

ICAEW KNOW-HOW  
AUDIT AND ASSURANCE FACULTY

A large red arrow points from the left towards the right, where the title is located. Several white paper airplanes are shown in flight, moving from left to right towards the red arrow. One blue paper airplane is also shown in flight, moving from left to right towards the red arrow.

# *Fraud risk factors in a financial statement audit*

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# *The prevalence and cost of fraud*



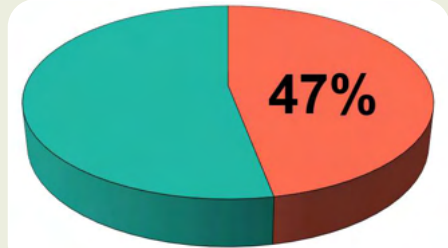
5% of revenue  
each year



Around \$5 trillion  
globally



21% of cases  
resulted in  
losses >\$1m



47% of  
companies  
surveyed by  
PwC in 2020 had  
experienced  
fraud in the last  
two years



# *The fraud risk assessment*

# *Professional scepticism – new/amended requirements*

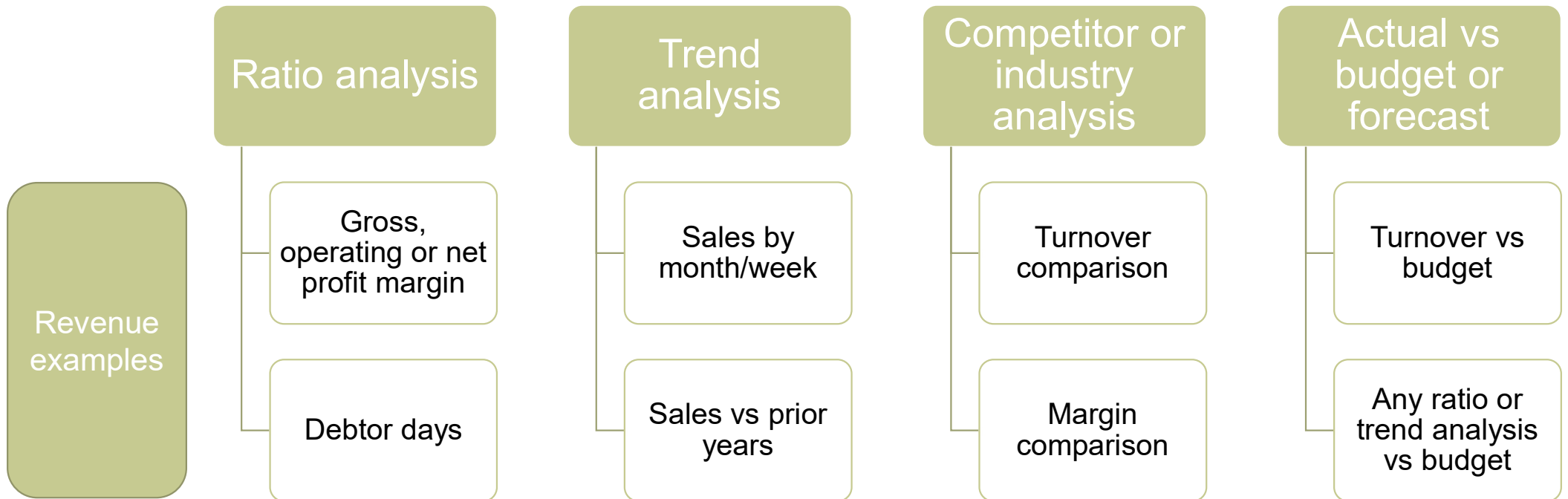
- The auditor shall undertake risk assessment procedures and design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. [ISA (UK) 240.12-1] **NEW**
- The auditor shall remain alert for conditions that indicate a record or document may not be authentic. [ISA (UK) 240.13-1] **NEW**
- Where responses to inquiries of management, those charged with governance **or others within the entity** are inconsistent, **or appear implausible**, the auditor shall investigate the inconsistencies **reasons**. [ISA (UK) 240.14]

