Eurorai November 2006

Fraud and Error - the Audit Commission perspective

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Agenda

- ISA+240 in summary
- How does fraud happen
- Our experience in the first year

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ISA+ 240 – a recap

- Management has primary responsibility for preventing and detecting fraud
- Two types of fraud:
  - – misappropriation of assets
  - – fraudulent financial reporting.

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How does fraud happen?

- London Public Partnership survey:
  - Override of existing controls 42%
  - Lack of segregation of duties 22%
  - Lack of supervision 20%
  - Lack of checks 15%
  - Other 1%

- Culture and behaviour are critical factors in any organisation:
  - controls can be designed within systems, but people can override or not apply them.

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"I'm afraid our accountants are being investigated for fraud -- on the brighter side, our financial statements have made the New York Times best-seller fiction list."

Code of Audit Practice 2005

In practice, auditors should:

- Consider governance and material fraud risks when planning their audit
- address identified material fraud risks
- reach a conclusion on authorities' arrangements

Fraudulent financial reporting

- Professional judgement
- Professional scepticism
- Risk assessment

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Who cooks the books?

Table 5 – Types and Frequencies of Individuals Named

Individual's Relation to Company	# of Companies	Percentage of Fraud Cases[6]
Chief executive officer (CEO)	141	72%
Chief financial officer (CFO)	84	43%
Either or both CEO or CFO involved	162	83%
Controller	41	21%
Chief operating officer (COO)	13	7%
Other vice president positions	35	18%
Board of Director (non-management)	21	11%
Lower level personnel	19	10%
Outsiders (e.g., auditors, customers)	74	38%
No titles given	30	15%
Other titles	24	12%

Note: We used the highest managerial title for an individual. For example, if a person served as CFO and controller, we classified that person as CFO when presenting results in this table. This classification scheme may contribute to the lower percentages associated with less senior positions in the firm. In addition, due to the relatively small size of fraud companies, many of the positions, such as chief operating officer, were not in existence at these companies, thus reducing the noted percentages for these less common positions.

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How do they do it? (1)

- Recording revenue too soon or of questionable quality
- Recording bogus revenue
- Boosting income with one time gains
- Shifting current expenses to earlier/later periods
- Failing to disclose or improperly reducing liabilities
- Shifting current income to a later period
- Shifting future expenses into the current period

How do they do it? (2)

- Senior management
- Pressure/needs
  - what do we need to achieve? (e.g. break even)
- Actions
  - **instruct staff** to make amendments
    - finance department
    - service department
- *Will anyone blow the whistle?*

How do we find it?

- Analytical review (but …)
- ISA+ 315 – knowledge of the entity
- Unpredictability testing
- Substantive testing e.g.

  - late adjustments (journals)

  - cut off

  - estimates

  - provisions and reserves

  - capitalisation

  - changes to accounting methods

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Reporting

- Opinion
  - qualified
  - unqualified
- Other
  - Final accounts memo
  - ISA+ 260
  - Public interest report
  - Secretary of State (S19 of the AC Act 1998)
  - Police
  - Proceeds of Crime Act considerations

What have we found in the first year:

- fraud risk assessment by auditors vary in consistency and quality
- anecdotal evidence of pressure on staff to manipulate accounts
- no actual cases of an ISA+240 qualification in health service accounts
- culture and behaviour are critical

Don’t count on the naivety of fraudsters

- fraudsters learning quickly
- importance of whistleblowing

Scope to improve:

- fraud risk assessment by auditors

- embed professional scepticism within audit teams