BY
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The Auditor and Fraud

As Auditors where do our responsibilities for the detection of Fraud start and end? Emer Kelly guides us through the requirements of ISA 240

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The risk of fraud in Irish organisations whether small or large, privately or publicly funded, increased during the financial crisis as businesses and employees faced ever increasing pressures to post stronger results. The impact of fraud on financial statements can be extensive - manipulation of sales figures, unrecorded liabilities or over-zealous valuations of assets can seriously distort the true and fair view of financial statements.

While this may sound like the narrative of scandalous business headlines, fraud can be found in all business types and sizes, from the corner shop to those entities with complex revenue recognition policies. Fraud can come in all guises, from employee fraud and cyber crime to financial statement fraud.

Fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

Two types of intentional misstatements in the financial statements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets and audit tests should be designed to take both into account.

The role of the auditor

So where does this leave the role of the statutory auditor and very importantly how should the auditor respond when faced with the uncovering of fraud in an organisation?

No longer the mere watchdog, the role of the auditor to be vigilant to the possibility of fraud is clearly set out in ISA 240 (UK and Ireland), The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. This standard looks at the role of the auditor with regard to misstatements arising from both fraud and error.

It is important to note that the primary responsibility for the prevention and detection of fraud rests with those charged with governance and management.

However the auditor has a secondary responsibility and 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.

ISA 240 requires the auditor to plan and perform the statutory audit with a view to ensuring that reasonable assurance can be given that the financial statements show a true and fair view.

It is essential that the auditor is focused and robust in their design of tests regardless of the size and nature of the client and the audit file must clearly document this focus.

The Financial Reporting Council published in January 2014 a thematic review in relation to "Fraud risks and laws and regulations". The scope of the project, conducted by the audit quality review team, was to review the audit methodology, guidance and training provided by the six largest audit firms in the United Kingdom to staff in respect of fraud risks and consideration of laws and regulation. The following key messages were identified by the Financial Reporting Council and lessons can be drawn from this for audit firms of all sizes;

a. An increased focus to be placed upon identifying fraud risk factors and the risks of material misstatement in both planning and conduct of the engagement
b. Tailoring of assessment of fraud risks and audit procedures to the circumstances of the audited entity

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c. Fraud risks should always be identified as significant risks, resulting from this the auditor should evaluate the design and implementation of the entity's internal controls to detect and prevent fraud, where such risks are identified
d. Auditors should exercise greater professional scepticism in identifying and addressing fraud risks

Professional Scepticism

The auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

The requirement to maintain professional scepticism should be highlighted with the engagement team and documented in the engagement team meeting memorandum. This is essential to the training culture within the firm.

ISA 240 - Objectives

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.

The consideration of fraud should cover the following types:

- Fraudulent financial reporting
- Misappropriation of assets
- Management override of controls

Audit Planning

The consideration and assessment of the risks of material misstatements due to fraud should be woven into all stages of the audit with the identification and designing of tests to be laid out at the initial planning stage.

The auditor will consider how susceptible the financial statements are to misstatement due to fraud and will design their tests accordingly. Knowledge of the client from previous years and the assessment of the controls operated by the entity will inform how these tests will be designed.

For example in the audit of a client with charitable status tests may be designed to take account of:

- Widespread branches or operations
- Reliance on volunteers and staff with limited management or supervision and lack of segregation and rotation of duties
- Informal controls around the finance function
- High level of transactions in cash
- Unpredictable patterns of receipts

Design of Tests

Tests identified may serve a dual purpose –they may prove an audit assertion and may also give some comfort over the susceptibility of the entity to fraud. The audit file should set out clearly both objectives.

Such tests could include for the example already given of a client with charitable status:

- Request a copy of returned paid cheques
- Test appropriateness of journal entries recorded and other adjustments made
- Confirming specific terms of contract especially with related parties.
- Obtain employment contracts and match gross pay to payslips.

It is advisable to incorporate unpredictability testing into audit tests – include some low value items in all samples chosen.

Revenue Recognition

When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Where the auditor concludes that such a presumption is not applicable the audit file must outline the reasons for that conclusion.

Written Representations

The auditor must ensure that the letter of representation includes a number of representations regarding fraud, including;

- The acknowledgment by management of their responsibility for the design, implementation and maintenance of a system of internal control to prevent and detect fraud.
- Confirmation that they have disclosed to the auditor their knowledge of fraud or suspected fraud involving management, employees and others.
- Confirmation that they have disclosed their knowledge of any allegations of fraud or suspected fraud.

Communication of Findings

Where the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor must communicate these matters on a timely basis to the appropriate level of management.

The auditor must be mindful of the offence of tipping off under S.49 of the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 as amended by the Criminal Justice Act 2013.

Reporting Obligations

The auditor must consider very carefully the myriad of reporting responsibilities that exist where a fraud is uncovered. The following legislation provides many complexities to be considered by the auditor.

- Companies Act 2014 – requirement to report Category 1 and 2 offences to the Director of Corporate Reporting.
- Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 to 2013
- Criminal Justice Act 2011
- Criminal Justice (Theft and Fraud Offences) Act 2001
- S.1079 of the Taxes Consolidation Act 1997

In conclusion, the consideration of fraud during the course of the audit is fraught with difficulty and requires the auditor to carefully plan and perform the engagement. There may be instances where legal advice may be required by the auditor.