AUDITING (AUD)
CPALE Concept Notes

FRAUD, ERROR, NON-COMPLIANCE
Source: CPAR Lecture (Sir G. Roque), REO Live (Sir George), and Pre-Recorded (Sir Escala)

Topics Covered:

1. *Theory on Auditing and Attestation Services*
   - 1.3. *Understanding the Entity and its Environment including its Internal Control and Assessing the Risks of Material Misstatement*
     - 1.3.3. *Assessing the risks of material misstatement*
       - 1.3.3.1. *Fraud and errors*
2. *Auditing Practice*
   - 2.4. *Audit Communication and Reporting*
     - 2.4.2. *Evaluating audit evidence*

Preliminaries to Misstatements

MISSTATEMENTS

- Occurs when the amount per book is not equal to the amount per audit ***(Per Audit ≠ Per Book)***

Types of Misstatements

Error	Fraud
Unintentional	Intentional *(with intent or malice)*
Easier to Detect	Harder to Detect *(due to the element of concealment)*
Error of Omission	Error of Commission

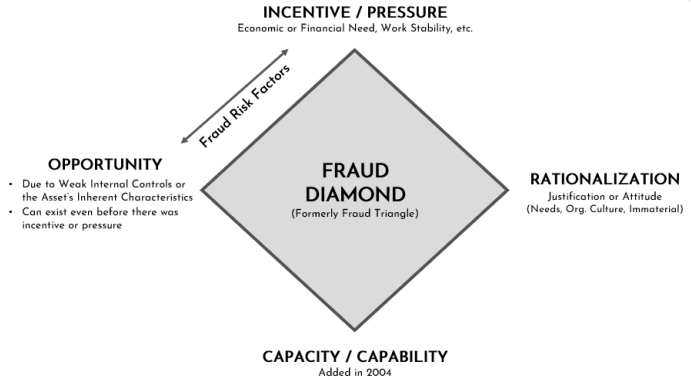
- Audits are conducted in a ***neutral premise*** – management and employees are not fraudulent nor honest *(in line with professional skepticism)*
- There is **EQUAL** responsibility in discovering both fraud and error; *fraud is not given higher importance than error*

PSA 240 – Fraud in an Audit of Financial Statements

Fraud involves

- Incentive or Pressure to commit fraud
- Perceived Opportunity to do so *(Control Deficiency or Asset's Nature)*
- Some Rationalization of the act

Updated Fraud Diamond



- *If fraud risk factors are present, it must be documented*

Responsibilities for Fraud

	Auditor	Management and Those Charged with Governance
Prevent *Fraud*	✗	✓
Detect *Fraud*	✓ Only fraud that are ***material and with direct effect*** to the FS	✓

- *Essentially, the **primary responsibility for preventing and detecting fraud** (fraud prevention and deterrence) lies to the management, with oversight of TCWG*
- *Auditors are not there to prevent and detect fraud; their obligation is to **make an assessment of the ROMM** whether due to fraud or error and develop appropriate responses*

Relevant Types of Fraud to the Auditor

Fraudulent Financial Reporting	Misappropriation of Assets
• Commonly associated to ***Management Fraud***	• Commonly associated to ***Employee Fraud***
• Misstatement in FS to deceive its users	• Theft of the entity's assets
• Harder to Detect	• Easier to Detect
Examples: • ***Window Dressing*** *(Overstatement of Assets, Income, and/or Equity)* • ***Secret Reserve*** *(Overstatement of Liabilities and/or Expenses)* • ***Kiting*** *(Delayed Disbursements)* • Overstatement of income and understatement of expenses for investors • Overstatement of expenses and understatement of income for the BIR • Overstatement of assets and understatement of liabilities for creditors • Intentional misapplication of accounting principles • Misrepresentation or intentional omission of events, transactions, or other significant information from the FS	*Examples*: • ***Lapping*** *(Delayed Receipts)* • Embezzling Receipts • Stealing Physical Assets and/or Intellectual Property • Use of Entity's Assets for Personal Use • Cause the Entity to Pay for Goods and Services Not Received

AUDIT PROCEDURES AND RESPONSES TO FRAUD

- ***Obtain an understanding of the entity and its environment***
  - Inquiry to Management
    - As to fraud risks, how they're identified and addressed, and how ethical behavior is communicated
  - Understanding how TCWG oversee fraud risk management and related internal controls
  - Evaluate existence of ***Fraud Risk Factors***
    - Circumstances present in the past when fraud has occurred, indicating or suggesting an *incentive/pressure or an opportunity to commit fraud*
  - Maintain professional skepticism
  - Perform audit with "***fraud lens***"
    - If fraud would happen here, how would it be done?
  - A *rebuttable presumption* exists that **there exists fraud in the revenue account**

- ***Identify and assess the ROMM due to fraud, and develop appropriate responses***

Overall Responses

  - Increase *more experienced team members*
    - Assigning appropriate staff based on their knowledge, skills, and abilities
  - Increase *emphasis on audit of subjective transactions*
    - Evaluate accounting policies, particularly those involving ***subjectivity or complex transactions***, which may indicate fraudulent financial reporting
  - Increase *unpredictability of audit procedures*
    - Unpredictability in the nature, timing, and extent of audit procedures

Specific Responses *(Assertion Level)*

Nature	***More Effective Procedures*** *Those to obtain more reliable and relevant evidence*
Timing	***Closer*** to Year-End
Extent	***Larger*** Sample Size

- ***As to the Risk of Management Override***
  - Test appropriateness of journal entries and adjustments
  - Review ***accounting estimates for bias*** that may indicate fraud
  - Obtain understanding of significant or unusual transactions' business rationale

