Examples of Key Audit Matters that Relate to Fraud

The examples of key audit matters (KAMs) that relate to fraud provided in this Agenda Item are based on existing KAMs set out in auditor’s reports in Europe. These examples are provided to illustrate how key audit matters related to fraud may be presented in the auditor’s report.

Since these are based on existing KAMs, the wording used may not be fully aligned with the wording used in the International Standard on Auditing (ISAs). Further, while the Fraud Task Force (Fraud TF) did not re-write the examples, the Fraud TF did anonymize the illustrations and, in certain instances, the examples were refined to highlight a specific matter.

The following examples are included:

- Example 1 – Revenue Recognition – A key audit matter in which both a fraud related matter and an error related matter are described.
- Example 2 - Manipulation of contract performance – A key audit matter describing the occurrence of an actual fraud.
- Example 3 - User Access Management – A key audit matter describing control deficiencies.

The Fraud TF has only included the examples and not the full KAM section in the auditor’s report. The Fraud TF is not intending to include the examples in proposed ISA 240 (Revised).1

Example 1 – Revenue Recognition

Contract Revenue - Risk of Material Misstatement due to Fraud or Error (Refer to notes X and Y of the financial statements)

The company has significant long-term contracts in its construction business. The recognition of revenue in respect of construction contracts is based on the percentage of completion (input method) basis, in accordance with the [applicable financial reporting framework].

There is a risk that revenue recognized is materially misstated due to fraud or error as there is significant judgement in determining the inputs that drive contract revenue recognition, such as forecast revenue, forecast costs to complete and recoverability of unagreed income. Such inputs could also be susceptible to management bias particularly in respect of estimates related to the cost to completion and percentage of completion at the year end. Additionally, there may be an incentive to overstate costs incurred to accelerate revenue recognition. Given the identified fraud risks and the significant auditor attention required to obtain audit evidence about the management judgements we considered this a key audit matter.

In addressing this risk we performed audit procedures that were responsive to fraud risks with respect to the cost incurred, the cost to complete and the percentage of completion.

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1 Proposed ISA 240 (Revised), The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements
The audit procedures included:

- Obtaining an understanding of the company’s information processing activities in relation to the generation and recording of journal entries related to revenue, and testing the appropriateness of journal entries;
- Reconciling incurred costs of materials to purchase orders, receipts authorized by project managers and purchase invoices, and reconciling labor and equipment costs incurred to approved time sheets and hourly rates;
- Obtaining evidence to support applied hourly rates and cost prices of materials to be used, challenging the number of expected hours and materials to complete the project and reconciling changes in budgets to supporting evidence such as contract modifications;
- Using our specialists to assist us in developing a range of possible contract out-turns and challenging the appropriateness of revenue recognized and provisions held in relation to these contracts;
- Discussing the progress of the projects with the responsible project managers and management of the operating companies; and
- Performing a retrospective review of complete contracts to assess management’s ability to accurately forecast anticipated gross margin at inception of the contract.

When performing these audit procedures, we remained alert to the inherent risk of management bias.

Example 2 - Manipulation of Contract Performance

**The Group – Fraudulent Manipulation of Contract Performance**

On 15 January 20YY, the Group announced that following an internal management operational review, it had identified a deliberate and sophisticated financial reporting fraud at a subsidiary in Country A. The Group also announced that it had commenced an internal investigation and has commenced the process of appointing an external party to undertake an investigation.

Further details of the investigation are set out on page X. Management’s response to the findings of the investigation, including the associated control deficiencies that were identified, is set out on page W.

The total impact, including changes in deferred tax recognition, amount to a reduction in net assets of $99 million compared with previously reported at 31 December 20YY and $ 66 million lower at 1 January 20YY. The prior year errors were reflected in the relevant comparative periods and the impact is set out in note V. The specific items are described in note U.

Our audit focused on evaluating the adequacy and robustness of management’s investigation, the impact on the financial statements, and addressing the risk of similar issues in other reporting units.

