Chapter 8
Fraud Risk Assessment

Full chapter infographic: LO 1 to LO 5

1 Fraud, types of fraud and responsibilities

Error vs fraud
- Error: unintentional misstatement
- Fraud: intentional act involving deception to obtain an unlawful or unfair advantage
- The auditor's response differs for each

(a) Misappropriation of assets
- Employees or management steal or misuse assets
- Embezzling cash receipts (e.g. depositing customer payments into a personal account)
- Stealing physical assets or intellectual property
- Creating fictitious suppliers or employees and diverting payments
- Using company resources for personal benefit

(b) Fraudulent financial reporting
- Intentional manipulation of accounts to mislead users
- 1 Fictitious journal entries, often near year-end
- 2 Manipulating assumptions and estimates
- 3 Prematurely recognising or delaying transactions
- 4 Altering documents or contract terms
- 5 Concealing material facts
- 6 Complex transactions to misrepresent performance
- Often through management override of controls

Management and TCWG
- Primary responsibility for preventing and detecting fraud
- Design, implement, maintain internal controls
- TCWG oversee controls and stay alert to management override

Auditor
- Main role: express an opinion on whether F/S are free from material misstatement
- Not directly responsible for preventing or detecting fraud
- ISA 240 requires: risk assessment procedures to identify fraud risks; audit procedures to address them; professional skepticism at all times
- Auditor gives reasonable assurance, not full detection

2 Risk assessment procedures and fraud risk factors

1 Inquiries of management
- Process for identifying and responding to fraud risks
- Specific fraud risks considered likely
- Communications on fraud and ethical practices
- Communication with TCWG about fraud risk processes

2 Inquiries of others
- Ask employees and internal audit about knowledge of fraud
- Discuss with TCWG how they oversee fraud risk management and controls

3 Analytical review
- Evaluate unusual or unexpected relationships (ratios, trends)

4 Evaluate other evidence
- Does information from risk procedures indicate fraud risk factors?

Incentives / pressures
- Motives: bonuses, avoiding debt covenant breaches, securing financing

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Opportunities
- Weak controls, ineffective oversight, complex transactions that can be exploited

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Rationalisation
- Unethical attitudes or justifications that make fraud seem acceptable

Misappropriation of assets: factors
- Incentives: personal financial pressures (debt, hardship); poor employee relations (layoffs, unfair rewards)
- Opportunity: easily movable valuable assets (cash, inventory); weak asset controls, poor records, poor segregation of duties
- Attitudes: failure to fix known weaknesses; overriding controls; tolerance of minor theft; dissatisfaction; unexplained lifestyle changes

Fraudulent financial reporting: factors
- Incentives: planned sale of shares or business; management shareholding; bonuses linked to results; pressure for targets; poor financial stability or performance
- Opportunity: significant related-party transactions; subjective estimates; weak financial reporting controls; one or few dominant managers; ineffective board or audit committee
- Attitudes: poor ethical standards; history of violating laws; low morale; unrealistic commitments to banks or creditors; giving inaccurate information to auditors

Record discrepancies
- Unauthorized or unsupported transactions
- Last-minute adjustments
- Missing or incorrectly recorded transactions
- Tips or complaints about fraud
- Employees with unnecessary access to financial systems

Missing evidence
- Missing or altered records; original documents unavailable
- Unexplained reconciliation differences
- Unusual ratios and trends
- Vague management answers
- Differences with external confirmations
- Numerous year-end adjustments
- Missing inventory or assets
- No evidence of system changes

Auditor relations
- Management restricts access to records or people
- Complaints or intimidation towards auditors
- Delays in information
- Refusal to address control weaknesses or correct misstatements
- Refusal to give access to IT personnel or data

Other indicators
- Accounting policies differ from industry norms
- Frequent changes in estimates without valid reasons
- Refusal to allow private meetings with TCWG
- Acceptance of code-of-conduct violations

Presumption of fraud risk in revenue recognition
- General: auditors assume a significant fraud risk in revenue recognition
- Rebuttable: in exceptional cases with simple revenue streams (e.g. rental income), the auditor may ignore the presumption

3 Auditor's action if there is a risk of fraud

Refer Chapter 7: response at F/S level
- More professional skepticism
- Lower materiality
- Assign more experienced staff or experts
- More supervision and review
- Add unpredictability
- Focus on year-end testing
- Obtain more reliable evidence
- Review estimates carefully

4 Auditor's action if there is a fraud or suspected fraud

1 Communicate
- To appropriate management, usually one level above those involved

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2 Inform TCWG
- When the fraud is significant or involves management

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3 Report
- If required by law

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4 Withdraw?
- If management integrity is in doubt and TCWG fail to act

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5 Assess effect
- On F/S; modify audit opinion if necessary

5 Management override of control

Definition
- Deliberately bypassing established policies to manipulate results
- Exists in every entity; always a significant fraud risk

Techniques
- 1 Fictitious journal entries (often near year-end)
- 2 Manipulating assumptions and estimates
- 3 Prematurely recognising or delaying transactions
- 4 Altering documents or contract terms
- 5 Concealing material facts
- 6 Complex transactions to misrepresent performance

Procedures (always, regardless of assessed risk)
- 1 Test journal entries: inquire about unusual activity; test year-end adjustments; consider testing throughout the year
- 2 Review estimates for bias: evaluate judgments; retrospective review of prior-year estimates
- 3 Evaluate unusual transactions: assess whether significant non-routine transactions lack a valid business rationale or conceal fraud