

CHAPTER 3

The Why of How of Auditing for Fraud

What is an auditor's responsibility for fraud in a financial statement audit? In this chapter, I'll answer that question.

Let's take a look at the following:

- Auditor's responsibility for fraud
- Turning a blind eye to fraud
- Signs of auditor disregard for fraud
- Cooking the books
- Theft
- Discovering fraud opportunities
- Inquiries required by generally accepted auditing standards
- The accounting story and big bad wolves
- Documenting control weaknesses
- Brainstorming and planning your responses

Auditor's Responsibility for Fraud

I still hear auditors say, "We are not responsible for fraud." But is that true? The detection of material misstatements, whether caused by error or fraud, is the heart and soul of an audit. So writing off our responsibility for fraud is not an option. We must plan to look for material fraud.

Audits will not, however, detect every material misstatement—even if the audit is properly planned and conducted. Audits are designed to provide *reasonable assurance*, not perfect assurance. Some material frauds will not be detected. Why? First, an

auditor's time is limited. He can't audit forever. Second, complex systems can make it extremely difficult to discover fraud. Third, the number of fraud schemes—there are thousands—makes it challenging to consider every single possibility. And, finally, some frauds are so well hidden that auditors won't detect them.

Even so, auditors should not turn a blind eye to fraud.

Turning a Blind Eye to Fraud

Why do auditors not detect fraud?

- We don't look for fraud because we don't understand it
- We disregard the importance of walkthroughs
- We believe that auditing the balance sheet is enough

Think of these reasons as an attitude—a poor one—regarding fraud. This disposition manifests itself in the audit file with signs of disregard for fraud.

Signs of Auditor Disregard for Fraud

A disregard for fraud appears in the following ways:

- Asking just one or two questions about fraud
- Limiting our inquiries to as few people as possible
- Discounting the potential effects of known theft
- A lack of walkthroughs
- No fraud brainstorming sessions
- Vague responses to brainstorming and risk assessment (e.g., “no means for fraud to occur; see standard audit program” or “company employees are ethical; extended procedures are not needed”)
- Unchanged audit programs though control weaknesses are noted

In effect, some auditors dismiss the possibility of fraud, relying on a balance sheet approach.

So how can we understand fraud risks and respond to them? First, think about fraud incentives. The reasons for theft vary, depending on the dynamics of the business and the people who work there.

Second, consider the opportunity element of fraud. Fraudsters can enrich themselves indirectly (by cooking the books) or directly (by stealing).

Cooking the Books

Start your fraud risk assessment process by asking, “Are there any incentives to manipulate the financial statements?” For example, does the company provide bonuses or promote employees based on profit? If yes, an employee can *indirectly* steal by playing with the numbers. Think about it. The chief financial officer can inflate profits with just one journal entry. Just debit receivables and credit revenue. How easy is that?

Some companies juice their profits by manipulating estimates. They might, for example, intentionally decrease the allowance for uncollectibles. Why? Doing so increases net income. This is why audit standards require retrospective reviews of certain estimates—to ensure there is no bias.

Auditors should review the prior year estimates and then consider what actually happened. In looking at the prior year allowance for uncollectible (say for December 31, 20X2), the auditor examines the actual bad debt write offs made during 20X3. Doing so assists the auditor in determining whether the prior year estimate was appropriate. Then he reviews the current year estimate for reasonableness.

Some estimates such as a bank’s allowance for loan losses are complex. The more complicated the estimate, the easier it is to manipulate. So, use retrospective reviews to assess the reasonableness of estimates.

While cooking the books is a threat, the more common fraud is theft.

Theft

Some employees enrich themselves *directly* through theft. But employees can only steal if they have opportunity. Where does opportunity come from? Weak internal controls. Therefore it's imperative that auditors understand the accounting system and more importantly, related controls.

Discovering Fraud Opportunities

My go-to procedure in gaining an understanding of the accounting system and controls is a walkthrough. Since accounting systems are varied, and there are no "forms" (practice aids) that capture all processes, walkthroughs can be challenging. Therefore, we have to roll up our sleeves and get in the trenches.

For most small businesses, performing a walkthrough is not difficult. Pick a transaction cycle; start at the beginning and follow the transaction to the end. Ask questions and note who does what. And as you do, inspect related documents. Then, ask two questions:

- What can go wrong?
- Can material misstatements occur without detection?

In more complex companies, break the transaction cycle into pieces. You know the old question, "How do you eat an elephant?" And the answer, "One bite at a time." The process for understanding small companies works for a large ones as well. Just break it down and allow more time.

Discovering fraud opportunities requires the use of procedures such as inquiries of personnel, observations of controls, and inspections of documents. Of the three, inquiry is the most common. Auditing standards do not, however, permit the use of

inquiry alone. Use a combination of inquiry, observation, and inspection.

