AFRC Accounting and Financial Reporting Council 會計及財務匯報局

Exploring ethical practices: identifying fraud in financial statements

Mary Leung
Head, Policy, Registration and Oversight

31 October 2023

Agenda

1. Examine common tricks used in committing fraud in financial statements through real-life case studies

2. Highlight the most typical red flags observed in day-to-day business transactions, and the ethical course of action in such circumstances

3. Share lessons learned for the accounting profession and explore the role of different parties in detecting fraud and promoting ethical conduct

Ethical role of professional accountants

Code of Ethics for Professional Accountants applies to:

- Professional accountants in **business**
- Professional accountants in **public practice**

Chapter A of Code of Ethics establishes the fundamental principles, which include:

- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional behaviour

Common tricks used in committing fraud

Falsifying documents

- Creating fictitious documents, fabricating invoice and receipts
- Alternating contract terms to change the timing / amount of revenue recognition
- Forging signatures

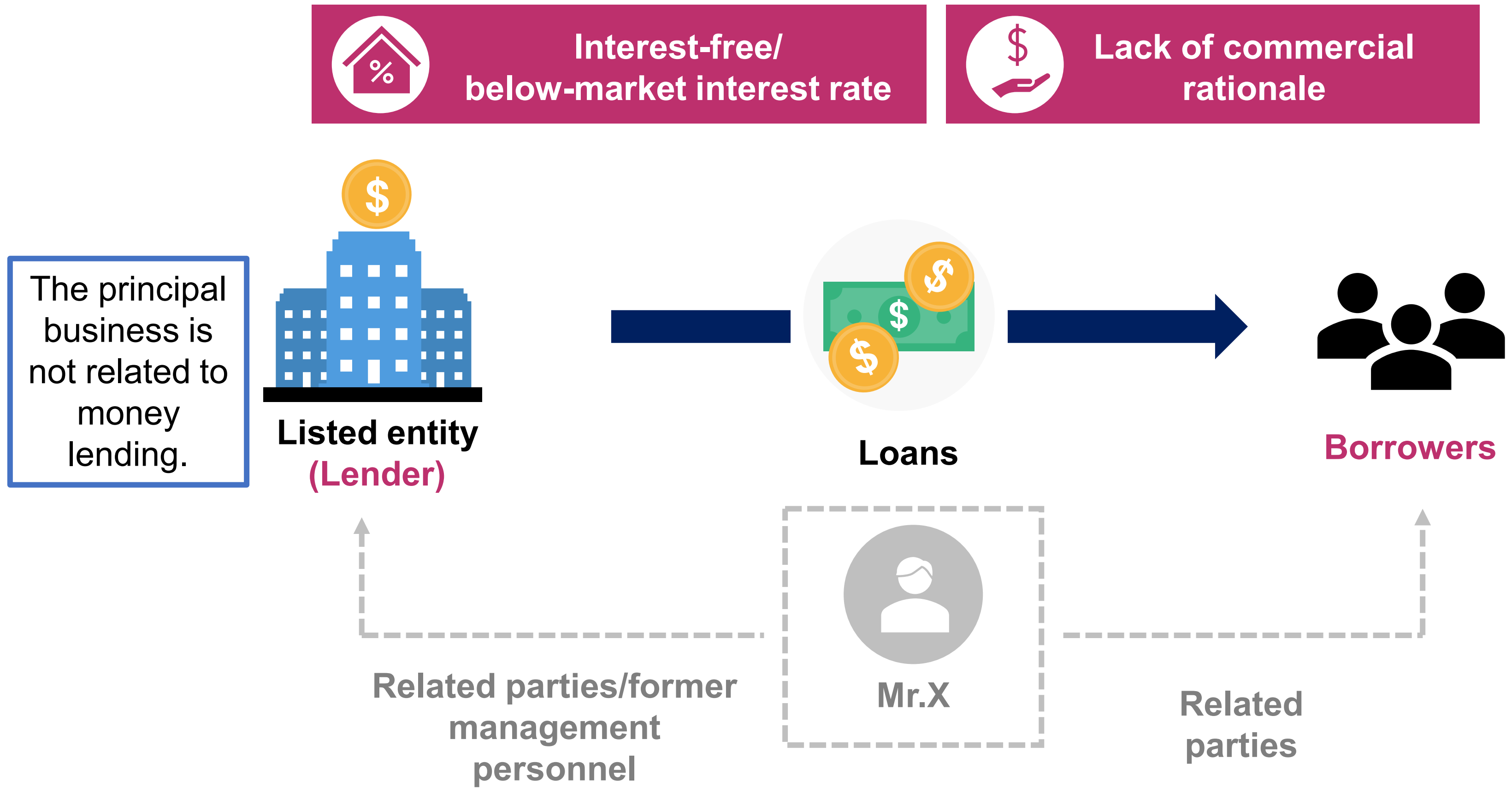
Creating fictitious transactions

- Creating dummy companies – a company might establish a fictitious supplier. This creates fictitious transactions, portraying the purchase of stocks from that fictitious supplier. One of the purposes is to artificially inflate the accounts payable of the company.
