ABSTRACT

The reporting of the financial results of an organisation is the responsibility of the management of that organisation. However, value may be added to the financial statements by the auditing of such financial statements and by the opinion expressed by the external auditors. Furthermore, there is the expectation on the part of the users of the financial statements that the auditors are also responsible for detecting fraud and, more specifically, financial statement fraud. It was stated in the Association of Certified Fraud Examiners 2010 Report to the Nations that it is the high-level perpetrators who cause the greatest damage to their organisations. The costs arising from financial statement fraud were found to be more than three times higher than the costs arising from fraud committed by lower-level managers and nine times more than the costs involved in employee fraud.

The question, thus, arises as to why the auditors would not detect financial statement fraud timeously. The external audit profession has formulated a specific standard which addresses the responsibility of the external auditor as regards the detection of fraud during the audit of financial statements. The aim of this research was to determine the adequacy of the internal auditor standards as regards providing guidance to the internal auditors in terms of detecting financial statement fraud.

This research highlighted the lack of guidance in the internal audit standards regarding the responsibility of internal auditors relating to financial statement fraud. In the main, both the directives and the guidance refer to fraud in general but not specifically to financial statement fraud and, thus, the professional internal auditor is forced to seek guidance outside of the internal audit standards as regards the detection of financial statement fraud.
Key words:

Internal auditors
External auditors
Fraud
Financial statement fraud
Fraudulent financial reporting
Forensic accounting
Investigation
Financial controls
External audit standards
Internal audit standards
Fraud risk assessment methodologies
Analytical analysis
Brainstorming
Interviewing
Red flags
Fraud risk indicators
Fraud risk assessment
1.7.5. The responsibilities of internal auditors regarding financial statement fraud detection
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GLOSSARY OF TERMS

Accounts receivables
The income generated from the sale of goods and services and which is the result of a credit transaction and not a cash transaction results in a debt receivable at a later date. This debt is known as account receivables and is classified as a current asset in the financial statements (Myburgh, Fouchè & Cloete 2012: 300).

Analytical analysis
Analytical analysis is a methodology used to ascertain the reasonable and logical relationships between the numbers in the financial statements, which may then be corroborated with other information outside of the financial statements (Taylor 2011: 323). This concept was used interchangeably with financial analysis in this study.

Brainstorming
Brainstorming is an audit technique in terms of which all the audit team members, from the most senior to the most junior, get together in order to identify and debate the risk factors which would indicate that fraud has been both committed and hidden. In the case of financial statement fraud the focus of brainstorming would be on where and how material misstatements may be made and concealed by management (AICPA 2002: AU Section 316, par14).

Creative accounting
Creative accounting is the term used to describe the use of the flexibility within regulated accounting frameworks. It is a way in which to present accounts which will benefit the preparers and not the users of such accounts. However, it does not necessarily constitute fraud (Jones, 2011: 5).

Control
Control refers to those actions taken by management at all levels and which are designed to plan, organise and direct the performance of staff in order to be reasonably sure that the objectives and goals of the organisation will be realised.
Control increases the likelihood that goals and objectives will be achieved and that risks will be managed appropriately (The Institute of Internal Auditors, 2011: 25).

**External auditing (Financial auditing)**

External auditing may be described as the examination of financial statements and other information, with the objective of expressing an opinion, in terms of an applicable financial reporting framework and statutory requirements, of the fairness of such financial statements and information (Auditing Profession Act no. 26 of 2005 Ch 1, s 1).

Financial auditing refers to the evaluation of the financial statements in order to express, with reasonable assurance; an opinion on the fairness of the financial statements as well as the fact that there are no material misstatements (Rezaee & Riley 2010: 230).

For the purpose of this research the terms external auditing and financial auditing will be used interchangeably.

**External auditors**

External auditors are independent, third-party professionals who examine financial statements and other information in order to express an opinion on the fairness thereof (Auditing Profession Act no. 26 of 2005, Ch 1 s 1).

**External auditing standards**

The Handbook of International Standards on Auditing and Quality Control is issued annually by the International Auditing and Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC). The Independent Regulatory Board for Auditors (IRBA) prescribes this handbook on an annual basis for use by Registered Auditors in South Africa. The handbook is then issued as the SAICA handbook for a given year (SAICA handbook 2009: Comm-1). For the purposes of this research the Statement on Auditing Standards No. 99 (SAS 99) of the United States (AICPA, AU Section 316, 2002) will be considered equal and interchangeable with the International
Standards on Auditing No. 240 (SAICA 2009) which is applicable to South African Chartered Accountants.

**Internal auditing**

Internal auditing is an assurance or consulting activity which independently and objectively evaluates the effectiveness of the risk management, control and governance processes within an organisation. Internal auditing involves making use of a systematic and disciplined approach in order to add value and improvement to the operations of the organisation in question (The Institute of Internal Auditors, 2011: i).

**Internal auditors**

Internal auditors are those individuals who use their variety of skills, knowledge, expertise and educational backgrounds to assist both the management of an organisation to achieve the business objectives of the organisation as well as the governing bodies of the organisation in the execution of their oversight roles and responsibilities. As such, internal auditors provide assurance to the stakeholders regarding the governance, risk management and control processes in place within an organisation (IIARF Volume 1 2012: 11-12).

**Internal audit charter**

The internal audit charter is a formal document in which the purpose, authority and responsibility of the internal audit activity are defined. It establishes the position of the internal audit activity within the organisation and the reporting lines of the chief audit executive. Furthermore, it defines the scope of the internal audit activities and grant authority to access records, personnel and physical properties relevant to areas in which engagements will be performed. (IIA Standard 1000 2011)

**Internal auditing standards**

Internal audit standards are issued by the Institute of Internal Auditors under the title of *International Standards for the Professional Practice of Internal Auditing* (The Institute of Internal Auditors, 2011: 3).
**Interviews**

An interview is a tool used by fraud examiners, internal and external auditors and other interested parties, to facilitate dialogue with a knowledgeable person in specific area of interest (Manning 2011: 501). In this research it was used interchangeably with the concept of inquiries.

**Financial forensics**

Financial forensics refer to the integration of the application of financial principles and legal principles through the use of the technical skills of those individuals trained in these disciplines, combined with their investigative skills, critical thinking and ability to communicate the results of a forensic investigation (Kranacher, Riley & Wells 2011: 8)

**Forensic accounting**

Forensic accounting refers to the comprehensive, all-inclusive approach to fraud investigation and the identification of the fraud up to the pursuance of the criminal case in a court of law. It is, thus, the process of either proving or disproving a fraud and includes the audit of financial information and the interviewing process. In addition, it may serve as expert testimony in a court case (Singleton *et al.* 2006: 43).

In some instances, especially in chapter three, the term “fraud examiner” was used as a generic term to refer to all examiners/investigators of fraud, including forensic accountants, internal auditors as well as external auditors.

**Forensic accountant**

The forensic accountant is the person who reacts to complaints of criminal conduct, civil litigation and corporate investigations regarding the financial facts pertaining to legal problems related to fraud. The ACFE uses the term “fraud examiner” when referring to a forensic accountant (Singleton *et al.* 2006: 44).

Forensic accounting is the term used to describe the process of auditing which is conducted with the aim of detecting fraud (Manning 2011: 584).
The terms “forensic accountant” and “fraud examiner” was used interchangeably in this research.

**Fraud examiner**
A fraud examiner is a person who possesses various, specific skills and abilities. Such a person must be part lawyer, accountant, criminologist and investigator. The fraud examiner requires technical skills as well as the ability to be fair in an interview whilst obtaining the necessary information or confession. In addition, it is essential that the fraud examiner be able to report accurately and fairly based upon the facts of the situation (ACFE 2011: I-5).

The following definitions describe the concepts of both fraud and financial statement fraud. The terms “financial statement fraud”, “fraudulent financial reporting” and “management fraud” are all used interchangeably throughout this research.

**Fraud**
Fraud is an intentional act which is committed by management, employees, those charged with governance or third parties in order to mislead people and, thus, to obtain an unfair or illegal advantage (SAICA ISA 240, 2009: par 11).

**Financial statement fraud**
Financial statement fraud is committed if the financial condition of an enterprise is deliberately misrepresented with the objective of deceiving the users of such financial statements. Financial statement fraud may be accomplished through misstatements, omissions or incorrect disclosures (ACFE 2011: 1.303).

**Fraudulent financial reporting**
Financial reporting is regarded as fraudulent if there has been a misstatement of, or omission from, the financial statements with the intent to mislead or deceive the financial statement users (Nigrini 2011: 388).
Management fraud
Management fraud refers to the intentional misrepresentation of the results of the actions by employees in management roles in order to obtain benefits such as substantial bonuses, promotions and other economic or status incentives for themselves (Singleton et al. 2006: 2).

The terms “management fraud”, “financial statement fraud” and the “misstatement of financial statements” are used interchangeably because it is the responsibility of management to present fair and reliable financial statements (financial reporting) as well as to protect the integrity and quality of the financial reporting processes (Rezaee & Riley 2010: 6).

Misstatements of financial statements
Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying factor causing the misstatement is intentional or not. There are two types of financial misstatements, namely, fraudulent financial reporting or misstatement resulting from the misappropriation of assets. (SAICA ISA 240, 2009: par. A2).

Management override of controls
A control environment is established by management to ensure that the goals and objectives of the organisation will be achieved (Taylor 2011: 216). Management override of controls is the result of persons abusing their authority by not adhering to the control environment in order to benefit personally from the use of the organisational assets (Wells 2005: 147).

Occupational fraud
Occupational fraud arises when people use their occupations to enrich themselves by either misusing or misappropriating their employer’s assets (ACFE2011: 1.301).

Fraud risk
Fraud risk refers to the risk of fraud occurring in an organisation and also to the severity of the consequences of such fraud (ACFE 2011: 1.259).
Fraud risk factors
Fraud risk factors are those indicators that may be identified and that suggest that the possibility exists that there are incentives, pressures or opportunities present within the organisation which may result in fraudulent activities (ISA 240, 2009: par 11)

Generally Accepted Accounting Practice
In the context of this research, Generally Accepted Accounting Practice (GAAP) refers to the use of basic accounting principles while not focusing on the formal accounting standards implemented in various countries. For example, the accrual basis is used in the respect of revenue. The financial statements refer to the balance sheet (statement of financial position), income statement and statement of cash flows (Rezaee & Riley 2010: 38).

Inventory
Inventory may be defined as all assets held by a company for resale purposes. Thus, inventory includes goods bought for the purpose of reselling, goods arising from the production process with the objective of trading and raw material used in the production process (Myburgh et al. 2012: 311).

For the purposes of this research, inventory is regarded as the accounting balance of inventory in the financial statements and refers to goods intended for ordinary trade by the organisation. In addition, inventory is discussed as a result of a revenue financial fraud scheme and not as a financial fraud scheme in its own right.

Management
Management comprises the group of people who set the tone at the top. In addition, these individuals are responsible for designing, implementing and maintaining effective systems of internal control to ensure that the organisation will achieve its objectives (Spencer Pickett 2003: 16 & Hopwood, Leiner & Young 2008: 54).
For the purpose of this research, unless differently stated, management refers to the executive or senior managers who have the power to influence both the financial statements and the financial reporting process.

**Red flags**
Red flags are indicators with unique characteristics associated with specific fraud schemes and which indicate the possibility of fraud existing in the area being either audited or investigated (ACFE 2011: I–9).

**Revenue**
Revenue refers to the income generated from the sale of goods and services during the normal trading activities of the organisation (sales revenue) (Mulford & Comiskey 2002: 196).

**Revenue recognition**
Revenue recognition refers to the way in which revenue is recognised in the financial statements of an organisation. Revenue recognition happens in accordance with generally accepted accounting principles which use the accrual basis of accounting for the purposes of financial reporting. Accordingly, the period in which the revenue is earned is the period in which the revenue it is recognised and reported upon. The intentional changing of the period in which revenue is recognised is a potential fraud risk (Kranacher et.al. 2011: 412 & Wells 2005: 292).

**Risk management**
Risk management refers to the processes which are used for the identification, assessment, management and control of potential events or situations to reasonably ensure that the organisation will achieve its objectives (The Institute of Internal Auditors, 2011: 28).
**LIST OF ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ACFE</td>
<td>Association of Certified Fraud Examiners</td>
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<tr>
<td>CAE</td>
<td>Chief Audit Executive</td>
</tr>
<tr>
<td>CAQ</td>
<td>Centre for Audit Quality</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CFO</td>
<td>Chief Financial Officer</td>
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<tr>
<td>IAA</td>
<td>Internal Audit Activity</td>
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<tr>
<td>IAASB</td>
<td>International Auditing and Assurance Standards Board</td>
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<tr>
<td>IFAC</td>
<td>International Federation of Accountants</td>
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<tr>
<td>IIA</td>
<td>Institute of Internal Auditors</td>
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<tr>
<td>IRBA</td>
<td>South African Independent Regulatory Board of Auditors</td>
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<td>ISA</td>
<td>International Standards on Auditing</td>
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<td>GAAP</td>
<td>Generally Accepted Accounting Practice</td>
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<td>SAICA</td>
<td>The South African Institute of Chartered Accountants</td>
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<td>SOX</td>
<td>US Sarbanes-Oxley Act of 2002</td>
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1.1 BACKGROUND TO THIS RESEARCH

Accounting scandals are, by their nature, extreme cases and usually involve creative accounting and fraud. They are usually the result of the extreme abuse of financial reporting and are, therefore very interesting (Jones 2011: xxiii). The Association of Certified Fraud Examiners (ACFE) 2012 Report to the Nations on Occupational Fraud & Abuse concluded that, despite the fact that regional findings differ slightly from each other, occupational fraud remains a global problem (ACFE 2012: 5). Regardless of where the fraud occurs in the world, the characteristics of both the fraudster and the anti-fraud control measures are similar. The question often arises as to why the auditors did not detect the fraud? This question was asked after Enron, WorldCom and other large corporations were declared bankrupt as a result of the misrepresentation of financial information to their users (Moeller 2004: 10). An expectation gap, that is, what the public in general expects from an auditor and what an auditor must do according to the Professional Standards guiding the conduct of auditors, exists. According to the public, in view of their education and training, auditors are responsible for detecting financial statement fraud (Singleton et al. 2006: 78).

Wells (2011: 201) edited a case study into Yellowstar Industries, a public company which adopted an aggressive expansion plan to ensure rapid growth and increased earnings for its shareholders. The chief financial officer (CFO) was regarded as a ruthless person who demanded absolute loyalty from his subordinates and nobody dared to contradict either his instructions or his opinions. The CFO reported to a chief executive officer (CEO) who did not care how success and growth were achieved, as long as they were achieved. This ambition resulted in hostile takeovers by Yellowstar Industries. The staff of the acquired companies was expected to follow
the instructions of the CFO to the letter, even if they were convinced that the instructions were contrary to generally accepted accounting practice (GAAP) and that they did not make good business sense. This strategy continued for more than five years until whistleblowers emerged, alleging that the government was being overbilled and the firm was following improper accounting practices. An investigation was launched into the practices at Yellowstar Industries, focusing specifically on improper accounting practices regarding acquisitions and inflated stock prices. At the end of the investigation and the law suits that followed it was concluded that both the internal and the external auditors had actually benefited from the fraud (Wells 2011: 120).

As gatekeepers the internal auditors as well as the external auditors had failed in their duties because they had been given incentives not to detect the fraud. For the internal auditors, the incentive was large stock option awards. Thus, the internal auditors wanted the stock prices to increase as much as the CEO and the CFO did because they would benefit from an increase in Yellowstar’s stock price. As regards the external auditors, they did not identify any red flags because the acquisitions had created more work for the external audit firm (Wells 2011: 120).

According to the standards applicable to both the internal and the external auditors, the prevention and detection of fraud is primarily the responsibility of management and those who govern an organisation. In the Practice Guide, Internal Auditing and Fraud (IIA 2009: 10), it is stated that the board of directors and the management of an entity are ultimately responsible for fraud deterrence. However, it is part of the responsibility of internal auditors to assist management in assessing the adequacy of the internal controls and the control environment of the entity (IIA Standard 2030 2011). In addition, the International Standards on Auditing (ISA) states that the prevention and detection of fraud is primarily the responsibility of management and the people responsible for the governance of the entity (SAICA ISA 240 2009: par 4).

In a study conducted by The Institute of Internal Auditors (2008: 1) it was reported that the internal audit participants had accepted moderate levels of responsibility regarding fraud detection. A higher level of responsibility was accepted for detecting
fraud regarding the misappropriation of assets than in the case studies on fraudulent
financial reporting or corruption. In the evaluation of the factors underlying the
acceptance of responsibility to detect fraud it was concluded that these factors
include a sense of professional obligation. Although the International Standards for
the Professional Practice of Internal Auditing (IIA Standards) does not distinguish
between the various types of fraud, there was a different level of responsibility
accepted by the internal audit participants regarding the detection of different types
of fraud, such as the misappropriation of assets, fraudulent financial reporting and
corruption.

This, in turn, raises the question as to why there is a perception that auditors, both
internal and external, do not detect fraud to the extent to which it is expected. The
external audit standard, ISA 240 (SAICA 2009: par 4), advises that it is the
responsibility of an auditor to obtain reasonable assurance that there is no material
misstatement, caused by either fraud or error, in the financial statements. The most
specific IIA Standard, Standard 1210.A2 (IIA Standards 2011) makes it clear that,
although it is not expected of the internal auditors to possess the same degree of
expertise as a specialist in respect of fraud detection and investigation, internal
auditors must, at least, be able to evaluate the risk of fraud and the way it is
managed by the organisation in question. How do the internal audit standards
compare to the external audit standards and how are they implemented in practice?
What does the literature have to say on the responsibility of external auditors and
internal auditors regarding the detection of financial statement fraud?

This research found answers to the questions as to how the two sets of standards
compare and what the responsibilities of internal auditors are regarding the detection
of financial statement fraud. However, the study did not attempt to answer questions
regarding the governance structure of internal auditors, training of internal auditors or
the certification of internal auditors. Instead the study focused on understanding the
standards relating to fraud detection and which are applicable to both internal and
external auditors and identifying gaps between the standards applicable to the two
professions. The internal audit standards were read in conjunction with the practice
advisories and applicable guidance documents and the interpretations thereof.
1.2. FINANCIAL STATEMENT FRAUD SCHEMES

1.2.1 Introduction

In order to understand the concept of financial statement fraud it is necessary to be aware of what is regarded as fraud and where financial statement fraud fits into the definition of fraud. There is no single definition of financial statement fraud and even the professional bodies such as The South African Institute of Chartered Accountants (SAICA), the IIA and the ACFE all have their own definitions. However, both the various professional bodies and writers on the topic make it clear that, in terms of financial statement fraud, management is involved, the fraud is intentional and it causes damage to stakeholders. In addition, the result of financial statement fraud is the undermining of the entire financial reporting process – the quality, the reliability and also the integrity of the process (Rezaee & Riley 2010: 4).

The Institute of Internal Auditors regards fraud as a concealed, unlawful act which is intended to deceive. The aim of the fraudulent act is to obtain money or property or to avoid payment, thus enabling the person or organisation concerned to secure an unfair personal or business advantage (IIA 2009: 4). The external auditor profession regards fraud as an intentional act to deceive in order to obtain an unjust or illegal advantage (SAICA ISA 240 2009: par 11). Financial statement fraud is regarded as a specific type of fraud and the deceit occurs through the misrepresentation of financial information to purposely misstate the financial statements in order to mislead the financial statement users (ACFE 2011: 1.303). Kranacher et al. (2011: 419) describe financial statement fraud as an act which is directed mainly at investors and creditors and which involves deliberately misstating the financial statements in order to deceive the users.

According to Rezaee & Riley (2010: 6), management is responsible for producing the financial statements as well as overseeing the process in order to ensure the quality and integrity of the financial statements and, therefore, financial statement fraud is not possible without their consent and/or knowledge. Financial statement fraud and management fraud may be considered as the same offence and the terms may be
used interchangeably. On the other hand, Jones (2011: 6) refers to creative accounting and describes management’s use of the flexibility in accounting frameworks in order to benefit those preparing the financial statements and not the users of such statements. This flexibility may be seen as the underlying basis for the various financial statement fraud schemes which are used to misrepresent financial statements.

Financial statement fraud may be committed by management in either the overstatement of assets and income or the understatement of liabilities and expenses (Wells 2005: 324). According to ISA 240 (SAICA 2009: par 31), management is in a position to perpetrate fraud by the manipulation of the accounting records and financial statements because management has the power to override controls which appear to be operating effectively.

### 1.2.2 Occurrence of financial statement fraud

To justify this research it is important to realise the current extent of financial statement fraud in South Africa as well as globally. Jones (2011: 7) investigated accounting scandals in 12 countries from Europe, Asia, Australasia and North America. This is an indication that accounting scandals and the use of creative accounting to present financial statements in a more positive light than is actually the case is a global problem. Jones’s study illustrated the fine line between presenting financial statements fairly or in a creative way within the regulatory frameworks of the various countries or fraudulently and outside of the regulatory frameworks of the countries.

In South Africa the occurrence of accounting scandals related to fraud in companies such as Macmed, Leisurenet and Regal Bank may be regarded as examples of the use of creative accounting in order to present financial statements (Rabin 2005: 68). An indication that financial statement fraud is not only a global problem but also a local problem as well is evident in the South African edition of the 2011 PWC Global Economic Crime Survey (2011: 2) in which 32% of the 123 respondents cited incidents of financial statement fraud. According to this same study the global
statistic for financial statement fraud is 24%. It is also interesting to note that the PWC survey (2011: 2) indicated a shift in the perpetrator profile towards that of senior management. In paragraph 1.2.1 of this chapter it was pointed out that some writers regard financial statement fraud and management fraud as synonymous (Rezaee & Riley 2010: 6). According to the ACFE’s Report to the Nations (2012: 4), it is the high-level (senior) perpetrators who cause the greatest damage to their organisations. The costs involved in fraud committed by owners/executives were more than three times the costs involved in fraud committed by lower level managers. In addition, the costs involved in fraud committed by owners/executives were also nine times more than the costs involved in employee fraud, that is, fraud committed by employees not at a management level. It is also more difficult and it takes considerably longer to detect fraud at executive level than to detect fraud committed at other levels within an organisation (ACFE 2010: 4).

1.2.3 Fraud risk assessment methodologies

The detection of financial statement fraud schemes may be more difficult than is generally assumed by the users of financial statements and, thus, such schemes are often not detected in the course of financial statement audits (Singleton et al. 2006: 33). A material misstatement in the financial statements may be the consequence of either an error or fraud. Awareness of the existence of fraud is usually the result of a tip-off; intuition or suspicion on the part of the investigator or auditor, the realisation of an unexplained exception from the norm such as higher profits; more sales or lower liabilities; or the discovery that something is missing, for example, cash or assets (Singleton et al. 2006: 33).

The external audit standards (SAICA ISA 240 2009: par 16; ISA 315 2009: par 5-10) identify the following main fraud risk assessment methodologies, namely, the performance of analytical reviews and the analysis of ratios, enquiring from management about the management of the risk of material misstatement of the financial statements; and holding discussion sessions with the audit teams regarding the possibility of financial statement fraud and where it may occur. The Statement on Auditing Standards No 99 (AICPA 2002: AU 316 par 14), applicable in the USA,
requires auditors to hold brainstorming sessions with their audit teams and to interview senior management and other senior officials, such as audit committee members and internal auditors. Furthermore it expects auditors to focus on revenue, inventory and accounting balances and to assume that there is a risk of material misstatement regarding revenue recognition. According to Clickeman (2009: 278), half of all the known frauds involve revenue and the way in which it is recognised.

Analytical reviews and the analysis of ratios are audit tools that may be used to support the fraud risk assessment or identify suspected fraud in the financial statements. The results may be corroborated by non-financial evidence obtained during the interviewing phase of the fraud risk assessment or else used to follow-up on previously identified red flags. The analytical procedures are used to conduct comparisons of the results with either existing data or expected results (Hopwood et al. 2008: 227).

According to the PWC Global Economic Crime Survey (2011: 13), there are three main groups of detection methods used to investigate economic crime. Firstly, there are corporate controls; including routine internal audit engagements, fraud risk management procedures, the reporting of suspicious transactions, corporate security (both IT and physical) as well as the rotation of personnel, and, secondly, there is the aspect of corporate culture which, in turn, includes tip-offs (both external and internal) and whistle-blowing procedures. It is significant that management has control over these first two groups of detection methods. The third group, however, is beyond the control of management and refers to accidental detection and law enforcement activities. The role of external auditors in the detection of fraud is not mentioned specifically in the PWC Global Economic Crime Survey (2011: 13) although it emerged that the internal auditors contributed 11% to the detection of fraud in South Africa and 14% globally. In addition, the survey noted corporate controls include internal audit and fraud risk management while the corporate culture includes whistle blowing systems.

