PacificCPE

# Fraud-Detection and Investigators' Responsibilities

**Course #1107A**

**Auditing**

**2 Credit Hours**

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# FRAUD-DETECTION AND INVESTIGATORS' RESPONSIBILITIES

This course covers practical techniques for developing fraud-detecting procedures, the auditors' responsibilities for fraud detection, digital analysis and number patterns.

## LEARNING ASSIGNMENTS AND OBJECTIVES

*As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.*

**SUBJECTS**

**Fraud-Detection Audit Procedures**
**Auditors' and Investigators' Responsibilities**
**Analysis of Digit and Number Patterns**

Study the course materials from pages 1 to 57

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

**Objectives:**

- Recognize some practical techniques for developing fraud-detecting procedures.
- Recall the auditors' responsibilities for fraud detection.
- Recall what is Digital Analysis



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## EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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# CHAPTER 1: FRAUD-DETECTION AUDIT PROCEDURES

## Chapter Objective

### After completing this chapter, you should be able to:

- Recognize some practical techniques for developing fraud-detecting procedures.

The AICPA generally accepted auditing standards (GAAS) contain two barriers for the performance of fraud-detection audit procedures. The first is the risk assessment prerequisite that can trigger a responsibility to perform them. The second is the concentration on management fraud almost to the exclusion of employee fraud. Fraud-detection procedures are usually regarded as costly. Many managements do not believe they are necessary and do not care to pay for them. However, independent auditors may find that some fraud-detection procedures are easy and may produce service benefits to clients.

## TWO BARRIERS

Fraud-detection audit procedures are conditional. According to GAAS: "Considering the assessment of risk that fraud may cause the financial statements to contain a material misstatement, the auditor should plan the audit to include overall responses and specific procedures designed to determine whether fraud has occurred and whether the financial statements are materially misstated." The risk assessment comes first. It must show the auditors reasons to suspect errors and frauds in the accounts. This risk assessment demands the skills for noticing "red flags" and deciding that they are significant for planning subsequent procedures. Thus, performance of fraud-detection procedures is conditional upon (1) the existence of red flags, (2) the auditors' skill in noticing them, and (3) the auditors' willingness to follow them with fraud-detecting procedures. Performance of fraud-detecting procedures generally is not "normal" in most financial statement audits.

The auditing standards concentrate on management fraud—the production of materially false and misleading financial statements. This concentration of interest focuses on balance sheet accounts in terms of asset overstatement and liability understatement. It does not suggest high interest in the income statement. Many employee frauds are "expensed"; that is, they involve revenues that are never recorded or improper payments that are charged to expense accounts. When such frauds occur, the net income ("bottom line") is not wrong. After all, the fraud losses are in the income statement; they are just not separately identified and labeled. Granted, the income statement is not presented as it "should be" without the fraud, but independent auditors do not have a responsibility to give opinions on financial statements with relation to "no fraud" conditions. (Likewise, independent auditors do not give opinions on financial statements with relation to "what they could have been" had the organization obtained a new contract, produced better quality products, or achieved targeted expense reductions in the normal course of business.) Employee frauds may be large, but they are rarely large enough to create material distortions of important income statement numbers and ratios and thus materially misstate an income statement.

## CLIENT RELATIONS AND "NORMALITY"

Before SAS 82 was issued (effective December 15, 1997), independent auditors resisted any requirements to perform fraud-detecting procedures as a part of every audit. They tended to leap to the conclusion that a "fraud audit" is very costly and time-consuming. They regarded fraud-detecting procedures as "not normal." GAAS still somewhat supports this view by making such procedures conditional upon the risk assessment.

However, "normality" is in the eyes of the beholder. In the 1930s, confirmation of receivables and observation of inventories were not widely regarded as normal procedures. Under SEC pressure after the McKesson & Robbins affair, these two procedures were written into the auditing standards and made normal for all audits. Today, auditors regard confirmation and observation as standard procedures. Auditors perform them to try to detect errors and frauds, but they are not conditional. They are performed in all audits. Tomorrow, other procedures may become "normal" either through client demand or through external regulatory pressure.

