

3.4 Going Beyond Red Flags – Further Examination

Session Overview

In the previous session, we discussed about the suggested red flags in some of the common types of frauds in the various activities of public sector. However, the existences of red flags are not inevitably or universally associated with fraud. Rather, their presence suggests a degree of fraud risk. Conversely, their absence is no guarantee that a situation or circumstance is ‘fraud proof’. Therefore, an auditor has to evaluate all the evidence to establish the existence or non-existence of fraud from the auditors’ point of view. In case the auditor concludes that there is no fraud, then the process ends there and he can devote on other areas of the entity.

In most cases once we have identified the red flags, it does lead to the existence of fraud. Once the existence of fraud has been established, some SAIs hand over the case to other units within the SAI, while other SAIs hand over such cases to some other organisations or agencies within their respective countries. In some SAIs, only the major fraud cases are handed over to other units.

However, based on the survey conducted by the IDI, many of the SAIs have the mandate to either investigate or further examine the fraud cases. In this session, we will discuss on the following three topics;

- i. Evaluate initial evidence gathered and establish the existence or non-existence of fraud,
- ii. Identify further evidence requirements,
- iii. Collecting additional evidence.

Learning Objectives

Given INTOSAI Auditing Standards, ASOSAI Guidelines, discussions, case study and exercise, the participants should be able to collect evidence to the extent that these are sufficient and competent to arrive at a reasonable conclusion regarding the existence or non-existence of fraud/corruption as evaluated by the instructor.

Basic Concept

Audit Evidence

Audit Evidence are all the information obtained by the auditor in arriving at the conclusion on which the audit opinion is based. The audit findings and conclusions are to be supported by appropriate analysis and interpretation of such evidence.

1. Evaluate initial Evidence

In arriving at the conclusion of existence or non-existence of fraud, the auditor would have already collected some of the evidence, since audit evidence is obtained during all phases of the audit process. Besides, in the process of any normal audit, the auditor gathers audit evidence to help him derive audit conclusions on the basis of which he gives an opinion, makes judgment and recommendations about the auditee organization.

Most of the red flags could also be used as evidence. Therefore, once the auditor has established the existence of fraud, the evidence needs to be evaluated so as to determine the extent of further evidence required. The ASOSAI Guidelines for Dealing with Fraud & Corruption specifically states *‘since complete evidence about cases of fraud and corruption may not be available to the SAI, due care should be exercised in arriving at an audit conclusion. In many circumstances additional tests may have to be performed and additional evidence acquired than would normally be considered appropriate and necessary for arriving at an audit opinion’*.

The audit evidence has to be evaluated depending on the **sufficiency**, **reliability** and **competency** of the evidence. The INTOSAI Auditing Standards also states that *“Competent, relevant and reasonable evidence should be obtained to support the auditor's judgment and conclusions regarding the organisation, program, activity or function under audit”*.

1.1 Sufficiency of Evidence

Sufficiency is the measure of the quantity of audit evidence. Evidence is sufficient if there is enough of it to support the auditor's findings. Therefore, in determining the sufficiency of evidence it may be helpful to ask such questions as: Is there enough evidence to persuade a reasonable person of the validity of the findings? For example, most of the red flags could be used as audit evidence but they, in themselves, do not constitute sufficient evidence to support the auditor's findings. Carrying unusually large sums of money could be evidence of embezzlement but to support that embezzlement has occurred, this needs to be supported by other evidence such as bank statements showing the money withdrawn/deposited, a copy of the particular page of the cashbook showing the payments made and other documents supporting that the money has not been used for any other purposes. In other words there should be sufficient evidence to support that embezzlement has actually occurred in the organization.

The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency, competency and reliability of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality.

1.2 Reliability & Competency of Audit evidence

The following presumptions are useful in judging the competence and reliability of evidence. However, these presumptions are not to be considered sufficient in themselves to determine competence.

- i. Evidence obtained from a credible third party is more competent and reliable than that secured from the audittee. *E.g. Bank Statements*
- ii. Evidence developed under an effective system of management controls is more competent than that obtained where such controls are weak or nonexistent.
- iii. Evidence obtained through the auditors' direct physical examination, observation, computation, and inspection is more competent and reliable than evidence obtained indirectly. *E.g. visiting the construction sites to see that construction has taken place as per the specifications.*
- iv. Original documents provide more competent and competent evidence than do photocopies or facsimiles. *E.g. photocopies could be manipulated by erasing the figures such as dates, amount etc. and replacing it with some other figure, dates etc. .*
- v. Testimonial evidence obtained under conditions where persons may speak freely is more competent and reliable than testimonial evidence obtained under compromising conditions (*e.g. where the persons may be intimidated*).
- vi. Testimonial evidence obtained from an individual who is not biased or has complete knowledge about the area is more competent than testimonial evidence obtained from an individual who is biased or has only partial knowledge about the area. *E.g. statement from unbiased doctors.*

The auditors' approach to determining the sufficiency, competence, and reliability of evidence depends on the source of the information that constitutes the evidence. Information sources include original data gathered by auditors and existing data gathered by either the audittee or internal auditors.

