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## METHODOLOGICAL RECOMMENDATIONS FOR THE IDENTIFICATION AND ASSESSMENT OF FRAUD'S RISKS BY AN AUDITOR

*Today, the quite actual issue is the identification and assessment of fraud's risks by an auditor in his audit activity performing. Fraud's risk assessment is aimed at proactively eliminating business vulnerability to internal and external fraud.*

*For an effective assessment, it is worth paying attention to the International Standards on Auditing (ISA), in particular ISA 200, ISA 240 and ISA 315, which provide the main qualifying fraud's indicators and methods of their detection.*

*In the audit performing the leading place is occupied by the correct assessment of the management personnel's response on fraud's risk factors, because such factors acquire real determinants of misconduct as a result of their assessment by specific subjects from among management personnel.*

*That is why, in these methodological recommendations, it is proposed to consider the key questions for an auditor's effective assessment of management personnel's response on fraud's risk factors, which include nine consecutive points.*

*Based on such knowledge, an auditor can express a hypothetical judgment based on professional skepticism on the presence of version fraud. They are subject of verification by obtaining relevant evidence that confirms or refutes them.*

*If the fact of fraud is discovered, it should be noted that an auditor is not authorized to provide the official legal opinion. But he is obliged to report the discovered distortions of financial statements due to fraud to the highest management and law enforcement authorities.*

*An auditor's procedure for detecting and assessing fraud's risks should also be considered. This procedure includes six main stages, which are divided into stages only conditionally, since the performing the audit procedures is interconnected and can be carried out at different stages. This procedure includes acceptance of the client, planning of the general strategy and general audit plan, risk assessment (intertwined with the general strategy), detailed audit plan, performance of substantive audit procedures and analysis of detected distortions, final procedures.*

**Keywords:** *management staff behavior, professional skepticism, professional judgment of an auditor, audit, fraud, legal assessment, distortion of financial statements*

According to International Standards on Auditing (ISA), namely paragraph 15 of ISA 200 [1, 2] and paragraph 12 of ISA 240 [1, 3] an auditor must maintain professional skepticism during the audit, recognizing the possibility of fraud regardless of the positive characteristics of management personnel [4].

According to paragraph 11 of ISA 240, fraud is the intentional act of management personnel using delusion to obtain an improper benefit. This paragraph shows the main legal qualifying fraud's indicators from the position of which an auditor should assess the distortions of financial statements, and thus to find out what extent they are intentional and contain deception to obtain improper benefit. *As a result of obtaining information that there is no fraud, an auditor has reason to conclude that there is an error.*

An auditor is responsible for detecting fraud only within the scope of the audit, and *does not perform a special task regarding the research of fraud in the activity of economic entities.*

An auditor is obliged properly not only to respond on fraud's indicators in the form of distortions of financial statements, but also to carry out audit procedures to identify them.

According to ISA 315 [1, 5], an auditor in order to identify fraud's indicators, in the prescribed manner examines

*business risks* for the presence of fraud's risk factors. Based on the results of such an assessment, an auditor expresses a judgment in the form of professional skepticism [4], which includes an assumption on the possible distortions of financial statements by management personnel.

In terms of their content, fraud's risks include events or conditions that indicate a motive or pressure to commit fraud, as well as the possibility of committing fraud. Like other risks, they are probable and indicate only the presence of favorable conditions for fraud and the attitude of management personnel towards them. It can be neutral, positive or take the form of opposition in the form of development and implementation of appropriate preventive measures in the internal control system and improvement of economic activity.

Ultimately, fraud's risk factors acquire real determinants of misconduct not by themselves, but as a result of their assessment by specific subject of management personnel. *Therefore, an auditor's assessment of management personnel's response on fraud's risk factors should be at the forefront during an audit based on a risk-based approach (RBA).* A mandatory prerequisite for such an assessment is the availability of knowledge on the such issues.

### **1. Conceptual provisions of the ISA and Accounting Standards**

First of all, an auditor's acquisition of the behavioral approach, set out in the ISA, for the analysis of the socio-psychological aspects of behavior motives of the subjects of accounting and audit. This methodology directs an auditor on the need to achieve audit's objectives to increase the trust and confidence of financial statements users in its reliability, completeness and accordance with the law in the conditions of the misstatement risk due to fraud.

The presence of such a risk, in turn, determines the RBA to a complex socio-psychological understanding of the economic behavior of economic entities and their environment by an auditor.

It should also be noted that the separately taken concepts of increasing the trust and providing the confidence to users of financial statements have a corresponding psychological content. They emphasize what the psychological attitude in users of financial statements should be before the audit results.

As for *behaviorism*, it broadly studies human behavior and ways to influence it. In more detail the specified direction of studying the economic entities' behavior is researched in *economic psychology*.

An auditor's professional judgment on providing confidence for users of financial statements must take into account *the behavioral approach at all audit's stages*. This mostly concerns the research of the socio-psychological aspects of decision-making by specific subjects of management personnel related to *business risks*, especially those containing fraud's risk factors. Fraud's risk factors need to be identified and assessed through an understanding of economic entities and their environment in terms of motives or pressure to commit fraud, opportunities to commit fraud, as well as attitude and logical justification for misconduct.

