The auditor and fraud risk

MODULE 2 | 2.6.1 | STUDENT COMPANION

Fraud is **intentional**; error isn't. The fraud standard focuses on two kinds: **fraudulent financial reporting** (deliberately misstated statements) and **misappropriation of assets** (theft). Management and those charged with governance carry the primary responsibility for preventing and detecting fraud; the auditor seeks **reasonable assurance** that the statements are free of material misstatement, whether from fraud or error, knowing that fraud is harder to find. The **fraud triangle** shows where to look. **Revenue** fraud risk is presumed unless rebutted, and **management override** is always a significant risk, met with three responses on every audit.

Fraud or error?

	Error	Fraud
Intent	Unintentional	Intentional, involving deception to gain an unjust or illegal advantage
Examples	A data-processing slip; an estimate wrong through oversight; a misread accounting standard	Fictitious sales; hidden liabilities; stolen stock; payments to a fake supplier
Who	Anyone involved in the process	Management, employees or outsiders, sometimes acting together
How it hides	It usually doesn't: the trail is still there	By design: forged documents, collusion, transactions deliberately left unrecorded

Two kinds of fraud, side by side

Error (Unintentional) → **The difference is intent** → **Fraud** (Intentional, involving deception)

Fraudulent financial reporting

Deliberately misstating or leaving out amounts or disclosures to deceive users

- Recording fictitious sales
- Hiding liabilities
- Manipulating estimates

ACFE surveys: least common kind, but the largest losses per case

Misappropriation of assets

Stealing the entity's assets, usually concealed with false records

- Stock and cash
- Payments to fake suppliers

ACFE surveys: by far the most common kind of occupational fraud

Both now travel through digital channels too: fake invoices sent by email, hacked payment systems

Digital channels. Both kinds of fraud increasingly arrive online: a fake invoice emailed from what looks like a regular supplier, a request to change a supplier's bank details, or a payment system taken over by hackers.

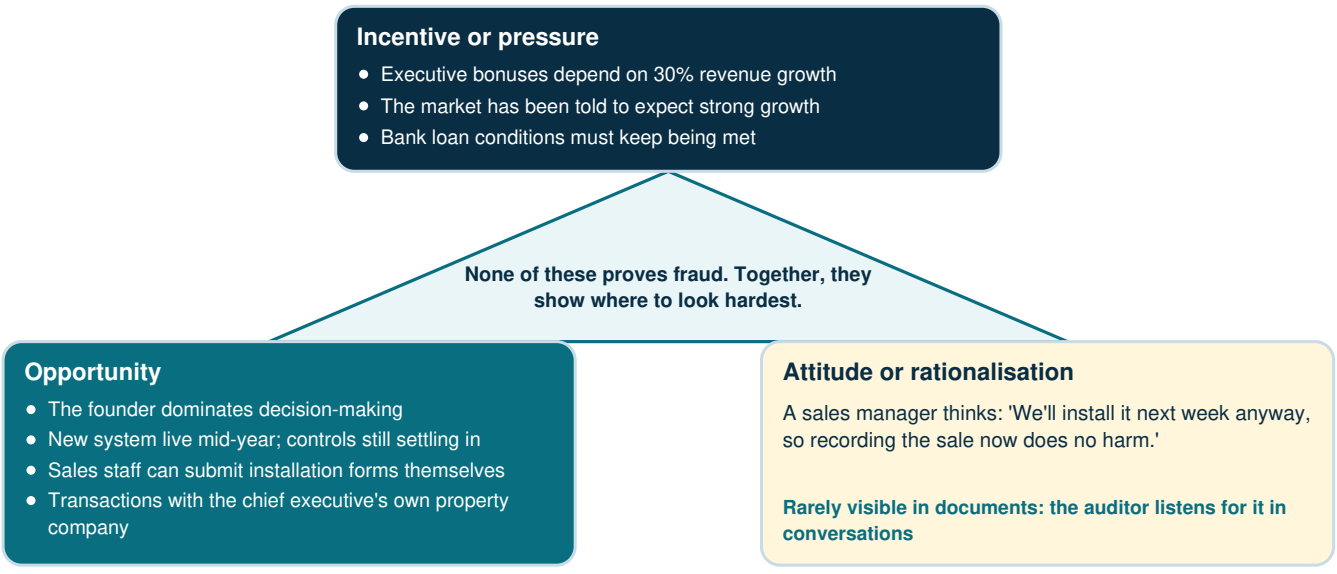
How often, and how costly. The Association of Certified Fraud Examiners' surveys keep finding the same pattern: theft of assets is by far the most common kind of fraud by people inside an organisation, while financial statement fraud is the least common but causes the largest losses per case.