Data Gathered by Auditors.

Data gathered by auditors include the auditors' own observations and measurements. Among the methods for gathering this type of data are questionnaires, structured interviews, direct observations, and computations. The design of these methods and the skill of the auditors applying them are the keys to ensuring that these data constitute sufficient, competent, and reliable evidence.

Data Gathered by the Audittee.

Auditors can use data gathered by the auditee as part of their evidence. Auditors may determine the validity and reliability of these data by direct tests of the data. Auditors can reduce the direct tests of the data if they test the effectiveness of the entity's controls over the validity and reliability of the data, and these tests support the conclusion that the controls are effective. The nature and extent of testing of the data will depend on the significance of the data to support auditors' findings.

When the auditors' tests of data disclose errors in the data, or when they are unable to obtain sufficient, competent, and relevant evidence about the validity and reliability of the data, they may find it necessary to

- a. seek evidence from other sources,
- b. redefine the audit's objectives to eliminate the need to use the data, or
- c. use the data, but clearly indicate in their report the data's limitations and refrain from making unwarranted conclusions or recommendations.

Data Gathered by Third Parties

The auditor's evidence may also include data gathered by third parties. In some cases, others may have audited these data, or the auditors may be able to audit the data themselves. In other cases, however, it will not be practical to obtain evidence of the data's validity and reliability. How the use of unaudited third-party data affects the auditors' report depends on the data's significance to the auditors' findings.

Report and Findings of Internal Auditors

The internal auditors also gather various data in their audit. They could constitute important sources of evidence. However, the reliability and competency of such data will depend on the competence and independence of the internal auditors.

Validity and Reliability of Data From Computer-Based Systems.

Auditors should obtain sufficient, competent, and reliable evidence that computer-processed data are valid and reliable when those data are significant to the auditors' findings. This work is necessary regardless of whether the data are provided to auditors or auditors independently extract them. Auditors should determine if other auditors have worked to establish the validity and reliability of the data or the effectiveness of the controls over the system that produced the data. If they have, auditors may be able to use that work. If not, auditors may determine the validity and reliability of computer-processed data by direct tests of the data. Auditors can reduce the direct tests of the data if they test the effectiveness of general and application controls over computer-processed data, and these tests support the conclusion that the controls are effective. However, the following points should be noted when using the evidence from computer-based systems;

- When the reliability of a computer-based system is the primary objective of the audit, the auditors should conduct a review of the system's general and application controls.
- When computer-processed data are used by the auditor, or included in the report, for background or informational purposes and are not significant to the auditors' findings, citing the source of the data and stating that they were not verified will satisfy the reporting standards for accuracy and completeness.
- A GAO guide, *Assessing the Reliability of Computer-Based Data* (GAO/OP-8.1.3, September 1990), provides guidance on the following key steps:
 - i. Determining how computer-based data will be used and how they will affect the audit objectives,
 - ii. Finding out what is known about the data and the system that produced them,
 - iii. Obtaining an understanding of relevant system controls, which can reduce risk to an acceptable level,
 - iv. Testing the data for reliability, and
 - v. Disclosing the data source and how data reliability was established or qualifying the report if data reliability could not be established.

Audit Evidence should also be reasonable. The cost of gathering the evidence should commensurate with the result, which the auditor/SAI is trying to achieve. *E.g. it may not be reasonable to send some auditors to another place, by spending so much of money on airfare and hotel expenses, merely to see whether a repair work amounting to about USD 250 has been done.*

Based on the sufficiency, competency and reliability of the evidence, an auditor has to evaluate the existing audit evidence. The results of the evaluation could be any of the following depending on the mandate of the respective SAIs;

- There is no fraud, therefore no need to pursue the case,
- There is high probability of existence of fraud, therefore transfer the case to other units within/outside the SAI for further examination/investigation.
- There is high probability of existence of fraud but the evidence may not be sufficient and therefore the auditor must collect additional evidence.
- The evidence gathered is believed to be sufficient and competent to reasonably conclude that fraud exists and therefore include in report and take further actions.

