How to consider ‘Red Flags’ for potential fraud

Having access to the client’s financial transactions, historical records, and policies places accountants in a unique position to detect fraud. Below are some of the considerations that accountants should keep in mind relating to potential fraud:

1. Understand the areas where fraud commonly occurs in the client’s industry, may it be revenue recognition, asset misappropriation, or fraudulent financial reporting.
2. Identify historical incidents of fraud within the entity or industry and flag the areas of vulnerability.
3. Apply professional skepticism when it comes to discrepancies or anomalies in financial data, no matter how small. Investigate until a reasonable explanation is found. Regularly consult with colleagues or industry peers to gain different perspectives on unusual findings or to validate your skepticism.
4. Be on the lookout for fraud ‘red flags’ when working with financial information, for example:
   - **Unusual transactions near period end:** Significant, unexplained adjustments or transactions recorded just before the end of the reporting period, which may be done to manipulate financial results.
   - **Inconsistencies in financial records:** Discrepancies between the financial statements and underlying operational data, or between the book and bank balances, that cannot be logically explained.
   - **Changes in accounting estimates:** Frequent or unexplained changes in accounting estimates (like depreciation methods or bad debt provisions) that enhance financial performance.
   - **High turnover of senior financial staff:** Regular changes in key financial positions might indicate an environment where challenging unethical financial reporting practices is not tolerated.
   - **Unusual relationships between variable and fixed costs:** costs that historically have varied with sales volume but now remain constant, or vice versa, without a plausible explanation.
   - **Significant transactions with related parties:** transactions that are not conducted on arm's length terms or are not properly disclosed, which could be used to shift profits or losses.
   - **Complex or unusual transactions:** transactions that are complex, overly elaborate, or involve significant amounts of cash, especially if they lack a clear business rationale.
   - **Complaints or tips from employees:** informal complaints or tips from employees regarding discrepancies in financial reports or misconduct by senior management.

- **Missing documentation or inadequate records** for significant transactions, suggesting possible concealment of information.
- **Excessive pressure on management or staff,** unrealistic targets and performance expectations, which may incentivise individuals to manipulate financial results.
- **Sudden and unexplained increases in profits**, especially if not aligned with industry trends or economic conditions.
- **Internal controls frequently overridden** by management instances where established internal controls, potentially to conceal fraudulent activities.

5. Steps to take when fraud risk is identified

- Schedule meetings with management and auditors to discuss the any concerns related to fraud.
- Prepare a summary of fraud risk assessments and controls in place for discussion with the audit committee.
- Prepare a comprehensive package for external auditors that includes detailed explanations of the financial statements, highlighting areas where fraud risk was considered high and how those risks were addressed.
- Be proactive in offering additional information or explanations to auditors, facilitating their understanding of your organisation's financial environment and controls.