

RISK, GOVERNANCE AND AUDIT

CORPORATE LEVEL

TUTE 02



by

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The logo for JMC vLearning is located in the bottom left corner. It consists of a stylized 'V' shape formed by two overlapping 3D rectangular blocks. The front block is light purple, and the back block is light orange. To the right of this graphic, the text 'JMC vLearning' is written in a large, light purple, sans-serif font. Below this, the tagline 'your virtual learning partner' is written in a smaller, lighter purple, sans-serif font. The entire logo is semi-transparent.

Introduction

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Definition – What is Fraud?

“An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage”

Fraud can be segregated into two segments.

a) Fraudulent Financial Reporting

Fraudulent Financial Reporting involves intentional misstatements, including omissions of amounts and disclosures in the Financial Statements, in order to receive the users of the Financial Statements

Examples for Fraudulent Financial Reporting

- + Intentional misapplication of Accounting Principles
- + Recording fictitious journal entries
- + Concealing facts that could affect the amounts in the Financial Statements
- + Manipulation, alteration of accounting records or supporting documents from which the financial statements are prepared
- + Inappropriately adjusting the assumptions and the judgements used on accounting estimates.

b) Misappropriation of Assets

It includes theft of the entity's assets which includes Management and Employees in small, medium and large scale.

Examples for Misappropriation of Assets

- ✚ Stealing or misusing the receipts from the customers
- ✚ Using entities assets for personal use
- ✚ Stealing physical assets or intellectual property

Important

Although fraud is a broad concept, for the purpose of audit, the auditor is concerned about frauds that cause material misstatements in the financial statements.

Responsibility for the Prevention and Detection of Fraud

a) Responsibility of the Management

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment.

This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

The following steps to be taken by the management to fulfil their responsibilities with regard to the prevention and detection of Frauds

- A) Implementation of good Accounting and Internal Control System within the Business Organization
- B) Implementation of Good Control Environment and Control Activities within the Business Organization

Additional Notes for Control Environment and Control Activities



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C) Responsibility of the Auditor

Auditor who conducts in accordance with S.L.Au.S is responsible for obtaining a reasonable assurance that the Financial Statements are taken as a whole are free from material misstatements, whether due to Fraud or Error.

Due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements due to fraud, may not be detected, even though the audit is properly planned and performed in accordance with S.L.Au.S and the potential effects are significantly high.

This is because a fraud may involve sophisticated and carefully organized scheme designed to conceal it. Further, the fraud may be perpetrated by individuals by collusions. Frauds committed by the management are harder to detect because management is in a position to manipulate accounting records or override controls. Therefore, the Auditor should perform following audit procedures to reduce the risk.

Therefore, the auditor should perform following procedures when conducting the audits to reduce the risk.

A) Having discussions among the Engagement Team

This requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity

This includes discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team.

This discussion;

- 1) Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud
- 2) Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- 3) Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegation of fraud that may come to the auditor's attention

The discussion may includes following matters,

- 1) exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- 2) A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management,
- 3) A consideration of any unusual or unexplained changes in behaviour or lifestyle of management or employees which have come to the attention of the engagement team.
- 4) An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- 5) A consideration of any allegations of fraud that have come to the auditor's attention.

B) Performing Risk Assessment Procedures and Related Activities

Management accepts the responsibility for the entity's Internal Control and the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding the management own assessment of the risk of fraud and the controls in place to prevent and detect it.

This includes the evaluation of Fraud Risk Factors such as Incentives/Pressure, Employee Attitudes and Opportunities

a) Incentives/Pressures

Circumstances that provide a motive for committing a fraud

Eg: High degree of competition or market saturation, accompanied by declining margins

Significant declines in customer demands and increasing business failures

Continuous operating losses which has a negative impact on the financial stability

b) Opportunities

Circumstances that provide the chance to committing a fraud

Eg: Weakness in Internal Controls, such as less segregation of duties

Use of business intermediaries for which there appears to be no clear business justification

c) Employee Attitudes

The mindset of the Management that allows them to justify fraudulent action or unethical behaviour

Eg: Tolerance of petty cash frauds

Management overriding the controls

Disregard for the need for monitoring or reducing risk related to misappropriation of assets

C) Inquire from Management with regard to Fraud & Errors and performing mandatory procedures

The following are mandatory procedures needed to be performed by the Auditor

a) Evaluating the business rational for significant unusual transactions

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b) Reviewing Accounting Estimates

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c) Testing Journal Entries and Other Adjustments

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D) D) When the auditor identifies an indication of Fraud and Error, needs to consider the Nature of the indication, the possibility of converting the indication to a reality and the impact to the FS

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Communication to Management and Those Charged with Governance

If the auditor identifies fraud or receives information that a fraud may exist, the auditor shall report this on a timely basis to the appropriate level of management. If the auditor identifies or suspect fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements, he shall communicate this on a timely basis to those charged with governance.

The auditor also needs to consider Confidentiality when deciding the responsibility with regard to a third-party disclosure

What are Fraud Risk Factors?

Conditions or events which increase the Risk of Fraud and Errors are referred as Fraud Risk Factors.

Fraud Risk Factor	Fraudulent Financial Reporting	Misappropriation of Assets
Opportunities	Weaknesses in the internal control systems	Weaknesses in the internal control systems
	High complex transactions	Large amount of cash on hand or processed daily
Employee Attitudes	Integrity of Management/Board of Directors	Integrity of Management/Board of Directors
Incentives and Pressures	Higher level of competition accompanied by declining margins	Personal financial obligations
	Increase in operating losses, which creates a threat of Bankruptcy.	Recent changes of employee benefits plans
	Negative cashflows	

Additional Notes



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