### **2. Socio-psychological mechanism of decision-making by management personnel**

According to ISA 315 an auditor must identify and assess fraud's risks factors through an understanding of economic entities and their environment. *Economic entities are specific individuals authorized to make decisions on financial statements depending on the circumstances of the external environment and personal qualities of character and value orientations.*

Peculiarities of managerial decision-making in various economy branches are determined by objective and subjective circumstances. Objective circumstances include the specifics of the enterprise's activity, which depends on the technological process, regulated by the relevant regulations. Subjective circumstances are significantly related to specific individuals, their management style, which can be authoritarian, democratic or liberal.

Paragraph A106 of ISA 315 provides that in order for an auditor to understand the control environment, it is appropriate to study the philosophy and management personnel's working style.

The authoritarian management style is characterized by decision-making by one person or a single center. In a democratic style a managerial decision-making is agreed with a number of structural units and other interested persons, particularly the supervisory board, internal control body, etc. The liberal style of management has largely chaotic cha-

racter and managerial decision-making with unknown consequences. It all depends on who and how can convince the management of the economic entity.

Ultimately, management personnel's decision-making is the result of the interaction of the individual and the environment. The main factors in the environment that influence the management personnel's decision-making are business risks. They are the main source of management personnel's decision-making related to distortions of financial statements. As noted in paragraph A61 of ISA 315, understanding the business risks, on which a economic entity is exposed; increases the likelihood of identifying the material misstatement risks, as most business risks will ultimately have financial consequences, and hence the influence on financial statements. However, it should be noted that an auditor is not responsible for identifying or assessing all business risks because not all business lead to an occurrence of material misstatement risks.

### **3. Risk-based approach in auditing**

As mentioned above, the RBA in auditing is a mandatory prerequisite for an auditor's assessing the management personnel's response on fraud's risk factors.

Characteristically, the RBA in auditing did not appear immediately, but at a certain historical stage of its development. Initially, at the end of the 18th century, there was the calculating audit, the task of which was to confirm the maximum number of accounting operations. Subsequently, the test audit appeared, which purpose was to test the internal control's condition and analyze the most significant operations. Calculating and test audits have been replaced by a RBA to studying the risks in a economic entity activity of and assessing the in auditing.

It should be noted that the historical development of the audit had a natural character. At each stage there was an improvement of previous achievements by increasing the effectiveness of audit procedures. *Accordingly, the RBA does not ignore the calculating and test procedures for checking the financial statements, but focuses their implementation on specific risks in the activity of a economic entity on condition of determining risk during the audit.*

In this regard, there is the question: what is the risk in economic and audit activity, and how does it influence on conducting an audit?

Usually, the concept of risk is associated with *uncertainty related to occurrence of negative consequences*. It is uncertainty that is characterized by a significant number of parameters that can be predicted and measured only conditionally. In publications on risk management, the properties of risk are considered in several aspects: probability of occurrence, cause-and-effect relationships, power of influence, management ability.

The activity of any modern enterprise is carried out in conditions of risk and at its own risk. Such indicators of entrepreneurial activity are given in Art. 42 of the Economic Code of Ukraine [6]. State and municipal, including non-profit, companies operate in market conditions. Their economic activity is also associated with risks.

To provide the effective activity in a competitive market environment, an enterprise needs to make substantiated risky decisions combined with the proper management of problematic and contradictory processes. Therefore, risk management is a mandatory enterprises' activity, which a

certain extent also extends to the field of finance.

The order for organizing the risk management at an enterprise is determined by international standards, particularly ISO 31000-2000 "Risk management. Principles and Recommendations" [7], as well as domestic regulations and internal regulations of the enterprise. Among them, it is necessary to pay attention to the report on the management and anti-corruption programs. On a separate enterprises the special risk management programs are developed. An auditor's analysis of the implementation of such programs makes it possible to assess the condition of enterprise's internal control.

The order for identifying and assessing the *economic risks* in the activity of economic entities is defined by ISA 315. This standard specifies that business risk by its content is broader than the risk of material distortions of financial statements, although it includes the latter.

The given approach guides an auditor to the need of assessing the business risks from the position of professional skepticism. It consists in the fact that an auditor in its professional judgment related to business risks must research the presence in them of the possibility of distortion of financial statements, regardless of the positive assessment of management personnel [4]. And the management personnel's behavior itself related to business risks should be assessed on the basis of the "fraud triangle", which is given in ISA 240. Thus, it is determined, what extent business risks exert pressure and create motives for fraud, whether there are opportunities for fraud in the surrounding environment, what attitude and logical justification of shortcomings in economic activity on the part of management personnel.

An auditor's guideline and focus on business risks of a business entity determines the need to take into account one's own risks related to the identification and assessment of distortions of financial statements.

The content of audit risk is considered in paragraph 13 of ISA 200. This paragraph states that *audit risk* is the risk that an auditor will express an inappropriate opinion if the financial statements are materially misstated. By its content, audit risk is the function of the material misstatement risk and the risk of non-detection.

