

### Fraud Risk

#### Fraud

The misrepresentation of facts that the individual knows to be false with the intention to deceive

Overstating revenues and assets

Understating expenses and liabilities

Giving disclosures that are misstated or that omit important information

Management fraud    Fraudulent financial reporting

Employee fraud    Misappropriation of assets

Fraud Risk categories    ▶ Management's Characteristics and Influence

▶ Industry Conditions

▶ Operating Characteristics and Financial Stability

Errors = unintentional

Fraud = intentional

### Misappropriation of Assets

#### Fraud

Requires **intent** to deceive the victim

#### Embezzlement

→ employees or nonemployees wrongfully taking money or property entrusted to them, by cover-up

⚙️ to permanently deprive the owner

#### Larceny

→ theft of an employer's property that is not entrusted to an employee

⚙️ to permanently deprive the owner

#### Defalcation

→ Misuse of funds by a fiduciary

⚙️ intentional wrongdoing

### Misappropriation of Assets (cont)

⚙️ OR negligence\*

Errors → unintentional misstatements or omissions

If negligence: ⚠️ fraud

### Engagement planning

#### Goals

obtain or update    *Important Events*

ID areas    *Special Risks*

Ensure that engagement is    *Timely*

Control    *Engagement Risk*

Identify the risk of material misstatement at the financial statement level and the relevant assertion level.

### AU-C 300

#### Planning an Audit

##### Purpose

Identify risk of material misstatement at F/S and assertion level

design procedures to mitigate

issue appropriate opinion

##### Goals

Understand important events

identify special risks

ensure timely completion

control engagement risk

##### Requirements

Client acceptance/continuance

independence/ethics check

engagement letter

##### Key signal

Procedures may change.

Standards do not.

The nature and extent of planning activities that are necessary depend on:

### AU-C 300 (cont)

● the size and complexity of the company

● the auditor's experience with the company

● changes in circumstances that occur during the audit

### CLIENT SELECTION & RETENTION

#### Main factor

Management integrity

#### Sources

● Annual reports (8-k)

● Background checks

● Inquiry of bankers/counsel

● Prior auditors (must inquire)

#### PREDECESSOR / SUCCESSOR

Requirement    Attempt to communicate only

#### Topics

Accounting disagreements

fraud/illegal acts communications

reasons for change

### 8 Gathering Evidence Procedures

#### Inspection of records and docs

● Books → Source vouching

(occurrence)

● tracing    Source → Books

(completeness)

● scanning    general looking for anything unusual

existence, completeness, cutoff

#### inspection of tangible assets

existence

valuation (asset condition)

NOT necessarily 'Rights'



### 8 Gathering Evidence Procedures (cont)

#### observation

watching people's actions/reactions

#### inquiry

asking questions

written representations or management representations

"inquiry alone" is never enough

Verbal Inquiry = Interview

Prepare

Make an appointment

Be conversational

Ask questions

Listen carefully

Be noncommittal

Close gracefully

Document the interview

#### confirmation

direct correspondence with independent parties

existence

rights and obligations

valuation

cutoff

#### recalculation

recalculation of computations previously performed by client personnel produces compelling evidence

existence and valuation

#### reperformance

review of controls

reperformance is much broader than recalculation

#### analytical procedures

### 8 Gathering Evidence Procedures (cont)

studying relationships among both financial and nonfinancial data.

CAATs: computer-assisted audit techniques

(1) accounts receivable balances for amounts over the credit limit

(2) inventory quantities for negative balances or unreasonably large balances

(3) payroll files for terminated employees

(4) loan files for loans with negative balances

(5) debits in revenue accounts

(6) credits in expense accounts

### Permanent Files

the corporate/association:

charter

bylaws

partnership agreement

continuing contracts such as:

leases

bond indentures

royalty agreements

A history of:

the company

its products

markets

background

minutes of meetings

stockholders/directors that have lasting interest.

Continuing schedules of long term accounts

such as owners' equity

partnership capital

retained earnings, ect.

prior-years' financial statements and audit reports.

Client organization chart.

### Current Files

aka. planning memorandum

The document summarizing the preliminary analytical procedures and the materiality assessment with specific directions about the effect on the audit.

In other words, the documentation must be sufficient to enable an experienced auditor, having no previous connection with the engagement, to understand

(1) the nature, timing, extent, and results of procedures

(2) the overall conclusions reached with respect to the area covered by the audit documentation

(3) the audit team member performing the work, the date of work, the audit team member

reviewing the work, and the date of review.

The audit documentation should also be sufficient to allow another auditor to

reperform the work if necessary.

(1) the client's accounting records agree or reconcile with the financial statements,

(2) the work was adequately planned and supervised,

(3) a sufficient understanding of the client's internal control was obtained, and

(4) sufficient appropriate audit evidence was obtained as a reasonable basis for an audit opinion.

