

3.2 Assessing Risks of Fraud and Corruption

Session Overview

During previous session 3.1 Overview of Fraud and Corruption Detection Process, participants have been introduced to major steps in detecting fraud and corruption during a normal audit. It is clearly discussed that the SAI's consideration of fraud and corruption should be integrated into the overall audit process. It is not something separate that is somehow added to the existing audit process. Fraud and Corruption detection process should be blended in seamlessly with the current audit process.

This session discusses the first major step – which is Assessing Risks of Fraud and Corruption at an entity level - that auditors should perform during the audit planning stage to detect fraud and corruption. This assessment will help auditors to identify potential high risk areas which will then be subjected to appropriate tests to identify red flags and to respond appropriately to meet their audit objectives.

Learning Objectives

By the end of this session, participants will be able to assess risks of fraud and corruption at entity level in accordance with INTOSAI Audit Standards and ASOSAI Guidelines for Dealing with Fraud and Corruption.

Basic Concepts

Fraud Triangle - Fraud triangle depicts three conditions that generally are present when fraud and corruption occurs:

- *Incentive or pressure* - Management or other employees may have an incentive or pressure that provides them with a reason to commit fraud and corruption;
- *Opportunity* - Circumstances may exist within the entity (e.g. weak internal control or lack of internal control) that provide an opportunity for a fraud and corruption to be perpetrated;
- *Rationalization or attitude* – some individuals possess an attitude, character, or set of ethical values that allow them to rationalize committing a dishonest act.

Internal Control - A process within an organization designed to provide reasonable assurance regarding the achievement of the following primary objectives:

- The reliability and integrity of information
- Compliance with policies, plans, procedures, laws, and regulations
- The safeguarding of assets
- The economical and efficient use of resources
- The accomplishment of established objectives and goals for operations or programs

Professional Skepticism - An attitude that includes a questioning mind and critical assessment of audit evidence. Some examples demonstrating the application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud include:

- increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and
- increased recognition of the need to corroborate management explanations or representations concerning material matters, such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity.

Red Flags – Anomalies that point to symptoms or indicators that are known to be associated with fraud and corruption. One of the keys to detecting fraud and corruption is recognizing red flags.

Risk - The uncertainty of an event occurring that could have an impact on the achievement of objectives. Risk is measured in terms of consequences and likelihood.

Risk Assessment - The identification and analysis of relevant risks associated with the achievement of objectives.

Risk Factors - The criteria used to identify the relative significance of, and likelihood that, conditions and/or events may occur that could adversely affect the organization. Risk factors can be external or internal. External risk factors are outside the organization, usually beyond management's span of control. Internal risk factors are within an entity, usually within management's span of control. In financial audits, risk factors are grouped into three categories: business failure risk, fraud risk and error risks.

Guidance on Risk Assessment

The INTOSAI Auditing Standards require the auditor to consider situations, control weaknesses, inadequacies in record keeping, unusual transactions that might indicate the presence of errors, irregularities and illegal acts to satisfy the audit objectives of a normal audit. To specifically guide SAIs in meeting this standard, the ASOSAI Guidelines for Dealing with Fraud and Corruption provides the following guidance for SAIs to conduct an assessment of fraud and corruption risks during their normal audit.

- **ASOSAI Guideline-17**

While planning his audit the auditor should assess the risk that fraud may cause the financial statements to contain material misstatement or record material irregular transactions.

- ✓ The auditor may keep in view that the risk of fraud and corruption could be higher in certain organization like those involved in procurement of goods and services.

- ✓ The auditor may keep in view that when a fraud is conducted there is a deliberate effort to conceal the facts and distract the auditor.

For planning the audit the auditor should have a complete understanding of the auditee including the environment in which the entity operates the level of internal control and the past performance of the auditee especially previous instances of fraud and corruption

- **ASOSAI Guideline-18**

Based on the risk assessment the auditor should develop the audit objective and design audit procedures so as to have reasonable expectation of detecting and evaluating material misstatement and irregularities arising from fraud and corruption. In case of high risk audit the audit team should be selected keeping in view the requirement of such audit

- **ASOSAI Guideline-21**

The changes and improvements in the internal control system made by management when there have been previous instances of fraud and corruption or in response to changes in the auditee environment should be particularly studied and evaluated during audit.

