



CHARTERED CERTIFIED ACCOUNTANTS

The Auditor's Responsibility in the area of Fraud

In 2005, International Standards on Auditing (ISAs) replaced the Statement of Auditing Standards (SASs) that governed the audit profession in the UK and Ireland. The introduction of ISAs saw more emphasis being placed on the auditor's responsibility relating to fraud and error.

Prior to the introduction of ISAs, fraud and error were dealt with in SAS 110: *Fraud and error*, which was issued in January 1995. Fraud and error are now dealt with in ISA 240: *The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements*.

ISA 240 clearly distinguishes fraud from error and provides comprehensive guidance on addressing the issues surrounding fraud and error. It states that error is "an unintentional misstatement in the financial statements including the omission of an amount or disclosure". Note the term 'unintentional' – this term is key to distinguishing whether misstatements in the financial statements are classed as fraud or error.

So what is fraud?

ISA 240 gives a clear interpretation of fraud as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage'.

Fraud, by its interpretation, can be extremely difficult to detect. The intentions of an individual(s) to realise financial gain by deception may be designed that even the most alert auditor could overlook a fraud.

ISA 240 states that the auditor must plan and approach their audit with professional scepticism. In other words, the auditors must expect fraud at the planning stage and satisfy themselves, by performing audit testing during the course of the audit, that fraud has not, in fact, occurred. Thus, the phrase 'guilty until proven innocent' is appropriate in these circumstances.

So what are the characteristics present if a fraud is being committed? Here are some examples:

- Management override of controls such as recording fictitious journals (especially towards the year end), inappropriately adjusting assumptions and judgements, or omitting or delaying events that have occurred before the accounting period;
- Employees not taking holidays;

- External pressures from third parties – for example, potential breaching of loan covenants;
- Threatening or intimidating management;
- Lack of segregation of duties;
- A high standard of living by individuals whose income would not normally allow it;
- A history of dishonesty with those charged with governances; and
- Unusual characteristics within the financial statements.

Let us consider a practical example. Assume that we are planning an audit for an owner-managed business that operates in the “Do-it-Yourself” (DIY) sector with a turnover of £1 million. The client is in the retail trade offering goods and services to the public. We have audited the client for five years and have never encountered any problems. The client has a March 2006 year-end and this is the first year we have undertaken the audit under the new ISAs.

IAS 240 states that the auditor has to approach the audit with a degree of professional scepticism. In terms of fraud, even though the client has never had any instances of such, we have to adopt the ‘guilty until proven innocent’ approach. What would be the risks that the auditor would have to consider for a client operating in the retail DIY sector?

- The client will invariably be cash-based. By their very nature, cash-based businesses have a high degree of risk attached to them, as cash could be understated through theft, resulting in under-declared sales. This results in under-declared VAT, trade receivables, bank balances and corporation taxes i.e. multiple misstatements.
- Owner-managed businesses have more potential for management override of internal controls.
- Owner-managed businesses tend to have a lesser degree of segregation of duties.
- Smaller enterprises may wish to suppress profits to reduce tax liabilities.
- Financial statements may be manipulated to boost profits in order to comply with loan covenants imposed by financiers. For example, closing stock could be misstated to boost profits.
- Shareholders might expect increased dividend payments.

The size and complexity of the client will have a bearing on the relevance of fraud risk factors. In smaller companies, the fact that one person may exercise influence over the running of the company does not, in itself, constitute a weakness in the internal control environment – it does, however, offer the controlling individual the potential to override the internal controls in the financial reporting process for personal financial gain. More commonly, an ineffective internal control environment has the potential to give rise to fraud.

Auditors can use various techniques to give clear indications of the presence of fraud. One such technique would be the use of ‘analytical review’. When using analytical

procedures in assessing a company's internal control environment, the auditor needs to be alert to unexpected or unusual characteristics which could be due to fraud.

For analytical procedures to be effective, the auditor must have a clear understanding of the business their client operates and its environment. Analytical procedures can be quite useful in identifying unusual changes in trends. The auditor will have their expectations on the client's financial relationships based on their understanding of the business and its environment, and any unexpected rise or fall will prompt the auditor to consider the risk of material misstatement due to fraud.

The auditor's use of professional judgement is a critical aspect of the modern audit profession. The auditor will exercise his or her judgement to assess the risk that material misstatement has occurred in the financial statements due to fraud. ISA 240 states that the auditor will use professional judgement that:

- Identifies risks of fraud by considering the information obtained through performing risk assessment procedures and by considering the class of transactions, account balances and disclosures in the financial statements;
- Relates the identified risks of fraud as to what can go wrong at the assertion level; and
- Considers the likely magnitude of the potential misstatement, including the possibility that the risk may give rise to multiple misstatements and the likelihood of the risk occurring.

It is for these reasons that the auditor must obtain a detailed understanding of the business and its environment as well as understanding the controls management and those charged with governance have put in place to prevent and detect fraud.

ISA 330 requires the auditor to perform substantive testing on those risks that are identified as significant. In determining the overall responses to address the risk that material misstatement has occurred due to fraud at the financial statement level, the auditor is required to:

- Consider the assignment and supervision of personnel;
- Consider the accounting policies used by the entity; and
- Incorporate an element of unpredictability in the nature, timing and extent of audit procedures.

Imagine that the auditor discovers that the management has overridden internal controls during the course of an audit for benefit of obtaining financial gain. This is a risk that is present in all entities, large and small. In order to respond to the risk, the auditor should design and perform specifically tailored audit procedures in order to:

- (a) test the appropriateness of journal entries recorded in the general ledger and other adjustments/assumptions made in the preparation of the financial statements;

- (b) review accounting estimates and provisions that could result in material misstatement due to fraud; and
- (c) obtain an understanding of the business rationale of significant transactions that the auditor becomes aware that are outside the normal course of business for the entity.

If the auditor concludes that the financial statements are misstated due to fraud, he/she needs to communicate this to those charged with governance as soon as possible. This can be made orally or in writing and the auditor needs to consider the appropriate means of communication. If the integrity of those charged with governance is brought into question, the auditor must seek legal advice as to determine the most appropriate course of action.

ISA 260: Communication of Audit Matters to those Charged with Governance identifies those factors that the auditor needs to communicate. It also states that any weaknesses within the internal control environment must be communicated in writing.

If, as a result of exceptional circumstances, the auditor has to consider their ability to continue performing the audit, ISA 240 states that he/she must:

- Consider the possibility of withdrawing from the engagement;
- Consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report the person(s) who made the audit appointment to regulatory authorities; and
- If the auditor withdraws, he/she must discuss their reasons with management and those charged with governance and consider whether there is a professional obligation to report the person(s) who made the audit appointment to regulatory authorities.

The adoption of ISAs on Auditing in 2005 has meant that fraud has become a significant factor that auditors must address. The requirement for professional scepticism places more responsibility for auditors in their consideration of fraud both at the planning stage and during the course of the detailed audit work.

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