statements con ducted annually. Most auditors will never encounter a material fraud during their careers. Also, through client acceptance and continuance evaluation procedures, auditors reject most potential clients perceived as lacking honesty and integrity.

**Questioning Mind**

Auditing standards emphasize consideration of a client’s susceptibility to fraud, regardless of the auditor’s beliefs about the likelihood of fraud and management’s honesty and integrity. During audit planning for every audit, the engagement team must discuss the need to maintain a questioning mind throughout the audit to identify fraud risks and critically evaluate audit evidence. There is always a risk that even an honest person can rationalize fraudulent actions when incentives or pressures become extreme.

**Critical Evaluation of Audit Evidence**

Upon discovering information or other conditions that indicate a material misstatement due to fraud may have occurred, auditors should thoroughly probe the issues, acquire additional evidence as needed, and consult with other team members. Auditors must be careful not to rationalize or assume a misstatement is an isolated incident. For example, say an auditor uncovers a current year sale that should properly be reflected as a sale in the following year. The auditor should evaluate the reasons for the misstatement, determine whether it was intentional or a fraud, and consider whether other such misstatements are likely to have occurred.

**SOURCES OF INFORMATION TO ASSESS FRAUD RISK**

**Communications among audit team**

SAS 99 requires the audit team to conduct discussions to share insights from more experienced audit team members and to “brainstorm” ideas that address the following:

1. How and where they believe the entity’s financial statements might be susceptible to material misstatement due to fraud. This should include consideration of known external and internal factors affecting the entity that might:

* + Create an incentive or pressure for management to commit fraud.
  + Provide the opportunity for fraud to be perpetrated.
  + Indicate a culture or environment that enables management to rationalize fraudulent acts.

2. How management could perpetrate and conceal fraudulent financial reporting.

3. How anyone might misappropriate assets of the entity.

4. How the auditor might respond to the susceptibility of material misstatements due to fraud.

These discussions about fraud risks will likely take place at the same time as discussions about the susceptibility of the entity’s financial statements to other types of material misstatement.

**Inquiries of Management**

SAS 99 requires the auditor to make specific inquiriesabout fraud in every audit. Inquiries of management and others within the company provide employees with an opportunity to tell the auditor information that otherwise might not be communicated. Moreover, their responses to the auditor’s questions often reveal information on the likelihood of fraud.

**Risk Factors**

SAS 99 requires the auditor to evaluate whether fraud risk factors indicate incentives or pressures to perpetrate fraud, opportunities to carry out fraud, or attitudes or rationalizations used to justify a fraudulent action. The existence of fraud risk factors does not mean fraud exists, but that the likelihood of fraud is higher. Auditors should consider these factors along with any other information used to assess the risks of fraud.

**Analytical Procedures**

Auditors must perform analytical procedures during the planning and completion phases of the audit to help identify unusual transactions or events that might indicate the presence of material misstatements in the financial statements. When results from analytical procedures differ from the auditor’s expectations, the auditor evaluates those results in light of other information obtained about the likelihood of fraud to determine if fraud risk is heightened.

**Other Information**

Auditors should consider all information they have obtained in any phase or part of the audit as they assess the risk of fraud. Many of the risk assessment procedures that the auditor performs during planning to assess the risk of material misstatement may indicate a heightened risk of fraud. For example, information about management’s integrity and honesty obtained during client acceptance procedures, inquiries and analytical procedures done in connection with the auditor’s review of the client’s quarterly financial statements, and information considered in assessing inherent and control risks may lead to auditor concerns about the likelihood of misstatements due to fraud.

**CORPORATE GOVERNANCE PRACTICES THAT REDUCE FRAUD RISKS**

We have mentioned that fraud prevention and detection is primarily the duty of management. Towards this end, the following corporate governance practices may help reduce fraud risks;

* Culture of honesty and integrity; this includes
  + Tone at the top

Management and the board of directors are responsible for setting the “tone at the top” for ethical behavior in the company. Honesty and integrity by management reinforces honesty and integrity to employees throughout the organization. Management cannot act one way and expect others in the company to behave differently. Through its actions and communications, management can show that dishonest and unethical behaviors are not tolerated, even if the results benefit the company.

* + Creating a Positive Workplace Environment

Research shows that wrongdoing occurs less frequently when employees have positive feelings about their employer than when they feel abused, threatened, or ignored. A positive workplace can generate improved employee morale, which may reduce employees’ likelihood of committing fraud against the company.