- **ASOSAI Guideline-22**

Increasing use of IT systems by auditees requires that the auditor should have access to reliable and verifiable system-based audit trails to evaluate the internal control. For meeting this objective legislation or executive guidance should ensure that audit is viewed as a stakeholder in the system development

Procedures for Assessing Fraud and Corruption Risk on an entity wide basis

Traditionally, auditors are familiar with the risk assessment process that they should do during planning the audit. In dealing with fraud and corruption, auditors are required to find out the presence of certain fraud risk factors. They analyse the nature and type of the fraud and corruption risk factors and develop an understanding of where the entity is vulnerable to fraud and corruption. This assessment will bring auditors to arrive on what audit responses they should do: either modifying planned procedures or determining that the existing audit procedures are adequate to deal with identified fraud and corruption.

In practice, there is a tendency among auditors to minimize the identification of fraud and corruption risks to a simple checklist, which ultimately results in a failure to adequately assess fraud and corruption risks, design appropriate procedures, and detect the existing fraud and corruption within their audit scope and objectives.

Even, it is common that when conducting audits, auditors just simply use and follow the previous audit program. This SALY (Same as Last Year) practice obviously make

audit become a routine work which tends to decrease auditors' awareness and sensitiveness to fraud and corruption risks during their audit.

The following fraud and corruption risk assessment procedures might help auditors to gather and consider much more information to assess fraud and corruption risks:

1. Brainstorming on how and where the entity might be susceptible to fraud and corruption

As an initial step in assessing fraud and corruption risk, auditors should discuss or brainstorm within their audit team about fraud and corruption – related matters. They should seek to identify how and where the entity might be susceptible to fraud and corruption. Setting the tone in the very beginning of audit assignment obviously demonstrates auditor's awareness of fraud and corruption risks throughout the audit process. This practice is a new concept and almost all auditors do not concern themselves with this practice when they start conducting a normal audit.

1.1 Objectives

Primary objectives of the brainstorming are:

- To obtain a good understanding of (1) information that experienced team members have about their experiences with the auditee and (2) how and where fraud and corruption might be perpetrated and concealed at the entity.
- To set proper 'tone at the top' for conducting the engagement.
- To emphasize the importance of maintaining the proper state of mind throughout the audit – i.e. professional skepticism.

1.2 Brainstorming Process

1.2.1 Initial preparation

Brainstorming session will be much more effective if all members have a similar level of understanding about the entity, the nature of its business and its current level of financial performance.¹

Each team member should make an initial preparation or "home work" before conducting brainstorming session. This might include:

- Performing analytical, fact-based research before conducting brainstorming session.

This might be research on:

¹ Tom Kelly's *The Art of Innovation* describes his experiment among three groups: one who did no homework, another who performed detailed quantitative analysis of the situation; and the last one who was more intuitive and impressionistic in nature, such as visiting the store of the entity's competitors. The second group outperformed the first group, but the third group who conducted less structured research performed best of all.

- ✓ Analytical procedures of the most current financial information
 - ✓ Review of prior year's or interim financial statements
 - ✓ Review of previously issued management letters and working papers from the previous engagement that may provide ideas for possible areas of vulnerability to fraud.
 - ✓ Review of the entity's acceptance and continuance documentation
 - ✓ Review of press release, current legal requirements and other information released by the entity
 - ✓ Review information about the industry
- Performing physical inspection, such as visit to the entity location to observe the operating procedures and method.

1.2.2 *During brainstorming*

During early stages of the session, the facilitator should describe the objective of the session and be patient and encourage the group share ideas. Facilitator should avoid the temptation to have the most senior person in the group express his or her views to 'get the ball rolling' as this will tend to stifle creativity.

In structuring the session, it will help to consider the characteristics of the fraud triangle. For example, auditors might discuss the incentives/pressures that may exist at the entity or the opportunities management or employees have to commit fraud. Auditors may also discuss observations about attitude/rationalization that may indicate the presence of fraud and corruption risks.

To facilitate creative and practical ideas, pose topics or discussion that people can more easily understand, for example: "If you were the bookkeeper for the entity, how could you embezzle funds and not get caught?", "If you were the top management of the entity, what impression would you want to make on third parties, such as banks, tax department, etc? How might you manipulate the financial statements to create this impression?"

In fact, brainstorming session is not restricted only when auditors are about to start the audit. This practice can be used as well in all stages of risk assessment and throughout the audit process. Auditors may use it in the information gathering process or near the conclusion of the audit in order to consider the findings and experiences of all team members during the audit and whether the team's assessment about and responses to the fraud and corruption risks are appropriate.

2. Obtaining information needed to identify fraud and corruption risks

After conducting brainstorming session, auditors then begin their audit engagement by understanding the business entity. In dealing with fraud and

corruption, at this stage, auditors should also obtain information to identify fraud and corruption risk.