Material misstatement risk is the risk that financial statements that has not been reviewed by an auditor during the audit contain material misstatements. It consists of two components at the assertion level:

- inherent risk – the vulnerability of an assertion on a class of operations, account balance or disclosures, or in combination with other misstatements, before any appropriate controls are taken into account;
- control risk – the risk that a misstatement that may occur in an assertion on a class of operations, separately or in combination with other misstatements, will not be promptly prevented or detected and corrected by the economic entity's internal control system.

*Non-detection risk* is the risk that the procedures, performed by an auditor to reduce audit risk to an acceptably low level, will fail to detect an existing misstatement; this is the result of the inherent limitations of an audit. According to paragraph A55 of ISA 200, the potential influence of inherent limitations is particularly significant in the case of misstatement due to fraud.

According to ISA 320 "Materiality in Planning and Performing an Audit" [8], during the audit *an auditor must*

*assess materiality in relation to audit risk*. Information is important if its omission or misrepresentation *could influence the users' economic decisions made on the basis of the financial statements*.

According to ISA 320, these levels of materiality are determined:

- at the level of financial reporting;
- materiality of the performance of audit procedures (materiality of performance).

*Materiality at the level of financial statements* in practice is determined, as a usual as a percentage of the basic indicator. For balance sheet items, the basic indicator is considered to be the amount of assets, for income statement items – the amount of net income or net profit.

*The determination of materiality is based on an auditor's judgment*. In this case, one can be guided by the Letter of the Ministry of Finance of Ukraine No. 04230-04108 dated 29.07.2003 "On materiality in Accounting and Reporting" [9].

An example of determining materiality at the financial statements level is shown on Table 1.

**Table 1 – An example of determining materiality at the financial statements level**

Possible values of the basic indicator, thousand UAH	Level (limit) of materiality, %
0 – 100	7
100-500	6
500-5 000	5
5 000-10 000	4
10 000-50 000	3
50 000-100 000	2
> 100 000	1

*Materiality of the performance of audit procedures* (materiality of performance) is also determined by an auditor's judgment. The requirements for materiality of performance, established by the ISA, are as follows:

- materiality of performance should be less than materiality at the level of financial statements;
- materiality of performance must be such as to reduce to an acceptably low level the likelihood that the aggregate of uncorrected and undetected misstatements will exceed the level of materiality for the financial statements in general (paragraph 9 of ISA 320).

*The materiality of performance* is multi-level and is established related to specific account balances, classes of operations, disclosures, and is supplemented throughout the planning and conduct of the audit.

At the first level, those items of the balance sheet, statement of financial results, statement of cash flows and related disclosures that are selected by an auditor to perform audit procedures are determined. At this level, the materiality of performance in the amount of 2-3 % of the base indicator or half the materiality of financial statements can be determined (e.g.). At the same time, it should be guided by the such rule: the higher the risk, the lower the threshold for the materiality of performance.

$$AR = IR \times CR \times NDR, \quad (1)$$

where *AR* – audit risk; *IR* – inherent risk; *CR* – control risk; *NDR* – non-detection risk.

$$MMR = IR \times CR. \quad (2)$$

where *MMR* – material misstatement risk.

The greater the audit risk, the less the non-detection risk should be. Reduction in non-detection risk, in turn, occurs due to a decrease in the threshold of materiality of performance.

Thus, *audit risk is inversely proportional to the materiality threshold.*

After determining the material elements of financial information at the first level, it is necessary to decipher them in synthetic and analytical accounting, and to distinguish within their limits material account balances, classes of operations, which will become the basis for verification. E.g., the net income of the water utility is divided into groups – income from water supply to the population, legal entities, income from the provision of meter verification services. The material elements are the income from water supply of the population and legal entities.

*An auditor's selection of material account balances, classes of operations and disclosures cannot be reduced solely to their specific weight.* Elements of financial statements can be determined as material based on the following:

- have a significant specific weight;
- accounts or operations with a high level of risk: confirmation of the relevant assets for theft, accounts, operations on which traditionally need significant corrections or other circumstances;
- information on them is important for making economic decisions by users of financial statements.

E.g., rental income of a utility company may have insignificant specific weight, but important to the primary user of the financial statements, the local council, to whose budget interest on rent is paid.

After determining the material elements of the financial statements, their specific weight in the financial statements should be determined. It is appropriate for the audit firm to establish a general guideline that the specific weight of the classes of operations, account balances selected for audit should not be less than a certain percentage of the base indicator. E.g., the amount selected within the cost should be at least 50% of the "cost" item and at least 70% of the total costs.

Determining the materiality of disclosures requires a separate approach. For this purpose, it can be applied the control checklists for disclosures according to Accounting Regulations (Standards) (ARS – *ukr. PSBO*) [10] or International Financial Reporting Standards (IFRS) [11]. The materiality of disclosures is determined by an auditor's judgment, if the disclosures can influence the economic decisions of financial statements users. This takes into account:

- the nature of the information;
- the main users of financial statements;
- the nature of the subject.

E.g., if the client is a utility company, the information on the founder and beneficial owner is not material, as it is publicly available.

According to paragraph A2 of ISA 320, in considering whether misstatements in qualitative disclosures could be material, an auditor may identify such relevant factors as:

- the circumstances of the economic entity during the period (e.g., the entity may have gone through a major merger during the period);

- the applicable financial reporting framework, including changes to it (e.g., a new financial reporting standard may require new qualitative disclosures that will be important to a economic entity);

- qualitative disclosures that are important to financial statements users due to the nature of the economic entity (e.g., liquidity risk disclosures may be important to users of financial statements of a financial institution).