Many of the SAIs in Asia have the mandate to examine fraud cases. Therefore, once the existence of fraud has been reasonably concluded with the requirement for further evidence, the auditors have to identify the further required evidence.

2. Identify Further Evidence Requirement

Based on the evaluation of the initial evidence gathered, the auditor may have to identify further evidence required to establish the existence of fraud. In identifying the further evidence, the auditor should first identify the types of evidence required and then look for the sources from where the evidence could be gathered.

2.1 Types of Fraud Evidence

There are different types of audit evidence gathered from the various sources. While those general categories of evidence can be used in fraud auditing as well, classification of the types of evidence is often more helpful.

All the further evidence should be the evidence required to establish the existence for the real fraud cases, as it has now been reasonably established that there is the existence of fraud. Fraud examiners generally classify evidence into four broad types: people, documents, physical evidence, and personal observations.

i. People as Evidence

People evidence includes witnesses, victims, complaints, contacts, informants, clients, suspects, police, expert witnesses, or anyone else. People evidence can be direct, such as an eyewitness, or indirect, such as an expert witness. It has the advantage of being able to communicate but has the disadvantage in that testimony can be confused, confounded or inconsistent. Because of a natural tendency to not want to be involved, getting the cooperation of witnesses is sometimes difficult.

ii. Documents as Evidence

Documents are often used to conceal fraud. Documents can be altered, created (counterfeit), forged, or destroyed. Documents usually meet the criteria of relevance competence, and timeliness because they are objective, independent, and easily understood. In order to properly understand how documents are used in fraud, auditors need to be well-versed in accounting and a familiarity or a working knowledge of a discipline referred to as ‘questioned document examination’ will be an advantage.

Physical Evidence

Auditors will not use physical evidence as often as documents and people, but understanding the different types of objects that can be used, as evidence is still important. In broad terms, physical evidence can be classified into four types: objects, such as broken locks; substances, such as grease; trace, such as paint left on tools or equipment; and impressions, such as cutting marks, tire tracks, fingerprints, pictures or video films.

Personal Observations as Evidence

Personal observation is the use of the senses to assess certain activities. There may be opportunities for an auditor to exercise sight, hearing, touch, and even smell to evaluate evidence. Observation is rarely sufficient evidence by itself. Rather, personal observation corroborates other evidence collected.

Computer Evidence

There are many different types of computer evidence that may be required to prove fraud. They may include the following:

- Hardware and network diagrams;
- Operating systems software;
- Network and communications software;
- External bureaus and services;
- Journal and activity logs;
- Operator and console logs;
- Time and attendance records;
- Application programs;
- Library listings;
- Flow diagrams, source code and file layouts; and
- Other records and media.

Collecting computer evidence requires careful planning and maximum speed in execution. If employees in charge of computers are involved in fraud, it is possible they will have concealed or destroyed all incriminating evidence.

2.2 Sources of Audit Evidence

Auditors gather audit evidence through various sources that help in detecting fraud. Some of the important sources of audit evidence are;

a. Documents from Client

During the course of examination of books of accounts, the auditor retains certain documents that serve as evidence for the audit. These documents may be originals or photocopies depending upon their importance. In case of photocopies, the documents need to be countersigned/authenticated by the concerned persons in the auditee.

b. Report of Internal Auditor

The internal auditor may have identified instances of deviation from normal procedure. Based on possible fraud control weakness identified by the internal auditor, the auditor can modify his audit program to detect fraud. Hence internal audit reports are useful in detecting fraud.

c. Management and Officials of the audittee

The auditor can obtain important information from various officials. A few personnel design fraud. Other employees may have noticed this. Therefore, information from interviews and questionnaire are important sources of information.

d. Physical Inspection

Through physical inspection, auditor can confirm the existence and condition of the items. During this process, the auditor confirms the quality of documentary evidence as well as physical existence. Auditors can identify fraud cases (e.g. forged document, inventory not in existence or inferior quality) through this process. In some SAIs, they take pictures and video films during the physical inspection.

e. Documents from other related agencies

The auditor sometimes obtains information directly from other related agencies (e.g. bank balance confirmation from the bank, Debtor's balance confirmation from individual debtors etc). If the figures provided by these agencies do not tally with the books of account then he should check in detail to find out the reason for variation.

f. Results from Analytical Review

The auditor analyzes both financial and non-financial information, which can indicate abnormal trends. In that case, the auditor needs to concentrate on particular areas.

g. Expert Opinion

The auditor may seek expert opinion to derive a conclusion about a suspicious case. The expert's opinion becomes evidence if the auditor can rely on that opinion in assessing a fraud.