This can be done through the following activities:

- Make inquiries of management and others within the entity to seek their views about the risks of fraud and how they are addressed.
- Consider any unusual or unexpected relationships that have been identified while applying analytical procedures to financial and performance figures in planning the audit.
- Consider whether one or more fraud risk factors exist.
- Consider other information that may be helpful in the identification of fraud and corruption risks.

2.1 Making inquiries of Management and Others within the entity about the risks of fraud and corruption

Traditionally, auditors rely on typical audit procedures and their assessment of internal controls as sources for obtaining information to identify fraud and corruption risks. In dealing with fraud and corruption, auditors should expand their information sources for identifying fraud and corruption risks.

Additionally, many studies reported that often, when fraud and corruption is committed, people with knowledge or suspicion of the fraud and corruption would have “blown the whistle”, if only someone would have asked. Fraud and corruption may be anywhere within an entity, and employees may have knowledge that can help detect fraud and corruption.

For this reason, auditors should expand their inquiries of management and others within the entity. Auditors should not restrict their inquiries to senior management only but also make inquiries of personnel at various levels within the organization:

2.1.1 Inquiries of management

Auditors should inquire from management about:

- ✓ Whether management has knowledge of any fraud and corruption or suspected fraud and corruption affecting the entity
- ✓ Whether management is aware of allegations of fraud and corruption or suspected fraud affecting the entity, for example: received in communications from employees, former employees, regulators, or others
- ✓ Management’s understanding about the risks of fraud in the entity, including any specific fraud risks the entity has identified or in case of financial audit, any account balances or classes of transactions for which a risk of fraud and corruption may be likely to exist.
- ✓ Programs and controls the entity has established to mitigate specific fraud and corruption risks the entity has identified, or that otherwise help to

prevent, deter and detect fraud and corruption, and how management monitors those programs and controls.

- ✓ For an entity with multiple locations, (1) the nature and extent of monitoring of operating locations or business segments, and (2) whether there are particular operating locations of business segments for which a risk of fraud and corruption may be more likely to exist.
- ✓ Whether and how management communicates to employees its views on business practices and ethical behavior.
- ✓ Whether management has reported to the audit committee or others with equivalent authority and responsibility on how the entity's internal control serves to prevent, deter or detect fraud and corruption risks.

In performing inquiries of management and evaluating responses of management, auditors should be aware that management is often in the best position to perpetrate fraud and corruption.

2.1.2 Inquiries of audit committee

In the public sector or in the small entity, it is hardly that they have an audit committee. In case there is an audit committee, auditors should inquire directly of the audit committee regarding their views about the fraud and corruption risks and whether the audit committee has knowledge of any fraud and corruption or suspected fraud and corruption affecting the entity.

It is common that audit committee sometimes assumes an active role in the oversight of the entity's risk assessment and the programs and controls which mitigate the risks. Hence, auditors should obtain an understanding of how the audit committee exercises oversight activities in these areas.

2.1.3 Inquiries of internal auditors

Auditors should also inquire of appropriate internal auditors about their views on the fraud and corruption risks, to find out:

- ✓ Whether internal auditors have performed any procedures to identify or detect fraud during the year and whether management has satisfactorily responded to any findings resulting from these procedures
- ✓ Whether internal auditors have knowledge of any fraud and corruption or suspected fraud and corruption

2.1.4 Inquiries of others

Auditors have been criticized on their reluctance to make inquiries outside the accounting department as a reason for the lack of in-depth understanding necessary to conduct an effective and efficient audit.

In dealing with fraud and corruption, auditors should make inquiries of (1) operating personnel not directly involved in the financial reporting process; (2) individuals with knowledge of complex or unusual transactions; and (3) in-house legal counsel.

Auditors should use professional judgement in deciding when it is necessary to corroborate management responses to inquiries with other information. If responses are not consistent among inquiries, the auditor should obtain additional audit evidence to resolve the inconsistencies.

2.1.5 *Check list to guide inquiries*

Office of the Auditor General of Canada provides check lists for their auditors to conduct fraud and corruption risk assessment at an entity wide level. This check list is also helpful to guide auditors in their inquiries.