The determination of significant account balances, classes of operations and disclosures, as well as audit risk for each of them, is *the basis for the approach to planning subsequent audit procedures.*

To plan audit procedures, we apply the formula (1), which determine that the greater the material misstatement risk, the lower the risk of non-detection should be, i.e., the greater the misstatement risk, the "tougher" the audit procedures should be.

In turn, the material misstatement risk consists of: inherent risk and control risk. Therefore, *it is appropriate to assign a degree of material misstatement risk – inherent risk and control risk – to each of the significant account balances, classes of operations and disclosures, balance sheet.*

Therefore, *it is appropriate for each of the significant account balances, classes of operations and disclosures, and the balance sheet to assign a degree of material misstatement risk – inherent risk and control risk.* If the material misstatement risk of the item or class of operations is low, and control's risk is low, it may be chosen an approach with tests of controls and analytical procedures or a detailed test of a small sample. If the material misstatement risk is high, it is appropriate to apply the complete sample in the detailed test, as well as additional performance of analytical procedures based on an auditor's judgment.

Misstatements in financial statements identified as a result of the RBA are subjects to analysis based on knowledge of the legal qualification of fraud in the current legislation and its criminological characteristics and methods of committing.

#### **4. Legal qualification of fraud in the current legislation**

A brief legal definition of fraud is contained in paragraph 11 of ISA 240. It is noted that *fraud* is an intentional act of management personnel with applying deception to obtain an illegal benefit. The given legal definition of fraud contains the main qualifying features of the model of misconduct of management personnel. They make it possible to determine which exactly distortions of financial statements should be attributed to the category of fraud and to distinguish illegal behavior from legal one.

In more detail, the qualifying fraud's indicators are considered in the criminal law. They form the basis of the criminological properties of fraud.

#### **5. Criminological characteristics of fraud**

The main features of the criminological characteristics of fraud are given in paragraph 11 of ISA 240. It includes an assessment of the behavior of management personnel from the position of motive or pressure to commit fraud, the opportunities to commit it, as well as the attitude or logical justification of illegal acts. With its help, it is possible to find out the relationship between business risks and fraud's risk factors, if we *consider the economic entity not formally as a legal entity, but in the aspect of specific entities from among the management personnel* from the position of their attitude to their official duties and financial state-

ments. Thus, we can get answers on questions:

- what extent the business risks are able to put pressure on management personnel and be as motives for fraud?
- weather are in the environment the opportunities for fraud?
- what are the attitude and logical justification of shortcomings in economic activity on the part of management personnel?

A proper observance of the principle of professional skepticism [4] orients an auditor on the need to assess the behavior of management personnel from the position of the criminological characteristics of fraud at all stages of the audit. According to ISA 300 [1, 12] an auditor must identify and assess the significant factors that precede the task. In particular, preliminarily to identify areas with a high material misstatement risk and to determine the influence of the assessed risk of material distortions of financial statements in general on management, supervision and check.

A more meaningful description of the risks of material distortions of financial statements can be obtained by clarifying the mechanism for determining the misconduct of management personnel.

### **6. The mechanism for determining misconduct**

Knowledge of the mechanism for determining misconduct is also an important prerequisite for an auditor's assessment of the management personnel's response on fraud's risk factors. Basically, determination means the process of causation, that explains how a certain phenomenon arose and the degree of its stability.

In criminology related to misconduct determination, the terms "causes and conditions" or "circumstances" are used. In ISA, the fraud determination mechanism is considered in terms of fraud's risk factors. In particular, in paragraph 11 of ISA 240, the fraud's risk factors include events or conditions that indicate motive or pressure to commit fraud or provide an opportunity to commit fraud. The fraud determination mechanism itself in Appendix 1 of ISA 240 is proposed to be analyzed on the basis of the "fraud triangle", which includes the motive or pressure to commit fraud, the possibilities for committing it, the attitude and logical justification for misconduct.

Approaches to the research of the mechanism for determining misconduct in criminology and ISA are the same. Besides so-called "fraud triangle", given in ISA 240, was once developed by the American criminologist D. Cressey.

Domestic and foreign criminologists agree that the mechanism of misconduct determining should be studied as a result of the interaction of the individual with the environment. It is in this aspect the criminological characterization of fraud is considered in paragraph A1 of ISA 240. It is indicated that the source of the motive or pressure for fraud is situated outside or within the economic entity environment. The attention is drawn to the fact that the economic entity itself may, due to its anti-social attitudes, be prone to fraud. E.g., to achieve an unrealistic indicator of income under the pressure of the occurrence of a negative consequences of receiving a reprimand or deprivation of a bonus. At the same time, purposeful appropriation of assets can be carried out by persons with stable criminal intent.

Regarding the realized possibility of committing fraud, paragraph A1 of ISA 240 states that it may exist if an individual believes that internal controls can be neglected when

that person enjoys the confidence or knows specific internal control weaknesses. In turn, the attitude and logical justification of fraud are proposed to be assessed from the position of the moral value system of managerial personnel, which make it possible for them to commit dishonest actions consciously and intentionally. At the same time, it is noted that honest persons can commit fraud in an environment of sufficient pressure on them.

