Fraud Risk—Main Aspects and Approaches

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Abstract

Fraud can involve sophisticated and carefully organized schemes designed to hide it, such as a deliberate failure of the transaction record. It is important that a strong emphasis is placed on preventing fraud, to reduce the chances of its occurrence, discouraging it and trying to persuade individuals not to commit it due to the probability of its detection and punishment. Our fraud risk management study concludes that many management issues arise in the fraud risk management process that must be addressed by regulators and companies to ensure that the fraud risk management process is embedded as a corporate culture, not just as a process. Well-implemented audit processes make it possible to create the risk culture in an organization and whether auditors and risk management committees identify risks from each available source.

Keywords

Audit, Audit Tests, Fraud risk, ISA 200

1. Introduction

In accordance with ISA (International Standard on Auditing) 200, it is the auditor's responsibility to obtain reasonable assurance (a high level of assurance, but not absolute) of assurance as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or mistake. This means that the auditor cannot be fully assured of the existence or not of fraud.

2. Concept

Fraud can be understood as an intentional act by one or more individuals, whether belonging to the management bodies, employees of a company or other third parties through the use of practices that involve falsehoods in order to obtain an unfair or illegal advantage. There may be manipulation, falsity or alteration of records and supporting documents from which the financial statements were prepared, as well as misappropriation of assets, such as misappropriation of charges, theft of assets or monetary flows of goods or services not received. In these cases, there may also be collusion between the parties (Costa, 2014). A distinction should be made between fraud and error, where the error constitutes an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure. Errors are essentially distinguished by those that consist of arithmetic or bookkeeping inaccuracies in accounting data and those that result from a deficient application of legal principles and rules. So we can have:

- omission errors—operations incorrectly registered or not registered at all;
- duplication errors—duplicate registration of the same operation;
- imputation errors—recording in an account or item that is not appropriate;

- errors of principle—resulting from non-observance of administrative and accounting rules;
- arithmetical errors, errors in calculation, calculation, entry or transcription of balances;

The reasons for the appearance of fraud can be several (Almeida, 2017).

The ISA Application Guide mentions the following:

- Pressure—as a result of immediate needs, such as having significant personal debts or feeling obligated to achieve a certain profit;
- Opportunity—a weak organizational culture and lack of adequate internal control procedures often create confidence that fraud may go undetected;
- Rationalization—belief that fraud has not been committed. For example, you may have the feeling that the fraud you commit is not a big problem, or you may think that you are just taking advantage of what belongs to you.

A concrete example is the receipt of money without documentary support related to a commercial transaction.

The pressure could be to reduce taxes payable. The opportunity would be to derogate from internal controls over revenue recognition. Rationalization would be the feeling that taxes are high and that enough is already paid.

The environment for the emergence of fraud tends to be higher, the more involved top management is in illicit practices. Fraud is discovered by analyzing patterns, odd situations and exceptions, often in amounts that are thought to be small.

In this way, the behavior of the management body is the key to detecting whether the environment is conducive to the emergence of fraud.

According to the ISA Application Guide, the following attitudes, among others, are likely to indicate the possible emergence of fraud:

- The management body has a known history of violating laws and regulations;
- There are changes in behavior or lifestyle that may indicate misappropriation of assets;
- Derogation from existing controls and no appropriate corrective measures were taken to minimize detected deficiencies;
- Expense accounts are inflated and petty theft is regularly committed;
- There is promiscuity between personal and company transactions;
- There are disputes between the holders of the shareholdings.

In addition to the behavior of the management body, it is necessary to verify whether the internal controls present relevant deficiencies, among which we highlight the following:

- Inadequate supervision of expenditure by management bodies;
- Inadequate segregation of duties or verification;
- Inadequate management oversight of employees responsible for assets;
- Inadequate asset-related records;
- Inadequate authorization and approval of transactions;
- Inadequate physical safeguarding of cash, inventories or other assets;
- Lack of complete and timely asset reconciliations;
- Failure to document transactions in a timely and appropriate manner;
- Lack of vacations for employees who perform key functions;
- Etc.

It becomes evident that if the environment is favorable and as the popular saying goes “opportunity makes the thief”, the existence of assets susceptible to misappropriation involves, for example:

- Large amounts in cash or large amounts processed;
- Small, valuable or in high demand inventory items;
- Assets easily convertible into others;
- Assets that do not have ownership identification.

3. Treatment of the risk of fraud

The key issue in dealing with fraud risk is to integrate the identification of risks into the knowledge of the organization in question and the environment in which it operates. Information sources can be internal or external and

financial or non-financial.

Internal sources of a financial nature include, for example: financial statements, budgets, performance measures, tax returns;

As internal sources of a non-financial nature, there are, for example: vision, strategic objectives, organizational structure, job description;

External sources of a financial nature include, for example: industry information, competition data, government agencies;

As external sources of a non-financial nature, there are, for example: media articles, industry forecasts, internet information.

After knowing the entity, it is necessary to determine the factors that give rise to the risks and finally the impact that possible fraud may have on the financial statements (Nabais, 1993).

Risk assessment comprises two distinct parts:

- risk identification (questioning “what could go wrong”); and
- risk assessment (determining the importance of each risk).

Risks that have not been identified cannot be assessed. After identification, it is necessary to determine its importance, that is, the evaluation that involves considering two attributes:

- 1) How likely is a misstatement to occur as a result of the risk?
- 2) What is the magnitude (monetary impact) if the risk occurs?

There are several ways to document identified risks. The following table shows how the survey of risk factors and their respective assessment should be carried out (this is an example):

Table 1. Inherent Risk Assessment

Source of risk	Risk implication (distortion)	Inherent risk assessment		
		probability of occurrence	Impact (monetary)	combined score
Introducing a new product	Error in imputation and valuation of inventory	1	2	2
Remuneration of salespeople in sales commissions	Sales are unrealistic and recognized in an incorrect period	2	3	6
Insertion of fictitious suppliers	Payment of expenses for inflated prices or unbilled services	2	4	8
Transactions with unidentified related parties	Unrecognized revenue at market prices	1	5	5
Unrecognized and undeposited cash sales	Undervalued revenues and assets	3	4	12

Notes: 1—very low; 2—low; 3—medium; 4—high; 5—very high.

Source: own elaboration

Therefore, special attention should be paid to risks with a high probability of occurrence and monetary impact, such as “Unrecognized and undeposited cash sales”.

To detect risks, the usual procedures must be applied, namely:

- Substantive procedures—these are audit procedures designed to detect material misstatements at the assertion level. Comprise tests of detail (of classes of transactions, account balances and disclosures) and substantive analytical procedures;
- Tests of controls—are audit procedures designed to assess the operational effectiveness of controls in preventing, or detecting and correcting, material misstatements at the level of the assertion;
- A combined approach using both tests of controls and substantive procedures can be an effective approach;
- Regardless of the approach selected, you will need to design and execute substantive procedures for each class of transactions, balance sheet accounts and material disclosures.

4. Conclusions

In a normal year, the wickedest corporate scandals and worst executive malfeasance are impossible to forget. It is

therefore important to establish a set of effective internal procedures to prevent, detect and minimize the negative impact of fraud. We present in this work a table of possible application in tests to be carried out.

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