The Centre for Audit Quality (AICPA 2010: vi) adopted a similar kind of approach to the detection of financial statement fraud. Three themes have been identified,
namely, a strong corporate culture which includes a strong fraud risk management programme, a questioning mindset (scepticism) on the part of all the participants as regards the detection of financial statement fraud and also effective communication between all the participants.

In a study conducted by Intal & and Thuy (2002: 48), the following reasons were identified as to why auditors fail to detect financial statement fraud. These reasons included acceptance of the analytical procedures as sufficient audit evidence; weaknesses in the internal controls in respect of the assessment of risk in the audit risk model and the audit failure in related-party transactions as well as revenue recognition. However, the problem with these findings is the degree to which the failure to detect financial statement fraud may be regarded as the responsibility of the internal auditors and/or the external auditors. It is, thus, necessary to compare the standards of both these professional groups in order to determine if there are any gaps in the IIA Standards as compared to those of the external auditors.

One of the problems regarding financial statement fraud and that was mentioned earlier is the fact that that management (Rezaee & Riley 2010: 6) is often involved in the process of committing the fraud and, therefore, it may happen that both the internal auditors and the external auditors are limited in the scope of their audit engagements or that information is deliberately hidden to escape detection. Such actions of management may have an impact on the ability of, in particular, the internal auditors, who either report to management or are colleagues of management, to exercise their responsibilities regarding the detection of financial statement fraud (Rezaee & Riley 2010: 6).

1.3. EXTERNAL AUDIT AND FINANCIAL STATEMENT FRAUD SCHEMES

The external audit profession in South Africa is subject to the Auditing Profession Act, no 26 of 2005. In this act an “audit” (external audit) is referred to as an examination which is carried out in accordance with prescribed auditing standards. The examination will usually be conducted on the financial statements and on financial and other information with the specific objective of expressing an opinion on
the fairness thereof and compliance with statutory requirements and prescribed financial reporting frameworks (Auditing Profession Act, 2005: Ch 1, s 1). Both the audit report and the audit opinion are tabled at the annual general meeting and reported upon to the shareholders who would have appointed the external auditors (Auditing Profession Act, 2005: Ch1, s 1).

For the purposes of this research the Statement on Auditing Standards No. 99 (SAS 99) of the United States (AICPA 2002: AU 316) will be considered equal and interchangeable with International Standards on Auditing No. 240 (SAICA 2009) and which is applicable to South African Chartered Accountants. SAS 99 is titled “Consideration of Fraud in a Financial Statement Audit” while ISA 240 is titled “The Auditor’s Responsibilities relating to Fraud in an Audit of Financial Statements.” SAS 99 is the United States version detailing the responsibilities of external auditors in financial statement audits. These standards are similar in the requirements in respect of external auditors regarding financial statement fraud and were, therefore, both used in this research. These standards raise the expectations of the public that auditors should detect financial statement fraud while also increasing the liability of auditors in the detection of financial statement fraud (Singleton et al. 2006: 78).

ISA 240 prescribes the actions which the external auditor must take in respect of fraud in the financial statements. This standard prescribes that the external auditor must obtain reasonable assurance that there is no material misstatement present in the financial statements (SAICA ISA 240 2009: par 5). This, in turn, places the obligation on the auditor whilst planning the audit to ensure that a proper risk assessment regarding material misstatement as a result of fraud or error is carried out. This aspect is also emphasised by McConnell Banks (2003: 28) when they state that it is essential that auditors acquire in-depth information regarding the entity to enable them to conduct a proper risk assessment of fraud and possible misstatement of the financial statements.

ISA 240 (SAICA 2009: par 1) refers to ISA 315 (SAICA 2009) and ISA 330 (SAICA 2009) which address the identification and assessment of the risk of material misstatement and the responses of the auditor. Where it is deemed necessary in this
research to apply the principles of risk identification and the response of the auditor thereto, reference will be made to ISA 315 and ISA 330.

1.4. INTERNAL AUDIT AND FINANCIAL STATEMENT FRAUD SCHEMES

The profession of internal auditing has developed to the point that it has now been recognised as a professional, value adding component of good corporate governance for a period of more than 50 years (IIARF Volume 1 2012: 9). Internal auditors are traditionally perceived as compliance auditors whose responsibility it is to ensure the organisation adhere to both its policies and procedures (Manning 2011: 584). However, this role has developed over the years and, currently, as stated above, the internal auditors is regarded as an integral part of good corporate governance. The IIA describes the Certified Internal Auditor (CIA) as the only globally accepted certification which demonstrates the individual’s competency and professionalism in the internal auditing field (IIARF Vol. 1 2012: 13).

Internal audit is defined by the IIA as both an assurance and a consulting activity, which is independent of and objective towards the organisation in question and with the main focus on adding value to and improving the operations of the organisation. This, in turn, is accomplished by evaluating and improving the processes of governance, risk management and controls in a systematic and disciplined manner while reporting is to both senior management and the board of directors (IIA Standard 1000, 2011: i).

It is incumbent on internal auditors to assist management in the prevention and detection of fraud (IIA 2009: 2). According to Martin & Sanders (2009: 1), internal auditors have always had a fundamental role to play in the deterrence of fraud. They are in a position in companies to be able to detect both financial statement fraud and other fraud. There are various Internal Audit Standards that refer to fraud and the internal auditor’s role and responsibility regarding the detection and prevention of fraud, as well as the monitoring of fraud risk. For example, there is Standard 1200, "Proficiency and Due Professional Care" (IIA Standards 2011), which prescribes that
internal auditors must perform engagements with proficiency (knowledge and skills) and due professional care (apply the skill and care prudent to an competent internal auditor), Standard 1210.A2 which refers to the evaluation of the risk of fraud and how it is managed by the organisation (IIA Standards 2011), Standard 2060, “Reporting to Senior Management and the Board” (IIA Standards 2011) which states that reporting must include significant risk exposures and control issues and Standard 2210, “Engagement Objectives” (IIA Standards 2011) which stipulates that the probability of fraud must be considered. All of these standards refer to the way in which the internal auditor should take fraud risk, the probability of fraud and the reporting thereof into account when planning and executing an internal audit assignment.

As part of their day-to-day tasks internal auditors should pursue the perpetrators of fraud (Church, McMillan & Schneider 2001: 99), while Shim (2011: 25) regards the assurance on the fairness of the financial statements as an important function of the internal auditors. The introduction to the Deloitte Internal Audit Fraud Survey (2010: 1) states that the evolution of the mandate of the internal audit has meant an increased dependence on the monitoring, detection and investigation abilities of internal audit regarding fraud. It is also clear that the Practice Guide (IIA 2009: 2) recognises that the internal audit activity has a responsibility as regards the detection of fraud in general.

1.5. PROBLEM STATEMENT AND RESEARCH METHODOLOGY

1.5.1 The research problem

Auditors do not detect occupational frauds sufficiently (ACFE 2010: 16). The ACFE Reports to the Nations, 2008, 2010 and 2012 mention that there has been a decline in the number of frauds detected by both internal and external auditors with the detection of occupational fraud by internal auditors declining from 20.2% in 2006 to 14.4% in 2012 and detection by external auditors from 12.0% to 3.3%.
This research focuses specifically on the responsibilities of internal auditors regarding the detection of financial statement fraud according to the IIA Standards. According to the research problem, regarding the detection of financial statement fraud, the IIA Standards are inadequate in relation to the standards which are applicable to external auditors. The IIA Standards will be read in conjunction with the Practice Advisories as well as other guidance which is issued by the IIA to enhance the Standards with best practices.

As stated by the ACFE, in the main, financial statement fraud is the most expensive of all types of fraud committed (ACFE 2012: 4) and, generally, it involves management participation in the fraud. This research investigates the standards and the application thereof to establish the responsibilities of internal auditors as regards the detection of financial statement fraud. The study compares the IIA Standards with the standards applicable to external auditors, specifically ISA 240, to establish whether the IIA Standards are sufficient to guide internal auditors in the detection of financial statement fraud and whether there are any gaps between the two sets of standards that should be addressed in order to enhance the ability of the internal auditors to detect financial statement fraud. However, the study will not make any comparisons regarding the roles and responsibilities of external and internal auditors.

There may be a view that the standards of the external auditors should be more onerous than the standards of the internal auditors because of the reporting structure of the external auditors. However, based on relevant literature and the increasing expectations of internal auditors regarding financial statement fraud, this research is premised on the assumption that the standards of external auditors and internal auditors regarding the detection of financial statement fraud should be comparable, irrespective of their respective reporting structures. Accordingly, the research will not focus on any of the legal responsibilities of either the external or internal auditors.
1.5.2 The research objectives

1.5.2.1 Primary objective
The primary objective of this research is to determine the adequacy or not of the IIA Standards as regards guiding the internal auditors in the detection of financial statement fraud. Accordingly, the IIA Standards are compared with the International Standards for Audit applicable to external auditors to determine whether the IIA Standards are, indeed, sufficient on this matter or not. The focus of the research is on the overstatement of revenue and related assets because, according to literature, half of all known frauds are related to the misstatement of revenue (Clickeman, 2009: 277). This has been confirmed by Nigrini (2011: 389) and Hopwood, et.al. (2008: 266). Thus, this research focuses on fraudulent financial reporting (financial statement fraud) as it relates to falsified revenue recognition and related assets.

1.5.2.2 Secondary objectives
In order to support the primary research objective the following research questions will be answered:

- What is financial statement fraud and what are the various fraud schemes related to revenue recognition and related assets and which are used to commit financial statement fraud?
- What methodologies can be used to identify revenue recognition financial statement fraud schemes?
- What are the responsibilities of the external auditors, according to their Standards and applicable guidance, regarding the detection of revenue recognition financial statement fraud schemes?
- What are the responsibilities of the internal auditors, according to their Standards and applicable guidance, regarding the detection of revenue recognition financial statement fraud schemes?
- What are the potential shortcomings of the IIA Standards and applicable guidance, as compared to the external auditing standards and applicable guidance, regarding the detection of revenue recognition financial statement fraud schemes?
1.5.3 Research methodology

The research methodology used in this research includes an extended literature review, which forms a study on its own and not merely the first phase of an empirical study (Mouton 2005: 86).

Mouton (2005: 179) describes a literature review as an analysis of trends and debates within a specific discipline in order to provide an overview of previous research conducted in the specific discipline. According to Hofstee (2006: 121), extended literature reviews comprise an overview of the research conducted in a specific field. De Vos et al. (2011: 134) express the opinion that a literature review should aim at providing an in-depth understanding of the problem identified. In terms of the literature review it is necessary to identify which literature is relevant to the research, the way in which the research relates to the relevant literature and the researcher’s understanding of the main debates in the literature (De Vos et al. 2011: 109). According to Saunders, Lewis & Thornhill (2009: 60), the significance of a researcher’s work will be judged in relation to the research conducted by other researchers.

It is essential that an extended literature review be conducted critically in order to be able to contribute to a clearer understanding of the research problem. Saunders et al. describe the process of the critical review with the researcher combining the academic theories and ideas in the research project and demonstrating an understanding of the existing research by explaining the relationships between the various research findings as well as referring to the literature in which these research findings were originally reported (Saunders et al. 2009: 63).

1.5.4 Advantages and disadvantages of a literature review

One disadvantage of a literature review is that it will not produce any new knowledge although it evaluates and analyses related literature which has been produced by other scholars. However, no new insights will emerge nor will existing insights be
validated, as this is possible only by undertaking an empirical study. In order to test the theoretical insights it is necessary to undertake an empirical study (Mouton 2005: 180). Hofstee (2006: 121) confirms that nothing substantially new is ever produced by an extended literature review. On the other hand, the advantage of a literature review is that, in a good literature review, the most important ideas on an issue will be addressed and these will link in a logical way to various findings and statements. In addition, any discrepancies and weaknesses will be noted as such (De Vos et al. 2011: 141).

A further disadvantage of a literature review is that the way in which a researcher think about a specific topic may overrule the research of other scholars and therefore, the thinking of the researcher will not be influenced by the literature review in any way (De Vos et al. 2011: 141). Nevertheless, the opposite may also be a disadvantage where the review appears to be no more than a list of quotations of the work carried out by other researchers and there is no evidence of the thoughts of the researcher in the study. Thus, it will appear that the researcher has not integrated the knowledge acquired with existing knowledge at all (De Vos et al. 2011: 141).

1.5.5 Limitations of this research

There are limited South African articles and previous research on revenue recognition and financial statement fraud schemes. For the purpose of this research ISA 240 and the United States of America’s SAS 99 will be regarded as similar. This research focuses on the private sector because revenue recognition and related assets are more familiar concepts in private sector companies than in the public sector. This research does not include other aspects such as certification, training, education, the reporting structure or the capacity of internal audit activities regarding the detection of financial statement fraud within entities but, rather, it focuses only on the responsibilities of internal and external auditors according to the professional standards and guidance applicable to both professions. In addition, it focuses on financial statement fraud only and not on general occupational fraud, such as employee fraud or the misappropriation of assets or investor fraud such as Ponzi schemes.
Financial statement fraud may involve the overstatement of assets and income or the understatement of liabilities and expenses. The focus of this research is the overstatement in the financial statements and the fraud schemes related to the overstatement of revenue and related assets, such as account receivables and inventory. The valuation of inventory and accounts receivable will be relevant only if it is a result of a revenue fraud scheme that has an impact on the balances of the two accounts mentioned. However, fraud schemes related to inventory fraud or accounts receivable fraud are not part of this research. Furthermore this research does not address the converse, namely, the understatement of revenue which will be underlying to both tax fraud and divorce fraud.

In addition, this research focuses on those employees on a management level who have the power to manipulate the disclosures made in the financial statements. The reason for this limitation is that these are the people who present the financial statements to the auditors and other stakeholders and, therefore in the determining of the role and responsibilities of internal and external auditors regarding the detection of financial statement fraud, managers will be the first line of defence. In terms of financial statement fraud, management will either be involved or have control over the people involved in the fraud (Wells 2005: 294).

Bearing these limitations in mind, there are, nevertheless, substantial studies and publications on financial statement fraud available and which may be utilised to support the research conducted in this study.

1.5.6 Resources used for this research

Using the websites of the University of Pretoria and the University of South Africa, a search was conducted of academic articles and databases related to literature containing the words auditors and fraud, internal auditing and fraud detection, corporate governance and fraud detection, financial statement fraud, fraud risk management, fraud deterrence, misstatement of financial statements, detection of financial statement fraud, fraud risk factors, fraudulent financial reporting,
management fraud, forensic accounting and investigation, financial controls, financial systems and financial reporting, brainstorming, interviewing for fraud risk management and fraud detection as well as analytical reviews. The websites of the IIA, ACFE and SAICA were also searched for information and the latest developments regarding the responsibilities of auditors in general and internal auditors specifically in the detection of financial statement fraud.

This research is based on the professional standards and applicable guidance in both the internal and the external auditing professions and aimed to identify the role of internal auditors regarding the detection of financial statement fraud. Subsequent to the internet search academic books related to this field of research were sourced from the libraries of the University of Pretoria and the University of South Africa. A large number of books were identified, covering both case studies and research conducted globally in all the main regions such as Asia, Australasia, Europe and North America. Where a South African publication on the research topic was available it was consulted in order to bring a South African perspective to the research problem. A similar approach was followed in searching for journal articles on the research topic.

1.5.7 Exclusions and inclusions in respect of the resources used

As far as possible the literature review was limited to resources which had been published during the last 10 years unless a specific concept was discussed in an earlier resource. Only published articles in recognised academic and professional journals were included as well as academic textbooks. All books and articles written in a fictional style and which had not been subjected to a strict academic review process were excluded. Articles and books related to South Africa as well as the global auditing population were included because financial statement fraud is a global phenomenon.

Surveys and reports conducted by the ACFE, PriceWaterhouseCoopers, Deloitte LLP and KPMG were used to determine the occurrence of fraud locally as well as globally. In addition, the websites of recognised professional bodies such as the
ACFE, IIA and SAICA were also used in order to source recent developments and information regarding financial statement fraud.

1.6. BENEFITS OF THE PROPOSED RESEARCH

Globally, as well as in South Africa, economic crime, including financial statement fraud, continues to be an issue of major concern and a challenge to corporate business leaders (PWC 2011: 3). In some countries, this had led to legislation in reaction to the fraud committed to protect investors from losing money and employees from losing jobs and benefits such as pension funds (Rezaee 2005: 296). This research focuses on the responsibilities of one roleplayer, globally as well as in South Africa, namely, the internal auditors, in the detection of financial statement fraud. The IIA Standards read in conjunction with applicable guidance will be compared to the external auditing standards and applicable guidance in order to identify possible shortcomings in the IIA Standards.

The research findings of this study will inform boards of directors and audit committees about what they may expect from their internal auditors and also how it should be described in the internal audit charter according to the Standards so as to ensure that internal auditors fulfil their role in good corporate governance within an organisation. Furthermore, it will inform the Internal Audit Standard setting body regarding changes to be made.

1.7. CHAPTER OUTLINE

The chapters of this research are briefly summarised below:

1.7.1 Introduction

Chapter 1 contains the background to the study and the research methodology followed. It was expanded as the research progressed in order to reflect additional information, the actual contents of the chapters and any structural changes that needed to be made to ensure that the study is at an acceptable level of excellence.
1.7.2 Financial statement fraud schemes

*Chapter 2* consists of a general overview of financial statement fraud with the focus on revenue recognition and related assets. The fraud schemes used to commit the financial statement fraud and the role of management in such fraud are discussed.

1.7.3 Financial statement fraud risk assessment methodologies

*Chapter 3* analyses the various methodologies which may be used in the fraud risk assessment relating to financial statement fraud, including interviews, brainstorming and analytical reviews (SAICA ISA 240: 2009). The chapter also discusses red flags (Taylor, 2011: 131) and forensic analytics (Nigrini, 2011: 1). In addition, the chapter investigates the ways in which auditors and investigators are currently using the various methodologies and auditing techniques in order to assess the risk relating to financial statement fraud in the course of fulfilling their mandate from the board of directors and management.

1.7.4 The responsibilities of external auditors regarding financial statement fraud detection

*Chapter 4* consists of an analysis of the responsibilities of external auditors regarding financial statement fraud according to their professional standards and applicable guidance.

1.7.5. The responsibilities of internal auditors regarding financial statement fraud detection

*Chapter 5* aims to analyse and present the responsibilities of internal auditors in terms of the IIA Standards and applicable guidance regarding the detection of financial statement fraud. The analyses are based on a study of the relevant literature which is available both globally and in South Africa.
1.7.6 A comparison of the responsibilities of internal auditors and external auditors regarding the detection of financial statement fraud

*Chapter 6* consists of a comparison of the two sets of Standards read in conjunction with applicable guidance in order to determine the adequacy of the IIA Standards regarding the detection of financial statement fraud and to identify any gaps between the two sets of Standards which may contribute to the perception that auditors are not meeting the expectations of stakeholders sufficiently regarding the detection of financial statement fraud.

1.7.7 Conclusion and recommendations

*Chapter 7* concludes the research on the responsibilities of internal auditors regarding the detection of financial statement fraud. The chapter also offers recommendations based on the study regarding the way in which internal auditors should be empowered to fulfil their responsibilities. In addition, the chapter also reflects upon the limitations of the study and suggest possible areas of future research which may be conducted.
CHAPTER 2: FINANCIAL STATEMENT FRAUD SCHEMES

2.1 INTRODUCTION

Financial statement fraud refers to the intentional misstatement of financial statements so that the financial results of operations, the cash flow as a result of the operations and the financial position of the entity are not accurately reflected in the financial statements (Hopwood, et al. 2008: 225). Kranacher et al. (2011, 12) are of the opinion that, by their nature, fraudsters are people who violate the trust that is placed in them. Financial statement fraud is usually an extremely complex type of fraud involving senior managers and executives who are deliberately colluding in order to commit the fraud (Kranacher et al. 2011, 89). This type of fraud may be hidden by different interpretations of accounting standards and also the way in which the financial statements are prepared by management (Hopwood et al. 2008: 226). The interpretations of accounting standards may be inconsistent or they may differ from the next person’s interpretation of the same standard. Financial statement fraud and management fraud is the same (Rezaee & Riley 2010: 6). The PWC survey (2011: 2) found that, according to the respondents in the survey, there has been a shift towards more senior managers being the perpetrators of financial statement fraud. The ACFE’s report to the Nations (2012: 4) further states that, the greatest damage to organisations, usually arises from senior management committing financial statement fraud.

ISA 240 defines two major types of financial statement fraud, namely, fraudulent financial reporting or the misstatement of financial statements as a result of the misappropriation of assets (SAICA, ISA 240, 2009: par 3). The Institute of Internal Auditors (IIA 2009: 4) does not specifically define financial statement fraud although it defines fraud in general as an act outside of the legal framework with the purpose of being deceptive, concealing wrongdoing and violating trust.

Wells (2005: 324) describes financial statement fraud as a deliberate act designed to misstate or omit amounts from the financial statements in order to deceive the financial statement users. This may include the deliberate, incorrect disclosures of
balances and other financial information in the financial statements. On the other hand, financial statement fraud may also be regarded as creative accounting (Jones, 2011: 6) in which case it is defined as the way in which management uses the flexibility within the regulatory frameworks to support the measuring and presentation of accounts so as to meet the needs of the preparers of the financial statements rather than the needs of the users of the financial statements. The flexibility of accounting systems may be both the most significant advantage as well as the most significant weakness of these systems. Flexibility may result in the abuse of the accounting systems by management to further their own ambitions (Sherman, Young & Collingwood 2003: 29). Rezaee & Riley (2010: 7) describe financial statement fraud as a deliberate attempt to mislead investors and creditors, in particular, by materially misstating the financial information contained in the published financial statements. It may be done by a clever team of knowledgeable perpetrators such as top executives, including chief executive officers (CEOs) and chief financial officers (CFOs) and who make use specific fraud schemes in order to mislead the users of the financial statements (Rezaee & Riley 2010: 16).

This chapter provides some background information regarding the involvement of management in financial statement fraud and the reasons why management commits financial statement fraud. In addition, the various types of fraud scheme that may be used to commit financial statement fraud by the overstatement of revenue will be discussed.

### 2.2 INVolVEMENT OF MANAGEMENT

Over the years a hypothesis has developed on the reason why fraud is committed. This hypothesis is now known as the fraud triangle (Kranacher et al. 2011: 12). The three legs of the fraud triangle are the incentive or perceived pressure an individual or group may experience in order to obtain better results or appear more successful, the perceived opportunity to commit the fraud (this may be the result of a lack of internal controls or the belief that the fraud will not be discovered) and, lastly, the rationalisation which fraudsters use to justify the crime of fraud (Du Toit 2008: 4–5). All financial crimes have one common denominator, namely, greed (Manning 2011: 22).
15). Manning goes on to say that, before committing a financial crime, the perpetrator must regard something important enough to be manipulated, assume that the crime will not be detected and exhibit a certain willingness to commit the crime (Manning 2011: 15). Management may feel pressured to commit fraud in order to achieve better results and to meet targets which have been set in order to meet performance measures or market expectations. This, in turn, may be linked to performance bonuses or other reward schemes or may be used to settle the shortfall in sales because of the loss of a major client (Taylor 2011: 333).

Jones (2011: 21) is of the opinion that it is not possible for creative accounting and fraud to take place in a vacuum. Both the corporate environment and corporate governance practices will create a culture and climate that may either be conducive to fraud or serve as a deterrent to fraud. Fraud is most likely to happen should an organisation be experiencing financial difficulties. In addition, fraud is more likely to take place where there is a downward trend in earnings while, in the majority of cases, both the CEO and CFO are involved (Hopwood et al. 2008: 268). Du Toit (2008: 1) states that, despite the fact that management is primarily responsible for the prevention and detection of fraud, they are usually the main perpetrators. According to Wells (2005: 288), there are mainly three groups involved in committing financial statement fraud, namely, senior management, middle and lower level employees and organised criminals. Although organised criminals have no direct influence on the presentation of financial statements they may, nevertheless, commit financial statement fraud, for example, by obtaining fraudulent loans from financial institutions (Wells 2005: 288).

It may be very difficult for an outsider to detect financial statement fraud because managers may argue that they have different views of both the future and of ways in which to rely on estimates and the assumptions being made (Jones 2011: 23). Furthermore, managers may override internal controls and collude with colleagues to commit financial statement fraud (Silver, Fleming & Riley 2008: 48). Such behaviour may easily be underestimated by investigators and, therefore, not be detected sufficiently early (Taylor 2011: 333). Managers are supposed to manage companies on behalf of the shareholders but they may also have a specific interest in
committing fraud (Jones 2011: 22). This may be related to the way in which their remuneration packages are structured because these packages may be based on the positive earnings and growth of the organisation. Several companies link executive pay with the operational results of the company for a specific financial period and, therefore, it is far more important to increase the net income of the company than to report the financial results in accordance with the actual performance of the company (Albrecht et al. 2008: 33). This, in turn, may serve as an incentive to use creative accounting to ensure that the statements reflect the results required if managers are to maximise their remuneration and this may lead to fraudulent activities. Managers may also wish to increase reported earnings in order to secure their jobs or to enhance their personal status (Hopwood et al. 2008: 269).

