

cpab exchange

An auditor's responsibilities related to fraud in an audit of financial statements



There has been a brighter spotlight on fraud recently in the wake of high-profile corporate failures. A focus internationally has been on how far an auditor's responsibility extends in detecting fraud in an audit of the financial statements.

The Canadian Public Accountability Board (CPAB) launched a project in 2019 to explore this topic.

Our fraud project has two phases:

- During **Phase 1** we evaluated how auditors in Canada are complying with the Canadian Auditing Standard (CAS) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (CAS 240 or the Standard).
- **Phase 2** has us looking beyond CAS 240. As a follow up to our fall 2019 Canadian Audit Quality Roundtable¹, CPAB is organizing a working group in 2020 to further explore what actions can be taken by all relevant stakeholders to better prevent and detect corporate fraud.

WHAT WE DID

An auditor conducting an audit in accordance with the Canadian Auditing Standards (CAS) is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

Our objective for Phase 1 was to evaluate the quality of audit work being performed by auditors to meet the requirements of CAS 240 and to identify leading audit practices. The observations described in this paper are based on inspections carried out between March and September 2019.

We reviewed the audit work related to the following requirements of CAS 240:

- Fraud risk discussion among the engagement team².
- Fraud risk assessment procedures and related activities³.
- Responses to assessed risks of material misstatement due to fraud⁴.

WHAT WE FOUND



Auditors met the requirements of the Standard for the audit files reviewed.

During our reviews we identified a number of areas for auditors to consider as they design their audit approaches related to identifying and responding to fraud risks in their audits of financial statements.

¹The Audit Quality Roundtable was co-hosted by CPAB and the Office of the Superintendent of Financial Institutions - news release

²CAS 240, para. 16

³CAS 240, para. 17-28

⁴CAS 240, para. 29-34

AREAS FOR CONSIDERATION

1

Focus on the company's fraud risk management program



For discussion

A company's susceptibility to fraud, whether due to fraudulent financial reporting or misappropriation of assets, is significantly impacted by the strength of its fraud risk management program. The program includes a company's fraud risk governance policies, fraud risk assessments and fraud prevention and detection controls. An effective fraud risk management program creates a strong fraud deterrence effect.

In more than half of the audits we inspected, auditors evaluated aspects of the company's fraud risk management program to inform their fraud risk assessments. Procedures included evaluations of: code of conduct communications and related sign-offs by employees, processes in place to investigate fraud and take corrective action, and the quality of oversight exercised by audit committees over the program.

These procedures assist auditors to obtain an understanding of the strengths and weaknesses of a company's fraud risk management and where opportunities exist for internal controls to be circumvented and for fraud to occur.

- What is the nature and extent of audit work that auditors should perform when obtaining an understanding of the fraud risk management program?
- When would it be beneficial for auditors to test the effectiveness of important aspects of a company's fraud risk management program and report the results of this work to management and/or the audit committee?

2

Evaluating the effectiveness of the whistleblower hotline



For discussion

The Association of Certified Fraud Examiners' **2018 Global Study on Occupational Fraud and Abuse** found that 40 per cent of occupational fraud⁵ is detected through tips from employees, customers, vendors, and other anonymous sources.

About a quarter of the audits we inspected evidenced an evaluation of the effectiveness of the whistleblower hotline. Audit procedures included:

- Evaluation of the implications of whether the whistleblower hotline is handled by the company or outsourced to a third party.
- Evaluation of the hotline escalation process including whether complaints/tips are dealt with in a timely and appropriate manner.
- Mock whistleblower complaints. Some auditors made anonymous complaints through the hotline to confirm their understanding of how complaints are received, escalated, and resolved.

Evaluating the effectiveness of whistleblower hotlines also contributes to an auditor's understanding of the tone at the top of the company, including the importance placed on ethical conduct.

- When would a detailed assessment of the whistleblower hotline be necessary or beneficial?
- What is the nature and extent of that testing?

⁵The study defined occupational fraud as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets. Occupational fraud is committed against the organization by its own officers, directors, or employees.

AREAS FOR CONSIDERATION

3

Participation of specialists in the auditor’s fraud brainstorming meeting

As the complexity of the business environment continues to increase, so has the breadth of specialists engaged by auditors to participate in their audits. These specialists are key members of the extended audit team because of the expertise they contribute to highly specialized areas of the audit.

The perspectives of specialists during the planning phase of the audit are relevant to the audit team because of each specialist’s involvement in complex areas of the audit, including critical accounting estimates with high degrees of subjectivity that are particularly susceptible to fraud. Those specialists may also help the core audit team design an integrated, multi-disciplinary audit approach that responds to identified fraud risks.