- Falsifying corporate transactions which aims to overstate revenue and misappropriation of assets

Manipulating journal entries

- Creating journal entries that record fictitious and large sales to increase revenue (Existence)
- Deferring current period expenses to the next period to create higher profits for the current period, thus portraying a misleading picture of the financial results (Cut-off)
- Reversing journal entries are utilized to reduce the expenses recorded in order to enhance profitability (Completeness)

Case 1 - Misappropriation of corporate funds by ways of various financing arrangements



What should the auditors have done?

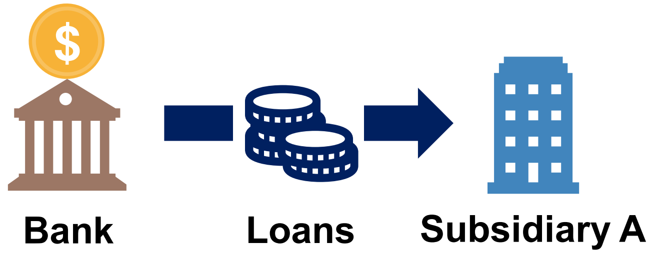
- Inspect the terms of agreement and evaluate the commercial rationale critically
- Inspect antecedent correspondence leading to the making of the loan, the original contracts or agreements, to ensure the validity of the loan
- Design and perform appropriate audit procedures responsive to risk of material misstatement due to fraud and management override

What should the company have done?

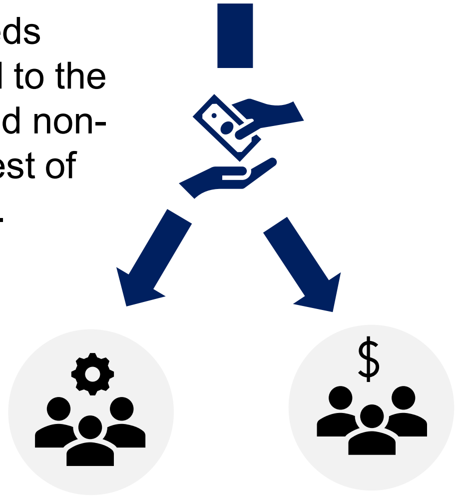
- Ensure that material loans are subjected to effective vetting, risk assessments and due diligence processes, and proper approval

Case 2 - Concealment of financial liabilities

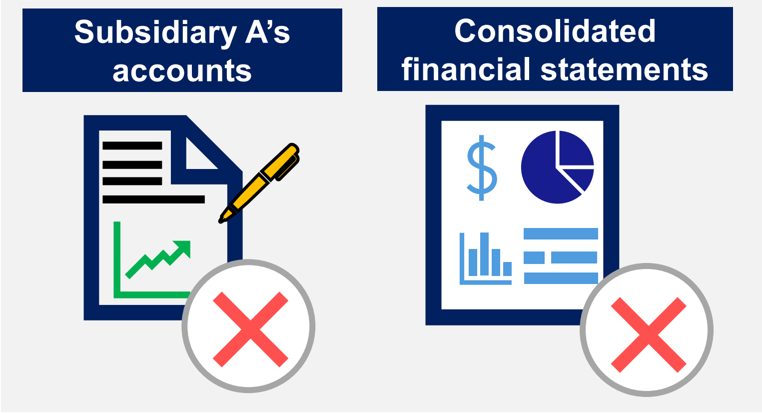
1 A subsidiary of a listed entity **obtained bank loans through collusive actions** involving **both the subsidiary's non-controlling shareholder and its management**.