Wells (2005: 288) lists three key reasons why people may commit financial statement fraud, namely, to hide the actual business results; to protect their personal status/control and to uphold their financial position. Rezaee (2005: 283) describes the most common reasons for committing financial statement fraud as economic reasons, the enhancement of personal prestige and ideological motivation to become the leaders in industry. In addition, the aim of financial statement fraud may also be to convince investors to make more capital available to the company (Hopwood et al. 2008: 269).

According to Jones (2011: 32), fraud usually begins with the use of creative accounting. Management may use creative accounting in year 1 because the results were not as good as expected by the shareholders and the market place while year 2 may be an even worse year. By year 3, it is not possible to present the results expected by the stakeholders by using creative accounting only. Management then decides to go outside of the regulatory framework and fraud is committed. Fraud is seldom a once off event but, instead, it is usually a scheme and process which takes place over many years and the result of well thought out methods.

Senior management may overstate business performance to create the impression that the business is better than it actually is (Wells 2005: 289) because it will then appear as if they are meeting the targets set by the governing body, or they will be
able to obtain more financing through loans, meet the criteria of personal performance agreements or enhance the stock prices for various reasons. Business performance is usually understated in order to create the impression that the organisation is worse than it actually is for reasons such as tax avoidance, management buyouts and divorce settlements. However, the understatement of financial statements is not the focus of this research.

Management members who experience pressure to perform better for various reasons will create the opportunity to use creative accounting outside of the regulatory framework in order to commit fraud and then rationalise the deed by intending to correct it in the future or reason that the better results presented will keep all the stakeholders satisfied (Jones 2011: 32). However, according to Marais and Odendaal (2008: 35), everybody suffers because of crime – higher prices are paid, shareholders lose on their investments, employees may lose benefits and even their jobs and government loses tax revenue when fraud is committed. This viewpoint is confirmed by Manning (2011: 14).

A company’s accounts consist of three main financial statements, namely, the income statement; the balance sheet and the cash flow statement (Jones 2011: 44; International Financial Reporting Standards 2010: A18). The main objective of any company is either to increase profit (income statement) or to increase net worth (balance sheet). Financial statement fraud schemes will usually target one or both of these statements and, depending on what the perpetrator wants to achieve, the accounts will be manipulated in such a way that there is a net effect on the results as disclosed in the financial statements. Financial statement fraud usually takes the form of either the overstatement of assets and revenue or the understatement of liabilities, expenses and losses (ACFE 2011: 1.303).

### 2.3 FINANCIAL STATEMENT FRAUD SCHEMES

There are mainly three methods used by perpetrators to commit financial statement fraud. These methods have to do with the accounting system and involve using, beating or going outside of the accounting system. The perpetrator may use the
accounting system to produce the results that he/she would like to see, the perpetrator may try to beat the accounting system by feeding falsified information into the system in order to create better than actual results and, lastly, the perpetrator may produce financial results not related to the accounting system at all by producing a set of financial statements on a word processor (Kranacher et al. 2011: 410). The various fraud schemes all involve one or the other of these methods and are both well known and well documented. The methodology used to detect a specific financial statement fraud will depend on the type of fraud scheme adopted by the perpetrators (Singleton et al. 2006: 122). These fraud schemes include deliberate acts such as the falsification, alteration or manipulation of documents or financial records; material misrepresentations of the financial information which is used in the preparation of the financial statements; the misapplication of accounting principles and other policies and procedures in the disclosure of the financial information in the financial statements as well as the omission of disclosures (Wells 2005: 324).

A fraud scheme may be followed on a transaction level such as pre-recognition of income or it may be the result of the deliberate, wrongful interpretation of accounting principles in the presentation of the financial statements. Furthermore, management may override controls in order to commit fraud or to participate in fraudulent financial reporting (Ramos 2003: 34).

Improper revenue recognition has been found to be one of the most common methods used to commit financial statement fraud (Skalak et al. 2011: 435). This point is emphasised by Singleton et al. (2006: 108), who maintains that the most common method used to commit financial statement fraud is to overstate revenue. Revenue, as it is reported in the financial statements, is an indication of the success of a company and its resultant earning power (Mulford & Comiskey 2002: 159). The double entry method of accounting is used by crediting Revenue and debiting Accounts Receivable. This will have an impact on both the income statement and the balance sheet. The overstatement of revenue may take the form either of premature revenue recognition generated legitimately or fictitious revenue generated either by fictitious sales or fictitious customers. The overstatement of revenue usually impacts
on related assets such as inventories, where no goods have been released in relation to the sale. There will, therefore, be an overstatement of inventory as well as the accounts receivable balance after the provision for bad debts because the fictitious sales will result in an increased accounts receivable balance (Hopwood et al. 2008: 268).

The following financial fraud schemes have been defined by the ACFE (2011: 1.306), namely, asset/revenue overstatement which is perpetrated by timing differences; fictitious revenues; concealed liabilities and expenses; improper disclosures and improper asset valuation. Wells (2005: 327) suggests the same descriptions to define fraud schemes in financial statements but goes on to say that proper financial records are maintained by a double-entry system and that any fraud scheme will affect at least two different categories in the financial statements. The fraud schemes related to revenue recognition will be discussed in more detail later. Revenue should be recognised only if specific criteria are met (Sherman et al. 2003: 42). Firstly, there must be specific evidence according to the normal practice of the organisation that a sales agreement is in place. Secondly, there must be persuasive evidence that the goods and services have been delivered and the buyer would not be able to return the goods at a later date. Lastly, the price must be determinable or fixed and the collection of receivables should be reasonably certain. The main difference between premature revenue recognition and fictitious revenue recognition is the aggressiveness of the accounting actions. Premature revenue recognition is the recognition of a legitimate sale, but in the wrong period, whereas fictitious revenue recognition is the recognition of a nonexistent sale (Mulford & Comiskey 2002: 160).

### 2.3.1 Fictitious revenues

**Description**

The main purpose of fictitious revenues is to increase the profit as it is disclosed in the financial statements. This may be done by the creation of fictitious sales to either existing or non-existing customers (Jones 2011: 12) and involves the recording of sales that have not, in fact, occurred. Such a sale may either involve non-existing
customers or an existing customer. However, the invoice is never presented to the customer and nor are any goods and services delivered to the customer. This transaction is then reversed at the beginning of the next accounting period in order to conceal the fraud but, in order to continue presenting positive growth and good profits, it will be necessary to continue the fraud scheme in the new accounting period (Singleton et al. 2006: 109).

Revenue should be recognised at the point at which it is actually realised and is earned by the entity and not when the funds (cash) are received – the accrual basis (Manning 2011: 575). This implies that the rights and risks of ownership regarding the goods and services sold have been transferred to the purchaser and, therefore, sales with conditions will form part of a fictitious revenue fraud scheme (Kranacher et al. 423). In addition, Wells (2005: 327) points out that fictitious revenue may be generated by inflating legitimate invoices by charging a higher price or by adding to the quantity of goods and services delivered. Fictitious revenue may also be created by the recording of a sale although the shipment is nonexistent or, if goods are shipped to a customer, they were never ordered by the customer (Mulford & Comiskey 2002: 161–162). This implies the falsification of orders and invoices. The other leg in the accounting equation that is affected is that of inventory as well as accounts receivable. In order to hide the falsified transactions it may become necessary to pass credits on the accounts receivable or to sell the inventory to another customer at a later stage (Mulford & Comiskey 2002: 162). It may even happen that employees hide inventory so as to create the impression that it has been sold (Hopwood et al. 2008: 266).

An example of a fictitious revenue fraud scheme is that of Equity Funding, an insurance company in the late 1960s and early 1970s. The CEO created false insurance policies in order to inflate both the revenue and the accounts receivable. However, a disgruntled employee blew the whistle in 1973. The falsified amount of the accounts receivable balance added up to $2 billion of the $3 billion dollar disclosed in the financial statements (Singleton et al. 2006: 109).
To date, the Parmalat scandal, which occurred in Italy and which was revealed in 2003, is the biggest known fraud scandal in Europe (Bava & Devalle 2012: 51). Parmalat SpA was founded in 1961 in Italy and expanded to become a major multinational group of companies with subsidiaries in various different countries. According to records Parmalat was, when it was listed on the Milan Stock Exchange in 1990, already technically insolvent. This may have been the underlying motive for the fraud committed, although greed played a role as well because the majority of the key actors, including the Tanzi family and the Parmalat CFO, Tonna, benefited personally from the fraud. The Parmalat group was a comprehensive group of companies with Parmalat SpA having multiple subsidiaries holding shares in various other subsidiaries around the world and with complicated transactions being conducted to hide the true state of affairs (Jones, 2011: 259).

One of the financial statement fraud schemes that were perpetrated involved the recording of fictitious revenue from sales of goods to phantom customers and which never occurred (Jones 2011: 263). One example of the generation of fictitious revenue was the selling of powdered milk to a Cuban state-owned importer, Empresa Cubana Importdora de Alimentos. The transactions were recorded during the period 1999 to 2003 by Bonlat Financing Corporation, a wholly owned subsidiary of Parmalat Malta Holding Ltd, a subsidiary of Parmalat SpA, to the amount of €2 billion. The sales were allegedly made by a Singapore-based shell company to Bonlat which then sold the powdered milk to the company in Cuba. The powdered milk was allegedly shipped from Singapore to Cuba. However, no sales were recorded in the accounts of the Singapore company (Jones 2011: 263).

Furthermore, the fictitious revenue scheme was made worse by Parmalat in the double billing of distributors and supermarkets in Italy. This, in turn, enabled Parmalat to account for the fictitious sales which had increased its liquidity via credit from banks. This then resulted in the reporting of a higher income which facilitated Parmalat’s access to credit markets (Jones, 2011: 263).
2.3.2 Timing differences

**Description**
Timing differences may be achieved in various ways, namely, matching revenue with expenses; premature revenue recognition; long-term contracts; channel stuffing; and the recording of expenses in the wrong period (Wells 2005: 330). In addition, timing differences may also be a way in which to abuse or ignore the cut-off principle in accounting by keeping the books open in order to process transactions belonging to the current financial period in the previous financial period. At the end of an accounting period there usually is a cut-off date at which the recording of sales for the one period stops and the recording of sales for the following period starts. Ignoring this date, and recording revenue which is meant for period 2 in period 1 results in inflated revenue figures for period 1 (Hopwood et al. 2008: 266).

**Matching revenue with expenses**
Wells (2005: 330) describes timing differences as the recognition of revenue or expenses in the improper period as a result of which earnings may be either increased or decreased as desired. One of the basic principles of generally accepted accounting practice is the matching principle in terms of which revenue and the corresponding expenses should be matched in the same accounting period. If sales are recorded in the month in which they occurred (period 1) and the expenses pertaining to those sales in the following month (period 2), which happens to be a different accounting period, then the net income for period 1 will be overstated and understated for period 2.. This may be regarded as the material misstatement of the financial statements and, when done deliberately in order to mislead the users of the statements it would be regarded as financial statement fraud (Kranacher et al. 2011: 424).

Enron was a prime example of not matching income and expenditure properly. Enron made use of the mark-to-market accounting used in the financial security industry. The underlying principle involves recognising income when there is an increase in the value of the security assets and recognising losses when there is a decrease in the value of security assets. However, this is not in accordance with the principle of
revenue recognition when there is the actual sale of security assets and the gains and losses are recognised as a result of the transaction (Hopwood et al. 2008: 284).

**Premature revenue recognition**

Premature revenue recognition is one of the most common fraud schemes and is based on the question as to when a sale is actually a sale (Jones 2011: 46). Revenue should be recognised after the completion of a sale and, thus, when the ownership and risks attached to goods and services have been transferred to the purchaser (Crawford & Weirich, 2011: 347). However, premature revenue recognition occurs when the transaction is recorded before the sale has been completed. Premature revenue also may result from a legitimate sale although the sale is recorded incorrectly to boost the income figures in the financial statements (Mulford & Comiskey 2002: 159). Accordingly, such a fraud scheme is committed by the company in the recording of sales after receiving the order but before the shipping of the goods to the customers (Hopwood et al. 2008: 266). It may be the result of using a verbal agreement to a sale in order to record the revenue, instead of the usual written agreement to confirm the sale (Sherman et al. 2003: 42). It may also involve a conditional sale, for example, in the case of consignment stock where the sale is realised only after it has been sold to the end user. There may even be an agreement regarding the return of goods not sold but, nevertheless, the total amount of the initial transaction is recorded as revenue (Kranacher et al. 2011: 425).

In the case of California Micro Devices Corp., the revenue goals of the company became aggressive and this, in turn, resulted in the recognition of revenue from products shipped to actual clients, but without any orders having been received from these clients (Jones 2011: 411). It was established that, in 1994, one-third of the revenue reported had, in fact, been non-existent. Even if the goods had been returned, the transaction was not reversed as it should have been. In the end revenue was recognised for fake shipments (Jones 2011: 411).

**Long-term contracts**

One of the unique problems relating to timing differences stems from long-term contracts. Revenue recognition can be done either by using the completed contract
method or the percentage of completion method. With the first method revenue is recorded only after 100% of the contract has been completed and, therefore, the construction costs are held in the inventory account until such time (Wells 2005: 333). The second method recognises revenue and matching expenses at specific measurable stages or at percentage of completion of the project. This latter method is particularly vulnerable to manipulation by management because management may decide on the percentage of completion to use when the calculation is done (Hopwood et al. 2008: 267). This fraud scheme will conceal cost overruns which may, in turn, result in the misstatement of the financial statements (Kranacher et al. 2011: 426).

**Channel stuffing**

Channel stuffing is the result of encouraging distributors to buy large quantities of goods by offering big discounts or extended periods in which to pay the account (Wells 2005: 333). In other words, the distributors are ordering goods that will be sold at a later stage only and, thus, they are actually buying ahead of the current accounting period (Mulford & Comiskey 2002: 171). There may even be a side letter outside of the reporting channels stating that the goods may be returned after the end of the accounting period. This may have an impact on the shelf life of some of the products and, in addition, this method will result in poor results in the new accounting period (Mulford & Comiskey 2002: 172). Channel stuffing in itself is not fraudulent but, when it is abused so as to overstate the revenue figures, it will be perceived as an intentional misstatement in order to mislead the users of the financial statements (Hopwood et al. 2008: 267).

A good example of channel stuffing is that of Sunbeam, an appliance maker. During the winter of 1996–97, barbecue grills were shipped to retailers on the condition that payment by the retailers to Sunbeam would be deferred until such time that the grills had been sold. It was even stated that the unsold stock could be returned to Sunbeam. In practice this resulted in consignment stock, however, Sunbeam recorded these transactions as sales and the revenue from these sales was recorded in the financial statements in the last quarter of 1997. The scheme led to an additional $71 million profits in the financial statements of 1997. The financial
statements were then restated at a later date. During 2002 the CEO (Chainsaw Al Dunlap) resigned and paid $500 000 to the state in settlement of a civil case against him and $15 million as settlement to a shareholder class action. He also agreed never to serve as a director or officer of another public company (Sherman et al. 2003: 30–31).

2.3.3 Improper asset valuation

Fraud schemes usually relate to the inflated value of current assets at the expense of long-term assets. These schemes usually involve inventory valuations; accounts receivable; business combinations and fixed assets. The value of inventory may be overstated by the inclusion of consignment stock which is kept on behalf of the supplier and recognised in accounting records only after it has been sold (Wells 2005: 343). The valuation of inventory and accounts receivable will be taken into account only if it is a result of a revenue fraud scheme that has had an impact on the balances of the two accounts mentioned.

2.4 SUMMARY

This chapter defined financial statement fraud as the intentional misrepresentation of the financial statements with the intention of misleading the users of the financial statements (Hopwood et al. 2008: 225). The fraud triangle was explained as the three legs which support the commitment of fraud, namely, the incentive or pressure to commit fraud, the opportunity to commit fraud and the rationalisation of the deed (Kranacher et al. 2011: 12). The involvement of management in financial statement fraud was explained in terms of both the fraud triangle and also the fact that management is in the position to override controls in order to conceal the fraud. It is clear that it is not possible to commit financial statement fraud without the knowledge and agreement of management because such fraud involves the overstatement and understatement of the financial statements and this is a management responsibility (Wells 2005: 294).
Management has various incentives to commit financial statement fraud. Such fraud usually involves the presentation of the performance of the business as more positive than it is in reality. This is done because management may often benefit personally through increased remuneration, including bonus payments and share options. Furthermore, if the organisation performs well, the shareholders will be satisfied because of the higher earnings deriving from the performance of the business while creditors will regard the organisation as a good investment (Taylor 2011: 333).

The different types of revenue fraud schemes, namely, fictitious revenue and fraudulent revenue schemes involving timing differences (Kranacher et al. 2011: 410) were explained. Fictitious revenue may either be as a result of fictitious sales to existing or non-existing customers (Jones, 2011: 12) or it may involve the recording of sales that have not, in fact, occurred at all (Singleton et al. 2006: 109). Revenue fraud schemes involving timing differences may be the result of premature revenue recognition in terms of which the revenue is from legitimate sales but is recognised in the incorrect period (Mulford & Comiskey 2002: 159) or it may involve the manipulation of revenue recognition in relation to long-term contracts (Wells 2005: p333). In addition, revenue fraud schemes involving timing differences may also be done by not matching revenue and expenses appropriately (Kranacher et al. 2011: 424) or by deliberately making use of channel stuffing to oversupply the market with goods which have not been ordered or are not needed (Mulford & Comiskey 2002: 171).

According to Jones (2011: 21), it is not possible for creative accounting or financial statement fraud to take place in a vacuum. However, it may be difficult for an outsider, such as the auditor, to detect the crime and, therefore, a sound knowledge of the various schemes is important.
CHAPTER 3: FINANCIAL STATEMENT FRAUD RISK ASSESSMENT

METHODOLOGIES

3.1 INTRODUCTION

Fraud risk management is the responsibility of management. This is stated in the standards applicable to both the internal auditors (IIA 2009: 10) and the external auditors (SAICA ISA 240, 2009: par4). The first step in fraud detection involves a sound fraud risk management plan and strategy to determine how and where the organisation may be at risk (Taylor 2011: 183). The policies and practices relating to fraud risk management should take the following factors into account, namely, the tendency of people to commit fraud; the areas in which fraud in the business may possibly be committed and breakdowns in the controls of the organisation as well as in important systems (Taylor 2011: 183). The primary responsibility for the prevention and detection of fraud lies with management and with those responsible for the governance of the entity (IIA 2009: 10). It is, thus, essential that management and the governance bodies create a culture which will encourage ethical behaviour and honest actions on the part of all staff members in order to deter fraudulent behaviour (SAICA ISA 240, 2009: par 4).

Management is responsible for presenting the financial statements to the users fairly as well for safeguarding the assets of the organisation (Rezaee & Riley 2010: 40). In order to achieve this, it is essential that management design an internal control framework that meets the objectives of having financial reporting systems in place which will result in the fair presentation of the financial results and which will safeguard the assets. However, these systems of internal controls may be compromised by management through the overriding of controls and collusion (Kranacher et al. 2011: 175). It is, thus, necessary that the internal and external auditors, fraud examiners and forensic accounting professionals design and execute specific techniques and procedures to establish whether the internal control systems have been compromised in any way. These techniques will assist in the identification of red flags and other anomalies which may be the result of financial statement fraud.
schemes being used to misrepresent the financial statements (Kranacher et al. 2011: 175).

There are specific methodologies that may be used in order to establish the degree to which an organisation is at risk of fraud. These methodologies are not applicable to internal and external auditors only, but also to all fraud examiners, forensic accountants or any other persons interested in detecting fraud within an organisation (Kranacher et al. 2011: 81). For the purposes of this chapter and to keep the discussion as general as possible, the term “fraud examiner” will be used as the generic term to describe all of the abovementioned individuals.

Before implementing any of the fraud risk assessment methodologies, such as analytical reviews, the fraud examiners must make sure that they have a proper understanding of the organisation and the way in which it conducts business (Taylor 2011: 321). Such knowledge must be obtained prior to any investigation into the detection of possible fraud and will include the degree to which management may feel pressurised to commit fraud, any conditions that exist and that may encourage management to commit fraud as well as the way in which the ethical culture of the organisation may facilitate management’s committing of fraud (Taylor, 2011: 321).

The phrase fraud detection is an indication that fraud has already been committed or is ongoing in the organisation (Kranacher et al. 2011: 181). The prevention and deterrence of fraud is the first choice for any organisation. However, because of the possibility of either management override of controls or collusion, fraud may happen and the detection route will have to be followed. Fraud detection is often difficult because fraudulent activities are usually concealed and the internal controls systems of the organisations would have been compromised. In addition, fraud detection is effective only if the fraud is exposed as early as possible before it gets out of control and the entity is bankrupted as a result of the financial statement fraud. It is, thus, vital that a structured and focused process be followed (Kranacher et al. 2011: 181).
3.2 PLANNING THE FRAUD RISK ASSESSMENT PROCESS

There are two general strategies which may be used to identify the risk of fraud, namely, the identification of red flags and a targeted fraud risk assessment (Kranacher et al. 2011: 182). Despite the fact that there will be costs involved in conducting a fraud risk assessment, the cost of underestimating the fraud risk would be considerably higher because of the consequences of expressing an incorrect opinion on the financial statements (Wood 2012: 24). In order to facilitate a structured and focused process to establishing where the organisation is at risk of fraud or to detecting fraud which has already been committed, it is essential that the fraud examiner plan the process in the same way in which an auditor would plan the auditing process at the beginning of an auditing engagement (Manning 2011: 571).

3.2.1 Fraud risk assessment

The following process will ensure that the fraud examiner obtains as much information as possible and it will also to lend structure to the engagement. The fraud examiner should obtain as much industry data as possible in order to understand the industry in which the organisation concerned is operating. This information gathering should be done for both financial and non-financial information. Organisations in similar industries report data in more or less the same manner and trends outside of the industry norms may be an indication of a fraud risk area (Manning 2011: 571). Furthermore, the fraud examiner must understand all the factors that may have an impact on the performance of the organisation. Such factors include the global economic climate, the control, budget and reporting processes of the organisation itself as well as the accounting policies being applied for reporting purposes (Skalak et al. 2011: 238).

After acquiring the required information from the organisation the fraud examiner must conduct a financial analysis involving possible comparisons and ratio analyses in order to identify possible fraud risk areas. The most common financial analysis involves the vertical and horizontal analysis of the financial statements and various ratios which can identify material fluctuations in the financial statements (Wells 2005:
This must be compared with non-financial information in order to corroborate the results, for example, if the financial analysis indicates an increase in inventory, then the fraud examiner should be able to observe the increased inventory in the warehouse (Manning 2011: 573).

An evaluation of the internal control systems must be conducted to identify further problem areas which may place the organisation at risk of fraud being committed. Internal control systems refer to those policies and procedures which are implemented by management in order to prevent and detect errors and irregularities on a timely basis (Rossi 2012: 14). The next step in the process involves gathering evidence of possible fraudulent actions within the organisation. Such evidence must then be evaluated to confirm whether fraud is actually taking place or has taken place within the organisation. The final step involves reporting any findings to the appropriate, interested parties (Manning 2011: 571).

There are generic methodologies that may be used during the fraud risk assessment process. ISA 240 (SAICA 2009: par A7-A12) discusses the following basic methodologies, namely, discussions amongst team members, also known as brainstorming, interviewing of members of management regarding their assessment of fraud risk and related controls and the performance of analytical procedures and the analysis of ratios. In addition, Kranacher et al. (2011: 182) suggest the evaluation of red flags to identify possible fraud risk areas. All of these methodologies should identify anomalies which will, in turn, lead to further investigation.

3.2.2 Red flags

In the accounting context red flags are the result of a set of tests having been conducted and which point towards the risk levels involved in a set of financial statements (Feroz 2008: Abstract). Red flags are defined as fraud risk indicators or warning signals that emerge from trends analyses and the interviews conducted. Such red flags do not prove the existence of fraud but are a signal to raise awareness of the possibility of fraud being committed (Kranacher et al. 2011: 24). Red flags may be somewhat of a cliché, but a fraud examiner would have to be
extremely brave just to ignore any red flags (Taylor 2011: 131). As regards financial statement fraud there are specific red flags which are related to the various fraud schemes. Furthermore, there may be behavioural red flags that may indicate that fraud is being committed. These red flags will correspond strongly to the fraud triangle where one of the legs of the triangle refers to the pressure on an individual and that may be either a result of greed or a real or perceived need. These red flags would be reflected in the lifestyle of individuals and would include cars, homes, and other material possessions which cannot be explained on the basis of the individual’s remuneration package (Kranacher et al, 2011: 185; ISA 240: Appendix 1).