3. Collecting additional evidence

Once the auditors have identified the further required evidence and their sources, the auditor must collect the evidence. During the process of collecting the audit evidence, it is possible that the auditor may draw the conclusion that the identified evidence is not valid evidence and therefore may have to identify and collect some more evidence. It is also possible that it may not be possible to collect the identified evidence. Even at this stage and based on the accumulated evidence it is possible that the conclusion could be 'no fraud'.

Methods for Obtaining Audit Evidence

The auditor obtains audit evidence by one or more of the following procedures: inspection, observation, inquiry and confirmation, computation and analytical procedures. The timing of such procedures will be dependent, in part, upon the periods of time during which the audit evidence sought is available.

Inspection

Inspection consists of examining records, documents, or tangible assets. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and the effectiveness of internal controls over their processing. Three major categories of documentary audit evidence, which provide different degrees of reliability to the auditor, are;

- (a) documentary audit evidence created and held by third parties;
- (b) documentary audit evidence created by third parties and held by the entity;
- (c) documentary audit evidence created and held by the entity.

Inspection of tangible assets provides reliable audit evidence with respect to their existence but not necessarily as to future economic benefits or measurement.

Observation

Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control procedures. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.

Inquiry and confirmation

Inquiry consists of seeking information of knowledgeable persons throughout the entity or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries like questioning the operating personnel about the possibility of obsolete or slow moving items. Evaluating responses to inquiries is an integral part of the inquiry process.

Inquiry involves:

- Considering the knowledge, objectivity, experience, responsibility and qualifications of the individual to be questioned;

- Asking clear, concise and relevant questions;
- Using open or closed questions appropriately;
- Listening actively and effectively;
- Considering the reactions and responses and asking follow-up questions; and
- Evaluating the response.

In some cases, replies to inquiries take the form of written representations from management.

The auditor's ability to evaluate the reliability of audit evidence obtained from responses to inquiries is also affected by the training, knowledge and experience of the auditor performing the inquiry, because the auditor analyzes and assesses responses while performing the inquiry and refines subsequent inquiries according to the circumstances. When obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source.

The auditor ordinarily performs audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily will not provide sufficient audit evidence to detect a material misstatement at the assertion level or to evaluate the design of a control and to determine whether it has been implemented.

Confirmation

Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, sending letters directly to third parties who hold the client's inventory and request they respond directly to auditor.

Confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, what the relevant details are.

Re-performance

Reperformance is the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control, either manually or through the use of CAATs, for example checking the arithmetical accuracy of source documents and accounting records.

Analytical review procedures

Analytical review procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data such as comparison of account balances with expected amounts, evaluation of balances in relation to predictable historical patterns. Analytical review procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Collecting Audit Evidence in an IT Environment

Guideline 26 of the ASOSAI Guideline on Dealing with Fraud and Corruption states *“Since many records are produced by computers in the usual and ordinary course of work, auditors should understand how to collect and handle those records as audit evidence. Collecting computer evidence requires careful planning and execution. Auditors should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence”*.

Collecting audit evidence in an IT environment is often more complex than traditional manual audit. In an IT environment not only it is necessary to understand the techniques of assessing system and data soundness but also necessary to establish means of collecting evidence.

Auditor can use the above methods through the use of manual audit procedures, computer-assisted audit techniques, or a combination of both. For example:

- A system which uses manual control totals to balance data entry operations might provide audit evidence that the control procedure is in place by way of an appropriately reconciled and annotated report. The auditor should obtain audit evidence by reviewing and testing this report
- Detailed transaction records may only be available in machine-readable format requiring the IS auditor to obtain audit evidence using computer-assisted audit techniques

Every auditor faces the decision of how much evidence to gather. Given enough time and money, perhaps more frauds could eventually be resolved. In many cases, however, the cost of gathering additional evidence is more than can be justified. In each fraud case, a tradeoff could be made between the cost and the benefits of additional searching.