Inquiries Required by Generally Accepted Auditing Standards (GAAS)

GAAS requires auditors to inquire of management and others about the occurrence of fraud. We should also ask about any suspected theft or allegations of the same.

Audit standards state that auditors should inquire of management regarding *their* fraud risk assessments. We should ask:

- Who is responsible for assessing the risk of financial statement fraud?
- How often is this risk assessment performed?
- How does the organization monitor the threat of fraud?
- Who receives and reviews the fraud risk assessment and monitoring reports (including management and those charged with governance)?
- How often do they receive these reports?
- How does management communicate its ethical views (e.g., code of conduct)?
- What fraud detection procedures are performed by their internal auditors? How does internal audit address the risk of fraud in their annual audit plan? Do internal audit employees report directly to those charged with governance rather than to management alone?

If management has no method of detecting fraud, might this be a control weakness? Yes.

In smaller entities, you may get a deer-in-the-headlights look when you ask the above questions. These companies usually have no internal audit staff and may not be aware that they are responsible for fraud prevention. They might even say to you (the auditor), “Isn’t that what you do?”

What are the respective roles of management and auditors regarding fraud?

- Management *develops* and *operates* the accounting system
- Auditors *review* the system in order to plan and perform audit procedures to detect material misstatements (including theft)

In short, the company creates the accounting system, and the auditor gains an understanding of it. It is not the external auditor's job to *prevent* fraud. Detect it, yes (at least, if it's material). Prevent it, no.

The Accounting Story and Big Bad Wolves

Think of an accounting system as a story. Your job is to understand the narrative. As you describe the accounting system, you may find missing pieces. And when you do, you ask more questions. Why? To complete the story.

The purpose of writing the narrative is to identify any “big, bad wolves.”

Threats in childhood stories are easy to see—wolves are hard to miss. Not so in walkthroughs. It is only in connecting the dots—the workflow and controls—that the wolves materialize. So, how long should the story be? That depends on the size of the organization.

Scale your documentation. If the transaction cycle is simple, the documentation can be short. If the cycle is complex, more details are needed. Regardless, focus on control weaknesses that allow material misstatements.

Documenting Control Weaknesses

I usually summarize internal control strengths and weaknesses within the walkthrough narrative. For example:

Control Weakness: The accounts payable clerk (Judy Jones) can add new vendors and print checks with digital signatures. She can create new vendors and send checks without anyone else's involvement.

Highlighting weaknesses makes them prominent and useful in your brainstorming session.

Brainstorming and Planning Your Responses

Now you are ready to brainstorm about how fraud might occur.

Armed with knowledge of the company, the industry, fraud incentives, and the control weaknesses, you and your audit team are ready to think like a thief. And why would you do this? To unearth how fraud might occur. Once you do, use these ideas to develop responsive audit procedures.

The Auditor's Responsibility for Fraud

I started this chapter by saying I'd answer the question, "What is an auditor's responsibility for fraud?"

Our responsibility is spelled out in the language of the standard audit opinion (the italics are the authors):

The procedures selected depend on the auditor's judgment, including the *assessment of the risks of material misstatement* of the consolidated financial statements, *whether due to fraud* or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements *in order to design audit procedures* that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

The purpose of fraud risk assessments—in a standard audit

engagement—is to assist the auditor in designing appropriate substantive audit procedures. It is not to opine on internal controls. (Some audit engagements do include opining on internal controls, but most do not.)

Additionally, even well-performed audits will not detect all material fraud. As we saw above, some frauds are extremely difficult to detect. Audits are designed to provide *reasonable assurance*, not perfect assurance. The standard audit opinion states (the italics are the authors):

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free from *material misstatement*.

In summary, the auditor should conduct the audit in a manner to detect material fraud. But it is possible that some material frauds will not be detected.

Auditing for Fraud - A Simple Summary

- Auditors should design their audits to detect *material* misstatements whether caused by error or fraud
- An auditor's disregard for fraud is evidenced by a lack of fraud-related work paper documentation
- Fraud occurs when (1) the client intentionally misstates financial statement numbers (cooking the books) or (2) assets are stolen (theft)
- Walkthroughs shed light on how fraud might occur
- Auditors should inquire of management and those charged with governance about fraud

- Documenting internal control systems is similar to writing a story (where you point out the big bad wolves—control deficiencies)
- Brainstorm (with your audit team) about how fraud might occur based on your understanding of the entity and its controls
- The purpose of understanding controls in a standard audit is to develop audit procedures, not to opine on controls
- Plan and perform your audit to provide reasonable assurance that the financial statements are free from material misstatement

Next, we'll look at how to develop your audit plan.