Fraud is a crime involving the deliberate concealment of certain actions as well as deceit the people concerned and, thus, red flags will not always be clearly visible and easy to recognise and interpret (Skalak et al. 2011: 238). It is equally important to remember that fraud risk factors are not the same as concrete evidence that fraud has been committed but that they are an indication of the possibility that fraud may be committed. However, they may also be an indication of other factors such as a heightened margin of errors because of the pressure on staff members to improve performance. The interpretation of red flags would differ from fraud examiner to fraud examiner, depending on the experience and mindset of the individual. It may be easy to overreact when a red flag has been identified, without taking into account other mitigating factors which may exist in the organisation (Skalak et al. 2011: 239). In addition, the number of red flags identified is not necessarily an indication of greater certainty that fraud may be committed. It is, thus, essential that red flags be seen in context and investigated more before a conclusion is drawn based on the fraud risk factors identified (Skalak et al. 2011: 240).

Red flags may be divided into either personal or environmental related fraud indicators. The environmental fraud indicators that may encourage a culture of fraudulent behaviour are those factors which are related to the organisation and the control environment and ethics culture created by management. In a poor control environment there is a greater possibility that fraud may be committed because of the fact that the opportunity to commit the fraud exists as well as the possibility of not being caught. If top management creates a culture of dishonesty in the sense that
management itself is being fraudulent or exerts undue pressure on the staff of the organisation regarding demands and targets, this may lead to fraudulent behaviour which is driven by the desire to survive. In addition, if the impression exists that fraudulent behaviour is tolerated and that staff members may get away with fraud, this will create an environment conducive to fraud being committed (Crawford & Weirich 2011: 354).

Adverse economic conditions or the possible sale of the business may result in employees feeling afraid that they may lose their jobs and this, in turn, may increase the possibility of more fraud being committed. The increased risk of fraud is also related to low employee morale, which may be caused by the cash flow problems within the organisation or other factors such as promotions, salary increases, disciplinary action or frustration related to the job. The tendency to commit fraud when these factors are present will be increased if there is a poor ethical culture with no ethical policy to direct staff in terms of what is right and wrong and what the consequences of fraudulent behaviour will be (Hopwood et al. 2008: 275–277). The lack of background checks to ensure that the organisation employs appropriate, trustworthy people as well as the lack of support programs that may assist employees during difficult times may create an environment in which staff will commit fraud (Wolfe & Hemanson 2004: 42). Furthermore, the fraud examiner should be aware of personal symptoms, including financial problems on the part of staff members, personal pressure, job stress or illness as well as emotional feelings relating to mistreatment or expectations not being met. When these factors are affecting individual staff members, fraud may be a solution to the personal problems which individuals are experiencing (Taylor 2011: 131–132).

In financial statement fraud as a result of the overstatement of revenue, the fraud examiner should possess knowledge related to those red flags which are specific to the fraud schemes which are used to overstate revenue. The following include some of the red flags that may indicate the possible overstatement of revenue.
**Fictitious revenue**

When the fraud scheme of choice is that of the creation of fictitious revenue, the following red flags may assist the fraud examiner in the identification of the fraud risk – the company shows a more rapid or a higher growth than is the norm in terms of industry profitability; management reports higher earnings but the reported cash flow over more than one accounting period remains negative; significant or unusual transactions take place close towards the end of the financial period, for example, journal entries made or provisions entered, specifically with entities which may be regarded as related parties; or a longer than usual period of outstanding revenue receivable balances are shown (Kranacher *et al.* 2011: 423). Furthermore, a high level of credit notes or unusual adjustments to accounts receivable may be an indication of fraud being committed through a revenue scheme by means of the creation of fictitious revenue figures (Crawford & Weirich 2011: 357).

**Timing differences**

The following may be signs that fraud is being committed by schemes relating to timing differences – when a company shows a bigger increase in growth or higher gross margin than is the norm in terms of industry profitability; when management reports higher earnings but the reported cash flow over more than one accounting period remains negative; significant or unusual transactions take place towards the end of the financial period as a result of journal entries or provisions, the outstanding revenue receivable balances has increase more than expected or there is a significant decline in the accounts payable balances (Kranacher *et al.* 2011: 427).

### 3.3 INTERVIEWING

One of the specific fraud risk assessment methodologies which may be used to assist in the fraud risk assessment in order to detect financial statement fraud is that of interviews. Interviews should be conducted with members of the board of directors and the audit committee, management at all levels as well as staff members. During these interviews the fraud examiner will endeavour to obtain information on possible fraud risk indicators such as a lack of segregation of duties, performance incentives,
declarations of conflicts of interest and suchlike, so as to make a judgement of the culture of the organisation, including the control environment (Wells & Gill 2007: 63).

Interviewing is a tool which may be used to facilitate the process of dialogue with a person who possesses knowledge about areas of interest to the fraud examiner. It is important to take into account the fact that the person being interviewed must be able to provide timely and reliable information regarding the specific area of interest (Manning 2011: 501). The fraud examiner’s objective in conducting an interview is to obtain evidence which he/she may then report as facts. During the process it is essential that the interviewer remains objective and maintains professional scepticism (Porter & Crumbley 2012: 132). It is important to realise the difference between interviewing and interrogating. Interviewing is non-threatening and the person being interviewed is not accused of any wrong doing while the main focus is to obtain information. In other words, interviewing is non-confrontational with the purpose to seek information. On the other hand, during interrogation the interviewee is accused of wrongdoing and the main focus is to obtain an admission of guilt (Crumbley, Heitger & Smith 2007: 4-34).

Management and staff members must be questioned on how they perceive both the risk and the possibility of fraud and whether they believe that the controls aimed at addressing the risk of fraud are sufficient (Wells 2005: 349). Management must be interviewed when anomalies in the financial statement analysis are found, even if only to record the reaction of management to the deviations identified. Furthermore, the fraud examiner must also discuss the financial results with the staff, sales staff or customer liaison staff in order to gain information on the market, industry, customers and suppliers in an effort to obtain a possible, logical explanation for the deviations identified (Taylor 2011: 323).

In research conducted by Porter and Crumbley (2012: 135) it was found that the best way in which to conduct an interview is by not being aggressive but by showing compassion, honesty and a neutral attitude throughout the interview. In addition, it is essential that the interviewer listen carefully to the answers to the questions asked about the risk of fraud in the staff member’s area of responsibility. This will ensure
that the interviewer detects any avoidance of the issues under scrutiny (Hopwood et al. 2008: 239). Questions may also be asked of the CFO, the chairperson of the audit committee or the clerk entering the initial transactions into the accounting records. If straightforward answers are not given then further investigations must be considered (Sherman et al. 2003: 45).

3.3.1 Interviewing with the aim of establishing financial statement fraud risks

Interviewing is an essential tool to establish the fraud risk management programme within the organisation as well as the tone at the top regarding financial statement fraud. The interviews must be conducted at different levels within the organisation in order to obtain a comprehensive picture of the fraud risk management within the organisation (Skalak et al. 2011: 242).

A fraud risk questionnaire may be used as a tool during the interview process. The questionnaire is directed at obtaining information related to the three components of the fraud triangle, namely, opportunity, pressure and justification. A fraudster will perceive an opportunity to commit fraud as the chance of not being discovered, pressure refers to financial or other pressures such as a personal debt or having to present positive performance targets to management while justification refers to the reasons or arguments underlying the commission of the crime to make a case for the act being acceptable (Kolman 2007: 46).

The information that the fraud examiner must obtain from the board and senior management should provide an indication of remuneration policies, such as performance bonuses and share options, as well as the strategy for the growth of the organisation. This group must also be questioned on any knowledge they may have regarding incidences of fraud and also on the attitude of the organisation towards the prevention and deterrence of fraud. The supervisory function of the audit committee must be investigated to establish the way in which fraud risks are mitigated by the actions of the audit committee (Skalak et al. 2011: 252).
The inquiries of management must include issues such as unusual transactions and trends which were identified during the execution of the analytical procedures and the ratio analysis while the control over the process of journal entries and provisions must also be established. The risk of financial statement fraud must be discussed in conjunction with the remuneration policies and other benefits which management and key staff members would receive if certain results were achieved (Wells 2005: 349). In order to obtain the optimum information there are several questions that may be posed to management, for example, which processes are followed during adverse economic circumstances in order to meet budget and other goals? How does the organisation manage to do business in a different way as compared to their competitors in the market place in order to remain profitable while the industry in general is not doing well? In addition, the fraud examiner must ask management whether any processes or goals have been changed or new customers obtained during the accounting period (Skalak et al. 2011: 243).

The financial staff may be questioned on undue pressure to maintain the accounting records in such a way that they reflect the budgeted figures set out at the beginning of the accounting period. The financial staff may also be questioned as to whether they have ever received specific instructions from management with which they were uncomfortable as well as details about the ethical environment of the organisation. Does a code of ethics exist and is management serious about the implementation of such a code (Skalak et al. 2011: 243).

The internal auditor(s) must be approached in order to obtain background knowledge about the organisation and all the subsidiaries of the organisation. Internal audit reports may be reviewed and discussed to establish any areas of concern identified by the internal auditors and management’s reactions to the recommendations made. Internal auditors may also provide an indication of any incidences of fraud at the organisation (Skalak et al. 2011: 253).

Other information which must be obtained during the interviews should establish whether there were any incidents of fraud related to financial reporting at the organisation which have occurred in the past or during the year under review. It is
also necessary to enquire about the way in which the accounting treatment of transactions is approved and by whom and whether there is an awareness of any deliberate attempts to overstate or understate revenue and expenses. It is important to establish any related party transactions and known conflicts of interest amongst those members of management who are in the position to manipulate the financial statements. Information regarding other red flags, such as resignations within the financial department, individuals living a more elaborate lifestyle than expected or any criminal proceedings against individuals (Crumbley et al. 2007: 4-33) must be obtained during interviews.

During the interviews conducted with board members and executives of the organisation it is necessary to establish whether there is an ethics policy in place and how the organisation promote adherence to such a policy. Information regarding remuneration, bonuses and share options must be obtained in order to establish whether there may be any incentive for management to manipulate the financial statements in order to improve the earnings of the organisation (Crumbley et al. 2007: 4-33).

### 3.3.2 Types of questions

In general there are five types of questions which may be asked during an interview. However, all these questions may not necessarily be asked in all the interviews and not necessarily of all the interviewees. The general types of questions that may be used in the interview process in order to obtain information regarding fraud risk will be both introductory and informational (Kranacher et al. 2011: 239). It is important to note that, throughout the interview process, no promises of confidentiality are made and agreement to both the question and the information obtained must be established (Kranacher et al. 2011: 240).

**Introductory questions**

The main goals during the introduction involve establishing a rapport with the interviewee, providing background information regarding the interview process, as well as set a specific trend or theme for the interview (Porter & Crumbley 2012: 136).
**Informational questions**

The aim of informational questions is to gather information. These questions are posed after the scene has been set with the introductory questions during the first phase of the interview. Informational questions are divided into open, closed or leading questions. It is essential that this phase of the interview be conducted in a relaxed, transparent manner (Kranacher *et al.* 2011: 241).

Open questions are worded in such a way that interviewees have to expand upon their answers and, thus, a yes or no response is not sufficient. Open questions are meant to encourage the interviewee to give as much information as possible. On the other hand, a closed question should be specific about the confirmation of the information that must be obtained, such as amounts, dates, times and the actions (Kranacher *et al.* 2011: 241). Leading questions are the third type of informational question to be asked. These questions contain part of the answer and are used in order to confirm facts and information already known to the interviewer. Questions regarding the way in which revenue is defined, what would be defined as a revenue-generating transaction and deviations from the disclosed revenue-recognition policy should be asked in order to acquire information regarding how the balances on the financial statements were reached (Wells 2005: 373).

**Closing questions**

It is important to close the interview in such a manner that goodwill is obtained, that if the interviewer needs to follow up on something, the interviewee would be willing to meet with the interviewer. Closing questions are used to ensure goodwill, to confirm facts, to seek new, undiscovered information and to conclude the interview (Wells 2005: 374).

**3.3.3 Interview process**

In order to conduct an interview successfully it is essential that the interview is properly planned. This planning will take into account the information already available to the interviewer, where the interview should take place and the
information the interviewer would like to obtain or confirm (Manning 2011: 502). The fraud examiner needs to schedule interviews with employees at different levels of management and operational staff levels at a specific time and place in order to obtain as many different viewpoints as possible. Before the actual interview starts the fraud examiner must allow time for the interviewee to ask questions about the interview process and the audit or investigation taking place (Kolman 2007: 48). While conducting the interview the interviewer should establish good communication channels in order to obtain as much information as possible. The interviewer must be the listener encouraging the interviewee to do the talking and this will ensure that as much information as possible will be obtained (Crumbley et al. 2007: 4-34).

3.4 DISCUSSIONS AMONGST TEAM MEMBERS

3.4.1 Introduction

The process of conducting a risk assessment does not differ significantly from the decision-making process. One way in which to ensure that a group makes a decision is to make use of the brainstorming technique (Singleton et al. 2006: 197). Brainstorming, also known as discussions amongst team members, is a technique during which both more experienced and less experienced team members sit down together and all have equal opportunity to discuss possible fraud risk indicators. The aim of brainstorming is not only to identify possible fraud risk areas but also to establish the mindset of the team throughout the investigation (Skalak et al. 2011: 250). In research conducted by Carpenter (2007: 1119) it was found that brainstorming sessions facilitate the identification of better quality fraud risk indicators than those generated by auditors on an individual basis and this, in turn, leads to an improved quality of fraud risk assessments. The subject of such discussions should be which risks regarding material misstatements of the financial statements as a result of fraud may exist as well as areas in which management may override controls and whether it is possible to place reliance on the integrity of management (Skalak et al. 2011: 250). In other words, brainstorming is a way in which to generate ideas of how fraud may be committed and concealed (Crumbley et
However, in practice, brainstorming may be used to discuss possible ways in which to respond to any fraud risks identified (Ramos 2003: 29).

### 3.4.2 General rules regarding the brainstorming session

General rules should apply to brainstorming sessions so as to ensure that no one team member dominates the discussion. All team members should be encouraged to participate fully and to share their ideas while no team members should claim ownership of any idea during the discussion. The atmosphere should be open and frank and no ideas must be disregarded as either unimportant or not valid. Team members must be treated as equals for the duration of the discussions, even if there are the most junior staff members taking part together with the most senior staff members in the team. Note-taking should be limited in order to enhance the spontaneity of the process and to encourage all team members to think out loud (Ramos 2003: 29).

No problem must be defined which is either too specific or too vague and the problem defined must allow the team members to generate as many ideas as possible about the problem. In other words, it is the quantity of ideas which is important and not the quality of the ideas. It is important to remember that the best ideas are usually generated at the end of the session and not at the beginning. However, most companies fail to evaluate and implement the ideas properly after the brainstorming sessions (Crumbley et al. 2007: 4-21).

Brainstorming may be done as an open group discussion where very few rules apply, or it may be a session where the team members have been given the opportunity to generate their own ideas and present them to the group – also known as the round-robin, brainstorming session. Another way in which to conduct the brainstorming session involves making use of electronic means. This means that the ideas generated are not connected to a person and the meetings are shortened (Crumbley et al. 2007: 4-21).
The potential problems that may be experienced during brainstorming are that one or two team members may dominate the session and inhibit the participation of the other team members. This, in turn, may mean that fewer ideas are generated. Some team members may remain quiet and allow the other team members to do all the work, or else the team may be so focused on unity and consensus that the ideas are not properly evaluated or discussed. It is also possible that the mindset of the team members may shift to the extreme and an imbalanced position be taken on fraud risks (Crumbley et al. 2007: 4-21):

3.5 ANALYTICAL ANALYSIS

3.5.1 Introduction

The financial analysis of the financial statements, also known as analytical procedures, is another technique which may be used to identify fraud risk factors. Financial analysis is conducted by using vertical analysis, horizontal analysis as well as ratio analysis to identify material fluctuations in the financial statements (Wells 2005: 357). This may be done over one or more financial periods or else the results may be compared to other non-financial information obtained (Crumbley et al. 2007: 4-35). Analytical procedures may be used to support other evidence relating to financial statement fraud or to identify suspected fraud in the financial statements. The findings of these analytical procedures may be corroborated by non-financial evidence obtained during the interviewing phase or else be used to follow up on previously identified red flags (Hopwood et al. 2008: 227).

Analytical procedures are an effective tool to obtain an understanding of the operations of the company and to identify red flags and areas of possible audit and fraud risk (Crumbley et al. 2007: 4-4). Analytical procedures are used to carry out comparisons with existing data or expected results. The financial analysis and the ratios applicable to revenue and related assets, such as inventory and accounts receivable, will now be discussed in more detail.
3.5.2 Analytical procedures

Analytical analysis or analytical reviews are one of the most powerful tools available to fraud examiners. They assist the fraud examiner by telling the story of the financial statements as presented by management. Analytical analysis involves ascertaining the reasonable and logical relationships between the numbers in the financial statements, which may then be corroborated with other information outside of the financial statements (Taylor 2011: 323). Using this tool may enable the fraud examiner to identify key areas that are more susceptible to fraudulent activities and to focus on these areas (Taylor 2011: 333). Analytical anomalies in financial statements may include transactions that appear either too large or too small for the type of industry and organisation, there may be unusual sales patterns, weak cut-off procedures would result in revenue being recognised in the wrong accounting period while large volumes of credit notes may be an indication of overstated revenue at year-end or long outstanding receivables (Taylor 2011: 334). All such anomalies may not necessarily be a result of fraud but the fraud examiners must satisfy themselves that there is a valid explanation for each analytical anomaly identified (Kranacher et al. 2011: 187).

The five main types of comparisons used in analytical analysis include the following. Firstly, comparing the organisation’s data with industry data; in other words, how does the company compare with similar entities in the same industry? The second type of comparison will involve comparing the entity’s data for a specific period with that of the previous period or periods and should expose, for example, an unusual growth in either revenue figures or bad debts. Thirdly, analytical procedures may be used to compare the data generated with non-financial data, for example, the number of units produced to be sold with the actual sales figures. A fourth comparison will involve the expected results as stated in client data, such as budgets and forecasts and, lastly, the analytical procedures will involve comparisons with the expectations of the fraud examiner in relation to the general economic conditions (Hopwood et al. 2008: 227).
The three types of financial statement analysis that may assist in the risk assessment of financial statement fraud are vertical analysis, horizontal analysis and ratio analysis (Wells 2005: 357). In order to illustrate the various types of financial statement analysis that may be conducted an example of a set of financial statements (Taylor 2011: 325) is provided and the different types of analysis are discussed in the following paragraphs.

A vertical analysis gives the relationship between a specific line item with that of a specific base item. In the case of the example the base item in the balance sheet is total assets and each line item of the assets is given as a percentage of the total assets. This indicates the position within a specific accounting period and any movements or changes in relation to earlier periods may be used both to evaluate trends and to identify anomalies (Wells, 2005: 358). It is important that the source of the figures being compared is the same for all the accounting periods. There may be sound business reasons for the variances in the figures, including economic conditions. However, it is essential that all variances be further investigated in order to establish the root cause of the anomaly (Taylor, 2011: 325).

The horizontal analysis compares line items from one accounting period with the line items from the next accounting period. The fraud examiner will look for unusual movements per line item which may be an indication of the manipulation of the figures. (Taylor, 2011: 324).

<table>
<thead>
<tr>
<th>“BALANCE SHEET”</th>
<th>Vertical analysis</th>
<th>Horizontal analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year one</td>
<td>Year two</td>
</tr>
<tr>
<td>Cash and bank</td>
<td>7 000 4%</td>
<td>4 000 2%</td>
</tr>
<tr>
<td>Inventories</td>
<td>12 000 6%</td>
<td>14 000 7%</td>
</tr>
<tr>
<td>Receivables</td>
<td>9 000 5%</td>
<td>11 000 5%</td>
</tr>
<tr>
<td>Total current assets</td>
<td>28 000 5%</td>
<td>29 000 4%</td>
</tr>
<tr>
<td>Non current assets</td>
<td>167 000 85%</td>
<td>172 000 86%</td>
</tr>
<tr>
<td>Total assets</td>
<td>195 000 100%</td>
<td>201 000 100%</td>
</tr>
<tr>
<td>Payables</td>
<td>22 000 11%</td>
<td>24 000 12%</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>2 000 1%</td>
<td>2 000 1%</td>
</tr>
</tbody>
</table>
Ratio analysis (analytical procedures) contains elements of horizontal analysis and should either be conducted in a specific segment of the organisation or on specific accounts. More analysis does not necessarily result in better outcomes although a set of ratios should tell a story about the organisation. It is important to realise that, if two accounting periods only are compared, this will not necessarily reveal any anomalies if the figures were manipulated for both periods. Accordingly, either an accounting period which is known not to have been manipulated should be used as the base figures or the industry norms should be used as the base figures (Taylor, 2011: 327). Analytical procedures should always be conducted over more than one accounting period and any ratio should be seen in the context of the procedures carried out. One ratio will not demonstrate any unusual results and should not be used in isolation (Hopwood et al. 2008: 252).

### 3.5.3 Recommended ratios

The ACFE recommend various types of ratios to be used in order to analyse financial statements for possible fraud (ACFE 2011: 1331–1.333). The ratios applicable in the detection of revenue fraud schemes include the following:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Year one</th>
<th>Year two</th>
<th>Change</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>257 000</td>
<td>286 000</td>
<td>29 000</td>
<td>11%</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>224 000</td>
<td>255 000</td>
<td>31 000</td>
<td>14%</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>33 000</td>
<td>31 000</td>
<td>-2 000</td>
<td>-6%</td>
</tr>
<tr>
<td>Administration costs</td>
<td>9 000</td>
<td>8 000</td>
<td>-1 000</td>
<td>-11%</td>
</tr>
<tr>
<td>Selling and marketing costs</td>
<td>11 000</td>
<td>12 000</td>
<td>1 000</td>
<td>9%</td>
</tr>
<tr>
<td>Interest</td>
<td>3 000</td>
<td>2 000</td>
<td>-1 000</td>
<td>-33%</td>
</tr>
<tr>
<td>Taxation</td>
<td>2 000</td>
<td>3 000</td>
<td>1 000</td>
<td>50%</td>
</tr>
<tr>
<td>Net Profit</td>
<td>8 000</td>
<td>6 000</td>
<td>-2 000</td>
<td>--25%**</td>
</tr>
</tbody>
</table>
**Current ratio** = **current assets/current liabilities** or **quick ratio** = **(current assets-inventory)/current liabilities**

These ratios indicate the liquidity of the organisation and, therefore, the ability of the organisation to cover the current liabilities with the current assets. A ratio greater than 1 is an indication that the organisation would be able to meet all current liabilities with the current assets in hand. Removing the inventory in the quick ratio provides an indication of whether there is sufficient cash and sources of cash, such as receivables, available to cover the current liabilities (Wells 2005: 360). An increase in both these ratios may be an indication of inflated revenue figures which may, in turn, be the result of the manipulation of the accounts and, therefore, indicate a financial statement fraud scheme (Hopwood et al. 2008: 253).

**Inventory turnover** = **cost of goods sold/average inventory**

This ratio is an indication of how quickly inventory is converted into cash and receivables. A higher turnover rate is an indication of more sales and improved income. If inventory has been stolen, then the closing inventory figures would be lower and the cost of goods sold would be higher because the lost inventory would have been written off (Wells, 2005: 361). This ratio would then show an increase. If the closing inventory figures are higher because they have been falsified then the ratio would decrease. Any one of these deviations should be investigated and corroborated with other information such as units sold (Taylor 2011: 328).

**Receivable turnover** = **credit sales/average trade receivables**

This ratio is an indication of the rate at which the organisation collects the monies owed to it by its debtors. If there is fictitious revenue included in the receivables figures then this ratio would decrease because the fictitious debts (accounts receivables) would never be collected. An increased ratio in this case may also be an indication of bad debts not being written off in order to maintain higher profit figures. This ratio may be reduced by the writing off of fictitious accounts receivables and any investigations into anomalies should include credit notes as well as bad debt calculations and write-offs (Taylor, 2011: 329). The inflated revenue from fictitious sales would inflate both the net sales figure and the accounts receivable (trade receivables) figure and this would, in turn, result in a lower turnover ratio. Once again
this should not be seen in isolation, but as part of a broader investigation which would involve comparisons with previous years and other ratios before the conclusion may be drawn that financial statement fraud has been committed (Hopwood et al. 2008: 252).