The fraud brainstorming meeting⁶ is a discussion during the audit planning phase where auditors consider areas of a company’s financial statements that may be susceptible to fraud. We observed that specialists engaged in audits participated in the audit team’s fraud brainstorming meeting in two thirds of the audits inspected.

We think it is beneficial for specialists engaged in audits to participate in fraud brainstorming meetings. We understand, based on initial discussions with audit firms, that specialists are typically invited to attend those meetings.

For discussion



- How much importance should be placed on having specialists engaged by auditors participate in the fraud brainstorming meeting?
- When would their participation be unnecessary?

4

When to involve fraud and forensics specialists

With the digitization and automation of financial reporting systems, fraud is increasingly more sophisticated. This suggests that the specialized skills of fraud and forensics specialists (fraud specialists) may be beneficial in helping auditors identify areas where sophisticated fraud could be perpetrated against a company.

The use of fraud specialists was observed in five per cent of the audits we inspected. Those specialists were typically engaged after a trigger event including when suspicions emerged about the integrity of management or to respond to allegations that company assets had been materially misappropriated.

Auditors should consider when it is appropriate to engage fraud specialists before a trigger event. Considerations may include the complexity of the business model and operations of the company, whether the company has operations in emerging markets, the complexity of the company’s regulatory environment, and idiosyncratic fraud risks associated with the company or industry.

For discussion



- When should fraud specialists be engaged in audits of the financial statements?

⁶CAS 240, para. 16

Other observations relevant to identifying and responding to fraud risks



For discussion

Understanding compensation arrangements and analyst expectations

A common framework used by auditors to identify and assess fraud risks is the fraud risk triangle. The sides of the triangle are represented by⁷: (i) *incentives or pressures* to commit fraud, (ii) perceived *opportunities* to commit fraud, (iii) *rationalizations* used by individuals to justify an act of fraud.

We identified instances where auditors considered how management is compensated to inform their fraud risk assessments. This information is useful to auditors when obtaining an understanding of the incentives or pressures that could influence management to manipulate financial results. We also identified instances where auditors reviewed investment analyst reports or listened to analyst earnings calls to understand the degree of pressure on management to meet analyst earnings targets.

Rebuttal of the presumption of fraud in revenue recognition

Revenue and revenue growth are often key performance measures for public companies. Auditors are required to presume⁸ that there is a risk of fraud associated with revenue recognition and then evaluate more carefully the unique facts and circumstances applicable to each company that give rise to such risks.

The Standard allows auditors to rebut the fraud risk presumption in revenue recognition. The example described in the Standard is where auditors conclude: “there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property”.

We found that about a quarter of audits we inspected included a rebuttal of the risk of fraud in revenue recognition. The overall rate of rebuttals was higher than we had expected based on the risk profiles of those audits although the rebuttal rate varied considerably across audit firms.

Use of unpredictable audit procedures

Research suggests that when auditors use consistent procedures year over year, those procedures become predictable and less effective at detecting fraud in the financial statements.⁹

CPAB found that 90 per cent of files inspected incorporated unpredictable audit procedures in their audits as a response to identified fraud risks at the financial statement level. Examples included auditors changing sampling methods and performing audit procedures at different locations on an unannounced basis.

We plan to more carefully evaluate the quality of unpredictable audit procedures in our 2020 inspection cycle.

- Should auditors of public companies always obtain an understanding of compensation arrangements and analyst expectations as part of their fraud risk assessments?
- When is this unnecessary?
- When is it appropriate for auditors to rebut the presumption of fraud risk in revenue recognition?
- Are there industries where a rebuttal of the fraud risk presumption is more common?

⁷ CAS 240, para. 3, A1

⁸ CAS 240, para. 27, A29-31

⁹ Journal of Practice & Theory. 2009. Vol 27, Page 239. Financial Statement Fraud: Insights from the Academic Literature. No. 2.

WHAT'S NEXT?

It is useful to consider whether, in today's environment, there is an opportunity for auditors to do more in the area of fraud in the financial statement audit. We encourage further dialogue.

As a follow up to our fall 2019 Canadian Audit Quality Roundtable, CPAB is organizing a working group to further explore what actions can be taken by all relevant stakeholders to better prevent and detect corporate fraud.

We want to hear from you. Please reach out to us at thoughtleadership@cpab-ccrc.ca with your thoughts about this project.

Learn More

Visit us at www.cpab-ccrc.ca and join our mailing list. Follow us on Twitter — @CPAB-CCRC

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