Appendix-3.2A provides the check list on the five major areas on which auditors should obtain information and assess fraud and corruption risks at an entity wide basis:

- **Governance**
Management is in a position to commit major fraud and corruption if the mechanisms for the management oversight are ineffective.
- **General Environment**
The ethical tone of the organization is set at the top. The fraud and corruption risks are reduced when management demonstrates and communicates the importance of values and ethical behavior.
- **Entity's Financial Condition**
Pressure to achieve unrealistic financial results can create a motivation for fraud and corruption.
- **Internal Controls**
Inadequate or ineffective internal controls create opportunities for fraud and corruption
- **Entity co-operation analysis or Unusual Observations**

Appendix-3.2B provides the check list for fraud and corruption risk assessment in transactions and documents which covers access and questionable conduct; entity's financial condition; record keeping and compliance; and inadequate documentation or unusual transactions.

2.2 **Considering the results of the Analytical Procedures performed in planning the audit**

One reason why auditors fail to detect and identify fraud and corruption is a tendency to look at current numbers in isolation from the past or other relevant information.

Auditors should perform analytical procedures to identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters with audit planning implications. In performing the analytical procedures, auditors should develop expectations about plausible relationships that are reasonably expected to exist, based on the auditor's understanding of the entity and its environment. When comparison of these expectations with recorded amounts and ratios developed from recorded amounts generate

unusual or unexpected relationships, auditors should consider those results in identifying the fraud and corruption risks.

2.3 Considering Fraud and Corruption Risk Factors

Fraud risk factors refer to the Fraud Triangle which includes events or conditions that (1) indicate incentives/pressure to perpetrate fraud and corruption, (2) opportunity to carry out the fraud; and (3) attitudes/rationalizations to justify fraud and corruption.

Fraud risk factors do not necessarily indicate the existence of fraud and corruption, but they often present in circumstances where fraud and corruption exists.

When obtaining information about the entity and its environment, including during inquiries of management and others, auditors should consider whether the information obtained indicates that one or more fraud and corruption risk factors are present.

Appendix-3.2C provides examples of fraud risk factors

2.4 Considering other information that may be helpful in identifying fraud and corruption risks

In addition to the above information (2.1, 2.2 and 2.3), auditors may consider other information below in identifying fraud and corruption risks:

- Results of discussion among team members
- Review of interim financial reports
- Inherent risks with regards to the individual account balance or class of transaction, as part of the audit risk process.

3. Identifying Potential Fraud and Corruption Risks

3.1 Using the information gathered to identify fraud and corruption risks

From the information gathering process as discussed above, auditors should be able to identify potential fraud and corruption risks in the context of the three conditions present when fraud and corruption occurs. They are:

- incentives/pressures,
- opportunities; and
- attitudes/rationalizations (fraud triangle)

In addition, auditors should also consider:

- Auditors' experience and perceptions (professional judgement)
- *Nature of the entity, such as the size and complexity.* For example, in the case of a larger entity, auditors ordinarily considers factors that generally

constrain improper conduct by management, such as the effectiveness of the audit committee, risk management committee and internal audit, and the existence and enforcement of a formal code of conduct. In the case of a smaller entity, some or all of these considerations may be inapplicable or less important.

- *Attributes of fraud and corruption risks*, such as (1) the type of risk that may exist, (2) the significance of risks, (3) the likelihood of the risk, and (3) the pervasiveness of the risks related to areas being audited, whether the potential risk is pervasive to the financial statement and program as a whole or is specifically related to a particular assertion, account, or class of transactions and activities.

3.2 A Presumption that improper revenue recognition is a fraud risk

There is also a presumption that improper revenue recognition is a fraud risk. In this case, auditors should be aware that fraudulent financial reporting often result from an overstatement of revenues (e.g. through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (e.g. through improperly shifting revenues to a later period). Therefore, auditors should ordinarily presume that there is a fraud risk relating to revenue recognition.

3.3 A Consideration of the Risk of Management Override of Controls

Auditor should be aware that even if specific fraud and corruption risks are not identified by auditors who have gone through the above procedures, there is a possibility that management override of controls could occur, and accordingly auditors should address that risk apart from any conclusions regarding the existence of more specifically identifiable risks.

4. Assessing identified fraud and corruption risks after taking into account an evaluation of the entity's controls and programs to deter fraud and corruption

INTOSAI Auditing Standards requires auditors to obtain understanding of internal controls to plan audit. In doing so, auditors should also evaluate whether entity programs and controls that address identified fraud and corruption risks have been suitably designed and placed in operation.

These programs and controls may involve:

- Specific controls designed to mitigate specific fraud and corruption risks, for example, controls to address specific assets susceptible to misappropriation
- Broader programs designed to prevent, deter and detect fraud, for example, programs to promote a culture of honesty and ethical behaviour.

Auditor should consider whether such controls and programs mitigate the identified fraud and corruption risks.