The fraud determination mechanism is discussed in more detail in paragraph A2 of ISA 240. It states the following:

*"Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statements users. It can be caused by the efforts of management to manage earnings in order to deceive financial statements users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing".* In addition, fraud can manifest itself in increase or decrease of income due to the increase in the amount of dividends or their non-payment.

From the given example, it can be seen that the formation of the fraud determination mechanism, similar to such mercenary offenses, occurs as a result of the appropriate process of interaction of management personnel with the surrounding environment. In any circumstances, the dominant role in this process is played by the environment, which forms the consciousness and motives of actions. The environment itself influences the subject ambiguously, because it simultaneously contains criminogenic and anticriminogenic factors.

*Criminogenic factors* include fraud's risk factors in the form of causes and conditions, as well as background phenomena, that can put pressure on management personnel and form certain motives. *Among the background phenomena, it is necessary to highlight the significant spread of the shadow economy and corruption.* In some cases, they become the causes and conditions for committing fraud. Corruptionists from among high-level officials deliberately create opportunities for fraud and involve a significant number of participants in it.

*Anti-criminogenic factors* may include the existing system of penalties for fraud and its prevention in the form of internal and external control. The perception of criminogenic factors by managerial personnel is purely individual in nature and largely depends on consciousness and value orientations.

It is also necessary to pay attention to the moral and psychological climate in the immediate environment of management personnel. Depending on its content, it can have a criminogenic or anticriminogenic focus.

The influence of criminogenic and anticriminogenic factors on a person is contradictory. On one hand, the subject

is influenced by factors that predispose him to commit fraud, and on other hand – there are circumstances that restrain a person from illegal acts. In return, it the presence of persistent fraudulent intentions, the anti-criminogenic factors force management personnel to act more cautiously and in every possible way to mask distortions of financial statements. Therefore, the fraud determination mechanism is characterized not by absolute inevitability and linear dependence, but also by a probable contradictory content, which is subject to proper assessment by an auditor .

In each specific fact of fraud, one should see the general, special and individual aspects. And in this case, it should be taken into account the presence of general laws of fraud, which consist in applying the deception by management personnel to obtain an illegal benefit. The above-mentioned general laws have certain peculiarities of their manifestation in a specific industry, as well as in a single fact of fraud.

Conditionally, *the forming a fraud determination mechanism* can be divided into the following stages:

- formation of psychological and moral readiness to commit fraud;
- actualization of illegal intentions and making a volitional decision;
- practical implementation of unlawful encroachments.

As a usual, an auditor deals with the practical implementation of illegal encroachments of management personnel in the form of distortions of financial statements. They are identified and assessed *retrospectively on the basis of RBA* to understand the actions of specific economic entities and their environments. It is through analysis of economic entities' actions an auditor has the opportunity to learn about the social and psychological qualities of their personalities, which are reflected in the attitude of each of them to the results of economic activity. With a careful consideration of such activity, the essence of one or another subject from among the management personnel, their interests, value orientations and motives can be seen to a sufficient extent.

As a result of given approach, with following the principle of professional skepticism an auditor is able to model the management personnel's behavior related to possible distortions of financial statements as a result of fraud. Thus, to plan the audit and establish directions for collecting the audit evidence. In determining the directions for collecting the audit evidence, it is advisable to take into account the patterns of fraud reflection in financial statements and other documents.

### **7. Patterns of fraud reflection in financial statements and other documents**

As stated in paragraph 31 of ISA 240, the ability of management personnel to commit fraud is unique because of their ability to manipulate the accounting records and prepare deliberately distorted financial statements, neglecting the laws of control.

According to paragraph 6 of ISA 240, the reason is that fraud may be related to complex and carefully organized schemes, designed to hide it, such as forgery, deliberate omission of operations records, or deliberate misrepresentation to the auditor.

Regardless of concealment and masking, the illegal acts of management personnel are subject to the general principle of reflection. It inevitably leads to the fact that *the*

*fraud facts find certain reflections in the environment, both in documents and in the minds of specific individuals.* Mostly their reflection in financial statements and other documents is of a latent nature without obvious and sufficiently informative external features. The subjective fraud indicators in form of deliberate actions to obtain illegal benefits are the least reflected in financial statements and other documents.

As a usual, *management personnel try to explain the identified indicators of distortions of financial statements as lawful actions or an error.* As the facts of fraud are reflected in the minds of management personnel and other persons involved in it, *the analysis of their explanation's content deserves an auditor's attention.* From such explanations it will be seen the attitude and logical justification for distortions of financial statements, as well as the neglect of controls.

In all circumstances, an auditor's professional judgment on distortions of financial statements must be based on analysis and objective evidence of exactly how they are committed. Obtaining such information will make it possible to find out the purpose of the actions of management personnel and other signs of their subjective intentions.

Regardless of the latent nature of the fraud reflection in accounting documents, ISA require from an auditor to develop and perform a full range of audit procedures, guided by professional skepticism. The main ones are presented in paragraph 32 of ISA 240.

