

## 3.1 Overview of Fraud and Corruption Detection Process

### Session Overview

From the previous sessions, we have learned that fraud and corruption are the concern and responsibility of many parties, including management, internal auditor and SAI as an external auditor to the government entities. The detection of fraud and corruption is often an outgrowth of a SAI audit whether financial audits, performance audits or audits with a specific purpose. Even though detection of fraud and corruption is not the sole responsibility of the SAI, the SAI can play a significant role in anti fraud and corruption effort by focusing its audit on areas which are sensitive to fraud and corruption.

Previous sessions have provided a foundation for auditors to increase their awareness with regards to fraud prevention. This session which serves as a first session in the Section 3.0 Detecting Fraud and Corruption will provide an overview on how SAI should detect fraud and corruption during its normal audit activities.

### Learning Objectives

By the end of this session, participants will be able to explain the process of fraud and corruption detection during a normal audit in accordance with INTOSAI Audit Standards and ASOSAI Guidelines, as evaluated by instructor.

### INTOSAI Auditing Standards and ASOSAI Guidelines with regards to Fraud and Corruption Detection

The ASOSAI Guidelines for Dealing with Fraud and Corruption is designed and developed in accordance with The INTOSAI Auditing Standards. Each guideline refers to an auditing principle/standard and guidance prescribed by the INTOSAI Auditing Standards. The Guidelines serve as a further and specific guidance for SAIs when dealing with fraud and corruption during their normal audit, whether it is a financial audit or a performance audit. Therefore, the guidelines is not designed and developed to help auditors to detect fraud and corruption per se.

To guide auditors in detecting fraud and corruption as part of their normal audit, there are some guidelines which should become a concern of auditors:

- **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 transaction.

- **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 19**

The SAI should keep in view the need for flexibility in terms of budget, time and expertise of the audit team particularly when fraud and corruption are suspected or discovered in the course of 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 auditee requires that 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.

- **ASOSAI Guideline 23**

Whenever a material instance of failure to comply with the applicable laws and regulations is observed the auditor should without automatically assuming the management and staff are dishonest investigate the control failure with an appropriate degree of professional scepticism.

- **ASOSAI Guideline 24**

When auditors suspect the possibility of fraud and corruption, they should establish whether it has taken place and there has been resultant effect on the financial reporting, especially whether the certificate requires the qualification.

- **ASOSAI Guideline 26**

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.

- **ASOSAI Guideline 27**

Auditors need to be alert to deviations from acceptable accounting standards including disclosure requirements particularly when there is suspicion of fraud and corruption.

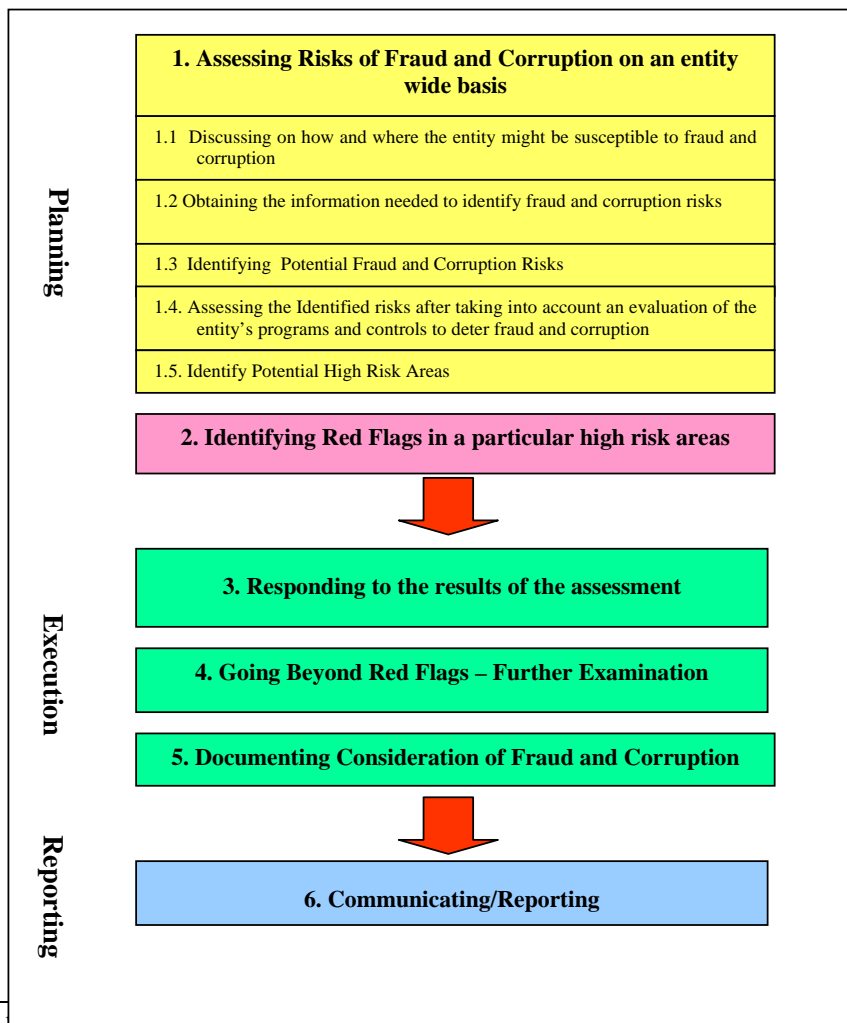
Understanding these guidelines would help auditors to fulfil their role and responsibility in dealing with fraud and corruption detection during their normal audit process.