Another ratio that may assist the fraud examiner in the detection of financial statement fraud is that of the **percentage of uncollectable accounts** (bad debts). Percentage of uncollectible accounts = allowance for uncollectible accounts/accounts receivable. If the uncollectibility of the fictitious revenue accounts is not reflected in the bad debts expenditure then the percentage of uncollectible accounts would decrease (Hopwood, et al.2008: 253).

**Receivables days = (trade receivables X 365)/credit sales**
An equally important ratio that may be used in the investigation of financial statement fraud is that of **number of days in receivables**. The higher the number of days in receivables the more suspicious the fraud examiner should be regarding the possibility of fraud having being committed (Taylor 2011: 329).

**Gross profit margin = (net sales – cost of goods sold)/net sales or gross profit/turnover**
This ratio enables the fraud examiner to determine the possibility of the misstatement of revenue as well as the cost of sales. If fraud has been committed by way of fictitious revenue recordings then the gross profit margin would be higher (Hopwood et al. 2008: 251).

**Net profit margin = profit before interest and tax/turnover**
The same applies to this margin as to the gross profit margin and this margin may also be affected if certain costs such as administrative costs are capitalised (Taylor, 2011: 330).

There is a school of thought that the ratio analysis of organisations in which fraud has been detected and organisations in which no fraud has been detected differ very slightly. Accordingly, the argument is made that ratio analysis is not a successful tool
with which to detect financial statement fraud. The study conducted by Kaminski, 
Wetzel and Guan was limited to those companies in which fraud had actually been 
discovered and the study did not take into account instances in which companies 
may have been misclassified as non-fraudulent and were, therefore, not used in the 
research. Thus, more research is needed to prove that analytical analysis is not a 
useful tool in the detection of fraud (Kaminski et al. 2004: 26).

3.6 SUMMARY

This chapter discussed the financial fraud risk assessment methodologies in general. 
It is clear that a fraud examination or a fraud risk assessment must be planned as 
thoroughly as any other audit or investigation (Kranacher et al. 2011: 181). Detailed 
planning provides structure to the process to be followed. The four main 
methodologies used to determine the possibility that fraud has been committed 
include interviews, brainstorming, financial analysis and the identification of red flags.

The interviews that are conducted in order to identify fraud risks are focused on 
attaining as much information as possible from various people with the requisite 
knowledge. Such interviews do not constitute an interrogation but are specifically 
structured in order to identify the possibility of fraud having been committed in the 
organisation (Manning 2011: 501).

Brainstorming involves getting a team of people together and ensuring that each 
team member has an equal opportunity to voice his/her ideas. The quality of the 
ideas is not important during the session although the ideas need to be evaluated 
and implemented after the brainstorming session has been concluded (Crumbley et 
al. 2007: 4-21).

Financial analysis is used to identify anomalies in the figures as presented in the 
financial statements. These anomalies may be an indication of the deliberate 
manipulation of the financial statements in order to mislead the users thereof. It must 
be borne in mind that such anomalies do not necessarily mean that fraud has been
committed, but they are an indication that the fraud examiner should conduct a further investigation into specific areas (Kranacher et al. 2011: 187).

The final methodology discussed was that of red flags which the prudent fraud examiner should not ignore (Taylor 2011: 131). Again, red flags are not necessarily an indication that fraud has been committed but they do create an awareness of the possibility of fraudulent behaviour (Skalak et al. 2011: 239).

Financial fraud detection requires an extensive set of skills on the part of the fraud examiner in addition to the normal set of skills which an external or internal auditor would have acquired as a result of experience and training.
CHAPTER 4: THE RESPONSIBILITIES OF EXTERNAL AUDITORS REGARDING FINANCIAL STATEMENT FRAUD

4.1 INTRODUCTION

In chapter 2 various financial statement fraud schemes related to the overstatement of revenue were discussed while chapter 3 discussed the general risk identification methodologies. Chapter 4 will focus on the roles and responsibilities of the external auditors as prescribed in the external audit standards (ISAs), the appropriate appendixes offering guidance on the implementation of the standards and relevant literature.

Research and surveys conducted by auditing firms, such as KPMG, Deloitte LLP., PWC and Ernst and Young, show that auditors, internal as well as external, do not detect fraud as often as is expected by the public. This phenomenon is commonly referred to as the expectation gap (Krambia-Kapardis 2010: 659). However, internal auditors are slightly more successful than external auditors in the detection of fraud (Corless 2009: 93). There are a variety of reasons why external auditors are not as successful as expected in the detection of fraud. External auditors usually have several different clients and, therefore, it is difficult to obtain detailed knowledge about each of these organisations. Likewise, with the expensive hourly charge-out rates, the organisation may reason that the actual costs of detecting the fraud may be more than the actual losses suffered as a result of fraud and finally, if an audit is based on a fixed fee, it may become a challenge to convince the management of the organisation to increase the audit fees to accommodate a fraud investigation. Thus, taking these factors into account as well as the pressure on external auditors to remain within budget mean that it often becomes extremely difficult to follow up on possible fraudulent activities (Corless 2009: 93).

The external auditor is responsible for the statutory audit of entities to express an opinion on the fairness of the financial information, as disclosed in the financial statements and according to an applicable financial reporting framework (Auditing Professions Act 2005: Ch 1: Definitions). If the audit is conducted according to
International Standards on Auditing (ISA) then the external auditor should provide reasonable assurance that there is no material misstatement in the financial statements, whether from error or fraud (Rezaee 2005: 285). The main purpose of the financial audit (external audit) is to give the intended users of the financial statements a greater degree of confidence in the financial statements than would be the case if the audit had not been carried out. This is done by providing an assurance in the opinion expressed by the external auditor that the financial statements were prepared and presented according to a specific financial reporting framework (SAICA ISA 200 2009: par 3).

There is an expectation, commonly referred to as the expectation gap, that fraud should be discovered through financial audits. However, the fact is that the existence of fraud is made known primarily as a result of a complaint or allegation made by a third party; suspicion on the part of an external auditor or investigator, management realising that expectations regarding sales or other performance indicators are not being met or it is discovered that something is missing, for example, documents, data or files (Singleton et al. 2006: 33). The expectation gap may also be described as where the public has certain expectations of external auditors to detect fraud, but in practice, this does not happen. The majority of studies conducted on fraud and fraud detection have focused on the way in which frequent fraud is detected by external auditors and not necessarily on how the external auditors reacted when red flags were identified (Hassink, Meuwissen & Bollen 2010: 862). Proactive fraud auditing, which involves a deliberate focus on the identification of fraud risk indicators, may be regarded as fraud detection and is the result of an active search which is conducted by means of various techniques and which is aimed at discovering that the potential for fraud exists. However, there is rarely conclusive evidence that fraud has been committed (Kranacher et al. 2011: 182).

It is essential that the external auditor plan the audit procedures in such a way that reasonable assurance may be obtained that the financial statements are not materially misstated as a result of either error or fraud (Kujinga 2010: 542). Nevertheless, it is still possible that the external auditor may not detect the fraud during the execution of the audit procedures because of the inherent limitations of an
audit. The external auditor expresses an opinion on the financial statements as a whole and, consequently, the external auditor is not responsible for detecting misstatements which are not material to the financial statements as a whole (Sirbu et al. 2009: 63). The non-detection of misstatement as a result of fraud is higher than the non-detection as a result of an error. The reason for this is that management is able to override controls and manipulate the accounting records specifically to conceal that the fraud is being committed. Although the external auditor may identify possible opportunities for fraud to be committed or potential fraud risks, it is difficult to determine whether a misstatement has been caused by either fraud or error (SAICA ISA 240 2009: par 6). In this vein, Kranacher et al. (2011: 182) emphasise that financial statement fraud may be difficult to detect because of collusion and override of controls on the part of management.

Fraudulent financial reporting is regarded as the deliberate abuse of power by clever and educated individuals who use either persuasion or intimidation. In addition, it may be that a lack of knowledge, skills and expertise on the part of the external auditors is the cause of the low rate of detection of financial statement fraud by external auditors (Krambia-Kapardis 2010: 659).

4.2 REPORTING STRUCTURE OF EXTERNAL AUDITORS

The external auditors are appointed annually at the annual general meeting of public companies and state-owned companies and, therefore, the final reporting responsibility of the external auditors is towards the shareholders, although the tabling of the annual audit report will, initially, be to senior management and the board of directors. The audit firm appointed decides which professional in the auditing firm will be responsible for the auditing engagement at the company (Companies Act no 71 of 2008: s 90(1) and Auditing Professions Act 2005: s 44(1)(a)).
4.3 EXTERNAL AUDITING OF FINANCIAL STATEMENTS

4.3.1 Introduction

The purpose of the external audit, also known as a financial audit, is to provide reasonable assurance that the financial statements are fairly presented and are without material misstatement (Rezaee & Riley 2010: 230). This is achieved by following the guidance of the ISAs in terms of which it is expected of the external auditor that he/she will use professional judgment and scepticism throughout the entire audit – whilst planning and performing the engagement (SAICA ISA 200 2009: par 7). Professional judgment refers to the ethical application of the external auditor’s training, knowledge and experience of auditing and accounting making a decision regarding the audit engagement (SAICA ISA 200 2009: par13k). The quality of the audit is dependent on the ability of the auditors to exercise professional judgment (Green 2008: 724). On the other hand, professional scepticism refers to a mental attitude regarding the critical questioning of all information in order to establish the possibility of the inclusion of misstatements in the financial statements as a result of fraud or error (SAICA ISA 200 2009: par 13l).

Professional judgment and scepticism involve conducting a proper risk assessment of the possibility of material misstatements in the financial statements. This, in turn, implies an understanding of both the environment in which the organisation operates as well as the internal control systems in place within the organisation. Sufficient audit evidence is then collected as a result of the design and execution of appropriate audit procedures which address the assessed risks and which will support the opinion expressed by the external auditor on the financial statements (SAICA ISA 200, par 7).

It is generally not regarded as the responsibility of the external auditor to detect financial statement fraud although the public expects the external auditor to detect fraud. As already stated this is known as the expectation gap and will not be further discussed. Nevertheless, it is incumbent on the external auditor to exercise scepticism and fraud alertness throughout the audit engagement and it is argued that
a lack of scepticism and fraud alertness may result in the failure to detect financial statement fraud (Krambia-Kapardis 2010: 659).

### 4.3.2 Financial statement audit process

In South Africa, as in most other countries, the law prescribes the independent attestation of the financial statements of an organisation. The party usually responsible for this duty is the external auditor who would have qualified as either a chartered accountant (CA) or as a certified public accountant (CPA) (Reding et al. 2009: 1-8). Furthermore, it is also expected of the external auditor to report upon the system of internal controls, including the internal controls related to the financial reporting process (Sarbanes-Oxley Act: s404 (b); SAICA ISA 315 2009: par12).

The financial audit process is a comprehensive process that ends in the financial audit and the opinion expressed by the external auditors. However, the process also includes other role players, such as the board of directors, management, the internal auditors and other staff members. In fact, it is the end result of an accounting process which includes effective internal controls to guide staff members and enable them to follow specific procedures when recording all transactions (Akpomi, Ugodulunwa & Nnadi 2005: 56). If any of these role players or steps in the process fails, then the possibility of financial statement fraud arises. The process starts with the assurance given by the directors in the leadership role which has been assigned to them, the creation of a functioning and effective internal control environment, effective internal audit and external audit processes in terms of which all misstatements are identified and corrected and financial statements which are presented by management reflect a fair view of the affairs of the organisation (Taylor 2011: 24).

The opinion expressed by the external auditor on the financial statements will be based on the financial statements conforming to a specific financial reporting framework. However, this does not include matters such as going concern issues or the compliance to the internal control system. The latter may be expected of the external auditor in certain jurisdictions but would result in further work done by the
external auditor because it does not form part of the basic audit on financial statements (SAICA ISA 200 2009: par A1).

4.4 EXTERNAL AUDITORS AND FINANCIAL STATEMENT FRAUD

It is acknowledged by the external audit standards that there is an inherent limitation in an external audit as regards to the identification of material misstatements in financial statements. This risk increases if the material misstatement is the result of fraudulent activities. However, this inherent limitation exists even if the audit was properly planned and performed (IIA et al. 2012: 13).

The external auditing standards relating to auditing financial statement fraud are ISA 240 and SAS 99. These standards provide detailed guidance on the responsibilities of the external auditor in respect of fraud in the financial statements. If the external auditor is to fulfil his/her responsibilities relating to financial statement fraud then it is essential that specific requirements be met. These requirements, as contained in the standards, are now discussed in more detail.

4.4.1 Professional scepticism

Due professional care demands that the external auditor exercise professional judgment and scepticism throughout the performance of the audit (AU 316 2002: par 13; SAICA ISA 200 2009: par 7). In other words, the external auditor must exercise due professional care during the planning of the audit engagement, the procedures performed, the evidence evaluated up to the final conclusions and the reporting phase of the audit engagement (Rezaee 2005: 293). In addition, while maintaining professional scepticism throughout the audit the external auditor must consider the possibility that fraud risks may be identified during the course of the audit and, thus, the external auditor should critically question all the information in order to establish the possibility of fraud (Wells 2005: 349). Even if, in the past, the external auditor observed honesty and integrity at an entity, it is essential that the external auditor keep an open mind regarding the possibility of fraud during the financial period under review (SAICA ISA 240 2009: par 12).
Fraudsters look no different from ordinary people. According to KPMG (2011: 3), many fraudsters have often worked for the entity a long time before they commit fraud. However, a trigger such as poor economic conditions or personal challenges may cause their behaviour to change and they may start to commit fraud. Thus, the external auditor must critically assess all information with both an open mind and an increased awareness of the possibility of the existence of a material misstatement as a result of fraud. All evidence must be evaluated and corroborated with well-founded expectations and credible internal and external sources to identify any inconsistencies in the information presented by management and staff (Skalak et al. 2011: 241).

ISA 240 (SAICA 2009: par A7) requires that the external auditor continuously question the audit evidence in order to ensure that there is no material misstatement in the information as a result of fraud. This is particularly important during the fraud risk assessment and the planning of the audit based on the risk assessment (Wells 2005: 349). Sherman et al. (2003: 20) maintain that the time to start asking questions and exercising scepticism is when the financial statements are not clear on how the organisation is making its money and when the organisation is receiving payment for sales. A common problem that external auditors experience is the fact that a single transaction may not necessarily constitute fraud or even a red flag pointing to fraud (Singleton et al. 2006: 147) and, thus, it is necessary to accumulate all the misstatements and possible red flags during the audit process, review them as a group and a total value in order to consider the possibility of financial statement fraud once all the audit evidence has been gathered. The external auditor must have a questioning mindset and be able to detect that one transaction that would result in financial statement fraud (Crumbley et al. 2007: 4-4).

Professional scepticism may also be described as the mindset adopted by the auditor whilst conducting a regular financial audit and which signifies an awareness of any signs (red flags) that may indicate the possibility of financial statement fraud. It is essential that the auditor be able to “think outside of the box” and critically
question the financial statements in order to ascertain whether there is a suspicion of something untoward hidden in the financial statements (Singleton et al. 2006: 43)

Ramos (2003: 28) indicates that, in accordance with SAS 99, auditors should overcome their natural tendency to rely on the representations of management. They must not assume that previous relationships of trust will continue into the current audit investigation and they must develop the instincts of a more critical and sceptical mindset. These instincts are developed over time and are acquired with experience. A junior auditor would, in all likelihood, not have the required mindset to question the ordinary and, thus, to detect the unusual. This is one of the reasons why discussions amongst team members are so important because it is during these discussions that the more experienced team members may share their knowledge and experience (Crumbley et al. 2007: 4-4).

4.4.2 Interviews

It is prescribed in the ISAs that the external auditor must perform procedures to assess the risks related to the material misstatement of the financial statements at the statement as well as the assertion level (SAICA ISA 240 2009: par A37). These procedures include inquiries of management and others within the organisation that may assist with information to identify possible misstatement of the financial statements, the performance of analytical procedures as well as observation and inspection (SAICA ISA 315 2009: par 6). All information regarding the organisation and which was previously obtained must be considered in relation to the current engagement and in the light of whether there is any indication of the possible misstatement of the financial statements as a result of fraud (SAICA ISA 300 2009: par 7-10).

Interviews are necessary at various levels because it is recognised that it is not possible for the external auditing process, on its own, to provide assurance that the identification of the risk of fraud and detection of financial statement fraud will take place. In many cases management is responsible for committing the financial statement fraud and, therefore, it is essential that parties other than the auditors and
managers be included in the fraud detection and identification process (Du Toit 2008: 8).

The standards [SAICA ISA 240 2009: par 17 & SAS 99 (AU 316 2002: par 20)] all require that the external auditor conduct interviews with management to establish the fraud risk management processes which are aimed at identifying financial statement fraud risks and which are followed within the organisation and also how often the fraud risk assessments are conducted. In addition, management must be asked whether any fraud risk relating to financial statement fraud has been identified and what actions have been taken to address the particular risks.

Interviews must be conducted with management and key financial staff as well as internal audit and operational staff members to obtain as much information as possible regarding fraud risk factors. The fraud examiner must also extend the interviews to include the corporate management group, including the board of directors, chairperson of the board and the audit committee (Skalak et al. 2011: 251).

The extent of the communication of the specific risks to governance bodies as well as staff members must be determined while interviews must be conducted with those charged with the governance of the organisation in order to ascertain how they monitor and oversee the fraud risk management processes, including the internal controls put in place to address the fraud risks identified (SAICA ISA 240 2009: par 17). Furthermore the external auditor should question them on any knowledge regarding possible fraudulent activities. The information obtained must then be corroborated with the information obtained from management (SAICA ISA 240 2009: par 20-21). The external auditor may follow the route of detecting fraud by accident or the route of deliberately identify vulnerable areas which are exposed to fraudulent activity. The deliberate attempt to seek red flags or fraud risk areas may be achieved by traditional audit procedures and analytical analysis. However, interviewing honest staff members may be of significant benefit to the auditor in the process of identifying financial statement fraud risks and fraudulent activities (Wells 2008: 6).
During the interviewing process the auditors must obtain an understanding of the journal entries and the processes followed to create these journal entries. It is essential that auditors discuss journal entries and the control over journal entries with staff members other than management and enquire about the appropriateness of the journal entries passed (Kranacher et al. 2011: 175). In addition, the auditor must have a thorough understanding of the accounting systems because, in the main, fraud is committed in the books. There are off the book schemes, but financial statement fraud, in terms of which the financial statements are manipulated to appear better than they actually are the accounting systems are used to commit the fraud (Singleton et al. 2006: 211).

4.4.3 Discussion among the engagement team

ISA 315 (SAICA 2009: par 10) requires of the external audit engagement partner and key engagement team members to hold a discussion regarding the vulnerability of the financial statements to the possibility of fraud causing a material misstatement of the statements. In addition, the discussion should include the appropriateness of the financial reporting framework used by the organisation and any other related facts and circumstances. SAS 99 refers to brainstorming with a similar expectation that discussions should be held (Alon & Dwyer 2010: 242).

The external audit team members should also hold a discussion amongst themselves specifically on the matter of where the entity’s financial statements may be at risk of material misstatement as a result of fraud and how the fraud may occur (Rezaee 2005: 293). This is a requisite audit procedure and it should be carried out with the same due care as any other audit procedure (Ramos 2003: 28). It puts a further obligation on the external auditor to obtain additional evidence if fraud is suspected, regardless whether the amount involved is material or not (Hopwood et al. 2008: 111).

The focus of the brainstorming session should be on those areas of the financial statements which would be the most susceptible to possible fraud, the fraud scheme which may be used by senior management to perpetrate fraud and the method which
may be followed to conceal the fraud from detection (Wells 2005: 349). In addition, such a session may be used to apply the fraud triangle conditions to the entity in order to identify possible factors that would impact on the pressure, opportunity and rationalisation of fraud (Wells, 2005: 349). The fraud triangle may be extended to the fraud diamond in terms of which the capability to commit fraud on the part of an individual must be taken into account (Wolfe & Hermanson 2004: 38). During the brainstorming session, all these elements may be discussed and the team members may contribute by assessing the capability of individuals who would be able to manipulate the systems, who would possess knowledge of the weaknesses of the internal control systems and also the technical skills to override the controls or who could dominate other staff members and coerce them into following inappropriate instructions (Wolfe & Hermanson 2004: 39). The brainstorming session should be held at the beginning of the audit engagement and provide all the audit team members with the opportunity to identify possible areas where fraud could be committed and how it may occur (Kranacher et al. 2011: 176).

The objectives of brainstorming are to enable senior team members to share their thoughts and experiences regarding the entity to be audited as well as to set the scene regarding the way in which the audit should be conducted with those team members who have less experience. All the team members are given the opportunity to share their thoughts on where and how fraud may be perpetrated (AU 316 2002: par 14). SAS 99 perceives the brainstorming session as a way in which to generate ideas of how fraud may be committed and concealed. However, in practice, the brainstorming session may also be used to discuss possible ways in which to respond to any fraud risks identified (Ramos 2003: 29).

ISA 240 (SAICA 2009: par A10) perceives the discussion session as an opportunity for the more experienced team members to share their knowledge with the lesser experienced team members as well as to discuss how the audit procedures will be followed and adapted to respond appropriately to the risks identified. This exercise should result in better professional care as regards the selection of the nature, timing and extent of the audit procedures that should be included in the audit programme (Rezaee & Riley 2010: 234). Furthermore, the brainstorming sessions should give all
the team members a better understanding of how the risk factors identified may impact on the financial statements and result in financial statement fraud (Crumbley et al. 2007: 4-4). The sessions will also give the team the opportunity to decide how the results of the various audit engagements will be shared amongst the team members and, if financial statement fraud is actually identified, how this will be dealt with by the team (SAICA ISA 240 2009: par A10).

It is essential that the auditor exercise professional scepticism during this brainstorming sessions or discussions. Professional scepticism requires that the auditor not accept any information at face value but that the auditor critically assesses the information and questions the integrity of the information throughout the audit process and also during these discussions (Sherman et al. 2003: 20). The auditing standards do not restrict the brainstorming sessions to the planning stage of the audit engagement and they may be held throughout the audit as and when necessary while the auditors are gathering information. This, in turn, should assist the auditors to keep an open mind and to be sceptical of any information presented to them. However, there must be continuous communication during the audit and not just during the formal brainstorming sessions (Ramos 2003, 29).

The discussion sessions will assist the team members to realise the impact of specific audit procedures on one component of the financial statement on another component of the financial statements. The sessions will also facilitate good communication between team members throughout the audit although it is not necessary that all the team members be included all the time in all the discussions. The engagement partner may use professional judgment regarding who should be included in specific discussions. The main focus of the discussions is the exchange of information in order to bring to the fore an awareness of possible fraud (SAICA ISA 315 2009: par A14).

4.4.4 Analytical analysis

Analytical analysis is another procedure which may be used to assist in the fraud risk assessment. As with any other audit being conducted the industry in which the
company operates should be analysed so as to ensure that sufficient background information is obtained in order to gain an understanding of the way in which business is conducted in the industry concerned. This knowledge is important in distinguishing between a routine transaction and an unusual transaction or an abnormally large transaction (Manning, 2011: 571; SAICA ISA 240 2009: par 22). This step will be followed by conducting a financial analysis by using ratio analysis to identify material fluctuations in the financial statements. This financial analysis may extend over one or more financial periods or it may involve a comparison with other non-financial information obtained (Crumbley et al. 2007: 4-35).

If a fraud scheme is committed in the financial information available to auditors, then computer assisted auditing techniques (CAATs) may be used to perform audit procedures on 100% of the data in order to detect unusual trends, exceptions or anomalies in the financial statements or unexpected revenue relationships. These findings may then be compared with non-financial information or else specific ratios may be calculated to verify the information in order to detect material misstatements and prove financial statement fraud (Singleton et al. 2006: 173). However, Zhou and Kapoor (2011: 574) are of the opinion that more advanced CAATs should be developed to address the issue of the ever-changing fraud schemes which fraudsters are able to implement because of the use of technology.

Where there is suspicious fraudulent financial reporting as a result of revenue recognition fraud schemes, the auditor should extend the audit procedures to address these risks by performing financial analysis procedures on the financial information on a month-to-month basis as well as on a product line or business segment basis. This must be done for the current period under review as well as for prior periods (SAICA ISA 240 2009: appendix 2).

It is also necessary to review all the accounting estimates because it is easy to practise creative accounting by manipulating financial results where judgment is required. Estimates or provisions may be used to conceal a financial statement fraud scheme (Kranacher et al. 2011: 175). In the case of revenue recognition and related assets such as accounts receivables, management may use estimates of bad debt
recovery to manipulate the accounts receivables balances at year end in order to conceal the fraudulent revenue recognition schemes being used to misrepresent the financial statements. Another audit procedure that external auditors should execute to identify financial statement fraud risks involves the examination of either unusual transactions or once-off transactions. These types of transactions may also be used to conceal financial statement fraud and fraud schemes (Kranacher et al. 2011: 175).