The following suggested steps could be followed when searching for evidence in fraud auditing;

- i. Always search for the strongest possible evidence;
- ii. Investigate without delay. The probability of resolving the case drops with time, as evidence can be destroyed, lost or forgotten. The computer evidences could be manipulated or erased.
- iii. Don't ignore small clues or leads;
- iv. Look for facts you can confirm or refute;
- v. Be persistent and creative; and
- vi. Concentrate on the weakest point in the fraud.
- vii. In case of doubts about the authenticity of a document he must verify with source documents (e.g. bank voucher may be confirmed directly by bank). He may also verify the document by cross referencing with documents from other sources.
- viii. When the auditor has reasonable suspicion that a fraud has occurred he should reconsider the reliability of other audit evidence and should confirm their reliability by applying other tests.

In some situations the auditor may be unable to obtain audit evidence either to confirm or dispel a suspicion of fraud. In this circumstance, the auditor should consider the possible impact on the financial information and the effect on his report.

Challenges faced by an auditor

Detecting fraud is a great challenge to the auditor. People may expect that the auditor should detect every fraud that has material effect on financial statement. The auditor has time and cost constraints and there are inherent limitations of audit. Many fraud cases may not be detected during the audit. The following are some of the challenges faced by the auditor while dealing with fraud & corruption;

i. No SAI Mandate

Most of the SAIs do not have the mandate or have limited mandate to cover fraud & corruption during the process of normal audits. So even if we identify certain red flags during the process of normal audit, we may have to handover the case to some other units. This is because, proving some one as fraudster involves certain legal requirements which can only be handled by the court.

ii. Lack of skills

Once we identify the red flags, gathering the requisite evidence require certain skills such as communication skills (like report writing, interviewing and expert witnessing), technological skills like (data mining, internet, database etc.) including other skills like analytical skills, critical thinking etc. The auditor should also have certain legal background in gathering sufficient and appropriate evidence. There are no specific steps in evaluating the evidence. Therefore, auditor has to make a judgment on ‘sufficient and appropriate evidence’. All such skills may not exist in an auditor.

iii. Resistance to release information/documents

In the case of fraud the deceiving party, whether a single individual or a syndicate, has no interest whatsoever in disclosing the existing information about the fraudulent act. To the contrary, the objective is to keep it concealed as long as possible. Thus the deceiving party could be regarded as an almost inaccessible source of information. So there is always a *tug-of-war* between the deceiving party and the auditor; the former would try to hold and conceal as far as possible while the latter would try to extract as much information as possible. So collecting evidence in such a situation would depend on auditors skill, experience and knowledge. This also implies that information about the incident of fraud should be obtained from sources other than the deceiving party. At times the managements are also supportive of their staff and may not cooperate with the auditors.

iv. Difficult to prove intent

Every fraud definition includes ‘*intent to deceive*’. As stated in the Shakespeare play, Merchant of Venice “*there’s no art to find minds construction on the face of man*”, it is difficult to prove through various evidences the ‘intent’, which is the mindset, of a person. So the challenge for the auditor is to prove the mindset of a person through various evidences.

v. Lack of proper follow-up by the government or other agencies

Often the auditors spent lot of time and effort looking for evidences to detect fraud. However, quite often their findings and observations remain only in the reports as no follow-up actions are taken by the Public Accounts Committee or other relevant bodies. Sometimes cases detected by the auditor gets lost by the time it reaches the Public Accounts Committee or higher bodies.

vi. Duplication of work between the SAI and other anti-corruption or anti-fraud bodies.

In most countries, they have anti-fraud or anti-corruption bodies to deal with fraud and corruption in the public sector. Therefore, there is often duplication

of work leading to conflicts between these bodies. At times the jurisdiction and the mandate of the SAI and other bodies are not well laid out.

4. Summary

Gathering of Audit Evidence is the most important part of the audit process. The role of audit evidence is even greater while dealing with fraud and corruption during the process of audit.

During the process of audit, auditor should always keep alert to the red flags and indicators of fraud. Audit evidence is obtained during all phases of the audit process, therefore auditor should use his professional judgment on appropriate mix of audit evidence and decide on ‘*sufficient, competent and reliable evidence*’ which would reasonably establish the existence of fraud.

5. References

1. ASOSAI, *ASOSAI Guideline for Dealing with Fraud & Corruption*
2. ASOSAI, *Fraud Awareness Module (Training Material)*
3. ASOSAI, *Financial Audit in an IT Environment (Training Material)*
4. National Audit Office, UK , *Good Practice in Tackling External Fraud*
5. Royal Audit Authority Website, Bhutan, *Fraud Indicators*
6. Australian Accounting Research Foundation, *Auditing Standard*
7. Information Systems Audit & Control Association, *IS Auditing Guideline*
8. Prof. G J Rossouw, *From understanding to undermining fraud*