Source: Association of Certified Fraud Examiners, Occupational Fraud 2026: A Report to the Nations (14th edition).

Who is responsible?

Management, and those charged with governance	Auditor
Primary responsibility for preventing and detecting fraud	Reasonable assurance that the statements as a whole contain no material misstatement, whether from fraud or error
Build an honest, ethical culture, and run controls that prevent fraud or catch it quickly	Identify and assess fraud risks, respond to them, and keep a sceptical mind throughout, whatever past experience suggests about the client's honesty
Oversight by the board, including of management's own fraud risk assessment	Accept the limits: fraud is built to be hidden, so a material fraud is harder to find than an error, and harder still when management is involved

The fraud triangle at Voltana



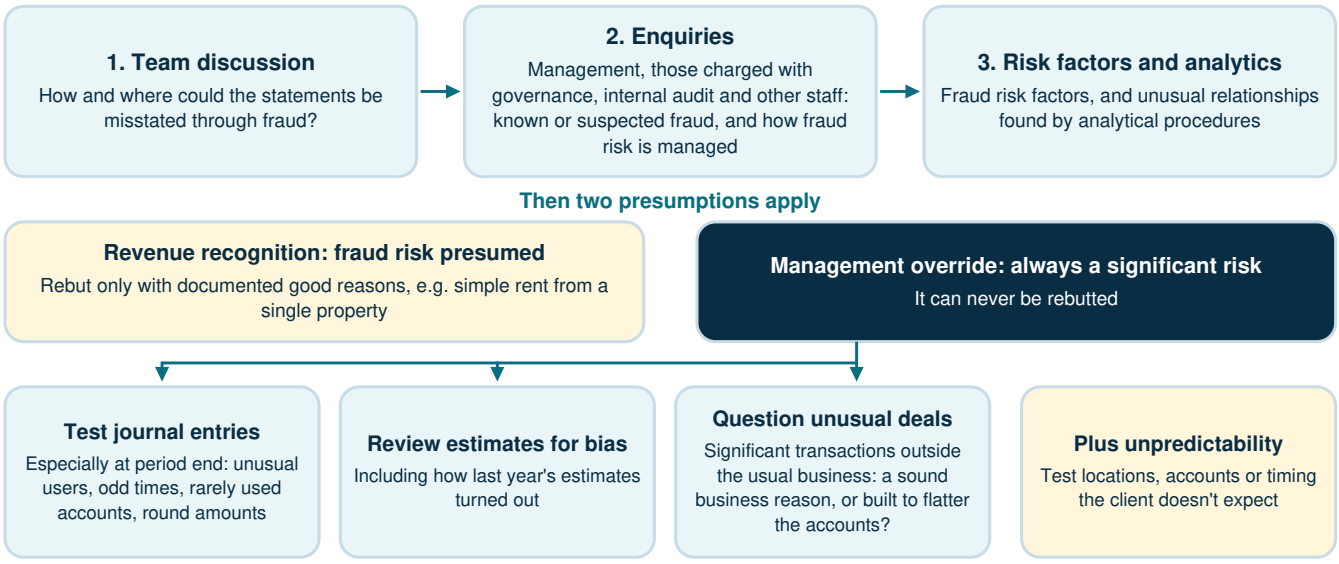
Reading the triangle. Pressure and opportunity are visible from outside; rationalisation rarely is, which is why the auditor listens for it in conversations. At Voltana every corner is present, and they point to the same place: revenue recorded before installation, where a sales manager's rationalisation meets a bonus scheme and forms that sales staff can submit themselves.

Case note: Steinhoff

Steinhoff was a global retail group with businesses in Europe, Africa, the United States and Australia, built up through rapid acquisitions. In December 2017 it announced accounting irregularities that needed investigation, and its chief executive resigned. Its share price collapsed by more than 60% in a single day and kept falling. A forensic investigation later reported that a small group of former executives had arranged transactions over many years that inflated the group's profits and asset values, with irregular transactions totalling about EUR 6.5 billion between 2009 and 2017. **The pattern:** pressure from a growth story the market loved, opportunity from a powerful leader and a complex web of entities, and transactions designed to look legitimate to anyone who didn't trace them all the way through.

Source: Steinhoff International Holdings announcement (5 December 2017); overview of PwC's forensic investigation (15 March 2019).

What the fraud standard requires on every audit



Rebutting the revenue presumption. The auditor can conclude that revenue carries no fraud risk only with good, documented reasons, typically where revenue is simple, predictable and leaves management almost no room for judgement, such as fixed rent from a single property. The conclusion can differ between revenue streams, and the reasons go on the file. The revised ASA 240, for periods beginning on or after 15 December 2026, keeps both presumptions.