4.5 AUDITING OVERSTATEMENT OF REVENUE FRAUD SCHEMES

4.5.1 Introduction

The overall response to the possibility of financial statement fraud should be to assign experienced and knowledgeable staff members to perform advanced procedures to determine the extent of the possible fraud. In addition, the manner in which management selected and applied the accounting policies to report on the financial statements must be evaluated (ISA 240 2009: par 29) The external auditing standard SAS 99 requires that the auditor change the audit procedures if the likelihood of financial statement fraud is judged to be high with these audit procedures being adapted according to the account or component affected by the risks (Ramos 2003: 32).

In the case of financial statement fraud as a result of the overstatement of revenue, the focus should be on accounts receivable, revenue (sales) and bad debts. The successful execution of audit procedures depends on the nature, timing and extent of the audit procedures when the audit programme is designed. (Hopwood et al. 2008: 249; ISA 240 2009: par A36). An auditor usually follows an audit programme when conducting a regular audit. However, when the auditor is conducting a fraud examination, evidence must be collected and analysed to uncover possible fraud and, therefore, professional judgement and other fraud indicators will play a more important role than a standard audit programme (Manning 2011: 571).
4.5.2 Audit procedures conducted on an assertion level

In response to the assessed risks of material misstatement due to fraud, the external auditors may have to change the nature, timing and extent of the audit procedures. The procedures may be extended to do more physical observation or inspection to obtain more reliable and relevant evidence (ISA 240 2009: par A37). The audit programme should be focused on either detailed tests or substantive tests because tests of controls alone will not detect financial statement fraud. The reason for this is that management may override controls and, therefore, the normal tests of controls would not be effective (Crumbley et al. 2007: 4-19). The successful execution of audit procedures depends on the nature, timing and extent of the audit procedures when the audit program is designed (Hopwood et al. 2008: 249).

The risks of material misstatement should be identified and assessed by the external auditor on financial statement level as well as on assertion level. This should be done for the various classes of transactions, the various accounting balances as well as all disclosures presented in the financial statements. The result of this risk assessment will provide a basis on which to develop and execute further audit procedures (Ayoola-Akinjobi & Omowumi 2010: 73; ISA 240 2099: par A37-A40).

In the case in which financial statement fraud is suspected as a result of the overstatement of revenue the external auditor may extend the audit procedures on the assertion level by visiting major customers and not merely sending out a customer confirmation letter. Any adjustments made to accounts receivables and bad debts must be reviewed in detail and corroborated with documentation and other evidence. This may be evidence arising from the interviews conducted with staff members and management or from the results of audits conducted at the organisation’s subsidiaries by other external auditors (SAICA ISA 240 2009: Appendix 2).

However, in a study conducted by Hammersley, Johnstone and Kadous (2011: 81, 98), it appeared that, although external auditors may identify high fraud risks, they are unable to respond effectively and appropriately to the higher risk. This, in turn, is
as a result of an inability to develop and adapt the existing audit programme in such a manner that it addresses the fraud risks effectively. In their response to higher fraud risks, the auditors tended to execute the same audit procedures on larger audit samples instead of designing more focused audit procedures designed to address the specific fraud risk. In other words, they focused on the extent and not the nature of the audit procedures (Hoffman & Zimbelman 2012: 26).

4.5.3 Audit procedures in response to misstatement resulting from fraudulent financial reporting

The controls surrounding electronically initiated revenue transactions must be specifically tested for the occurrence and recording of such transactions (SAICA ISA 240 2009: appendix 2).

Written representations should be obtained from management regarding their responsibilities and the fact that, if they were aware of any fraud, they disclosed it to the auditors. It is essential that any detection of fraud be communicated as soon as possible to the correct level of management so as to inform them of their responsibilities regarding the fraud (SAICA ISA 240 2009: par 39–42).

The results of the fraud risk assessment relating to the material misstatement of the financial statements must be included in the audit working papers. In addition, all decisions taken after discussions between the team members and the responses to the risks assessed must be properly documented in the audit working papers while the reasons for concluding that the risk of material misstatement as a result of fraud is not related to revenue recognition must also be clearly documented in the audit working papers (SAICA ISA 240 2009: par 44–47).

ISA 240 (SAICA 2009: appendix 2) further prescribes confirmation procedures with customers to establish contract terms and conditions, including discussions with legal and marketing personnel regarding such terms and conditions. If the customers are able to order goods under contract that will only be sold at a later stage, they are actually buying ahead of the current accounting period (Mulford & Comiskey 2002: 36).
Side agreements may state the goods may be returned after the end of the accounting period and this would, in turn, have an impact on the shelf life of some of the products. In addition this method would result in poor results in the new accounting period and the misstatement of the current period’s financial statements (Mulford & Comiskey 2002: 172).

It is expected of the external auditor to be present at year end at the various locations to observe the shipping and receiving procedures in respect of inventory (SAICA ISA 240 2009: appendix 2). If the financial analysis indicates a change in inventory as a result of increased sales then non-financial information such as observing the inventory in the warehouse should confirm the trend (Manning 2011: 573; ISA 240 2009: parA38).

4.5.4 Audit procedures in response to risks related to management’s overriding of controls

Management is in a unique position in that management members are able to manipulate the financial reporting process by manipulating both the internal controls and the accounting records (SAICA ISA 240 2009: par 31). In other words, managers may override internal controls and collude with colleagues to commit financial statement fraud (Rezaee 2005: 284). However, this behaviour may easily be underestimated by auditors and, therefore, not detected early enough (Taylor 2011: 333).

When the auditor responds to the fraud risk assessment in respect of the misstatement of the financial statements one of the first evaluations will involve the system of internal controls with the external auditor focusing on the controls related to both the financial systems and the financial reporting systems. The auditor will have to establish the type of control environment and the culture created by management as well as the implementation and monitoring of the internal control procedures (Gogtas, Pollner & Bay 2007: 27).
It is essential that the external auditors develop audit procedures to identify the breakdown of internal controls regarding the financial reporting processes and financial results. They must examine all journal entries and other adjustments to identify possible financial statement fraud. In addition, they must understand the internal control processes of the entity and ensure that all journal entries are properly approved and substantiated with valid documentation (ISA 240 2009: par 32). The timing of the journal entry must be examined as well as who has the final sign-off on the journal entries. The necessity for the journal entries must be established through discussions with operational staff members other than management (Kranacher et al. 2011: 175).

Specific audit procedures to test the suitability of journal entries must be performed and must focus on journal entries made at the end of the accounting period in terms of which the financial statements are being prepared. If deemed necessary in terms of the fraud risk assessment, the testing of journal entries may be extended to the entire period. The basis, logic and circumstances regarding accounting estimates must be reviewed if these accounting estimates represent a possibility of material misstatement of the financial statements (SAICA ISA 240 2009: par 32). The auditor should determine whether any other areas might be affected by the override of controls by management which may lead to financial statement fraud. If necessary the appropriate procedures to address these risks must be executed (ISA 240 2009: par 33).

ISA 315 (SAICA 2009: par13) specifically prescribes the understanding and testing of internal controls that are relevant to the audit. A weakness in the system of internal controls will create an opportunity for fraud to be committed (Singleton et al. 2006: 11). Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) prescribes that management must report upon the adequacy of the internal control structure and the procedures involved in the financial reporting process while the external auditor should assess and report upon management’s assessment (Wells 2005: 300). In South Africa both the King III Report and the Code on Governance for South Africa (King III) recommend a similar process and state that the external auditors should
report to the audit committee regarding the financial information (IOD King III 2009: principle 3.4).

4.6 FINALISATION OF THE EXTERNAL AUDIT

4.6.1 Evaluation and conclusion

After all the procedures have been performed the external auditor has to evaluate and draw conclusions based on the evidence obtained. If the audit evidence confirms the possibility or the existence of fraud, it is incumbent on the auditor to re-evaluate the initial risk assessment and determine the impact of the evidence on the audit (SAICA ISA 240 2009: par 34–37). If the auditor concludes that a material misstatement is due to fraud, or if the auditor is unable to make such a definitive conclusion, the implications to the audit of such conclusion should be evaluated (ISA 240 2009: par 37).

Analytical analysis should be done near the end of the audit to establish whether there is any previously unidentified fraud risks exposed (ISA 240 2009: par 34). The auditor has to apply professional judgment to determine whether any unusual trends have been identified near the end of the financial year (ISA 240 2009: par A50). Furthermore, if the auditor concludes that the financial statements are misstated, it should be evaluated whether the misstatement is due to error or fraud. The auditor must take into account that an instance of fraud is seldom an isolated occurrence and therefore the implications of this incidence must be expanded to other areas of the audit such as management representations and the location or area where the incident was identified. All misstatements must be evaluated as a group to ascertain that there is no material misstatement in the financial statements (ISA240 2009: Par 35). In addition the possibility of management involvement as well as collusion must be examined and whether previously obtained evidence and representations can be relied upon (ISA 240 2009: par 36).

If the results of the audit make it impossible for the auditor to continue with the audit engagement, the necessary legal requirements to withdraw from the audit should be
considered and discussions with management and those in charge of the governance of the organisation held in order to inform them about the withdrawal from the audit engagement as well as the reasons for such withdrawal (SAICA ISA 240 2009: par 38).

If fraud has been identified and detected the external auditor must insist that action be taken to address the fraud committed. If, however, management has already instituted appropriate actions to rectify the results of the fraud then the external auditor must evaluate these actions to ensure that they address both the fraud risk and the results of the fraud effectively (Hassink et al. 2010: 872).

4.6.2 Reporting of results

Consideration should be given to the possibility that the fraud and fraud risks identified should be reported to those people who initially appointed the external auditor as well as the regulatory authorities. The external auditors, board of directors and the audit committee must convene a specific meeting during which these results are discussed frankly and openly (Rezaee 2005: 294). Reportable irregularities are defined by the Auditing Profession Act, 2005 (Act No. 26 of 2005) as any unlawful act or omission committed by management which either results in financial loss to the entity and various stakeholders or is fraudulent or is a breach of the fiduciary duty towards the organisation. The auditor should take these stipulations into account when fraud is detected (SAICA ISA 240 2009: par 43).

It is essential that the external auditor report in writing to the appropriate management levels as soon as significant red flags and possible fraudulent activities have been identified. It may even be necessary to report certain types of fraud, material cases and management fraud directly to both the board of directors and the audit committee. In situations in which management refuses to initiate the necessary actions in order to address the significant fraud risks or fraudulent activities, it should be elevated to the board of directors and the audit committee (Hassink et al. 2010: 870–872).
4.7 SUMMARY

This chapter discussed the responsibilities of the external auditors regarding financial statement fraud according to the external audit standards and appendixes. According to the standards the external auditor has a responsibility to plan the audit procedures in such a way that reasonable assurance may be obtained that the financial statements are not materially misstated as a result of either error or fraud (SAICA 2009: ISA 200 par 5 & ISA 240 par 5). Due professional care must be exercised throughout the entire audit process. This is done by exercising consistent professional judgment and scepticism (ISAICA SA 240 2009: par 7).

It is expected of the audit team to conduct brainstorming sessions or team discussions to establish the vulnerability of the financial statements to the possibility of fraud causing a material misstatement of the financial statements. These discussions should also include the appropriateness of the financial reporting framework used by the organisation and any other related facts and circumstances (SAICA ISA 315 2009: par 10; AU 316 2002: par 14). Such discussions are also regarded as a way in which to generate ideas of how fraud may be both committed and concealed. In addition, such sessions may also be used to discuss possible ways in which to respond to any fraud risks identified (Ramos 2003: 29).

Interviews are necessary on various levels because it is recognised that it is not possible for the external auditing process on its own provide assurance that financial statement fraud will be identified and detected. In many cases management is responsible for committing the financial statement fraud and, therefore, parties other than auditors and managers must be included in the fraud detection and identification process (Du Toit 2008: 8). The standards (SAICA ISA 240 2009: par 17 & SAS 99 (AU 316 2002: par 20)) stipulate that the external auditor must conduct interviews with management to establish the fraud risk management processes in place and which are designed to identify financial statement fraud, and how often such assessments are carried out.
Analytical analysis is another procedure which may be used to assist in the fraud risk assessment. Where there is suspicious fraudulent financial reporting as a result of revenue recognition fraud schemes, the auditor should extend the audit procedures to address such risks by performing financial analysis procedures on the financial information on a month-to-month basis as well on a product line or business segment basis. This must be done for the current period under review as well as for prior periods (SAICA ISA 240 2009: appendix 2).

The external auditor must perform procedures to assess the risks related to the misstatement of the financial statements at the statement as well as the assertion level (SAICA 2009: ISA 240 par 25 & ISA 315, 2009: par 5). These procedures include inquiries of management and others within the organisation that may assist with information to identify the possible misstatement of the financial statements, the performance of analytical procedures as well as observation and inspection (ISA 300, 2009: par 6).

Managers are often able to override internal controls and collude with colleagues to commit financial statement fraud (Kranacher et al. 2011: 175). However, this behaviour may easily be underestimated by auditors and, therefore, not detected early enough (Taylor, 2011: 333). ISA 315 (SAICA 2009: par 13) specifically prescribes the understanding and testing of internal controls that are relevant to the audit. A weakness in the system of internal controls will create an opportunity for fraud to be committed (Singleton et al. 2006: 11).

With the finalisation of the audit engagement all evidence must be evaluated and documented appropriately as well as all the decisions taken regarding financial statement fraud. If the external auditor concludes that the financial statement fraud is not the result of a fraud scheme related to revenue recognition then the reasons for this conclusion must be documented in the audit working papers (ISA 240 2009: par 44–47).
CHAPTER 5: THE RESPONSIBILITIES OF INTERNAL AUDITORS REGARDING FINANCIAL STATEMENT FRAUD

5.1 INTRODUCTION

In chapter 2 various financial statement fraud schemes related to the overstatement of revenue were discussed while chapter 3 discussed the general risk identification methodologies. Chapter 4 dealt with the roles and responsibilities of the external auditors regarding financial statement fraud as prescribed in the external audit standards. The focus of chapter 5 will be on the roles and responsibilities of internal auditors regarding financial statement fraud according to the IIA Standards, appropriate guidance and relevant literature. The IIA Standards are read in conjunction with the Practice Advisories related to a specific standard and other applicable guidance suggested by the Institute of Internal Auditors, including practice guides and position papers.

Research and surveys conducted by auditing firms show that auditors, internal as well as external, do not detect fraud as often as is expected by the public. This is commonly referred to as the expectation gap (Krambia-Kapardis 2010: 659). However, internal auditors are slightly more successful than external auditors in the detection of fraud (Corless 2009: 93). The reason for this is that internal auditors are often employed by a single organisation and, therefore, their day-to-day interactions result in their acquiring a more in-depth knowledge of the organisation and the way in which it operates than the external auditors. In addition, the salaries of the internal auditors are lower than the charge-out rates of the external auditors and this, in turn, means that the internal auditors are more cost effective regarding an investigation into suspected fraud than the external auditors. It may also happen that management will encourage the internal auditors to investigate all possible fraudulent activities and not only those that tend to be material (Corless 2009: 94).

Per definition the primary role of internal auditors is to provide an independent objective assurance and consulting service to the organisation with the purpose of adding value to and improving the organisation’s operations (IIA Standards 2011: i).
This is achieved by a systematic and disciplined approach to the evaluation of the risk management, control and governance processes designed to improve the processes, thus enabling the organisation to accomplish its objectives and goals (IIA Standards 2011: i). The evaluation of the processes by the internal auditor must assess the efficiency, effectiveness and economy of operations and the performance of management in order to support management in the fulfilment of its responsibilities (Rezaee & Riley 2010: 206). Internal auditors, according to the definition, must make recommendations which will result in the continuous improvement of the performance of the organisation while, according to IIA Standard 2120.A1 (2011) the Internal Audit Activity (IAA) must evaluate the abovementioned processes in order to establish the reliability and integrity of all information, operational as well as financial.

Rezaee and Riley (2010: 208) maintain that internal auditors are in the best position to detect financial statement fraud. However, external auditors are traditionally held responsible for the detection of financial statement fraud. The prevention of financial statement fraud by internal auditors will consist of limiting the opportunities available to commit financial statement fraud and assessing possible financial statement fraud risks (Rezaee & Riley 2010: 210). According to IIA Standard 2120.A1 (IIA Standards 2011) this would involve assessing both the reliability and integrity of financial information and also how the process is dealt with by the management of the organisation. IIA Standard 1210.A2 (IIA Standards 2011) states that it is not expected of the internal auditor to be an expert in the detection and investigation of fraud but, nevertheless, the internal auditor must have sufficient knowledge to enable him/her to evaluate fraud risks and the way in which such fraud risks are managed within the organisation. The Standard refers to fraud in general and the assumption is made in this study that this includes financial statement fraud.

According to the standards of both the internal and the external auditors, the prevention and detection of fraud is primarily the responsibility of management and those who govern an organisation. In the Practice Guide, Internal Auditing and Fraud (IIA 2009: 10), it is stated that the board of directors and the management of an entity are, ultimately, responsible for fraud deterrence. However, it is part of the
responsibility of internal auditors to assist management in assessing the adequacy of the internal controls and the control environment of an entity (IIA Standard 2030 2011).

In order to exercise proper accountability, management is responsible for ensuring that an effective Internal Audit Activity (IAA) is instituted within the organisation. The IAA is in the position to inform management continuously on the adherence to all policies and procedures as well as the financial position of the organisation (Akpomi et al. 2005: 55–56).

5.2 REPORTING STRUCTURE OF INTERNAL AUDITORS

Per definition the function of internal auditors is to support management to achieve the objectives and goals of the organisation (IIA 2009: i). Accordingly, the primary reporting structure of the internal audit activity through the chief audit executive is towards senior management and the board of directors (IIA Standard 1100 2011). This, in turn, is achieved primarily by a dual-reporting structure in terms of which the CAE reports administratively to senior management, the CEO, and functionally to the audit committee representing the board of directors (IIA Standards 2011: Practice advisory 1110-1).

5.3 INTERNAL AUDITING OF FINANCIAL STATEMENTS

5.3.1 Introduction

The nature of the work of the internal auditor involves the evaluation of the governance, risk management and control processes in order to make a contribution to the improvement thereof. This is achieved by a systematic and disciplined approach (IPPF, IIA Standard 2100: 2011). The role of the internal auditors is important in the governance structure as they are able to provide assurance on proper and responsible governance and the financial reporting processes. The daily involvement of the IAA in the operational as well as in the financial reporting
processes and systems enables them to identify high risk areas in the financial reporting process (Rezaee & Riley 2010: 208).

### 5.3.2 Financial statement audit process

The assurance provided on the fairness of the financial statements as a result of an audit process is usually given by the external auditors who are from outside the organisation and independent. Internal auditors are also involved in the audit process of the financial statements but they report to a different audience as compared to the external auditors, with the external auditors reporting to the shareholders and the internal auditors to the management of the organisation (Reding et al. 2009: 1-8).

The IIA Standards are not prescriptive regarding the auditing of the financial statements, but they do prescribe the evaluation of risks related to the reliability and integrity of an organisation’s financial and operational information as processed by the systems of operations, information and governance (IIA Standard 2120.A1 2011). Furthermore, it is expected of the internal auditor to provide assurance regarding the risks related to the effectiveness and efficiency of operations and programmes as well as the realisation of the strategic objectives of the organisation (IIA Standard 2120.A1. 2011). Internal audit is seen as a management function with the primary responsibility of assisting management in the improvement of the operations as well as the financial functions of the organisation (Taylor 2011: 46). Furthermore, in South Africa, King III prescribes that the internal controls which an organisation puts in place must relate to the financial, operational, compliance and sustainability related activities of the organisation. It is then expected that the internal auditors to report in writing about the effectiveness of such controls and risk management aspects (King III 2009: principle 7.3).

Management is responsible for creating an efficient and effective control environment. This, in turn, includes adequate and effective internal control policies and procedures as well as an effective internal audit activity. It is essential that the internal controls address all risks within the organisation, including fraud risks. The
assumption made in this study is that this fraud risks also refers to financial statement fraud. The IAA is in the ideal position to provide management with the assurance that the controls and procedures which are designed to enhance a proper system of financial reporting and disclosures are implemented and complied with effectively (Rezaee 2005: 284–285).

5.4 INTERNAL AUDITORS AND FINANCIAL STATEMENT FRAUD

The IIA Standard 1210.A2 (IIA Standards 2011) states that, although it is not expected of the internal auditor to be a fraud expert, the internal auditor must possess sufficient knowledge of fraud to be able to evaluate both fraud risks and the control systems designed to address such risks within the organisation. The Standard does not address financial statement fraud specifically. Furthermore, due professional care, which will be expected of a competent internal auditor, must be exercised at all times; although this does not imply that the internal auditor will never make a mistake (IIA Standard 1220). Fraud risk assessments are tools which are used by management and internal auditors to identify fraud risks in a systematic way. In the case of financial statement frauds such assessments should focus on specific fraud schemes and previously reported frauds to establish whether there have been any control failures. The methodologies to achieve this include brainstorming, interviewing, analytical procedures and the review of previously committed frauds (IIA 2009: 16).

In the process of conducting a fraud risk assessment the impact of incentives, pressures and opportunities to commit fraud must be evaluated. This evaluation will include the remuneration strategy and performance reward programmes of employees. These elements may provide a focus for the fraud risk assessment. In addition, the roles and responsibilities that the board of directors expect the IAA to fulfil in relation to fraud risk management must be defined properly in the internal audit charter. Accordingly, this charter must describe whether there is an expectation that the IAA will have to carry out full blown fraud investigations, conduct root cause analyses of fraudulent activities detected and any other fraud prevention and detection related duties (IIA et al. 2012: 15).
5.4.1 Professional scepticism

The IIA Standards are not explicit when it comes to professional scepticism. However, in the Practice Guide on Internal Auditing and Fraud (IIA 2009: 11) it is stated that internal auditors must be alert to the indicators of fraud within the organisation. Professional scepticism may be described as a specific mindset that questions all information and critically evaluates such information. Such a mindset never assumes either honesty or dishonesty on the part of either management or staff members (IIA 2009: 13). It is expected of the internal auditor that he/she will use the professional judgment which is the foundation of the IAA’s assurance and consulting responsibilities (Reding et al. 2009: 8-31). In addition, the IIA Standards prescribe direct interaction with the board of directors (IIA Standard 1111 2011) and expect of the internal auditor to maintain an unbiased and impartial mental attitude which is supported by the avoidance of a conflict of interest (IIA Standard 1120 2011). Internal auditors are usually well placed within an organisation to detect red flags regarding fraud early in the process of the fraud being committed (Rezaee & Riley 2010: 208).

It is expected of the internal auditors to consider the possibility of significant errors, fraud and non-compliance (IIA Standard 1220.A1 2011). The internal auditor must be able to conduct a critical evaluation of all the information and evidence obtained. It may be an extremely complex process to unveil fraudulent activities, including the presentation of fraudulent financial statements; because the perpetrators will do all in their power to conceal the fraud schemes (Reding et al. 2009: 8-31). However, fraudulent activities may be detected by identifying fraud indicators and red flags and assuming this includes financial statement fraud, such as a poor internal control environment and an ineffective audit committee. The fraud risks must be evaluated in order to determine their significance as well as to establish the fraud risk management programme that have been put in place to address these risks. The findings must be communicated to both the relevant management levels and the board of directors as well as to the audit committee if deemed necessary (Rezaee 2005: 294).
5.4.2 Interviews

The internal auditor must conduct an assessment to measure the adequacy of the risk management processes driven by the management of an organisation. In addition, the IIA Standards state that the IAA has the obligation to evaluate both the fraud risks and the controls put in place by management in order to mitigate the risk that fraud will occur (IIA Standard 2120.A2 2011). One of the most common techniques prescribed by the Practice Advisory 2120-1 (IIA Standards 2011: par 8) involves conducting interviews with all levels of management in order to determine both the business risks and objectives. This may be done in a structured manner in terms of which the various responses are aggregated so as to reach a comprehensive conclusion regarding the matter under investigation (IIARF Volume 2 2012: 50). In order to conduct a successful interview it may be helpful to the internal auditor to have a purposefully designed questionnaire to guide him/her through the interviewing process. The focus of such a questionnaire would be on the internal control environment, operational weaknesses and general concerns regarding fraud, including financial statement fraud.

It is essential that the interviews be conducted with both management of all levels and also with various staff members who would be able to provide information regarding the possible financial statement fraud risks. During the interview with management and the other staff members responsible for the risk management programmes, information must be obtained relating to the appropriateness of the organisation’s perception of fraud risks (IIA et al. 2012: 15). The internal auditor will gain the trust of management if it is mentioned during the opening engagement meeting that fraud risk assessments form part of the standard audit engagement (Kolman 2007: 45-46). Interviews usually provide testimonial evidence but such evidence is not, in itself, sufficient. Accordingly, the information obtained during the interviews must be corroborated with stronger evidence before a final conclusion may be made (IIARF volume 2 2012: 119)
It is important that the internal audit charter grant the internal auditor unrestricted access to all records and information, including those obtainable by means of interviews. If there are any limitations imposed on the internal auditors in respect of the collection and analysis of information relating to fraud risks, this, in itself, should be regarded as a red flag and an indication that fraud is actually taking place at the organisation (Shamki 2009: 25).