Formatted

After auditors has evaluated whether the entity's programs and controls which address identified fraud and corruption risks have been properly designed and placed in operation, auditors then should assess these risks taking into account the evaluation. The results of assessment should be considered when auditors develop their response to the fraud and corruption risks.

However, in doing this activity, auditors should be aware of the following conditions:

- Controls/programs to deter risks exist BUT do not necessarily mitigate fraud risk because of override of controls by management.
- Some controls are not working as expected.
- There are risks where no program or control exist OR control/program do not address some risks.

5. Identifying High Risk Areas

As a result of fraud and corruption risk assessment, auditors should be able to identify high risk areas on which their audit will focus. The ASOSAI Guidelines for Dealing with Fraud and Corruption indicates some of commonly perceived high risk areas:

- Contracts of service/ procurement;
- Inventory management;
- Sanctions/Clearance;
- Program management;
- Revenue receipt
- Cash Management
- General expenditure
- Other areas with public interface

Fraud and corruption risk assessment at an entity wide basis conclude on the identification of high risk areas.

Appendix-3.2D provides an example of a working paper for auditors to conduct fraud risk assessment which incorporates the above risk assessment process.

Following the result of the assessment, auditors then identify red flags particular or specific to each of the identified potential high risk areas.

Session 3.3 *Identify Red Flags in the High Risk Areas* will be discussing this matter.

Result from activities in the session 3.3 will determine auditors' response to the fraud and corruption in the following ways:

- A response that has an overall affect on how the audit is conducted;
- A response to identified risks involving the nature, timing and extent of audit procedures
- A response to address management override of controls.

Session 3.4 *Going beyond Red Flags – Further Examination* will serve as an auditor's response to the identified fraud and corruption.

Assessing Fraud and Corruption Risks in IT Environment

Procedures for assessing fraud and corruption risks discussed above are also used to conduct risk assessment in an IT Environment. The difference simply raises on the nature of IT environment.

Basically, information technology has not significantly changed the types of frauds and corruption committed. For example, in the past management may have overstated revenues by altering a manual record. Now, they may overstate revenue by entering false information into the computer processing system. One thing that information technology has changed is that the fraud perpetrator no longer needs physical access to certain documents and information.

Some key points that auditors should be aware of in assessing fraud and corruption risks in IT Environment include:

1. Category of computerized fraud and corruption

Computerized fraud and corruption can be categorized according to three stages in processing transactions:

- **Input frauds.** Phony transactions are altered or added to the stream of data being processed. For example, input documents such as invoices are altered, forged and falsified
- **Throughput fraud.** These are the types of computer frauds that tend to be reported in the press. A computerized “wizard” alters the programming to achieve some desired result. For example, a program that calculates interest earned on savings accounts at a bank is changed so that rounded amounts (fractions of pennies) are deposited into an account controlled by the computer programmer.
- **Output frauds.** Output reports, documents or files are altered, suppressed or stolen. For example, exception report used for internal control purposes may be altered to conceal a defalcation.

2. Risk Factors related to IT Environment

Technological considerations are an integral part, not separate, part of the risk factors and risk assessment process on fraud and corruption. However, the following are example of risk factors most closely relate to IT environment:

- A failure by management to display and communicate an appropriate attitude regarding internal control and the computerized business and financial reporting process, including inadequate monitoring of significant controls and management continuing to employ an ineffective IT staff.
- Risk factors relating to controls, including a lack of adequate logical access control, lack of appropriate segregation of duties and lack of independent checks, which include the computer processing functions.

Appendix-3.2E provides an example of a checklist to assess the fraud and corruption related to IT.

Summary

Fraud and corruption risk assessment is an integral part of auditor's risk assessment in the planning and execution process of a normal audit. In order to effectively dealing with fraud and corruption during audit, auditors should be able to set the tone on fraud awareness and sensitiveness from early beginning of their audit by conducting effective communication among team members by discussing and brainstorming on how and where fraud and corruption can be perpetrated in an entity. This practice becomes a good basis for obtaining information needed to identify and assess fraud and corruption risks. A proper process of fraud and corruption risk assessment at an entity wide level will help auditors to identify high risk areas which then become a basis for auditors to respond adequately by identifying red flags particular or specific to each high risk areas. Session 3.3 as the continuation process in the fraud and corruption detection process will cover discussion on the identification of red flags in the high risk areas indicated in the ASOSAI Guidelines.

References

1. ASOSAI, *ASOSAI Guidelines for Dealing with Fraud and Corruption*, 2003
2. AICPA, *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS*, 2004
3. Office of the Auditor General of Canada, *Wrongdoing and Fraud Audit Guidance*, 2005.