Case 23-6c

Fraud Risk Assessment

Auditors have a responsibility to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, *whether caused by error or fraud*. Two types of misstatements are relevant to the auditor's consideration of fraud — misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

- Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users. Fraudulent financial reporting need not be the result of a grand plan or conspiracy. It may be that management representatives rationalize the appropriateness of a material misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements, including interim statements, expected to be corrected later when operational results improve.

- Misstatements arising from misappropriation of assets (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where such theft causes the financial statements not to be presented — in all material respects — in conformity with GAAP. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services that have not been received.

The auditing standards referenced in this case establish requirements related to fraud and provide direction, including the following risk assessment procedures for identifying and assessing risks of material misstatement of the financial statements due to fraud ("fraud risks"):

- Hold a **fraud brainstorming discussion** during which engagement team members exchange ideas about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how the assets of the entity could be misappropriated.

- Make **inquiries** of management, those charged with governance, and other appropriate individuals within the entity (e.g., internal audit) to obtain their views about the risks of fraud.

- Evaluate whether **unusual or unexpected relationships** have been identified through analytical procedures performed as part of risk assessment procedures.

- Consider whether **other information** obtained by the auditor indicates risks of material misstatement due to fraud. This would include, for example, an understanding of the entity and its environment related to:
  - The company's measurement and analysis of its financial performance (i.e., key performance indicators).
  - The company's internal control (e.g., its risk assessment process, including fraud risks).
  - Publicly available information about the industry.
  - Communications with company personnel.
- Evaluate whether one or more **fraud risk factors** are present (i.e., events or conditions that indicate an incentive or pressure to commit fraud or that provide an opportunity to commit fraud).

The auditor identifies risks of misstatement using information obtained from these procedures, considering the characteristics of the accounts and disclosures in the financial statements. The risk assessment process is iterative, as new information and audit evidence is obtained throughout the audit.

The auditing standards also establish requirements regarding design and implementation of appropriate responses to the risks of material misstatement due to fraud and determination of whether sufficient appropriate audit evidence has been obtained.

Required Discussion Topics:

1. What is the auditor's responsibility related to fraud in an audit of financial statements?
2. Why might an individual intentionally cause a material misstatement due to fraud (i.e., fraudulent financial reporting or misappropriation of assets)?
3. Provide examples of how fraudulent financial reporting or misappropriation of assets could be accomplished.
4. Read each case and evaluate how you might "connect the dots" from the results of fraud risk assessment procedures. Identify whether a fraud risk factor is present and next steps the engagement team might perform to determine whether there is a risk of material misstatement due to fraud. (Note that the presence of a fraud risk factor may or may not lead to identification of a risk of material misstatement due to fraud).
5. Using the knowledge you have gained from these case studies, determine the leading practices for performing an effective fraud risk assessment.

Case A — Under Too Much Pressure?

Sales 'R Us Corp. is a publicly traded company that specializes in e-commerce and online auctions.

- Through inquiry with the director of compensation, the audit engagement manager learned that management's incentive compensation is based on performance related to achieving annual targets for revenue, which are set at the beginning of each year. For the current year, eligible employees will receive a bonus of 5 percent of their annual salary if annual revenues reach $5.25 billion. They will receive a bonus of 15 percent of their salary if annual revenues reach $5.5 billion, and 25 percent of their salary if annual revenues reach $5.75 billion.

- The audit staff read and summarized the compensation committee's meeting minutes, noting that this year's annual executive incentive compensation plan uses performance-based restricted stock units. The audit engagement manager recalled that in prior years, share-based compensation was a fixed amount, not performance-based.

- The audit engagement manager, with assistance from his audit staff, researched analyst reports. Revenue predictions were often reported by the analysts before the company released its results. The team noticed that the company's performance rarely missed the analysts' predictions, and that historically, when missed, there was a decline in stock prices that took time to recover.

- A summary of the company's current year revenues (as predicted by analysts vs. actuals reported subsequently in the company's Form 10-Q) is shown below:

Period	**Three-Months Revenue — Analyst Prediction**	**Three-Months Revenue — Company Form 10-Q**
Q1	$1.4 billion	$1.482 billion
Q2	$1.35 billion	$1.375 billion
Q3	$1.3 billion	$1.307 billion

- The audit engagement team's workspace is on the same floor as the sales department. A flyer is posted in the breakroom announcing a promotional program in which sales personnel will be entered into a sweepstakes if they boost their sales by 25 percent by mid-December. The announcement notes that, to allow for maximum growth, individual seller limits (i.e., caps that are placed on accounts to manage risk) will be suspended through the duration of the program, but will resume in January.

Case B — Could There Be Supply Chain Shenanigans?

Global Products Inc. is a manufacturing company with suppliers located around the world.

- During inquiries with management, the audit engagement partner discussed recent operational challenges due to macroeconomic factors. The vice president of operations acknowledged that there has been some supply chain strain, but added that overseas vendors had been successful in securing the high-demand product with little additional cost.
- The engagement team inspected management's risk assessment documentation, which included bribery and supplier kickbacks as potential fraud risks. Management had rated the risks as low, based on the maturity of the company's relationships with its vendors.
- During a fraud brainstorming session, audit staff noted that they had seen shipping invoices from a country known to have a high corruption index. The experienced audit engagement team members recognized the vendor name but did not recall having seen transactions originating from this country in previous years.