It is essential that the interview focus on obtaining as much information as possible regarding the internal controls relating to the financial reporting processes and previously detected frauds (Kranacher et al. 2011: 180–181). The internal auditor should include questions about the relationship between management and the current and previous external auditors. Any disagreements between the mentioned parties may be an indication of fraudulent financial reporting (Moyes et al. 2006: 23). During the interviews with management the internal auditor must make enquiries about the corporate culture of the organisation, including enquiries about fraud prevention activities such as whistle-blowing systems and the management of fraud in general. Fraud risk pressures such as remuneration schemes, performance targets and bonuses must be identified because these may be a fraud red flag indicating a bigger risk. The detection methodologies used by the IAA must be adapted to address changes in the fraud risk environment (IIA 2009: 21).

5.4.3 Discussion among the engagement team members

In a research study conducted by the IIA Research Foundation (IIA 2008: 18–19) the participants indicated that brainstorming assists the audit team in the identification and detection of fraud. Although the IIA Standards do not differentiate between the different types of fraud, the participants in the study indicated that a brainstorming session would assist in the development of appropriate audit procedures to be followed in the identification and detection of financial statement fraud. In research conducted by Carpenter, Reimers and Fretwell (2011: 212) it was found that the interaction that takes place between the members of a group whilst brainstorming results in the identification of more relevant fraud risks than would otherwise have been the case. The results of this research indicated that the main advantage of
brainstorming sessions for internal auditors is the interaction which takes place and not the actual generation of ideas. The findings of the research are important when taking into account that internal auditors often work in isolation and not necessarily in groups (Carpenter et al. 2011: 222).

Brainstorming may facilitate the identification of fraud risks by the audit team as a result of the sharing of knowledge amongst the team members (Skalak et al. 2011: 250). During the brainstorming sessions, the internal auditors are able to discuss the possibility of fraudulent activities taking place with the fraud triangle in mind. This, in turn, will assist the team to identify possible opportunities to commit fraud while taking into account the incentives and pressures that have been identified in the organisation. A likely scenario for committing financial statement fraud through the use of revenue fraud schemes may arise if the performance bonuses of management are contingent upon profit growth within the organisation and, as a result, journal entries may be manipulated in order to overstate the financial statements. It is important that internal auditors possess sufficient knowledge of fraud to enable them to identify fraud risks and to be aware of possible opportunities for fraudulent activities to take place (Reding et al. 2009: 8–13). During these discussions the risk assessment team, including the internal auditors, must drill down to the elements of the fraud triangle in order to identify possible fraud risks and opportunities for the internal control systems to be compromised (IIA et al. 2012: 22). In addition, the team members must decide whether further investigations are necessary and who should be informed regarding the fraud risks identified (Shamki, 2009: 27).

5.4.4 Analytical analysis

It is the responsibility of the chief audit executive (CAE) to formulate risk-based, internal audit plans which are in line with the strategic goals of the organisation. Such risk-based plans will be based on the risk assessments conducted by both the IAA and the organisation itself. Risk assessment techniques are implemented during the risk assessment (IIA Standards 2011: Practice Advisory 2010-2). These risk assessment techniques include the analysis of recent developments, trends and
other industry background information which may impact on the business objectives of the organisation (IIA Standards 2011: Practice Advisory 2120-1 par 8).

An analytical analysis or analytical procedures are activities or techniques which the internal auditor uses in order to draw comparisons between two or more sets of information, for example, a comparison between known information obtained from independent sources and the expectations of the internal auditor or management or a comparison between financial periods, industry trends or financial and non-financial information. Any variances or anomalies identified in these comparisons must be investigated in order to identify the underlying reasons for such variances (IIARF volume1 2012: 179).

Analytical procedures assist the internal auditor to obtain audit evidence and are especially useful in identifying unexpected variances or the lack thereof if variances were expected. In addition, these procedures may assist in identifying potential errors, fraudulent or illegal activities as well as transactions or events that are once-off occurrences or else an unusual occurrence (IIA Standards 2011: Practice Advisory 2320-1 par 2).

The IIA Standards do not prescribe the type of analytical analysis that must be conducted but Practice Advisory 2320-1 (IIA Standards 2011: par 3) lists various analytical procedures that may be used to obtain audit evidence. It is expected of the internal auditor to conduct a financial analysis (IIA 2009: 17). The Practice Guide on Internal Auditing and Fraud (IIA 2009: 16) advises that the internal auditor must review how the organisation compares to its competitors in the same industry and if any discrepancies noted between the non-financial and financial information have been noted.

The Practice Guide of Managing the Business Risk of Fraud (IIA et al. 2012: 36) suggests a number of analytical analysis procedures which may be followed in order to detect fraud. These procedures may be used to identify variances from the expected norm or the lack of any such variances and then corroborate the findings with other audit evidence obtained (Reding et al. 2009: 10 - 8). Technology may be
used to conduct a data analysis of groups containing a high number of transactions in order to identify possible discrepancies that may be an indication that fraud has been committed. In addition, journal entries, especially at year-end, must be evaluated to identify seemingly suspicious transactions, including the manipulation of revenue accounts to improve the results of the organisation in respect of the balance sheet date (IIA et al. 2012: 36). Ongoing auditing which makes use of analytical analysis will assist the internal auditor to identify any breakdown in controls which may have occurred and, thus, prevent fraud being undetected for a lengthy period. This will also assist in identifying abnormal relationships between the initiation of specific transactions and staff members and this, in turn, will enable the internal auditor to report sooner on the possibility of fraudulent activates than would otherwise have been the case (IIA et al. 2012: 38).

5.5 AUDITING OF OVERSTATEMENT OF REVENUE FRAUD SCHEMES

5.5.1 Introduction

In order to ensure that fraud risk and the management of such risk are effectively addressed during the year by the internal auditors, the CAE must include the management controls which pertain to fraud in the annual audit plan which must be taken into account during various audit assignments throughout the year. This will include the auditing of policies and procedures, the tone at the top and fraud risk management practices (IIA 2009: 2). Furthermore, by testing high-risk processes and identifying fraud indicators (red flags) within and external to the business, the CAE will ensure that possible fraud is detected. The possibility of fraud should also be considered with every audit assignment and fraud risk, fraud controls and errors must all be evaluated to determine whether there is some indication of fraud. The internal audit activity may also engage in consulting assignments to assist management in the identification and assessment of fraud risk and to determine the adequacy of the control environment for process reviews, information technology applications and new business ventures (IIA 2009: 2).
5.5.2 Audit procedures conducted in response to misstatement resulting from fraudulent financial reporting

The nature of the work of the IAA includes the evaluation of all governance, risk management and control processes and the recommendation of actions to improve these processes (IIA Standards: 2100 2011). This includes any risks which may be identified in the operational processes regarding the reliability and integrity of financial and other information (IIA Standard 2120.A1 2011). Thus, the internal auditors have a responsibility in respect of both the operational and the financial reporting processes. However, this responsibility will be directed by the role of the internal auditors as set out in the approved internal audit charter (Kranacher et al. 2011: 180). The purpose, authority and responsibilities of the IAA are defined in an internal audit charter which also details the scope of the internal audit activities as well as the reporting structure of the CAE and the IAA. The internal audit charter must be approved by both the board of directors and senior management (IIA Standard 1000 2011). Accordingly, the audit procedures which an internal auditor may include in his/her engagement audit plans will be dependent upon the scope and reporting structure as defined in the internal audit charter. This, in turn, will determine how effective the internal auditor may be regarding financial statement fraud and the related financial reporting processes (Kranacher et al. 2011: 181).

The IAA may be regarded as the first line of defence in the prevention and detection of financial statement fraud because of the unique position which the IAA holds in the organisation. The IAA may play a role in the management of financial statement fraud by evaluating the control system regarding fraud risks. This is done by performing regular internal audit engagements which take these risks into account with each engagement performed as well as the effective reporting on the findings of these audit engagements (Rezaee & Riley 2010: 214).

One of the findings of the study conducted by the IIA Research Foundation (IIA 2008, 19) was the need to clarify the roles and responsibilities of the IAA regarding the overall fraud risk management. This clarification is necessary on the standard setting level as well as at the organisation’s management level.
5.5.3 Audit procedures in response to risks related to management overriding controls

During the performance of the fraud risk assessment the internal auditor must identify weaknesses in the systems of internal control, including the lack of a proper segregation of duties which would create the opportunity for management to override controls. Staff members will often be fully conversant with the internal controls in their areas of responsibility and it may happen that their knowledge is used to commit fraud and hide their actions (IIA et al. 2012: 23). The electronic environment, in which organisations operate today, facilitates the speed, access and functionality of transactions and this poses a substantial fraud risk to the organisation. It exposes the integrity and reliability of financial and operational information to being compromised or stolen and it is, thus, essential that the internal auditor provide assurance to management that the controls which have been instituted to prevent such fraud from taking place are sufficient and effective (IIA et al. 2012: 15).

The duties of the IAA include the evaluation of the control processes for effectiveness and efficiency, including those controls regarding the reliability and integrity of both financial and operational information (IIA Standard 2130 2011). The procedures which have been developed to identify fraudulent activities must be adapted on an ongoing basis to ensure that any changes in the possible fraud risks are addressed (IIA et al. 2012: 34). The CAE must form an overall opinion on the effectiveness and efficiency of the systems of internal controls and report the results to the board of directors and management (IIA Standards 2011: Practice Advisory 2130-1 par 3). Where discrepancies are identified the impact of such discrepancies must be determined and the corrective actions to be taken by management must be established (IIA Standards 2011: Practice Advisory 2130-1 par 9).

The IIA Standards are not specific regarding these responsibilities and, therefore, the internal auditor has to rely on the identification of red flags and other fraud symptoms to establish an indication of financial statement fraud risk as a result of to the override of the controls. If the internal auditor identifies that this risk had an impact
on previous financial statements then the board of directors must be informed in writing (Kranacher et al., 2011: 180–181).

Both the economic climate and fraud awareness in the current business environment have changed over the last decade and it is, therefore, essential that the internal auditor understand the control measures that are in place to prevent and detect fraud. The internal auditor must evaluate and test these measures with each audit engagement (Biegeleman & Bartow 2006: 243 note 2). The IAA’s position has changed as a result of the increase in fraud from the current economic uncertainty. The board of directors are focusing more on fraud risks and this, in turn, has meant that internal auditors have tended to shift their focus to risk indicators when the risk assessment is being conducted prior to formulating the annual internal audit plan (Deloitte 2010: 2).

Fraud prevention programmes, including proper policies and procedures to manage the risk of fraud, must be put in place by organisations. Adherence to these policies and procedures must be mandatory for all employees and the policies and procedures must also be communicated to all employees. The IAA plays a role in the enforcement of these policies and procedures and must report on compliance to the board of directors on a regular basis (Rezaee 2005: 291).

5.6 FINALISATION OF THE INTERNAL AUDIT

5.6.1 Evaluation and conclusion

As set out in the internal audit charter (IIA Standard 1000 2011) the CAE has a reporting responsibility. All the findings regarding the fraud risk assessment and deviations from the internal control policies and procedures must be reported according to the guidelines as set out in the internal audit charter.

The internal auditor must come to a conclusion regarding the work or investigation carried out. This conclusion must be based upon thorough evaluation and analysis of the evidence gathered during the investigation (IIA Standards: 2320 2011). The
report must be written in a clear, structured manner so that there are no problems in interpreting the issues being reported. The underlying cause of the issues identified must be clearly stated as well as the criteria for adherence and the impact the specific deviation has had on the organisation. In addition, it is necessary to define the policies, procedures, laws and regulations that were transgressed in respect of the specific fraud committed while an opinion must be expressed on the factual evidence obtained (Reding et al. 2009: 8-33).

5.6.2 Reporting of results

One of the key deliverables of internal auditors is the report on the engagement performed. The more important stakeholders in the communication process include senior management and the board of directors, especially if fraud is being reported. After the conclusion of the audit engagement an exit meeting with the management responsible for the audited area must be conducted to discuss the findings of the audit engagement. The report must be supported by the results of the exit meetings and take into account how management intends to address the issues reported. There is no other method of reporting on a fraud investigation than the reporting done on a routine assurance engagement (IIARF volume 2 2012: 276). The reports must be escalated to senior management and the board in much the same way as the assurance engagement reports, taking into account the urgency of the matter to be reported and the importance of the information regarding the matter (IIA Standard 2060 2011).

The internal auditors must include the objectives and scope of the investigation in the final report to management, including senior management and the board of directors. The conclusions and opinion in the report must be supported by appropriate evidence to enable the decision makers to take the necessary actions regarding the matters reported. In addition, the reports must include all risk exposures and control concerns, including those related to fraud (IIA Standard 2400 2011).
The IIA Standards also prescribe the necessity of conducting a follow-up engagement on all matters reported. This is required in order to obtain assurance that management has actually taken action regarding the matters reported and that the observations have been addressed (IIA Standards: 2500 2011 & IIARF volume 2 2012: 276).

5.7 SUMMARY

The primary role of internal auditors is to provide an independent, objective assurance and consulting service to the organisation with the purpose of adding value to and improving the organisation’s operations (IIA 2011: i). This is achieved by adopting a systematic and disciplined approach to the evaluation of the risk management, control and governance processes in order to improve the processes and, thus, to enable the organisation to accomplish its objectives and goals (IIA 2011: i). The evaluation of the processes by the internal auditor must include an assessment of the efficiency, effectiveness and economy of operations and the performance of management so as to support management in carrying out its responsibilities (Rezaee & Riley 2010: 206).

In terms of the definition of internal auditing the IAA has a definite risk management role to fulfil. This, in turn, indicates the assumption that the internal auditor has a role to play in the prevention and detection of fraud (Taylor 2011: 44). Although it is not expected of the internal auditor to be an expert in fraud, it is necessary that the internal auditor possesses sufficient knowledge of fraud to be able to evaluate fraud risks and controls aimed at addressing these risks (IIA Standard 1210.A2 2011).

The IIA Standards are not specific regarding these responsibilities and, therefore, the internal auditor is forced to rely on the identification of red flags and other fraud symptoms to establish an indication of financial statement fraud risk as a result of the controls being overridden. If the internal auditor identifies that this risk had an impact on previous financial statements then the board of directors must be informed in writing (Kranacher et al. 2011: 180–181).
The internal auditor must use fraud risk assessment methodologies such as interviews and financial analyses to identify fraud risks and the impact of such risks on the organisation. This must be done with a questioning mindset (IIA 2009: 14).

One of the key deliverables of internal auditors is the report on the engagement performed. The more important stakeholders in the communication process are senior management and the board of directors, especially if fraud has been reported. The report must be supported by the results of the exit meetings conducted after the conclusion of the audit engagement and must take into account how management intends to address the issues reported. There is no other method of reporting on a fraud investigation than the reporting done on a routine assurance engagement (IIARF volume 2 2012: 276). The reports must be escalated to senior management and the board in much the same manner as that of the assurance engagement reports, taking into account the urgency of the matter to be reported and the importance of the information regarding the matter (IIA Standard 2060 2011).
CHAPTER 6: COMPARISON OF THE RESPONSIBILITIES OF EXTERNAL AUDITORS AND INTERNAL AUDITORS REGARDING FINANCIAL STATEMENT FRAUD

6.1 INTRODUCTION

The purpose of this chapter is to compare the Standards of the internal auditors with those of the external auditors to determine the adequacy of the IIA Standards regarding the responsibilities of internal auditors to detect financial statement fraud.

A difference has already been noted between the Standards of both professions regarding the auditing of financial statements. From the outset it is clear that the roles and responsibilities of internal and external auditors are different. Whereas the external auditors are responsible for conducting the annual financial audit of an organisation in order to express an opinion on the fairness of the financial statements (Rezaee & Riley 2010: 230), the internal auditors are responsible for providing an independent, objective assurance and consulting service to the organisation with the purpose of adding value to and improving the organisation’s operations (IIA 2009: i).

Rezaee and Riley (2010: 208) are of the opinion that internal auditors are in the best position to detect financial statement fraud although external auditors, are traditionally regarded as being responsible for the detection of financial statement fraud. The prevention of financial statement fraud by internal auditors consists of the limitation of opportunities to commit financial statement fraud and the assessment of possible financial statement fraud risks (Rezaee & Riley 2010: 210).

6.2 RESPONSIBILITY REGARDING FINANCIAL STATEMENT FRAUD

Both research and surveys conducted by auditing firms reveal that auditors, internal as well as external, do not detect fraud as often as is expected by the public -
commonly referred to as the expectation gap (Krambia-Kapardis 2010: 659). Internal auditors are slightly more successful than external auditors in the detection of fraud (Corless 2009: 93). There are a variety of reasons why external auditors are not as successful as expected in the detection of fraud. External auditors usually have several different clients and, therefore, it is difficult to acquire an in-depth knowledge of each organisation. In addition, the expensive hourly charge-out rates of external auditors often result in the organisation reasoning that the costs of detecting the fraud would exceed the actual losses suffered as a result of the fraud. Finally, if an audit is based on a fixed fee it may become a challenge to convince the management of the organisation to increase the audit fees to accommodate a fraud investigation. Taking into account these factors as well as the pressure for external auditors to remain within budget it may become difficult to follow up on possible fraudulent activities (Corless, 2009: 93). In addition, the external audit standards refer to the material misstatement of financial statements and not all possible fraudulent activities (SAICA 2009: ISA 240 par 3).

In contrast to the abovementioned, internal auditors are often employed by a single organisation and, therefore, their day-to-day interactions result in their acquiring a more in-depth knowledge of the organisation and the way in which it operates than is the case in respect of external auditors. In addition, the salaries of the internal auditors are lower than the charge-out rates of the external auditors and, therefore, the internal auditors are more cost effective in the investigation of suspected fraud than the external auditors. It may also happen that management will encourage the internal auditors to investigate all possible fraudulent activities and not only those that tend to be material (Corless, 2009: 94).

However, even with the dilemma of fraud not being detected often enough both the internal and the external audit standards prescribe specific responsibilities regarding the detection of fraud, in particular, financial statement fraud. This chapter will compare the various prescripts of the respective standards as discussed in chapters 4 and 5.
6.3 PROFESSIONAL STANDARDS AND FINANCIAL STATEMENT FRAUD

6.3.1 Introduction

In order to facilitate the process of comparing the internal audit and external audit standards a similar order to that followed chapters 4 and 5 will be followed. Firstly, chapters 4 and 5 focused on the reporting structure of external and internal auditors, thereafter the fraud risk assessment methodologies such as professional scepticism, interviews, brainstorming and analytical analysis were discussed, followed by the specific procedures that may be used in response to the misstatement of financial statements as a result of fraud as well as the overriding of controls by management.

6.3.2 Reporting structure

The assurance provided of the fairness of the financial statements as a result of an audit process is usually provided by external auditors who are from outside the organisation and who are independent of the organisation. Internal auditors are also involved in the audit process of the financial statements but they report to a different audience as compared to the external auditors. The external auditors reports to the shareholders while the internal auditors to the management of the organisation (Reding et al. 2009: 1-8).

This difference may have an impact on the independence of the internal auditors and the scope of work as management approves the internal audit plan annually.

6.3.3 Professional scepticism

The external audit standards (SAICA ISA 200 2009: par 7) stipulate that the external auditors should exercise due professional care that is based on professional judgment and scepticism. This due professional care should be exercised throughout the audit engagement - from the planning phase through to the reporting phase (Rezaee 2005: 293). Wells (2005: 349) confirms that the external auditors should
consider the possibility of fraud throughout the audit engagement and be critical of all information obtained. It is reiterated by ISA 240 (SAICA 2009: par 12) that it is incumbent on the external auditor to keep an open mind in spite of any previous experience of honesty and integrity at an organisation.

The internal audit standards do not specifically mention professional scepticism although the IIA Standards expect the internal auditor to maintain an unbiased and impartial mental attitude (IIA Standard 1120 2011). Nevertheless, guidance on a specific mindset is found in the Practice Guide on Internal Auditing and Fraud (IIA 2009: 11). However, if the assumption is made that professional scepticism refers to a specific critical mindset then the internal auditor must go outside of the standards to other guidance offered by the Institute of Internal Auditors to learn about professional scepticism.

The conclusion drawn regarding the adequacy of the internal audit standards regarding professional scepticism is that the issue is not sufficiently addressed in the IIA Standards.

6.3.4 Interviews

The ISAs prescribe that procedures must be performed to establish the existence of material misstatement in the financial statements. ISA 300 (SAICA 2009: par 6) specifically mentions that inquiries must be made of management and other staff members within the organisation about fraud risk. This, in turn, is confirmed by both ISA 240 and SAS 99 (SAICA 2009: par 17 & AU316 2002: par 20) which indicate the expectation that interviews with management must be conducted in order to evaluate the fraud risk processes intended to address financial statement fraud. The ISAs go into much detail to give guidance to the external auditors who should be interviewed and what is the type of information which needs to be obtained (ISA 240 2009: par A15 – A18).

In contrast the internal auditing standards prescribe that the internal auditor must conduct an assessment of the risk management processes (IIA Standard 2120.A1
2011). This includes an assessment of the risk of fraud but not specifically financial statement fraud. However, the assumption is made that the term “fraud” includes financial statement fraud (IIA Standard 2120.A2 2011). The IIA Standards are read in conjunction with the practice advisories and, in Practice Advisory 2120-1 (IIA Standards 2011: par 8), one of the techniques mentioned is the conducting of interviews with all levels of management in order to determine business risks and objectives. However, the practice advisory does not specifically mention either fraud risk or financial statement fraud.

The conclusion to be drawn is that the internal auditor must assume that the Standard includes financial statement fraud as well as the fact that the interviews conducted should also focus on financial statement fraud risks and the information needed to make an assessment of the financial statement fraud risks.

### 6.3.5 Discussion among the engagement team

The external auditing standards prescribe the use of discussions amongst team members. ISA 315 (SAICA 2009: par 10) requires of the external audit engagement partner and the key engagement team members to hold a discussion on the vulnerability of the financial statements as regards the possibility of fraud causing a material misstatement of the statements. In addition, the discussion should also focus on appropriateness of the financial reporting framework used by the organisation and any other related facts and circumstances. SAS 99 refers to brainstorming with a similar expectation that discussions should be held (Alon & Dwyer 2010: 242).

In the case of the internal auditors there is no mentioned made in the IIA Standards of brainstorming. The results of research conducted by the IIA Research Foundation (IIA 2008: 18–19) indicated that the participants had agreed that brainstorming would assist the audit team in the identification and detection of fraud. Although the IIA Standards do not differentiate between the different types of fraud, the participants indicated that a brainstorming session would also assist in the development of
appropriate audit procedures to be followed in order to identify and detect financial statement fraud.

The conclusion regarding the brainstorming sessions is that the IIA Standards are totally lacking as regards offering either prescripts or even guidance on the use of brainstorming as a fraud detection methodology.

6.3.6 Analytical analysis

Appendix 2 to ISA 240 (SAICA 2009) prescribes the use of analytical procedures in the fraud risk assessment. The appendices may be considered as guidance or good practices to be read in conjunction with the ISA Standards. The appendix contains much more detailed guidance to the external auditor regarding the type of analytical analysis that should be conducted. Where there is suspicious fraudulent financial reporting as a result of revenue recognition fraud schemes; the auditor should extend the audit procedures to address these risks by performing financial analysis procedures on the financial information on a month-to-month basis as well on a product line or business segment basis. This should be done for the current period under review as well as for prior periods. (SAICA ISA 240 2009: appendix 2).

As with any other audit being conducted the industry in which the company operates should be analysed to ensure that sufficient background information is obtained so as to enable the auditor to understand how business is conducted in the industry concerned. This knowledge is particularly important in distinguishing between a routine transaction and either an unusual transaction or an abnormally large transaction (Manning 2011: 571 & ISA 240, 2009: par 22)

The guidance to the internal auditors is found in the Practice Advisory based on IIA Standards 2010 & 2120. Analytical analysis techniques are used to conduct the risk assessment (IIA Standards 2011: Practice Advisory 2010-2). These risk assessment techniques include the analysis of recent developments, trends and other industry background information which may impact on the business objectives of the organisation (IIA Standards 2011: Practice Advisory 2120-1 par 8). Analytical
procedures assist the internal auditor to obtain audit evidence and are particularly useful in identifying unexpected variances or the lack thereof if variances were expected. In addition, analytical procedures may assist in identifying potential errors, fraudulent or illegal activities as well as transactions or events that are either once-off occurrences or unusual occurrences (IIA Standards 2011: Practice Advisory 2320-1 par 2)

The IIA Standards do not prescribe the type of analytical analysis that must be done, although it is expected of the internal auditor to conduct a financial analysis (IIA 2009: 17). The Practice Guide on Internal Auditing and Fraud (IIA 2009: 16) advises that the internal auditor should review how the organisation compares to its competitors in the same industry and if any discrepancies have been noted between the non-financial and financial information.

