

KCO BLOGS 2020

This blog is written by **Mr. Maaz Khan**. Please read this blog and provide your valued comments

FRAUD CONSIDERATION IN AN AUDIT OF FINANCIAL STATEMENT (ISA-240)

Blog objectives:

- To understand fraud and types of fraud
- Responsibility of the auditor and management with respect to fraud
- Fraud risk factors
- Auditor courses of action if there is fraud risk factor or if auditor identifies fraud

Misstatement in the financial statements can arise from fraud or error. Fraud is an intentional act by one or more individuals involving the use of deception to obtain an unjust or illegal advantage. The difference between fraud and error is that of intention. Fraud is intentional while error is an unintentional misstatement in financial statements.

There are two **types of fraud** i.e. Misappropriation of asset and fraudulent financial reporting

Misappropriation of Asset	Fraudulent Financial Reporting
Misappropriation of asset is often committed by employees and includes;	Fraudulent financial reporting is often committed by management through override of controls and includes;
<ul style="list-style-type: none"> Embezzling receipts 	<ul style="list-style-type: none"> Recoding fictitious journal entries
<ul style="list-style-type: none"> Causing the entity to pay for goods and services not yet received 	<ul style="list-style-type: none"> Altering records and terms relating to significant or complex transactions
<ul style="list-style-type: none"> Using entity's asset for personal use 	<ul style="list-style-type: none"> Advancing or delaying recognition of transactions
<ul style="list-style-type: none"> Stealing physical assets or intellectual property 	<ul style="list-style-type: none"> Concealing the facts that could affect amounts recorded in the financials statements

It is important to mention here that the **primary responsibility** for the prevention and detection of fraud rests with management and those charged with management. Management shall establish controls and systems to prevent and detect fraud. Those charged with governance should monitor those systems and controls and should also consider the potential for management override of controls.

Auditor is not primarily responsible (contrary to what public think) for prevention and detection of fraud. However the auditor has to perform audit procedures to identify the risk of material misstatement due to fraud, address the risk of fraud and maintain an attitude of professional skepticism considering the possibility that a material misstatement due to fraud may exist.

Fraud risk factors are the factors that make it more likely that fraud will occur or is occurring in a business. The auditor must have an understanding of these factors in order to design appropriate audit procedures to identify and address the risk of fraud.

Category	Misappropriation of Asset	Fraudulent Financial Reporting
Incentive/pressure to commit fraud	<ul style="list-style-type: none"> -Personal financial obligations -Adverse relations between company and employees having access to cash and precious assets 	<ul style="list-style-type: none"> -Intended sale of business Acquiring new loans Majority shareholding by management -Pressure on management to achieve financial targets -Financial stability of the entity is threatened -Management bonuses are based on their financial performance
Opportunity to commit fraud	<ul style="list-style-type: none"> -Weakness in controls over assets -Existence of precious and movable inventory items 	<ul style="list-style-type: none"> -Significant related parties transactions -Assets, liabilities, income and expenses based on significant estimates -Weakness in controls over financial reporting -Ineffective oversight by audit committee/Board of directors -Domination of board by limited individuals
Attitude/rationalization to commit fraud	<ul style="list-style-type: none"> -Attitude showing dissatisfaction with the entity -Overriding existing controls -Tolerance of petty theft -Changes in life styles -Unwillingness to correct known deficiencies in internal controls 	<ul style="list-style-type: none"> -Ineffective communication/implementation of ethical values -Lack of integrity in senior management -Commitment to third parties to achieve unrealistic targets -low morale among senior management -Not providing or providing wrong information to the auditor

If there is a fraud risk factor (as mentioned in the above table), auditor shall revise the risk of fraud and shall modify his audit procedures to respond revised risk of material misstatement due to fraud i.e.