* + Hiring and Promoting Appropriate Employees

To be successful in preventing fraud, well-run companies implement effective screening policies to reduce the likelihood of hiring and promoting individuals with low levels of honesty, especially those who hold positions of trust. Such policies may include background checks on individuals being considered for employment or for promotion to positions of trust. Background checks verify a candidate’s education, employment history, and personal references, including references about character and integrity. After an employee is hired, continuous evaluation of employee compliance with the company’s values and code of conduct also reduces the likelihood of fraud.

* + Training

All new employees should be trained about the company’s expectations of employees’ ethical conduct. Employees should be told of their duty to communicate actual or suspected fraud and the appropriate way to do so. In addition, fraud awareness training should be tailored to employees’ specific job responsibilities with, for example, different training for purchasing agents and sales agents.

* + Confirmation

Most companies require employees to periodically confirm their responsibilities for complying with the code of conduct. Employees are asked to state that they understand the company’s expectations and have complied with the code, and that they are unaware of any violations. These confirmations help reinforce the code of conduct policies and also help deter employees from committing fraud or other ethics violations. By following-up on disclosures and non-replies, internal auditors or others may uncover significant issues.

* + Discipline

Employees must know that they will be held accountable for failing to follow the company’s code of conduct. Enforcement of violations of the code, regardless of the level of the employee committing the act, sends clear messages to all employees that compliance with the code of conduct and other ethical standards is important and expected. Thorough investigation of all violations and appropriate and consistent responses can be effective deterrents to fraud.

* Management’s responsibility to evaluate risks of fraud by;
  + Identifying and Measuring Fraud Risks

Effective fraud oversight begins with management’s recognition that fraud is possible and that almost any employee is capable of committing a dishonest act under the right circumstances. This recognition increases the likelihood that effective fraud prevention, deterrence, and detection programs and controls are implemented.

* + Mitigating Fraud Risks

Management is responsible for designing and implementing programs and controls to mitigate fraud risks, and it can change business activities and processes prone to fraud to reduce incentives and opportunities for fraud. For example, management can outsource certain operations, such as transferring cash collections.

* + Monitoring Fraud Prevention Programs and Controls

For high fraud risk areas, management should periodically evaluate whether appropriate antifraud programs and controls have been implemented and are operating effectively. For example, management’s review and evaluation of results for operating units or subsidiaries increases the likelihood that manipulated results will be detected. Internal audit plays a key role in monitoring activities to ensure that antifraud programs and controls are operating effectively. Internal audit activities can both deter and detect fraud. Internal auditors assist in deterring fraud by examining and evaluating internal controls that reduce fraud risk. They assist in fraud detection by performing audit procedures that may uncover fraudulent financial reporting and misappropriation of assets.

* Audit committee oversight

The audit committee has primary responsibility to oversee the organization’s financial reporting and internal control processes. In fulfilling this responsibility, the audit committee considers the potential for management override of internal controls and oversees management’s fraud risk assessment process, as well as antifraud programs and controls. The audit committee also assists in creating an effective “tone at the top” about the importance of honesty and ethical behavior by reinforcing management’s zero tolerance for fraud. Audit committee oversight also serves as a deterrent to fraud by senior management. For example, to increase the likelihood that any attempt by senior management to involve employees in committing or concealing fraud is promptly disclosed, oversight may include:

• Direct reporting of key findings by internal audit to the audit committee

• Periodic reports by ethics officers about whistle-blowing

• Other reports about lack of ethical behavior or suspected fraud

Because the audit committee plays an important role in establishing a proper tone at the top and in overseeing the actions of management, Auditing Standards requires the auditor (especially for a public company) to evaluate the effectiveness of the board and audit committee as part of the auditor’s evaluation of the operating effectiveness of internal control over financial reporting. As part of the evaluation, the auditor might consider the audit committee’s independence from management and the level of understanding between management and the audit committee regarding the latter’s responsibilities. An external auditor may gather insights by observing interactions between the audit team, the audit committee, and internal audit regarding the level of audit committee commitment to overseeing the financial reporting process. Ineffective oversight by the audit committee may be a strong indicator of a material weakness in internal control over financial reporting.

**FRAUD DETECTION USING BENFORD’S LAW (Practical)**