### **8. The ways of fraud**

The way of committing fraud is the main qualitative characteristic of the management personnel misconduct. Such behavior consists of a certain system of actions aimed at the preparation, execution and concealment of fraud. In the specific actions of management personnel their personal characteristics and personal attitude to the environment, including internal and external control, are manifested.

Typical ways of fraud are set out in paragraphs 2, 3, and A4 of ISA 240. An auditor may also have additional knowledge of fraud patterns from its own experience and the experience of other auditors.

Applying the method of analogy and stereotypes, it is expedient to model the behavior of management personnel, and thus put forward versions regarding the vulnerability of financial reporting related to specific ways of fraud and directions of collecting the audit evidence.

According to paragraph 16 of ISA 315 and paragraph 15 of ISA 240, it is stated that during the discussion by members of the task team, a special attention should be paid to under what circumstances and at what stage the financial statements of a economic entity may be vulnerable to material misstatement due to fraud, including the way for committing fraud.

### **9. Audit procedures and methods of economic and legal analysis**

Audit procedures are the system of an auditor's actions to obtain reliable and acceptable audit evidence. ISA 500 [1, 13] defines what constitutes the reliability and admissibility of audit evidence.

According to paragraph A2 of ISA 500, audit procedures aimed at obtaining the audit evidence may include, in addition to inquiries, inspection, observation, confirmation, recalculation, re-performance and analytical methods, which

are often combined with each other.

ISA 350 and ISA 330 provide for obtaining audit evidence as a result of procedures, risk assessment and subsequent audit procedures, which include:

- tests of control measures;
- substantive procedures including detail tests and substantive analytical procedures.

The above analytical procedures can be applied as risk assessment procedures, tests of control measures or substantive procedures dependent on the context of their direction (paragraph 11 of ISA 500).

As stated in paragraph A7 of ISA 500, audit procedures may be directed at the testing of accounting records, e.g., by means of analysis and verification, repeating the procedures used in the preparation and presentation of financial statements, as well as the reconciliation of related types and the application of one and the same information.

The testing itself consists in the fact that an auditor formulates a certain question for assessing an object of research and in this process an auditor receives certain answers by performing audit procedures.

Test options can be varied. This problem can be studied in detail in foreign publications (K. Robertson, R. Dodge) [14] and publications of domestic authors.

The selection of elements is important for the development of testing methods. The requirements for the selection of elements for testing are given in paragraphs A52-A54 of ISA 500.

Analytical procedures has important value for assessing the content of distortions of financial statements, they can be applied to assess risks in order determined in ISA 315, as well as in response to assessed risks according to ISA 330 [1, 15].

Substantive analytical procedures can be performed separately or together with detailed tests according to requirements of ISA 330. The order of performing the analytical procedures is determined by ISA 520 [1, 16]. They are aimed at assessing the financial information. Such an assessment is carried out by analyzing the relationships between financial and non-financial data, which includes the necessary study of identified deviations or relationships, which are inconsistent with other relevant information or significantly differ from expected values. The basis of analytical procedures is comparison. The example of such comparisons is given in paragraphs A1-A10 of ISA 520.

As stated in paragraph A3 of ISA 520, it can be used different methods to perform analytical procedures. These methods range from simple comparisons to complete analysis using modern statistical methods. In this regard, it is worth paying attention to *the methods of economic and legal analysis*.

*Economic and legal analysis* is based on general research methods of economic activity in terms of its construction, financial stability, liquidity, etc. At the same time, economic and legal analysis, unlike usual economic analysis, aims to study a special type of deviations and negative phenomena in the field of economic activity, among which the leading place is occupied by *the distortions of financial statements as a result of fraud*. To identify and assess such negative phenomena, economic methods are supplemented by legal ones, as a result of which the corresponding type of analysis acquires a complex economic and legal content.

Although the economic and legal analysis is based on the general methodology, its implementation has its own speci-

tics. Unlike economic analysis, *its main task is to identify offenses, in this case – fraud*. These offenses constitutes a specific object of knowledge, requiring special research methods. The patterns of such phenomena determine the possibilities of applying the economic and legal analysis to identify them.

In particular, the fraudulent activities of management personnel differ significantly from normal economic activity. Concealment of such destructive phenomena by guilty persons leads to the fact that the illegal nature of their actions is reflected in economic indicators not in full volume, but in a perverted and disguised form.

During an economic and legal analysis with the purpose to detect fraud in the field of economic activity, legal assessments of economic processes and financial reporting indicators are set from the very beginning and play a leading role during all research. The starting point of legal assessments are certain legal norms and the criminological characteristics of fraud. The legal fraud's indicators and its criminological characteristics constitute an appropriate model of misconduct, the presence of which is to be identified by an auditor in way of analytical research of economic activity.

The main reception of economic and legal analysis is *comparison*. All methods of detecting distortions of financial statements due to fraud are based on its applying.

*The leading place among such methods belongs to the methods of stereotypes, connected comparisons, special calculated indicators and methods of corrective indicators.*

A prerequisite for applying these economic and legal analysis' methods is the fact that all economic processes and their indicators, as well as accounting operations and documents reflected them, are interconnected and interdependent, including the relationship with environment and non-financial information. With the proper organization of economic activity, economic indicators and accounting documents are in a normal state and, in their content, meet generally accepted requirements.

