When large scale fraud is identified, the question often posed is "Where were the auditors?"

What makes detecting fraud so difficult?

- Fraud often involves sophisticated and carefully organised schemes designed to conceal the fraud. It may be more difficult to detect when two or more persons work together (collusion) to perpetrate and then hide the fraud.
- It is more difficult to detect fraud where the perpetrator is more skilled, the individual amounts are smaller, the fraud is less frequent and impacts fewer figures in the financial statements, and how senior the people are in the organisation.
- Because of their seniority, management or the Board are in a position to manipulate financial figures and other financial information, or override controls designed to prevent fraud. Management and the Board can also restrict access to information, which impacts the auditors ability to detect management fraud rather than employee fraud.

Detecting Fraud – What do the auditors do?

The detection of a material misstatement in the financial statements caused by fraud is an essential element of an audit. Understanding how the auditor plans for, tests and reports on the audit is critical in assessing your risks as investors and financiers of organisations.

Although fraud is a broad legal concept, external auditors focus on fraud that causes material misstatements in financial statements. There are two types of misstatements relevant to the auditor which are caused by fraud:

- Fraudulent Financial Reporting*, and
- Misstatements from the Misappropriation of Assets

*fraudulent financial reporting is an intentional act by one or more individuals involving the use of deception in respect of transactions that can impact the financial figures to obtain an unjust or illegal advantage.

Financial reporting fraud is the least common form of fraud, but when it occurs, it frequently results in the highest loss for investors or financiers.

So what do the auditors do?
The External Auditor's must assess risks and apply procedures designed to collect evidence to provide reasonable assurance that the financial statements do not include material misstatements whether due to fraud or error.
When planning and performing the audit, the auditor must also consider the potential for management to circumvent controls and must recognise the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

Why then does fraud sometimes go unnoticed?
It is more difficult to detect fraud than to detect errors. This is mainly because of the desire of the perpetrator not to have the fraud identified and intention with which fraud is conducted.
Reasonable, and not absolute assurance means that an auditor does not test 100% of the transactions in the year. Instead the auditor uses a concept called materiality whereby the audit is designed to focus more attention on areas of the financial statements that are considered high risk or "**material**".
Because of this, there remains an unavoidable risk that some material misstatements in the financial statements may not be detected even though the external audit is properly planned and performed.

Tips to reduce your risk

The difference between what the auditor does and what investors think they do is often referred to as the "expectation gap". This gap adds to an investor's risk because it can create a false sense of security.

What can you do to close the gap and reduce your risk?

- Check whether Board of Directors or Trustees and management are knowledgeable, skilled, ethical and competent for the jobs or tasks that they are entrusted to perform. Ask yourself "Would I have these people run my own business?"
- Familiarise yourself with the operations of the entity, to be able to know when something is unusual. Ask questions and do research about the industry. Remember the adage "Buyer Beware" and make sure you are aware of what the business is all about;
- Familiarise yourself with the audit process, responsibility of the auditors and the results of an audit conducted;
- Familiarise yourself with the issued auditor's opinion in relation to the financial statements;
- Familiarise yourself with the director's report in the financial statements or governance reports in the annual reports;
- Before getting into a business relationship with another business, or individual, that requires some level of trust get to know your business partner be it local or international.

Red Flags which may indicate fraud

The following are financial statement fraud Red Flags which may signal potentially fraudulent practices:

- Significant estimates including asset valuation, once off transactions, significant accrued liabilities etc.as well as significant changes in the assumptions relating to recurring estimates.
- Unexpected/ unusual figures, for example growing revenues without a corresponding growth in cash flows, consistent sales growth while competitors or the industry are struggling, a significant improvement in performance from the prior year.
- Accounting policies such as depreciation methods and estimates of assets' useful life that do not correspond to those of the overall industry.
- Questionable corporate culture.
- Large unusual transactions/ activities – this means transactions that don't relate to the normal business of the organisation. E.g. buying new businesses, reorganising the organisation etc.
- The sudden replacement of an auditor.
- Unusually large management salaries/ remuneration from bonuses.

CONTACT US

PUBLIC ACCOUNTANTS' AND AUDITORS' BOARD

Public Accountants' and Auditors' Board
Tel: 061 285 8425
Email:
secretariat@paab.com.na
Address: 123 Robert Mugabe Avenue, Windhoek, Namibia

iCAN INSTITUTE OF CHARTERED ACCOUNTANTS OF NAMIBIA

Institute of Chartered Accountants of Namibia
Tel: 061 220 218
Email:
secretariat@ca-nam.com
Address: 24 Orban Street, Windhoek, Namibia