# GLOSSARY OF KEY FRAUD TERMS

## DEFINED

**Black's Law Dictionary:** "b *Law*. any deliberate misrepresentation of the truth or a fact used to take money, rights, or other privilege or property away from a person or persons."

**Auditing Standards (AU Section 240 (new), paragraph .11):** Fraud is "an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.

**Compilation Standards (AR Section 80, footnote 2)**: "*fraud* is an intentional act that results in a misstatement in compiled financial statements."

**Review Standards (AR Section 90, footnote 2)**: "*fraud* is an intentional act that results in a misstatement in reviewed financial statements."

## CATEGORIES OF FRAUD

- **Corruption**
- **Fraudulent statements**
- **Asset Misappropriation**

**AU SECTION 240 (NEW)**
**CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT**

***Characteristics of Fraud***

**2.** Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

**3.** Although fraud is a broad legal concept, for the purposes of generally accepted auditing standards (GAAS), the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: par. A1–A8)

**A5.** **Fraudulent financial reporting** may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

**A6.** **Fraudulent financial reporting** often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as the following:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances
- Omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity
- Altering records and terms related to significant and unusual transactions

**A7.** **Misappropriation of assets** involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management, who is usually better able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including the following:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts from written-off accounts to personal bank accounts)
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, or colluding with a competitor by disclosing technological data in return for payment)
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for approving payment at inflated prices, or payments to fictitious employees)
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party)

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

## CONDITIONS GENERALLY PRESENT WHEN FRAUD OCCURS

- **Incentive**
- **Opportunity**
- **Rationalization**

**AU SECTION 240 (NEW)**
**CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT**

**Characteristics of Fraud** (Ref: par. 3)

**A1.** Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act, as follows:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps, unrealistic) earnings target or financial outcome—particularly because the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets (for example, because the individuals are living beyond their means).
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden (for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control).
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.