Independent auditors also resist requirements that increase the effort and cost of audits. They are very sensitive to the audit fees clients are willing to pay. Fraud is an unpleasant topic, and many client managements need to be "sold" on the prospect that it may actually exist in their organizations. Independent auditors are generally not eager to undertake the task of persuading managements that they need fraud-detection work as part of the audit engagement.

Dealing with fraud can be troublesome. Some auditors do not relish being perceived as "snoops" out to catch the bad people. Managers and employees, especially the ones engaged in frauds, do not generally encourage auditors to find fraud. Independent auditors are very concerned about maintaining good relations with client managers. After all, they depend upon the managers for cooperation in the audit. The dynamics of client relations no doubt has helped shape auditing standards toward viewing fraud-detection procedures as aberrations in the normal audit. Independent auditors prefer to keep clients satisfied—at least not indignant—and present themselves as useful consultants rather than snoops.

Management consulting services are another matter. CPA firms have created forensic accounting and litigation support groups to provide a wide variety of services. Skills are available in CPA firms, but they apparently are confined mostly to the consulting business.

## FRAUD-DETECTION AUDIT PROCEDURES

The remainder of this chapter presents a variety of audit procedures that can be used to detect fraud. The presentation is limited to procedures auditors generally do not include in standard audit programs. (Since space is limited, the fraud-detecting capability of "normal" audit procedures is not covered. The procedures are presented here do not address cost or feasibility. Auditors can decide whether to use them in consideration of all the circumstances in an engagement. Some of them can be performed with little cost. Others require considerable time and effort. Perhaps time will tell whether some of these procedures become "normal."

## PROCEDURES FOR CASH RECEIPTS, SALES, ACCOUNTS RECEIVABLE

### Cash Receipts – Lapping

- Select a sample of deposit slips, and compare listed checks by payee to subsidiary accounts receivable postings (remittance list or other bookkeeping document) for correspondence of name, date, and amount.

Lapping occurs when cash from a customer is misappropriated by an employee in the cash custody-bookkeeping loop. At a later date, the employee credits cash received from another customer to the first customer’s account, and so on repeatedly. The audit procedure matches individual checks deposited by the client with the corresponding credits posted to customers’ accounts. For example, if the deposit slip shows a check received from Customer B for $30 on February 14, but the daily posting shows no credit to Customer B but instead a credit for $30 to Customer A (not listed on the bank deposit), lapping is probable.

- When detail comparison of deposits to bookkeeping documents indicate lapping, obtain the customer’s canceled check (or a front and back copy). Inspect the endorsement(s).

An employee engaged in lapping must convert the customers’ payments to his or her own use. The endorsement on the customers’ checks may lead to identification of the employee, the employee’s bank account, or an accomplice. Endorsements to a bank for purchase of cashiers’ checks and travelers’ checks has been used to convert funds. (The receiving client ordinarily will not endorse customer payments to buy cashiers’ checks or travelers’ checks.)

### Customer Existence

- Select a sample of customers, and verify their existence as bona fide businesses or persons, using (a) Better Business Bureau inquiry, (b) criss-cross and telephone directories, (c) Secretary of State incorporation records, (d) local partnership registration and assumed name records. Call the telephone number or visit the address. The sample should include customers with initials for company names and those with post office box addresses.

Fictitious sales may be charged to non-existent customers. An internal embezzlement can be perpetrated by selling to conspirators at discounted prices for a kickback.

Experience has shown instances of manipulators being unimaginative with names (using initials like “ABC Company”) and being unwilling to go to the trouble to establish a false address other than a post office box. Auditors must exercise considerable care to notice clever use of private post box services. Fraudsters have used a real company name (e.g., General Motors) and a private box service to intercept mail that appears to be addressed to a legitimate company. Such addresses usually contain a street address as well as a “box number.”