# *1. Discussing fraud with the client*

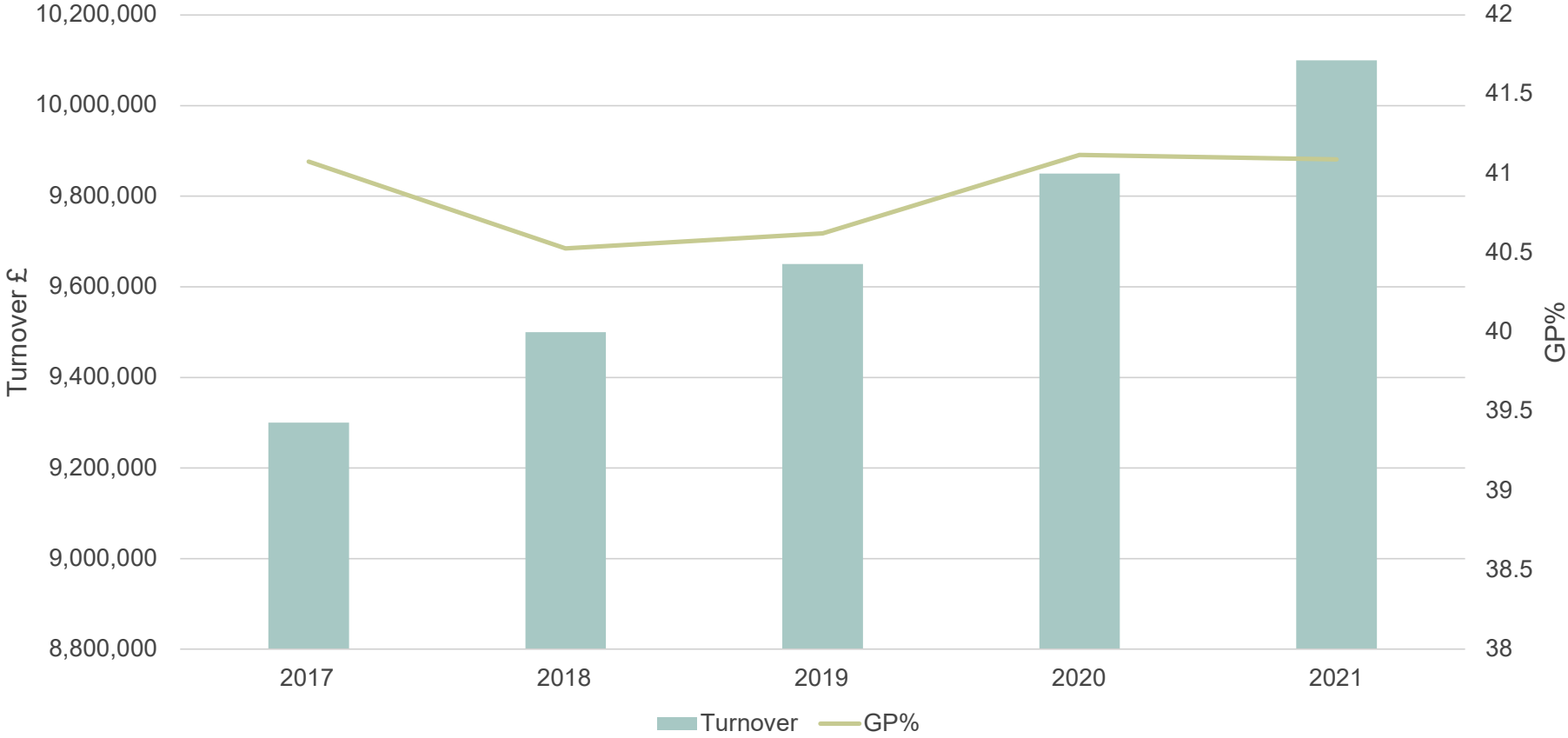


- a) Management's own fraud risk assessment
- b) Management's process for identifying and responding to fraud risks
- c) Management's communications to TCWG, if any, re (b)
- d) Management's communications to staff re business practices and ethical behaviour
- e) Knowledge of actual, suspected or alleged fraud
- f) How TCWG exercise oversight of (b) and the controls established by management to mitigate these risks
- g) Risks of fraud perceived by internal auditors (if any) **and TCWG**