The Practice Guide of Managing the Business Risk of Fraud (IIA et al. 2012: 36) suggests a number of analytical analysis procedures that may be followed in the detection of fraud. It is suggested that technology be used to conduct data analyses within groups containing high numbers of transactions in order to identify possible discrepancies that may be an indication of fraud being committed. Furthermore, journal entries, especially at year-end, must be evaluated to identify seemingly suspicious transactions, including the manipulation of revenue accounts to improve the results of the organisation as regards the balance sheet data (IIA et al. 2012: 36).

In the case of analytical analysis the Practice Advisories supporting the IIA Standards refer to analytical analysis, although it is not specifically mentioned that analytical analysis should be conducted to detect financial statement fraud.

6.3.7 Audit procedures in response to misstatement resulting from fraudulent financial reporting

In the case of external auditing ISA 240, read in conjunction with appendix 2 of ISA 240, is extremely specific about appropriate audit procedures in response of misstatement resulting from fraudulent financial reporting. ISA 240 addresses the
controls surrounding electronically initiated revenue transactions (SAICA ISA 240 2009: appendix 2) as well as confirmation procedures with customers.

The IIA Standards do not refer to specific audit procedures at all and, instead, they are focused on the assessment of risk management processes and which, presumably, includes the financial reporting processes (IIA Standard 2120.A1 2011). However, this responsibility will be directed by the role of the internal auditors as set out in the approved internal audit charter (Kranacher et al. 2011: 180). The purpose, authority and responsibility of the IAA are defined in an internal audit charter which includes the scope of the internal audit activities as well as the reporting structure of the CAE and the IAA. The internal audit charter must be approved by the board of directors and senior management (IIA Standard 1000 2011).

There is a serious shortfall in the IIA Standards as regards providing detailed guidance to the internal auditor about the specific procedures to be executed in response to financial statement fraud. Thus, the assumption may be made that the IIA Standards state the principle while the IAAs must develop their own detailed work programmes.

6.3.8 Audit procedures in response to risks related to management overriding controls

ISA 315 (SAICA 2009: par 13) specifically prescribes the understanding and testing of the internal controls that are relevant to the audit. A weakness in the system of internal controls will create an opportunity for fraud to be committed (Singleton et al. 2006: 11). Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) prescribes that management must report on the adequacy of the internal control structure and the procedures contained in the financial reporting process and also that the external auditor should assess and report on management’s assessment of the internal control systems (Wells 2005: 300). In South Africa the King III Report and Code on Governance for South Africa (King III) recommend a similar process as SOX but perceive it as one of the internal auditor’s responsibilities (IOD King III 2009: principle 7.3).
The nature of the work of the IAA includes the evaluation of the control processes for effectiveness and efficiency, including the controls in respect of the reliability and integrity of both financial and operational information (IIA Standard 2130 2011). The procedures which were developed to identify fraudulent activities must be adapted on an ongoing basis to address any changes in the possible fraud risks (IAA et.al. 2012: 34). In addition, the CAE must form an overall opinion of the effectiveness and efficiency of the systems of internal controls and report the results to the board of directors and management (IIA Standards 2011: Practice Advisory 2130-1 par 3). Where discrepancies are identified the impact of such discrepancies must be determined and the corrective actions taken by management must be established (IIA Standards 2011: Practice Advisory 2130-1 par 9).

The IIA Standards address the overall risk of a breakdown in the internal control systems, not only in those controls involved in protecting the organisation against financial statement fraud. In the guidance issued during 2012 the controls related to the risk of fraud are addressed in more detail than before although financial statement fraud is not mentioned specifically.

6.4 SUMMARY

The purpose of internal auditing and external auditing is not the same. Whereas the external auditors are responsible for conducting the annual financial audit of an organisation to express an opinion on the fairness of the financial statements (Rezaee & Riley 2010: 230), the internal auditors are responsible for providing an independent, objective assurance and a consulting service to the organisation with the purpose of adding value to and improving the organisation’s operations (IIA 2011: i).

However, there is the so-called expectation gap (Krambia-Kapardis 2010: 659) in terms of which both the public and the users of the financial statements expect the auditors to detect fraud and, more specifically, financial statement fraud where the
financial statements were manipulated to provide a “better than the real situation” report to the users of the financial statements.

The various prescripts and fraud risk assessment methodologies were discussed and a comparison made between the external and internal auditing standards. The external audit standards are very specific regarding the work that should be done to do a fraud risk assessment to determine the possibility of the misstatement of the financial statements due to fraud. In this standard various fraud risk assessment methodologies and procedures are discussed to provide specific guidance to the external auditors (ISA 240 2009). However, there is not a specific internal audit standard giving guidance to the internal auditor regarding the detection of fraud in general or financial statement fraud specifically. The internal auditor must make use of all the internal audit standards to achieve the same detail guidance on fraud risk assessments than that given in a single external audit standard to the external auditors.

It is clear that there is a shortfall in the IIA Standards as regards the definition of the roles and responsibilities of the internal auditors regarding financial statement fraud.
CHAPTER 7: CONCLUSIONS AND RECOMMENDATIONS

7.1 INTRODUCTION

According to relevant literature and the standards of both the internal and the external auditors the prevention and detection of fraud are regarded as the responsibility of management and those who govern an organisation. However, an expectation gap exists in terms of which the public and the users of financial statements in general expect the auditors (internal and external) to detect financial statement fraud. This research focused on what the standards of the two professions stipulate that the auditors do. The research did not focus on the roles and responsibilities of internal and external auditors but only on the standards.

Financial statement fraud schemes related to the overstatement of revenue and related assets were discussed as well as the various fraud risk assessment methodologies that may be used. The application of the fraud risk assessment methodologies by the external auditors, according to their standards, was discussed as well as the application of the fraud risk assessment methodologies by the internal auditors according to their standards. One of the objectives of the research was to determine whether there are any gaps in the internal audit standards. A summary of the findings follows.

7.2 FINANCIAL STATEMENT FRAUD SCHEMES

The involvement of management in committing financial statement fraud was discussed together with the various types of revenue fraud schemes (Kranacher et al. 2011: 410). It became clear that it is not possible for financial statement fraud to be committed if management is not involved. The presentation of financial statements is the responsibility of management and, therefore, it follows that management would have knowledge of and would have agreed to the over- and understatement of the financial statements (Wells 2005: 294).
Management often benefits personally from a more positive presentation of the performance of the business because management’s remuneration, including bonus payments and share options, is often based on the financial results of the organisation. Furthermore, if the organisation performs well, the shareholders would be satisfied because of the higher earnings which derive from the good performance and creditors will regard the organisation as a good investment (Taylor 2011: 333).

It is not possible for creative accounting to take place in a vacuum and, thus, management and, possibly, other employees would be involved in the process. However, because of the controls being ignored and the fraud being concealed, it may be difficult for an outsider, including the auditors, to detect the crime. This, in turn, makes it imperative that the auditors have sufficient knowledge of the various fraud schemes (Jones 2011: 21).

### 7.3 FINANCIAL STATEMENT FRAUD RISK ASSESSMENT METHODOLOGIES

The generic financial fraud risk assessment methodologies were discussed in chapter 3. In order to give structure to the process to be followed the fraud examination, or even a fraud risk assessment, must be as properly planned as any other audit or investigation (Kranacher et al. 2011: 181). The four main methodologies used in the determination of possible fraud include interviews, brainstorming, financial analysis and the identification of red flags.

The interviews that are conducted to identify fraud risks are focused on obtaining as much information as possible from the various people with the requisite knowledge. Such an interview is not an interrogation but, rather, a specific, structured interview which is intended to identify the possibility of fraud being committed in the organisation (Manning 2011: 501).

Brainstorming involves getting a team of people together and ensuring that each individual has an equal opportunity to express his/her ideas. The quality of the ideas
is not that important during such a session, rather the quantity of the number of ideas generated during a session. However, the information will need to be evaluated and implemented after the brainstorming session has been concluded (Crumbley et al. 2007, 4-21).

Financial analysis is used to identify anomalies in the figures as presented in the financial statements. These anomalies may be an indication of the deliberate manipulation of the financial statements to mislead the users of the financial statements. Once again, such anomalies do not necessarily signify that fraud is present but they may lead the fraud examiner in doing further investigations in specific areas (Kranacher et al. 2011: 187).

The final methodology discussed was that of red flags which the prudent fraud examiner would not just ignore (Taylor 2011: 131). In themselves, red flags are not necessarily an indication of fraud but they may create an awareness of the possibility of fraudulent behaviour (Skalak et al. 2011: 239).

Financial fraud detection requires an extensive set of skills on the part of the fraud examiner over and above the normal set of skills which an external or internal auditor would have acquired through experience and training.

7.4 THE RESPONSIBILITIES OF EXTERNAL AUDITORS REGARDING FINANCIAL STATEMENT FRAUD

External auditors are appointed by the shareholders at the annual general meeting of the organisation and are responsible for the attestation of the financial statements. In auditing the financial statements external auditors have to plan the audit procedures in such a way that there is reasonable assurance that the financial statements are not materially misstated as a result of error or fraud (SAICA 2009: ISA 200 par 5 & ISA 240 par 5). The external auditors have to present their audit opinion and report to the shareholders, usually through senior management and the board of directors (Companies Act 2008: s 90(1) and Auditing Professions Act 2005: s 44(1)(a)). It is essential that due professional care be exercised throughout the entire audit.
process. This is done by exercising consistent professional judgment and scepticism (SAICA SA 240 2009: par 7).

It is expected of the audit team to conduct brainstorming sessions or team discussions to establish the vulnerability of the financial statements to the possibility of fraud caused by a material misstatement of the statements. These discussions should also focus on the appropriateness of the financial reporting framework used by the organisation and any other related facts and circumstances (SAICA ISA 315 2009: par 10 & AU 316 2002: par 14). It is also regarded as a way to generate ideas of ways in which fraud may be committed and concealed. However, in practice they are also used to discuss possible ways to respond to any fraud risks identified (Ramos 2003: 29).

Interviews are necessary on various levels because it is recognised that it is not possible for the external auditing process, on its own, to provide assurance that the identification and detection of financial statement fraud will take place. In many cases management is responsible for committing the financial statement fraud and, therefore, parties other than the auditors and managers must be included in the fraud detection and identification process (Du Toit 2008: 8). The standards [SAICA ISA 240 2009: par 17 & SAS 99 (AU 316 2002: par20)] expect the external auditor to conduct interviews with management to establish the fraud risk management processes which are intended to identify financial statement fraud and which are followed within the organisation and also the frequency with which the assessments are conducted.

Analytical analysis is another procedure which may be used to assist in the fraud risk assessment. Analytical procedures include vertical analysis, horizontal analysis and ratio analysis. Where there is suspicious fraudulent financial reporting as a result of revenue recognition fraud schemes, the auditor should extend the audit procedures to address these risks by carrying out financial analysis procedures on the financial information on a month-to-month basis as well on a product line or business segment basis. This must be done for the current period under review as well as for prior periods (SAICA ISA 240 2009: appendix 2).
Analytical analysis should be done near the end of the audit to establish whether there is any previously unidentified fraud risks exposed (ISA 240 2009: par 34). The auditor has to apply professional judgment to determine whether any unusual trends have been identified near the end of the financial year (ISA 240 2009: par A50). Furthermore, if the auditor concludes that the financial statements are misstated, it should be evaluated whether the misstatement is due to error or fraud. The auditor must take into account that an instance of fraud is seldom an isolated occurrence and therefore the implications of this incidence must be expanded to other areas of the audit such as management representations and the location or area where the incident was identified. All misstatements must be evaluated as a group to ascertain that there is no material misstatement in the financial statements (ISA240 2009: Par 35). In addition the possibility of management involvement as well as collusion must be examined and whether previously obtained evidence and representations can be relied upon (ISA 240 2009: par 36).

The external auditor must also perform procedures to assess the risks related to the misstatement of the financial statements at the statement as well as the assertion level (SAICA 2009: ISA 240 par 25 & ISA 315 par 5). These procedures include inquires of management and others within the organisation that may assist with the information required to identify possible misstatement of the financial statements, the performance of analytical procedures as well as observation and inspection of the recording of transactions and the drafting of the financial statements (ISA 300 2009: par 6).

External auditors must test the internal controls as well as the possible overriding of controls if the fraud risk assessment points to possible fraudulent activity. This is as a result of the ability of management to override internal controls and collude with colleagues in order to commit financial statement fraud (Kranacher et al. 2011: 175). However, such behaviour may easily be underestimated by the auditors and, therefore, it would not be detected early enough (Taylor 2011: 333). ISA 315 (SAICA 2009: par 13) specifically prescribes the understanding and testing of the internal controls that are relevant to the audit. A weakness in the system of internal controls would create an opportunity for fraud to be committed (Singleton et al. 2006: 11).
With the finalisation of the audit engagement all evidence, as well as all the decisions taken regarding financial statements, must be evaluated and documented appropriately. If the external auditor concludes that the financial statement fraud is not the result of a fraud scheme related to revenue recognition the reasons for this conclusion must be documented in the audit working papers (ISA 240 2009: par 44–47).

7.5 THE RESPONSIBILITIES OF INTERNAL AUDITORS REGARDING FINANCIAL STATEMENT FRAUD

The internal audit activity's main role and responsibility is to support management in fulfilling its roles and responsibilities regarding the realisation of the objectives and goals of the organisation. Internal auditors are appointed by senior management and report to both senior management and the board of directors, usually through the audit committee (IIA Standard 1100 2011). This process is followed to ensure that the internal auditors provide an independent, objective assurance and consulting service to the organisation with the purpose of adding value to and improving the organisation's operations (IIA 2011: i). This, in turn, is achieved by following a systematic and disciplined approach in the evaluation of the risk management, control and governance processes within the organisation (IIA 2011: i). The evaluation of the processes and the recommendations for the improvement of such processes thereof must assess the efficiency, effectiveness and economy of operations and the performance of management (Rezaee & Riley 2010: 206).

In terms of the definition of internal auditing, the internal auditor has a specific role to play in the risk management process, including the risk of fraud. This, in turn, leads to the assumption that the internal auditor has a role to play in the prevention and detection of fraud (Taylor 2011: 44). Although it is not expected of the internal auditor to be an expert in fraud risk assessment and fraud detection, it is necessary that the internal auditor possess sufficient knowledge of fraud to be able to evaluate fraud risks and the controls intended to address these risks (IIA Standard 1210.A2 2011). Despite the fact that the IIA Standards are not specific on these responsibilities; the
identification of red flags and breaches in the internal control systems, especially as a result of abuse by management, may give the internal auditor an indication of financial statement fraud risks. If the internal auditor identifies that these risks have had an impact on the financial statements then the board of directors must be informed in writing (Kranacher et al. 2011: 180-181). The fraud risk assessment methodologies used by the IAA includes that of interviews and financial analysis. These methodologies must be accompanied by a questioning mindset (IIA 2009: 14). The IIA Standards are silent on discussions amongst team members, which is a specific fraud risk assessment methodology prescribe for external auditors in their standards (SAICA ISA 315 2009: par 10 & AU 316 2002: par 14).

One of the key deliverables of internal auditors is the report on the engagement performed. The more important stakeholders in the communication process are senior management and the board of directors, especially in the case where fraud is being reported. The report must be supported by exit meetings and take into account the way in which management intends to address the issues reported. Reporting on a fraud investigation follows the same process as reporting on a routine assurance engagement (IIARF volume 2 2012: 276). The reports must be escalated to senior management and the board in much the same manner as the assurance engagement reports, taking into account the urgency of the matter to be reported and the importance of the information regarding the matter (IIA Standard 2060: 2011).

Even without specifically mentioning financial statement fraud, it is clear in the study conducted by the IIA Research Foundation in 2008 that the internal auditing profession requires greater clarity on the roles and responsibilities of internal auditors regarding fraud detection than is currently the case (IIA 2008: 19).
7.6 COMPARISON OF THE RESPONSIBILITIES OF EXTERNAL AUDITORS AND INTERNAL AUDITORS REGARDING FINANCIAL STATEMENT FRAUD

The purpose of internal auditing and external auditing is not the same. Whereas the external auditors are responsible for conducting the annual financial audit of an organisation to express an opinion on the fairness of the financial statements (Rezaee & Riley 2010: 230), the internal auditors are responsible for providing an independent, objective assurance and consulting service to the organisation with the purpose of adding value to and improving the organisation’s operations (IIA2011: i).

However, there is the so-called expectation gap (Krambia-Kapardis 2010: 659) in terms of which both the public and the users of the financial statements expect the auditors to detect fraud and, more specifically, financial statement fraud where the financial statements were manipulated to provide a “better than the real” situation report to the users of the financial statements.

The various prescripts and fraud risk assessment methodologies were discussed and a comparison between the external and internal auditing standards was made. It is clear that there is a shortfall in the IIA Standards in respect of the definition of the roles and responsibilities of the internal auditors regarding financial statement fraud.

The external auditors, who qualified as chartered accountant or Certified Public Accountants, have specific standards regarding their responsibilities in respect of financial statement fraud. However, there are no such specific prescripts or other guidance for the internal auditors.

Financial statement fraud is not even discussed in as much detail in any of the Standards, practice advisories, practice guides or position papers provided by the Institute of Internal Auditors as guidance to Certified Internal Auditors regarding their responsibilities in respect of financial statement fraud.
The IIA Standards set general principles to which the internal auditors must adhere and provide guidance which is not mandatory but which may be regarded as best practices. This, in turn, results in serious shortcomings in the IIA Standards, including what senior management and the board of directors may expect from the internal auditors. The board of directors have the obligation to approve the internal audit charter which outlines the purpose, authority and responsibility of the internal audit activity (IIA Standard 1000 2011) but if fraud detection and, more specifically, the detection of financial statement fraud are not included in the internal audit charter, there is no obligation for the internal auditor to do more than is prescribed in the IIA Standards.

7.7 APPLICATIONS OF THIS RESEARCH

7.7.1 Introduction

In the study conducted by Deloitte (2010: 2) it is stated that there is an higher than before focus on fraud risks within organisations and, therefore, the focus of the internal audit activity has also changed and is now more driven than previously by the fraud focus of the board of directors. In addition, the implementation of the Sarbanes-Oxley Act, 2002 in the USA and the King III Report on Governance in South Africa (2009) has resulted in a stronger emphasis on management’s responsibility to ensure that there are proper financial internal controls in place and that these controls are monitored and reported upon (King III 2009: principle 7.3).

Senior management and boards of directors should take note of the viewpoint of Rezaee and Riley (2010: 208) that internal auditors are in the best position possible to detect financial statement fraud. This prevention of financial statement fraud by internal auditors will include limiting the opportunities to commit financial statement fraud and also assessing possible financial statement fraud risks (Rezaee & Riley, 2010: 210).

The role of internal auditors is important in the governance structure of an organisation. Internal auditors may provide assurance on proper and responsible
governance and financial reporting processes. The daily involvement of the IAA in both operational as well as in financial reporting processes and system enables them to identify high risk areas in the financial reporting process (Rezaee & Riley, 2010: 208).

7.7.2 Recommendations aimed at clarifying the responsibilities of internal auditors regarding financial statement fraud

IIA Standards and other guidance
Currently, only the definition of internal audit, the code of ethics and the IIA Standards are mandatory for internal auditors while the practice advisories, practice guides and position papers are strongly recommended guidance. It would clarify the responsibilities of internal auditors if the existing and possible expanded recommended guidance regarding fraud also became mandatory. Furthermore, the guidance regarding fraud should be expanded to specify the responsibilities of internal auditors regarding financial statement fraud.

Requirements of governance practices and legislation
Legislation such as the Sarbanes Oxley Act in the USA (2002) and the King III report in South Africa (2009) have placed more emphasis on the role of management in ensuring that there are proper internal controls over financial matters (King III 2009: principle 7.3). King III is specific in stating that the internal audit activity should provide assurance on the effectiveness and efficiency of such controls. This more comprehensive expectation regarding the responsibilities of internal auditors should be addressed by the Institute of Internal Auditors in a separate guidance document, even if the guidance is from the local South African chapter only.

Internal audit charter
The internal audit charter is an important instrument in managing the internal audit activity (IIA Standards 2011: Practice Advisory 1000-1). On an organisational level it enables the board of directors and senior management to ensure that the detection of financial statement fraud forms part of the scope of the internal audit activity. An assurance of the effectiveness of the fraud risk management policies and
procedures regarding financial statement fraud may form part of the annual audit plan. However, the internal audit charter must be in accordance with the IIA Standards and, therefore, it may not override any IIA standard referring to fraud and fraud risks, but it can be expanded.

7.8 FURTHER RESEARCH

The following areas may be considered for further research:

**Training and education of internal auditors to be more effective in the detection of financial statement fraud.** The internal auditors should receive more comprehensive training in the practical skills involved in the application of the fraud risk assessment methodologies discussed in this research. Such research should include the identification and interpretation of red flags indicating financial statement fraud.

**The adjustment to the standard audit programme when the risk of financial statement fraud is regarded as high.** One of the issues that were mentioned in the research was the inability of audit seniors to adapt the audit programme appropriately when the risk of financial statement fraud is regarded as high. The reaction in such a case tends to focus on extending the sample size rather than adapting the audit procedures to be more effective. Accordingly, research should be conducted into what would be regarded as more effective audit procedures and how the audit programme should be adapted if a risk of financial statement fraud is identified.

**The legal responsibilities of external and internal auditors.** Research into the legal responsibilities, if any, in respect of the detection of financial statement fraud by external and internal auditors should be researched in more detail.

**The co-signing of the financial statements by the internal auditors.** The research pointed out that greater emphasis should be placed on the role of internal auditors in respect of internal controls and the effectiveness of such controls,
specifically internal controls related to financial reporting. Thus, research should be conducted into whether internal auditors should not co-sign the financial statements, together with the chief financial officer and the chief executive officer.

**Impact of shares and share-options on the independence of the internal auditors.** Further research is needed on the effect of remuneration packages on the independence of internal auditors, specifically where shares and share-options are awarded to internal auditors. This kind of award is often based upon the financial results of an organisation.

### 7.9 LIMITATIONS OF THIS RESEARCH

A major limitation of this research arose from the limited availability of South African literature related to financial statement fraud and the responsibilities of external and internal auditors. Furthermore, the research did not identify whether the legal obligations of external and internal auditors have any effect on the relevant standards.

### 7.10 CONCLUSION

The primary objective of this research was to determine the adequacy of the IIA Standards in guiding the internal auditors in the detection of financial statement fraud. This was done by analysing the external auditing standard ISA 240 (SAICA 2009) in detail to determine what is expected from the external auditors regarding fraud risk assessment that may result in the misstatement of the financial statements, thereafter the internal auditing standards were compared with the external auditing standards. This was done to meet the secondary objective of identifying potential shortcomings in the IIA Standards, including applicable guidance, as compared to the external auditing standards and applicable guidance.

Various revenue recognition fraud schemes were discussed to emphasise the possibility of financial statement fraud as a result of such schemes and which methodologies should be applied to identify the fraud risks related to these schemes.
Fraud risk assessment methodologies were discussed generally and thereafter the application of these methodologies as prescribed by the standards of both the external and internal auditors was analysed and discussed. The conclusion was made that the IIA Standards lacked in detail prescripts to give specific guidance to internal auditors to use these fraud risk methodologies to identify fraud risk factors.

After comparing each of the financial statement fraud risk assessment methodologies prescribed by the external auditing standards it was clear that the IIA Standards are lacking in detail and specific guidance regarding financial statement fraud. Financial statement fraud is never mentioned specifically in the IIA Standards and it is assumed that any reference to fraud and fraud risks includes financial statement fraud and risk indicators.

In guidance outside of the IIA Standards and research conducted into certain detection methodologies, the techniques are mentioned and discussed in more detail. However, the internal auditor must not depend on the IIA Standards only for appropriate guidance. To enhance the role of the internal auditor to support management fulfilling their management obligations toward the organisation the standard setting bodies of the IIA should consider in expanding the standards to be more specific regarding the detection of financial statement fraud. Another tool that can be used to enhance the role of internal auditors is the internal audit charter, where the scope can be specific regarding the detection of financial statement fraud.

The expectation is currently changing towards a more comprehensive role of internal auditors in the assessment of financial controls and the reporting thereof. This may lead to a more focused approach of internal auditors to prevent and detect financial statement fraud by limiting the opportunities to commit such fraudulent acts.
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