Why test journal entries when nothing looks wrong? Management override leaves few traces until someone looks, and journal entries are one of the main tools for it: a manual entry can move profit between years, inflate revenue or bury an expense. So the standard requires the test on every audit, whatever the risk assessment says. The team first checks that the list of journals is complete, by reconciling it to the general ledger, and then selects entries with the features of override.

Practice questions

MODULE 2 | 2.6.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Sort the fraud risk factors

Mirrabook Facility Services Ltd (imagined) is listed and runs cleaning and maintenance contracts for offices, shopping centres and universities. Sort each fact into incentive or pressure, opportunity, or attitude and rationalisation.

Fact	Incentive, opportunity or attitude?
(a) The chief executive's bonus doubles if revenue passes $300 million this year	
(b) The finance director approves new suppliers and can also release payments alone	
(c) The chief operating officer says bending accounting rules is 'what everyone in this industry does'	
(d) Lenders require gearing below a set limit, and the company is close to it	
(e) The internal audit role has been vacant for nine months	
(f) Two long-serving site managers say they 'deserve a bit extra' after a two-year pay freeze	
(g) Analysts expect 15% earnings growth, and the share price already assumes it	
(h) Month-end accruals for unbilled work are calculated by one finance officer, with no review	
(i) Management dismissed last year's audit findings on payment controls as 'red tape'	
(j) The group has 14 subsidiaries, several set up this year with no clear business purpose	
(k) The chief executive has a large personal loan secured over company shares	
(l) Management often argues that disputed adjustments are 'too small to matter'	

Question 2 - Three tests of journal entries

Design three tests of Mirrabook's journal entries and explain what each would detect.

Test you would run on Mirrabook's journal entries	What it would detect

Question 3 - Can the property trust rebut the presumption?

Keswick Industrial Property Trust (imagined) owns five warehouses, each let to one unrelated tenant on a long lease. Rent is fixed in each lease, rises by 3% a year, is invoiced monthly in advance and is paid by direct debit. There is no turnover-based rent. The trust has no employees; an outside manager runs it for a fee based on the value of the properties. In May, the trust waived three months' rent for one tenant in return for a two-year extension of its lease. Could the auditor rebut the presumed risk of fraud in revenue recognition? What would you document?

Worked answers

MODULE 2 | 2.6.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Mirrabook Facility Services

	Category	Why
(a)	Incentive	A personal reward tied to a revenue target
(b)	Opportunity	Incompatible duties: one person can create a supplier and pay it
(c)	Attitude	A ready-made excuse for misstating the accounts
(d)	Incentive	Pressure to meet a lender's condition
(e)	Opportunity	Weak monitoring: nobody independent is checking
(f)	Attitude	A sense of entitlement that can justify theft
(g)	Incentive	Pressure to meet outside expectations
(h)	Opportunity	A judgemental figure prepared and controlled by one person
(i)	Attitude	Disregard for controls and for the auditor
(j)	Opportunity	A complex, changing structure in which transactions can be hidden
(k)	Incentive	Personal financial pressure linked to the share price
(l)	Attitude	Repeatedly justifying doubtful accounting on materiality grounds

Question 2 - Journal entry tests (suggested)

Test	What it would detect
Manual entries to revenue, accrued income or receivables in the last two weeks of the year and the first two after it	Revenue or unbilled work recorded early, or invented, to reach a target, especially if reversed soon after year end
Entries posted by senior people who rarely post (the chief executive, the finance director), by IT staff, or at weekends and late at night	Override by people able to bypass normal approval, and entries kept away from routine review
Round-amount entries, entries with blank or vague descriptions, and entries to rarely used or suspense accounts	Plugs and manipulations, such as moving costs between accounts or into the balance sheet
First, for every test	Reconcile the journal listing to the general ledger so the population is complete; then inspect support, check approval and ask why each entry chosen was needed

Question 3 - Keswick Industrial Property Trust (sample answer)

- **Mostly yes.** Rent on the four unchanged leases is fixed, predictable, paid by direct debit and easy to recalculate, and the manager's fee depends on property values, not revenue. Rebutting the presumption for that stream is reasonable.
- **Not for the changed lease.** The rent waived must be spread over the new lease term, a judgement that is easy to bend in a flattering direction, so keep the presumed risk for this stream, or test it closely.
- **Document** the reasons and evidence (leases inspected, rent recalculated, receipts traced), the treatment of the changed lease and when to revisit the conclusion. Substantive work on rent and the three responses to management override still apply.