## *2. Preliminary analytical review procedures*

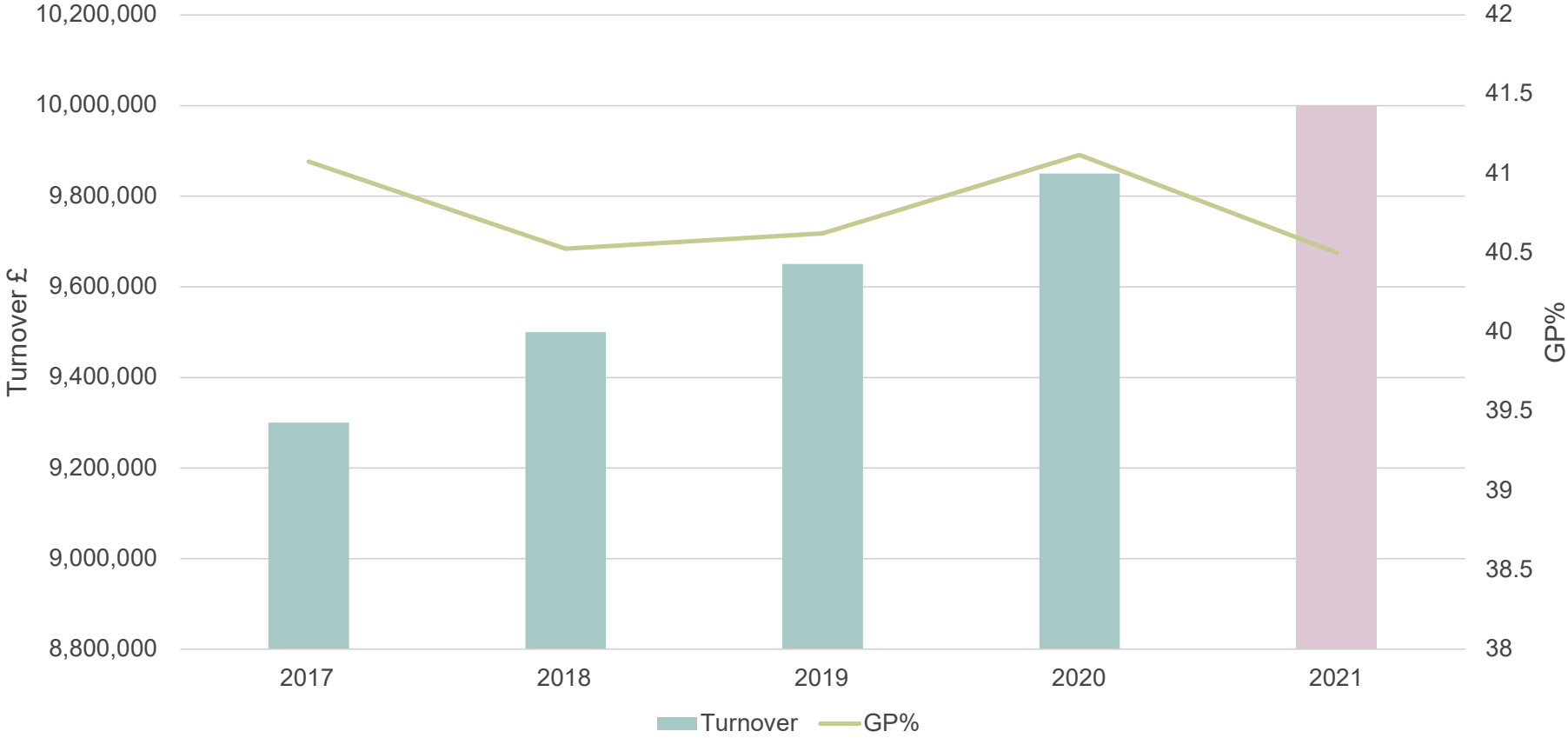


# 2. Preliminary analytical review procedures





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# *Fraud Case Study 1*



- London Philharmonic Orchestra:  
Cheque fraud
  - FD stole £666k over a four year period by forging signatures on cheques
  - Lost a further £1.5m from poor financial decisions taken due to manipulated management accounts to cover up the theft

### ***3. Other information obtained by the team***

Client  
acceptance  
procedures

Interim  
financial  
information

Other services  
provided to  
the client



# *Fraud risk factors and indicators*

# *Fraud risk factors*

## (a) By source of risk

### Management

- Increased involvement in setting accounting principles and financial estimates
- Responsibility to achieve aggressive financial targets
- Tension with external auditors
- History of violations
- High senior staff/board turnover

### Industry

- Economic factors
- New financial regulations
- Increased competition
- Market saturation
- Adoption of more aggressive accounting policies

### Operations

- Nature of the business
- Complexity of financial transactions
- Locations where transactions are recorded and payments made
- Location of operating activities
- Profitability and general financial condition

# *Fraud risk factors*

## (b) Related to fraudulent financial reporting

### Incentive/pressure

- Threat to financial stability or profitability
- Excessive pressure on management to meet external requirements or expectations
- Excessive pressure on management to meet requirements or expectations of TCWG
- Threats to personal financial situation of management / TCWG