### Overview of Fraud and Corruption Detection Process During Normal Audit

In a normal audit, auditors go through three major stages of an audit process. They are planning, execution and reporting, which includes a follow up action in case of performance audit. Detection of fraud and corruption may be done in the planning and execution stages during a normal audit.

Some major steps for detecting fraud and corruption during normal audit can be depicted as follows:

#### Overview of Fraud and Corruption Detection Process during normal audit



Auditor's role and responsibility in fraud and corruption detection process during a normal audit constitutes activities 1 – 6 above which fall into planning and execution stages.

## 1. Assessing Risks of Fraud and Corruption on entity wide basis

### 1.1 Discussing on how and where the entity might be susceptible to fraud and corruption

As part of planning the audit, auditor should discuss with its audit team and consider how and where the entity might be susceptible to fraud and corruption. The discussion should include consideration of the known external and internal factors affecting the entity that might:

- Create incentives or pressures for management and others to commit fraud and corruption;
- Provide opportunity for occurrence of fraud and corruption;
- Indicate a culture or environment that gives perception of tolerance, laxity and weak management oversight that increase the risks of occurrence of fraud and corruption;

Discussion will also include a consideration of the risk of management override of controls and how the auditor might respond to the susceptibility of the entity with regards to fraud and corruption.

This practice will also reinforce the importance of adopting an appropriate mindset of professional skepticism of the SAI's auditors.

### 1.2 Obtaining the information needed to identify fraud and corruption risks

During the planning process of any type of audit, auditors should obtain sufficient knowledge about the entity's business and the industry or sector in which it operates. As part of this work, auditors should pay attention to information that should be considered in identifying fraud and corruption risks. The following procedures might help auditors in doing so:

- 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.

At this stage, auditors should also consider the significance of the use of Information Technology in the entity's financial and operations. The more

significant the use of information technology in doing business, the more complicated the business should deal with fraud and corruption detection.

In performing the fraud and corruption risk assessment at the entity level, a checklist of risk assessment is the most common technique used by auditors. However, auditors should bear in mind that the use of check list should not replace their professional judgment and professional skepticism.

### 1.3 Identifying Potential Fraud and Corruption Risks

Based on the information gathered from the above process, auditor should be able to identify fraud and corruption risks in the context of the three conditions -incentives/pressures, opportunities; and attitudes/rationalizations (fraud triangle)- present when fraud and corruption occurs.

Auditor should also consider:

- Nature of the entity, such as the size and complexity.
- Attribute of fraud and corruption risks, such as the type, the significance of risks, the likelihood, and the pervasiveness of the risks related to areas being audited.

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

As part of the understanding of internal controls sufficient to plan the audit, auditors should evaluate whether entity programs and controls that address identified fraud and corruption risks have been suitably designed and placed in the 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.

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 to identify high risk areas.

### 1.5 Identifying High Risk Areas

As a result of assessment at an entity wide level as discussed above, auditors will be able to identify high risk areas on which the audit should be emphasized. In identifying high risk areas, the SAI's experience and perceptions would be beneficial.

ASOSAI Guidelines for dealing with fraud and corruptions indicates some of commonly perceived high risk areas: contracts of service/procurement, inventory management, sanctions/clearances, program management, revenue

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receipt, cash management, general expenditure and other areas with public interface.

## 2. Identifying Red Flags in a particular or specific high risk area

Once auditors have already identify high risk areas as a result of the risk assessment at an entity wide basis, auditors should be able to identify red flags in a particular or specific high risk area. Red flags are anomalies that point to symptoms or indicators that are known to be associated with fraud and corruption.

Auditors should be aware of red flags, know when to use them, and understand their strengths and limitations. Additionally, auditors should bear in their mind that a red flag does not always indicate that fraud and corruption exist in the particular high risk areas under their scrutiny. While red flags may be present, fraud and corruption may not be. Hence, auditors should be careful and able to demonstrate their professional judgement in making conclusions that fraud and corruption exists.

**Session 3.3** will discuss in more detail about red flags commonly found in the perceived high risk areas, as indicated in the ASOSAI Guidelines for Dealing with Fraud and Corruption.

## 3. Responding to the results of fraud and corruption risk assessments

**ASOSAI Guideline 18** provides a guidance on how auditors to response to the risk assessment result. This guideline states that 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.

Auditor's response to the assessment of the fraud and corruption risks and to the identified red flags in a particular or specific high risk areas is influenced by the nature and significance of the fraud and corruption risks as being present and the entity's programs and controls that address these identified fraud and corruption risks.