The loan proceeds were transferred to the management and non-controlling interest of the subsidiary A.



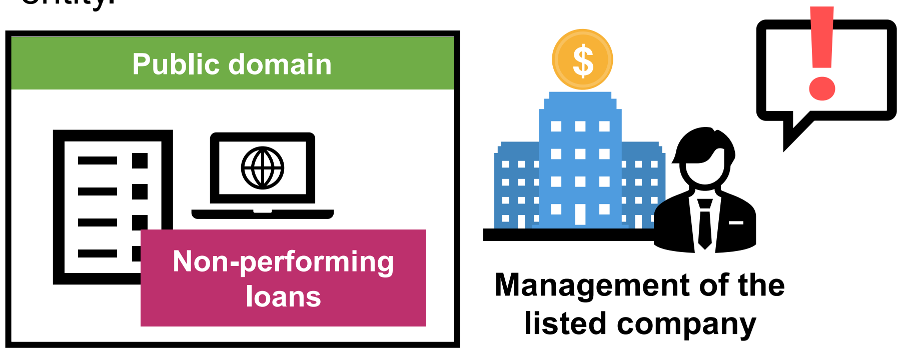
2 **These loans were not recorded in the subsidiary's or the listed entity's books.**



Insufficient risk assessments and due diligence

Inadequate internal controls

3 Subsequently, **the loans were disclosed as non-performing loans in the public domain** and were discovered by the listed entity.



Case 2 - Concealment of financial liabilities (continued)

What should the auditors have done?

- **maintain professional skepticism** and critically evaluate management's representations of different aspects of the loan
- consider **additional audit procedures** responsive to assessed fraud risks, in particular to fraud or other irregularities and **management override**

What should the preparers of financial statement have done?

- maintain **accurate and complete documentation** for the financial reporting process
- ensure that all the procedures are **in compliance with the applicable accounting standards**
- perform regular **risk assessments** to identify areas with higher fraud risk and put in appropriate control
- ensure that all the processes **comply with established internal controls**. In case of any breaches or breakdowns in these controls or potential misstatement, they should **promptly escalate the situation to the relevant parties as appropriate**

What should the directors, management and audit committees have done?

- ensure that the company sets clear transaction thresholds that would require board approval
- **maintain a dialogue with the company's auditors** so that significant matters are duly addressed by the company
- the board should ensure that the company's financial statements give a **true and fair view** in accordance with the relevant financial reporting requirements.
- the board should ensure that the company has **established and maintained appropriate and effective internal controls**

Ethical course of action – What should professional accountants do if you encounter fraudulent activities?

Assess and consider the issue

- Assess what are the ethical issues and to whom do you owe a duty?
- Consider the issue objectively and avoid any bias

Identify and document your findings

- Document suspicious activities, unusual transactions or behaviors that seems to indicate a cover-up

Report to management / audit committee

- Report your findings to higher management or directly to the audit committee, as the audit committee are independent directors who can investigate the matter impartially

Whistleblowing

- Report the issue to an external body such as a regulatory authority or law enforcement
- E.g. if wrongdoing or misconduct in an area under the AFRC's remit (e.g. misconduct of PIE auditors), you can submit a whistleblowing report to the AFRC
- E.g. if you suspect corruption case, you can submit a report to ICAC
- E.g. if you note malpractice / fraud relating to listed companies, you can submit a report to the HKEx

Lessons learned

Auditors	Financial statement preparer	Directors, management and audit committees
▪ **Maintain professional skepticism** ▪ **Remain vigilant** to misstatement due to errors and fraud; ▪ **Maintain strict compliance** with the auditing standards when performing audit work ▪ **Allocate sufficient time and resources** for financial reporting planning	▪ **Comply with accounting standards** ▪ Maintain **accurate and complete documentation** for the financial reporting process ▪ Maintain **segregation of duties** to prevent misuse of resources and fraud ▪ Perform regular **risk assessments** to identify fraud areas ▪ Report any breaches or breakdowns in internal controls	▪ **Oversee the activities of management** ▪ **Ensure that adequate internal control policies and procedures are established and operate effectively** ▪ **Maintain a dialogue with the auditor** during the audit on significant matters identified from audit

AFRC Accounting and Financial Reporting Council 會計及財務匯報局

Thank you