*The methods of stereotypes* is focused on identifying the typical changes in financial statements and economic activity due to specific methods of fraud. Stereotyped behavior characterizes a specific method of fraud and is based on an analytical relationship between changes in relevant indicators that are vulnerable to a method of fraud known to an auditor. As a result of his knowledge, it is possible to model the behavior of management personnel at the research object. Thereby *to identify the vulnerable aspects of the financial statements and directions for collecting the audit evidence*.

*Method of connected comparisons*. The construction of connected pairs' units of economic indicators in the way of calculating the dynamic series of their growth for several reporting periods and plotting the corresponding graphs of interrelated changes in the dynamic series or searching for possible connected indicators, the dynamics of which would not exist under normal conditions.

In the broad case, pairs of indicators with interrelated dynamics are selected as a connected. E.g., the volume of electricity consumption of the utility company "Vodokanal" for the supply of water from wells to consumers has disagreements in comparison of quarters and for the last three years. In the second variant, fuel consumption in certain periods is overestimated, especially after receiving coupons from gas stations.

*Method of, special calculated indicators* is designed to identify certain configurations of economic indicators in usual conditions of economic activity.

Special calculated indicators are determined by an analytical method aimed at eliminating or reducing the influence of an offense on the estimated aspect of economic activity.

At the same time, it is assumed that obtained by this way indicator should characterize normal activity, and a comparison with it of another indicator, modified by an offense, makes it possible to establish such a change.

E.g., calculated in the utility company "Avtodor" the indicator of consumption of asphalt concrete mixture does not correspond to the total amount of performed work.

On example it is used the two types of special calculated indicators:

- 1) loss indicators;
- 2) indicators of fictitious or hidden economic activity.

Loss indicators may be excessive consumption of electricity, water, etc.

Fictitious economic activity consists in the write-off of materials and the payment of funds for unperformed work. E.g., repair work, the purchase of software and office supplies.

*The method of corrective indicators* is used to compare available economic indicators in the reporting or specially found economic indicators with environmental factors. In this method, loss indicators and indicators fictitious or hidden economic activity are also distinguished.

*The first approach* is mostly based on the characteristics of the existing connections formed between the results of the economic activity of the enterprise and the environment. The search for new connections is possible related to economic indicators, which are the least falsified by management personnel due to the fact that such indicators of the external environment are beyond their influence.

The prerequisite for this approach is the general principle of reflection, which necessarily leads to the fact that any offense in the form of a material misrepresentation of financial statements, even with latency, during interaction with the external environment, leaves traces of reflection not only in economic activity, but also in related processes. Therefore, the requirement of ISA 315 related to identification and assessment of the material misstatement risks is quite relevant, *not only on the basis of analysis of a economic entity direct activity, but also as a result of studying its environment. The external environment of a economic entity can be studied both by reconciling calculations and by analyzing unusual and unexpected relationships.*

*The second approach* is based on identifying the existing relationships of the enterprise with the environment. Its purpose is to identify fictitious or hidden economic activity. In studying hidden economic activity, first of all, the beginning of economic relations is researched. On the other hand, the analysis of hidden activity, which is not fully reflected in the accounting, is mostly focused on the research of an enterprise's result economic relations.

Thus, the energy company should have received appropriate consulting services for marketing research, accounting and auditing. In fact, the services were not provided, as evidenced by the fact that they were not used and received in full.

In the second option, the state enterprise repaid the cost for purchasing gasoline and diesel fuel in volumes that clearly exceed its needs.

\* \* \*

The auditor, relying on such knowledge, can express a hypothetical judgment based on professional skepticism on the presence of fraud in the *form of versions*. They are subject to verification by obtaining relevant evidence that confirms or refutes them.

In the case of establishing evidence, which indicates the misleading of financial statements users and illegal enrichment, an auditor has certain grounds for concluding that there are signs of fraud. The logical explanation of financial statements distortions by the management staff as an error should be assessed from the position of how much such actions had deliberate character and selfish motives.

Related to identified facts of fraud an auditor is not authorized to provide an official legal opinion. He is obliged to inform the highest management and law enforcement authorities about detected distortions of financial statements caused by fraud.

### **AN AUDITOR'S ACTIONS ORDER**

*An auditor's actions order is divided into stages conditionally, as the implementation of audit procedures is interconnected and can be carried out at different stages.*

#### **STAGE I. Client acceptance: preliminary study, preliminary risk assessment**

1. Studying the general information about the client: organizational and legal form, main directions of activity, ownership structure, number of employees, distribution of responsibilities, partners and related parties, basic legal provisions and regulations, preliminary checks, indebtedness, lawsuits, financial condition, the category the enterprise belongs: small, medium, large; subject of public interest, etc.

In more detail, the directions for studying a client on the above issues to identify business risks in his activity and possible distortions of financial statements are given in paragraphs A61-A73 of ISA 315.

According to paragraph 12 of ISA 315, it is proposed to include in business risks the risks, which resulted of significant conditions, events, circumstances of activity or inaction, and may have a negative impact on the economic entity's ability to achieve its goals and implement a strategy, or the establishment of inappropriate goals and strategies.