- ***Evaluation of Audit Evidence***
  - *Analytical procedures are used to identify **any new unrecognized fraud risks***
  - Identified misstatements are evaluated if indicative of fraud, and the reliability of management representations
  - If a misstatement is believed to be the result of fraud, auditor shall ***reassess ROMM and its audit responses***

COMMUNICATION TO MANAGEMENT AND TCWG

*Communication is required if the auditor has obtained information that indicates possible fraud, at a **timely basis** to the appropriate level of management*

To the Management	Information that *indicates* possible fraud
To TCWG	Fraud and material ***weaknesses in controls*** Identified *fraud involving management, employees with significant role in internal control*, or those that result to *material misstatement in FS*
To Regulatory Authorities	Only when required by law (legal responsibilities)

Auditor Unable to Continue the Engagement (Withdrawal)

- Due to any of the following
  - ***No remedial action*** of the management and/or TCWG
  - Risk of ***pervasive fraud*** *(information spread-out)*
  - Question of ***client's integrity*** or competence
- Must be communicated to the appropriate level of management and TCWG, ***together with the reasons for withdrawal***
- Must also be communicated to appropriate regulatory authorities, *if there is such requirement or duty to do so*

Documentation Specific to Fraud

- *Engagement team discussions* and *significant decisions* about the entity's susceptibility to fraud
- Identified and ***assessed ROMM*** due to fraud at both the financial statement and assertion levels
- Overall and specific ***responses***, and its ***linkage*** to assessed ROMM
- ***Results*** of audit procedures
- ***Communications*** about fraud to the management, TCWG, and regulatory authorities, if any
- ***Reasons for the non-applicability*** of the *fraud presumption in revenue recognition*, if the auditor concluded so

PSA 250 – Non-Compliance to Laws and Regulations

NON-COMPLIANCE

- Omission or commission of the entity ***contrary or in violation to laws and regulations***, whether intentional or unintentional
- *Excludes* ***personal*** misconduct, unrelated to business activities, of employees, management, and TCWG
- Auditor's *main concern* is the ***effect*** of such non-compliance ***to the FS***, not to identify who was responsible for such
- Has a ***higher risk of non-detection*** as compared to fraud since laws and regulations *primarily relate to the operating aspects*, whereas audits primarily relate to financial and accounting aspects.
- Single person management or small management with no effective oversight is ***not of itself*** an indication of non-compliance

Responsibilities for Non-Compliance

	Auditor	Management and Those Charged with Governance
Prevent *Non-Compliance*	✗	✓
Detect *Non-Compliance*	✓ Only fraud that are ***material and with direct effect*** to the FS	✓

- *Essentially, the* **primary responsibility** *to ensure compliance, and to prevent and detect non-compliance lies to the management*

Possible Indications of Non-Compliance

- Government investigations or payment of fines and/or penalties
- Unauthorized or improperly recorded transactions
- Purchasing at prices ***significantly*** above or below the market price

AUDIT PROCEDURES

- ***Obtain understanding*** of the applicable legal and regulatory framework and how the entity complies with it

Laws and regulations with DIRECT effect on the FS *Ex. Tax Laws*	Auditor gathers evidence of ***Compliance***
Laws and regulations with INDIRECT effect on the FS *Ex. Public Health and Safety Laws, Data Privacy, AMLA*	Auditor gathers evidence of ***Non-Compliance***

  - *The auditor provides **no assurance** that non-compliance with **indirect effects** to FS are detected*
  - *In assessing if laws and regulations have direct or material effect to the FS, the auditor may do the following:*
    - ***Inquiry*** *to management and TCWG*
    - ***Inspecting correspondence*** *with relevant regulatory authorities*
- The auditor must also ***obtain written representation*** from the management and TCWG, if appropriate, that *all known or suspected non-compliance has been disclosed*
  - *However, the auditor must **remain alert of possible non-compliance** arising from other audit procedures*

If Non-Compliance is Identified or Suspected

- Obtain ***understanding*** of the nature of the act and the circumstances, and its possible effect on the FS
- ***Discuss the matter*** with management and TCWG, if appropriate
- Consider ***implications to other aspects*** such as the assessed ROMM and reliability of written representations, and take appropriate further action
- If no sufficient and appropriate evidence can be obtained, evaluate its ***effects to the auditor's report***

If No Non-Compliance is Identified or Suspected

- The auditor is ***not required*** *to perform further audit procedures*

Communication of Identified or Suspected Non-Compliance

Required to be communicated to TCWG, unless inconsequential

*Believed to be **intentional and material***	Reported immediately or ***as soon as practicable to TCWG***
*Suspects that **management and TCWG is involved** in non-compliance*	Reported to the ***next higher level of authority in the entity*** *(Audit committee or supervisory board)* • If no higher authority exists within, the auditor shall ***obtain legal advice***

- *Communication with the audit committee should include **disagreement with the management about significant audit adjustments**, whether resolved or not, whether occurred before or after the issuance of the auditor's report*
- *If there is a requirement by law, the auditor must also report to the relevant regulatory and enforcement authority*

Effects to Auditor's Report

Material and not properly disclosed or reflected in the FS	Qualified or Adverse Opinion
Auditor is ***precluded by management or TCWG to obtain evidence*** for evaluation of non-compliance	Qualified or Disclaimer of Opinion *(Scope Limitation)*
No remedial action was made or ***client refuses to accept*** auditor's report	Withdraw from the Engagement

Documentation Specific to Non-Compliance

Required documentation

- Identified or suspected non-compliance
- Results of discussion with management and TCWG, and other parties outside the entity, if any