- Adequate planning and reduced materiality levels
- Assigning more experienced staff and increased supervision of staff
- Increased level of professional skepticism
- Incorporating unpredictability in nature, timing and extent of audit procedures
- Obtaining more reliable audit evidence(e.g. from external sources)
- Performing more procedures at year end rather than at interim date(*if applicable*)

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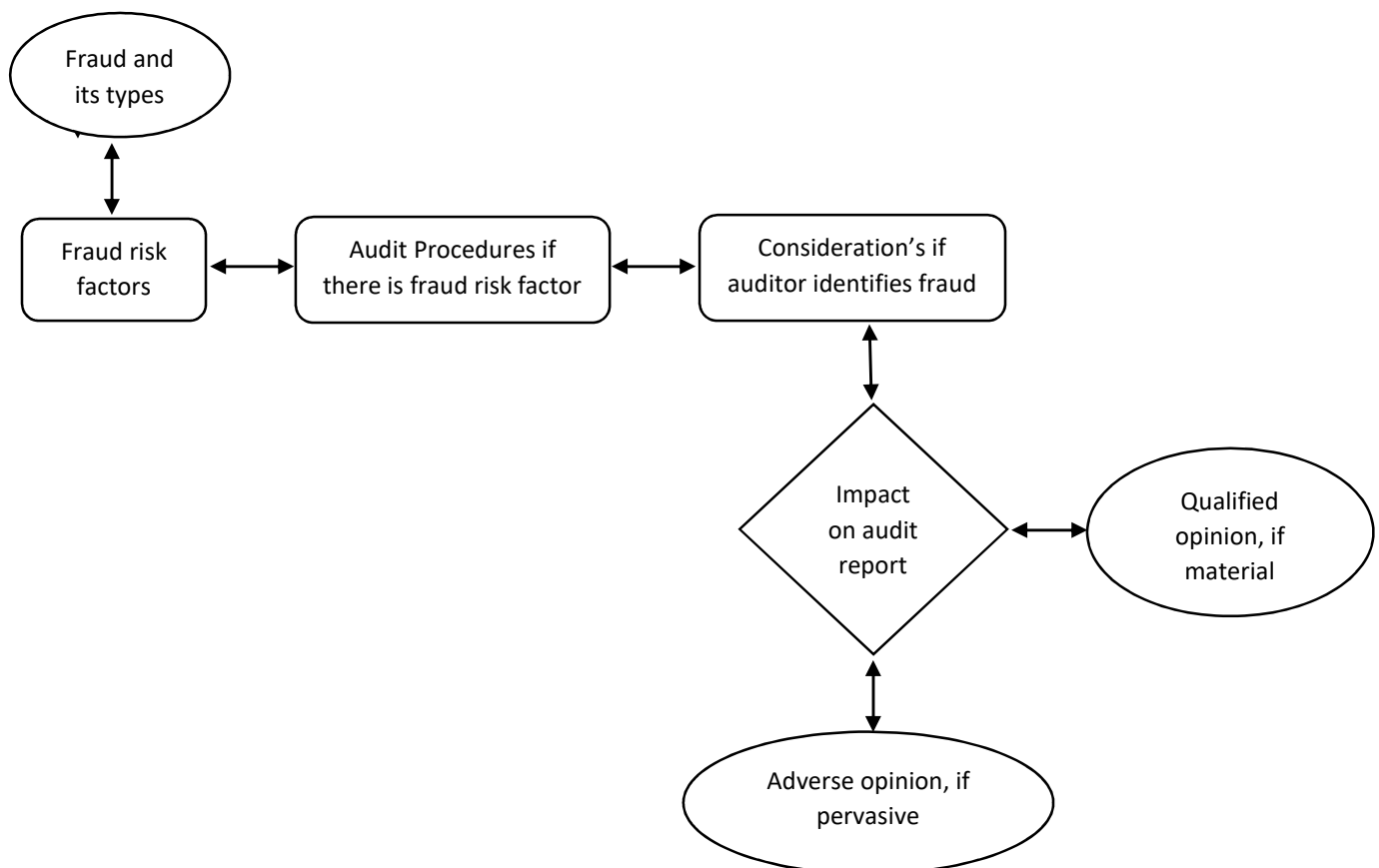
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If auditor identifies a fraud, auditor shall adopt the following courses of actions appropriate in the circumstances;

- ❖ Auditor shall communicate fraud to appropriate level of management on timely basis(*i.e. at least one level above the person involved in fraud*).
- ❖ Auditor shall communicate fraud to those charged with management, if amount is significant or management is involved.
- ❖ Auditor shall communicate fraud to regulatory authority only if such communication is required by law.

If the auditor doubts the integrity of the management (*because of involvement in fraud*), he may consider withdrawal from the engagement. If fraud results in misstatement in financial statements, the auditor shall also consider its impact on audit report and shall express modified opinion if the impact is material or adverse opinion if the impact is pervasive.

Blog chart:



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