### Opportunity

- Nature of the industry or entity's operations
- Ineffective monitoring by management
- Complex / unstable organisational structure
- Inadequate internal controls, especially lack of segregation of duties
- **Related party relationships**

### Attitude / Rationalisation

- Weak response to prior fraud
- Excessive non-financial staff input into accounting policies or estimates
- Low morale
- No distinction between personal and business transactions
- Questionable accounting justified by materiality
- Strained relationship with the auditor

# *Fraud Case Study 2*



- Expenses fraud
  - Two out of six directors on the board of a small manufacturing business claimed substantial non-business travel expenses
  - Undetected for 21 years due to collusion between related parties and no internal review

# *Fraud risk factors*

## (c) Related to the misappropriation of assets

### Incentive/pressure

- Personal financial obligations
- Poor relationship between the entity and staff with access to assets

### Opportunity

- Circumstances or asset characteristics
- Inadequate internal controls

### Attitude / rationalisation

- Overriding existing controls
- Tolerance of petty theft
- Changes in behaviour or lifestyle



# *Fraud Case Study 3*



- Fixed asset theft
  - IT manager stole new PCs meant for office staff and sold them from the office basement on the weekends
  - Undetected for years as old PCs remained in use and no one noticed the age disparity of the hardware vs the fixed asset register

# *Evaluation of fraud risk factors*

The auditor shall determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement due to fraud, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. [ISA (UK) 240.24-1]

**NEW**

# *Matters that may impact the need for specialist skills or knowledge*

- The complexity of transactions
- The complexity of data flows
- The use of complex models
- The complexity of contractual terms
- The complexity of related party relationships
- The use of complex financial instruments or other complex financing arrangements
- The use of special-purpose entities
- Matters involving a high degree of judgment
- The complexity and extent of the entity's use of information technology
- The estimation of non-financial information
- Possible need for forensic skills as part of the risk assessment process, and to follow up on identified or suspected fraud



# *Discussion of fraud at the engagement team meeting*

# *Discussion amongst the engagement team*



# *Default significant risks*

Present on all audits



Management override  
of controls  
(ISA (UK) 240.32)

If identified



Significant related party  
transactions outside the  
normal course of business  
(ISA (UK) 550.18)

Rebuttable presumption



Revenue recognition  
(ISA (UK) 240.27)

# *Fraud Case Study 4*



- Greenvale – Supplier collusion
  - Collusion between supermarket buyer and potato supplier to inflate sales price (£8.7m)
  - Excess profits were partially used to bribe the supermarket buyer (£4.9m)



# *The auditor's response to fraud risks*



# *General responses to the risk of fraud*



Consider the knowledge, skill and ability needed within the audit team  
(para 29a)



Evaluate whether the selection of accounting policies may indicate fraudulent financial reporting  
(para 29b)



Incorporate an element of unpredictability in the nature, timing and extent of audit procedures  
(para 29c)

## *Other fraud risk response procedures*

- Ensuring inventories are counted at or as close to the year end as possible
- Seeking third party evidence where possible
- Performing substantive analytical procedures using disaggregated data
- Using data mining to test for anomalies in a population

TAKE  
ACTION

# *Responding to default significant risks*

1. Management override of controls [ISA (UK) 240.32]
  - Test the appropriateness of **manual or automated** journal entries recorded in the GL and other adjustments **including consolidation adjustments in group accounts**
    - Make inquiries of individuals **with different levels of responsibility** involved in the financial reporting process and inappropriate or unusual activity related to processing journals and other adjustments
    - Select journal entries and other adjustments made at the end of a reporting period **and post-closing entries**
    - Consider the need to test journal entries and adjustments throughout the period.
  - Review accounting estimates for bias
  - Obtain the rationale for significant transactions outside the normal course of business

# *Responding to default significant risks*

2. Significant RPTs outside the normal course of business [ISA (UK) 550.23]
  - Inspect underlying contracts/agreements
    - Evaluate the business rationale
    - Terms are consistent with management's explanations
    - Appropriate accounting
  - Confirm the transactions were authorised and approved
3. Revenue recognition
  - Nothing specific to revenue, although there are some suggestions in ISA (UK) 240 Appendix 2
  - Consider if controls testing is required if unable to obtain sufficient evidence from substantive procedures e.g. cash sales

## *Responding to **all** significant risks*

- Understand relevant controls, and perform D&I testing on them
- Planned audit response cannot consist wholly of controls testing or substantive analytical procedures
- No reliance can be placed on the prior year testing of controls

