

## A Case of Client Fraud – Part 2

By Stephen Hollander, CFE, MIPI, CGA – October 2005

(Note: some edits to update the original content for current day standards were made in 2016)

In the first part of our series of articles on fraud and error, your client, Joe Wittering, came to you with a suspected fraud incident. The article discussed what to consider when asked by a client to investigate a suspected case of fraud. This matter has now been dealt with. In this second article, for the purpose of obtaining enhanced assurance, this year Joe has engaged you to perform an audit of his company rather than the usual review engagement. In part three of this series, we will consider what to do when you find clear and convincing evidence that a fraud has occurred.

### **Additional Case Facts**

*During the course of your audit, you perform a routine check of vendor invoices using Audit Command Language (ACL®). This program tests the effectiveness of internal controls by checking the accuracy and integrity of a client's transactions. One of your tests involves sorting invoices by vendor and invoice number and checking for sequences. You find that one vendor, Speedy Electronics, submitted 12 invoices during the year totalling approximately \$18,000, excluding taxes, with only two gaps in the invoice-number sequence. You pull the invoices and find that they are for on-site maintenance and repair work on photocopiers, computers and peripherals, video projectors, and so on. They appear to be in order, properly coded, and signed off by the office manager. Further checks show that the vendor does not appear in the phone directory. A call to the phone number printed on the invoices reaches a voice mail system.*

*What do you do now?*

At this point in your audit, you have come across some possible indicators of fraud. They are:

- The sequence in vendor invoice numbers, indicating that Joe's company may be the only customer of that particular vendor
- The absence of a phone-book listing for the vendor

These, combined with the nature of the purchases being services rather than goods, and the absence of a "live" person at the vendor's phone number, ought to raise suspicions of some kind of procurement fraud, by the vendor, a company insider, or a collusive effort between an insider and the vendor. At this point, however, all that you have is "red flags," which may or may not indicate fraud. Small, specialized vendors may have a legitimate reason for issuing sequential invoice numbers to a particular customer, and, in any case, there were some gaps in the sequence that you found. With regard to the absence of a phone listing, there may also be a legitimate explanation.

There are a number of steps that you could take to get a better handle on what might have been going on. Some of them would be fairly inexpensive and straightforward, such as using ACL® to find out how much was paid during the audit period to each vendor in this particular category, how much was paid to each vendor in previous periods, and so on. On the other hand, other steps, such as travelling to the vendor's premises, would involve some expense, and they might simply lead to the necessity to perform still further steps. If, in the example given, the electronics company's address was the reception desk of

a "rent-an-office" place, you would be no further ahead, since there could be a legitimate explanation for this. Pulling and examining the cancelled cheques sent in payment of the invoices may or may not provide some clues. You could go on like this for quite some time, with each step leading to the necessity of performing a further step, thus increasing your costs and slowly driving your time budget off-course.

The questions that you now have to ask yourself are:

1. What is my obligation to report my findings to management, that is, to Joe?

According to the [CICA-CPA Canada Handbook, Section 5135.098 CAS 240.40](#):

~~If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management on a timely basis. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). [Emphasis added]~~

~~3.2. At what point does this obligation arise?~~

According to [CPA Canada Handbook section 5170.13 CAS 240.A60](#):

~~When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.~~

~~Matters to be communicated with management may be identified by the auditor at any stage of the audit process. Although the communication of these matters will not necessarily take place before issuance of the auditor's report on the financial statements, the communication needs to be made on a timely basis to enable management to take appropriate action. In determining what constitutes a timely basis, the auditor would be guided by the significance of the matter and an assessment of its urgency. [Emphasis added] In the case of the possibly fraudulent procurement, timeliness may be determined by at least two factors:~~

- ~~a) If this is a fraud, it is an ongoing one, and Joe will, or should, want to take prompt action to prevent further losses~~
- ~~b) If you are going to investigate the issue, it will add to the costs of the audit and you will likely want Joe to know about this in advance.~~

~~What How and what should I communicate to Joe regarding the potential fraud? According to [CPA Canada Handbook section 5750.07 CAS A61-A63](#), there are three things that should be contained in~~

communication of matters that are identified during a financial statement audit: the communication may be made orally or in writing:

- The auditor's communication with those charged with governance may be made orally or in writing. CAS 260 identifies factors the auditor considers in determining whether to communicate orally or in writing. 25 Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.
- In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.
- In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.
- ~~The communication is a by-product of the financial statement audit and therefore is a derivative communication;~~
- ~~The audit would not usually identify all matters that may be of interest to management;~~
- ~~The communication is prepared solely for the information of management and is not intended for any other purpose.\*~~

~~Apart from these formalities,~~ Your communication would likely include the following elements:

- A statement of your findings. To date, this would include the sequential invoice numbers from a single vendor and the observation that the vendor does not appear in the most current telephone directory.
- Your interpretation of what you have found. You would likely point out that:
  - These findings are consistent with the existence of a phoney-vendor scheme, a conflict-of-interest situation or some other form of occupational fraud or abuse;
  - Nevertheless, these findings do not necessarily indicate that such fraud or abuse has taken place, since there may be alternative, legitimate explanations.
- Recommendations regarding further investigative steps, together with an estimate of the associated costs.\*\* If you do not have competence in this area, consider a referral to a professional who has the required expertise.
- A request that, if the client agrees to the further investigative steps, he sign-off on a copy of your communication and return it to you. This communication would effectively function as an engagement letter.

The last item mentioned, the sign-off, is for your protection, since the investigation of a possible fraud would not have been covered in your original audit engagement letter.

A question that might arise in your mind is, what if you communicate all of this to Joe and he does not want you to undertake the investigative steps that you have suggested? You don't want to create a

situation in which you may later be sued for failing to perform the necessary investigative steps to follow up on a potential fraud that you discovered during the audit process. Accordingly, if Joe does not want you to follow up, it would be advisable that you send a further communication to him, in which you:

- Reiterate your findings, interpretation, and recommendations
- Note that Joe has directed you orally, not to take the follow-up steps recommended by you
- Advise Joe of the possible consequences of failing to take these steps, i.e., failure to recover funds possibly embezzled so far, possible existence of ongoing fraud and consequent further economic loss
- Advise Joe further that, if you conclude, based on the evidence and your professional judgment, that the suspected fraud would result in a material misstatement of the financial statements, and if these misstatements are not addressed, you will have to express a reservation in your audit report. \*\*\* If fraud is pervasive, then consideration of a denial of opinion would be necessary.
- Request that Joe confirm, by his signature on a copy of the additional communication, that he is aware of these possible consequences and nevertheless directs you not to take the follow-up steps that you have recommended.

There remains one final question that should nag at you. If Joe does not want you to follow up on the suspected fraud, what would be the reason for this? You may well have to consider the possibility that this may be indicative of a more pervasive problem, indeed, it might reflect upon the integrity of management, meaning Joe. If you find yourself uncomfortable in this situation, you may want to consider resigning from the engagement. You will lose the fee, but you may well find yourself sleeping better.

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