COLLEGE OF ACCOUNTING

AUDITING/CORPORATE GOVERNANCE | BASIC/INTERMEDIATE

Video Transcription: Fraud

Hi there, my name is Mark and this video will be answering the question: What is fraud, and is it relevant to an external audit?

Simply put, fraud is a lie that is told by someone so that they benefit personally from that lie. Some examples of fraud could be an employee, stealing inventory and when conducting the inventory count, the employee writes down a false number to hide the theft; a creditors clerk making payments into their personal bank account and hiding this when completing the bank reconciliation. Stealing a cheque from the company's chequebook, and using the cheque for a personal purchase.

While the above examples may seem quite small and would hardly impact large companies, it is still important for companies to prevent them occurring. What can be even more concerning is fraud that is very material. Examples of this include, management posting large, incorrect journal entries that increase revenue, decrease liabilities and increase the value of their assets. The benefit management derives from this could include either higher performance bonuses (if based on profitability) or better performance in the stock market.

Several fraud scandals have occurred recently and these have a massive impact on the company, audit firms, industries, as well as legislation itself. Fraud is therefore a wide term covering any illegal act that the guilty person tries to hide. Fraud generally takes place when the following three conditions exist:

1. Opportunity
2. Pressure
3. Rationalisation

This is known as the fraud triangle.

Opportunity is when an employee is actually able to commit fraud. This can happen when employees are not properly supervised, allowing an employee to perform an illegal act and then hide it. If employees are not properly supervised, they are able to act without their behaviour being reviewed by a senior member of staff. It is also important to recognise that if certain duties performed by employees are not separated, in other words, performed by different employees, it will present the opportunity for employees to commit illegal acts and hide them.

For example, if the same employee orders inventory, receives the inventory, when it is delivered, and is also responsible for paying the invoice, the employee could order inventory, take the inventory for themselves, and then get the company to pay for the inventory – nobody would know the illegal act had taken place.

Pressure exists when the financial situation of the employee is such that they would want to commit a crime, to improve their financial situation. Pressure is different for different people, but common pressures would include having to support a large family, unrealistic deadlines, growing medical bills, gambling problems and unrealistic performance goals. This may also take the form of an incentive; for example, when management's bonuses are based on how well the company does, management would want to falsely overstate the profits.

Rationalisation is the employee's way of justifying the fraud. As with pressure, this is different for different people, but the following are examples of rationalisation:

- "I really need this money, and I'll put it back when I get my salary."
- "I just can't afford to lose everything – my home, car… everything."
- "Besides, the company owes me, my friends at other companies received a higher increase than me."

It is the reason an employee who normally would not commit a crime, might be willing to do so. If these three conditions exist, the likelihood of fraud is higher.

While employees and management could commit fraud, who is responsible for ensuring that fraud does not happen? Management is responsible for trying to prevent fraud from happening. Fraud is a cost to a business so management would want to prevent these losses from occurring. The primary method management has to prevent fraud is to put good controls in place. Good controls prevent and detect fraud.

For example, if different employees are responsible for ordering, checking deliveries of inventory, and paying the invoices it will be significantly more difficult for one of the employees to steal the inventory, as three people are involved in the process of ensuring that the correct inventory is ordered, delivered and paid for. If management is responsible for preventing fraud, who is responsible for finding fraud that has actually taken place? Management is responsible as they should have put good controls in place to prevent or detect fraud, and these controls should highlight fraud as it occurs

For example, if the person ordering the inventory took it for their own personal use before the delivery note, or proof of delivery, was signed, the person paying the invoice would query the invoice before paying and the stolen inventory would be identified. However, if there is a concern that the controls in place are not sufficient, the internal auditors could conduct tests to try and identify whether there has been fraud. These tests could include performing test counts of items counted by employees during the inventory count process, or comparing bank account details of employees to bank account details of suppliers. If they are the same the employee could be paying themselves for goods and service they did not provide. But, as internal audit cannot test every transaction, the best way to reduce fraud is to prevent it from happening through good controls within a business.

Management is responsible for preventing and identifying fraud that happens within a business. This is most effectively done through good control systems. So, what role do the external auditors play in detecting fraud? The external auditors are only responsible for detecting fraud that has happened, and that is considered material. This does not mean that if fraud, that is not material, is detected it should not be reported to management. All fraud, if found, should be reported to management.

So, how can an external audit potentially detect material fraud? In completing an audit, the team should consider what opportunities, pressures and rationalisation may give rise to material fraud, and pay particular attention when auditing these areas.

It is, however, important to note that detecting fraud is not the primary purpose of an external audit as that responsibility falls on management. So, even if a business is given an unqualified audit, it does not necessarily mean that no fraudulent transactions have occurred.

Thank you so much for watching.