At this stage, auditors must determine what impact of the risk assessment will have on how the audit is conducted. Auditor's response to the identified fraud and corruption risks may follow three ways:

### 3.1 A response that has an overall effect on how the audit is conducted.

The response involves more general considerations apart from the specific procedures and can take in the following ways:

- Auditors may respond by assigning additional persons with specialized skill and knowledge, such as Information Technology specialists , or by assigning more experienced personnel to the engagement.

With regards to this response, **ASOSAI Guideline-19** states that the SAI should keep in view the need for flexibility in terms of budget,

time and expertise of the audit team particularly when fraud and corruption are suspected or discovered in the course of audit.

- In case of financial audits, auditors may respond by carefully considering management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions. In this case, auditors may develop judgments about the quality of significant accounting principles.

### 3.2 A response to identified fraud and corruption risks involving the nature, timing and extent of the auditing procedures to be performed

In this case, auditing procedures performed in response to identified risks will vary depending on the type of risks identified. This may involve both substantive tests and tests of controls. However, because management may have the ability to override controls that may otherwise appear to be operating effectively, it is unlikely that the risks can be reduced appropriately by performing only tests of controls.

Therefore, the auditor's response to specifically identified risks of fraud and corruption should include:

- Changing the **nature** of the auditing procedures to obtain more reliable or additional corroborative evidence. For example, auditors may need more evidential matter from independent sources outside the entity or auditors may choose to employ computer-assisted audit techniques (CAATs) to gather more extensive evidence about data contained in significant accounts or electronic transaction files.
- Changing the **timing** of substantive tests. For example, auditors may conduct substantive tests at or near the end of the reporting period.
- The **extent** of the procedures should also reflect the assessment of the fraud and corruption risks. For example, auditors may increase the sample sizes or performing analytical procedures at a more detailed level.

### 3.3 A response to further address the fraud and corruption risks involving management override of controls

Management is in a unique position to perpetrate fraud and corruption because of its ability to directly or indirectly manipulate information or accounting records. They might prepare fraudulent financial reports by overriding established controls that otherwise appear to be operating effectively.

Therefore, in addition to two other responses above, auditors should perform the following procedures to further address the risk of management override of controls:

- Examining journal entries and other adjustments for evidence of possible fraud and corruption

- Reviewing accounting estimates for biases that could result in fraud and corruption risks.
- Evaluating the business rationale for significant unusual transactions.

At this stage, auditors should be able to determine appropriate response to the result of fraud and corruption risk assessment.

#### **4. Going beyond Red Flags - Further examination**

Auditor's response to the results of the assessment of the fraud and corruption risks as well as identified red flags should involve the application of professional skepticism in evaluating initial evidence obtained from audit. This will provide basis for further examination necessary to identify and obtain further evidence to support auditor's conclusion with regards to fraud and corruption risks. At this stage, auditors should be able to determine whether the identified fraud and corruption likely exist, considering the evidence they obtained.

**Session 3.4** will discuss the auditor's response to the result of risk assessment at an entity level and the identified red flags in particular high risk areas. This session will mainly focus on the evaluation of audit evidence which will help auditors to decide the specific follow-up actions.

#### **5. Documenting the auditor's consideration of fraud and corruption**

Documentation is a very critical aspect which quite often has a less attention from auditors. Basically, auditors should document all the above activities and their result for supporting their conclusion and for further reference. This documentation will also serve as a significant resource when auditors should follow up on their report with law enforcement authority and for some cases they have to be present before the court.

To be specific, auditors should document:

- The discussion among audit team members regarding the susceptibility of fraud and corruption, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed;
- The procedures performed to obtain information necessary to identify and assess fraud and corruption risks;
- Specific fraud and corruption risks that were identified and a description of the auditor's response to those risks.
- The results of the procedures performed to further address the risk of management override of controls.
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks and other conditions;
- The nature of the communications about fraud made to management, the audit committee, and others.

## 6. Communicating about fraud and corruption to concerned parties

Once auditors have a strong evidence and indication that fraud and corruption occurs, auditors are responsible to communicate about fraud and corruption to management, audit committee and law enforcement authority. For some SAIs, they have a special unit to investigate the fraud and corruption. In this case, audit team of a regular audit might communicate about fraud and corruption to this unit for further investigation process.

However, auditors should recognize that in the following circumstances a duty to communicate or disclose to parties outside the entity may exist:

- To comply with certain legal and regulatory requirements
- In response to a subpoena
- To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.

Auditors should also be aware that because potential conflicts between auditors' ethical and legal obligations for confidentiality of the entity matters may be complex, auditors may wish to consult with legal counsel before discussing matters with parties outside the client.

### Summary

This session has provided a framework for auditors in detecting fraud and corruption during their normal audit.

Understanding on the guidelines relating to fraud and corruption detection enables auditors to take proper action in dealing with fraud and corruption detection under their role and responsibility in achieving the objective of a normal audit. This will also assure the quality of auditor works and their contribution to combat fraud and corruption.

Overview of fraud and corruption detection process which includes six major steps – from assessing fraud and corruption until communicating about fraud and corruption to concerned parties- will help auditors to visualize major activities they should focus on during audit to be able to take action properly with regards to fraud and corruption detection.

### 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. ACFE, *How to Detect and Prevent Financial Statement Fraud*, 2004