**Our Response**

We incorporated forensic specialists in Country B and Country A into our audit team to assess the structure, scope, approach and independence of the investigation commenced by the Group, and to satisfy ourselves that it considered the risk that the issues identified may be more pervasive across the Group, and that the conclusions reached were appropriate. Where appropriate, we shadowed,
independently reperformed or extended the scope of forensic procedures to address our ISA 240 requirements for audit purposes.

We also used our forensic specialists to support us in considering the associated audit risks arising from each of the matters identified by the investigation and determining the impact on our audit risk assessment and developing an appropriate audit response.

We considered the scope of the audit and, in particular, assessed which reporting units required additional audit procedures to be performed, including but not limited to Country A.

We also instructed our component teams to perform additional procedures to respond to the risk of fraud, including incremental procedures over unbilled revenue and additional journal entry testing.

We considered the impact of the investigation on management’s internal control environment both in Country A and in other locations exposed to the same risks.

Taking the above into account, consistent with our original audit plan, we instructed our component audit team in Country A to perform a full scope audit on the subsidiaries complete financial information and evaluated the component team’s work. In addition, we performed a significant level of oversight, with senior members of the group engagement team including the involvement of our forensic specialists throughout the process.

As part of these oversight activities, we were involved in the component audit team’s risk assessment to identify significant risks of material misstatement, evaluated the appropriateness of the audit procedures to be performed by the component team to respond to the identified significant risks, reviewed certain working papers of the component audit team to evaluate the work performed and held regular meetings with our component audit team and with local, regional and Group management to consider the component team’s audit work and findings.

Our component team in Country A also specifically tested the prior year revisions and the specific items restated.

Key Observations Communicated to the Audit and Risk Committee

In our communications to the audit committee about the fraud we also communicated the associated identified significant deficiencies in internal controls.

Example 3 – User Access Management

User Access Management – Risk of Material Misstatement Due to Fraud

The Group operations support a wide range of products and services across several countries resulting in a large and complex IT infrastructure relevant to the financial reporting processes and related internal controls.

Controls over user access are an integral part of the IT infrastructure to ensure both access to IT applications and program changes are authorized and appropriate. Our audit approach relies on the effectiveness of user access controls.

Our audit procedures identified deficiencies in certain user access controls for IT applications relevant to financial reporting. More specifically, control deficiencies continue to be identified around monitoring of activities performed by users on components of the IT infrastructure. As control deficiencies could lead
to unauthorized changes to automated controls over financial reporting, including in respect of journal entries, we identified and assessed this as a risk of material misstatement due to fraud at the financial statement level.

Given the significant auditor attention needed in assessing and testing the automated controls that support material balances in the financial statements, the general IT controls over user access, and the compensating controls to overcome the effect of identified control deficiencies required, we considered this a key audit matter.

Our Procedures to Address the Risk

Control Testing

We identified the IT applications and supporting IT infrastructure relevant to the financial statement closing process.

We tested the design, implementation and operating effectiveness of automated controls in the IT applications and supporting IT infrastructure that support material balances in the financial statements relevant to the audit. We also tested the design and operating effectiveness of the relevant preventative and detective general IT controls over user access management including:

- Authorization of access rights for new joiners;
- Timely removal of user access rights;
- Logging and monitoring of user activities;
- User access management and monitoring;
- Developer access to transaction and balance information;
- Segregation of duties; and
- Re-certification of user access rights.

We performed procedures to assess whether additional detective compensating controls operate at the same level of precision to support our assessed risk of unauthorized activities and we tested management's detective compensating controls.

Substantive Testing

We selected a number of journal entries, using a statistical sample, that were originated by users with privileged user access rights. We assessed whether it was appropriate for these users to initiate those journal entries. In addition, we have established the validity of the transactions on the basis of source documents.

Communications with the Board and the Audit Committee

We discussed our response to the Key Audit Matter with the Board and the Audit Committee.