Further study of a economic entity and its environment should take into account the above approach to identifying and assessing the business risks, as well as identifying the circumstances that indicate the possibility of distortions of financial statements.

2. Detailed characteristics of business segments and the need for special knowledge for their analysis.

3. Studying the accounting condition, information technologies and software.

#### **STAGE II. Planning: general strategy and general audit plan**

1. Significant changes in the balance sheet and financial statements for the current period compared to the previous one/s.

2. Assessment of assertions for classes of operations, account balances and disclosures.

3. The level of disclosures and detailing the accounting operations, particularly operations, the disclosure of which contains information not from the general ledger, turnover

and balance sheet, and registers.

4. Identification of unusual and unexpected relationships associated with income and expense accounts.

5. Possibilities of applying information technologies of an economic entity for audit.

6. Significant events in the industry and the economy, their influence on the economic entity.

7. Preparing the requests for management personnel, internal control and employees about known and suspected fraud.

8. Purposeful and tactful communication with management personnel to understand their competence, business reputation and social and psychological characteristics.

9. Attitude of management personnel to the order of accounting and auditing.

10. Generalization of theoretical knowledge, own experience and experience of other specialists related to ways of financial statements misrepresenting as a result of fraud.

11. Construction of general versions on possible distortions of financial statements.

12. Preliminary analysis of public financial statements and accounting policies based on the forwarded versions.

13. Determination of materiality and audit risk, particularly, the material misstatement risks in classes of operations, account balances and disclosures; their quantitative indicators and qualitative significance related to influence on the economic decisions of financial statements users.

14. Developing the general audit strategy, the necessary resources to complete the task and specific directions to verify the formed versions.

### **STAGE III. Risk assessment (the stage is conditional, as it is intertwined with the general strategy)**

1. Generalization of information on business risks in the economic entity's activity and determining the main directions of their research.

2. A condition of internal control and risk management: attitude of management personnel to internal control and maintaining it in an effective condition.

3. Finding out what importance is given by the top management to internal control, to what extent it is used to provide a successful economic activity.

4. The results of the business risks assessment and the measures taken in relation to them by management personnel.

5. Detailed analysis of typical fraud's risks in terms of their identity with the identified business risks.

6. Establishing in business risks the potential ability to put pressure on management personnel and act as determinants of fraud motives.

7. Performing the risk assessment procedures related to accounting policy and accounting assessments. Assessment of uncertainty level from the previous assessment associated with the accounting assessment. Determining whether, by the auditor's opinion, accounting assessments, which have a high level of uncertainty, lead to significant risks.

8. Analysis of types of income, business operations and assertions on potential to lead to fraud's risks.

9. Finding out which aspects of financial statements may be most vulnerable to typical fraud's risks.

10. Determining which of the management personnel, according to their functional duties, is directly related to the formation of the most vulnerable financial statements indicators.

11. Analysis of unusual and unexpected relationships among existing fraud's risks.

### **STAGE IV. Detailed audit plan**

1. Clarifying the proposed versions and preparing an audit plan for their verification, which includes a list of audit procedures to obtain sufficient and acceptable evidence.

2. Discussing an individual planning measures with management personnel in a manner that avoids threats to their effectiveness.

3. Processing with team members the main directions of an audit and the collection of audit evidence. Paragraph A11 of ISA 240 provides that the following questions should be discussed with team members:

– an exchange of views between audit team members on the task of under what circumstances and at what stage, in their opinion, the financial statements of the economic entity (including separate reports and disclosures) may be vulnerable to material misstatement resulting in fraud, in what way management personnel could commit and hide fraud during financial reporting and how it is possible to illegally appropriate the assets of a economic entity;

– considering the circumstances that may indicate income management or practices that management personnel may follow to manage income that could lead to fraudulent in financial reporting;

– considering the risk that management personnel may attempt to present the disclosures in a manner that makes it difficult to understand correctly the disclosed question (e.g., by including a significant amount of non-material information or applying unclear or wordy formulations);

– considering the involvement of management personnel in the supervision on employees with access to funds or other assets available for illegal appropriation;

– considering any unusual or unexplained changes in the behavior or lifestyle of management personnel, or workers who came into notice of the task team;

– the special importance to maintain the proper direction of views during the all audit due to the possibility of significant misstatement due to fraud;

– considering the circumstances types that, if detected, may indicate the possibility of fraud;

– considering how the element of unpredictability applies to the nature, timing and volume of audit procedures to be performed;

– considering the audit procedures that may be selected in response to vulnerability of an economic entity's financial statements to material misstatement due to fraud, and whether certain types of audit procedures are more effective than others;

– considering any allegations about fraud that drew an auditor's attention;

– considering the risk of neglect of control by management personnel.

### **STAGE V. Performance of auditing procedures. Analysis of identified misstatements**

1. Analytical and other procedures to check the auditing financial statements, assessing risks and forwarded versions.

2. Inspection and supervision on significant directions of economic activity.

3. A complex analysis of identified deviations from normal activity and abnormal operations, and presence in them fraud's risks and possibility for committing it.

4. Characteristics of significant distortions of financial statements and their relationship with the job duties of management personnel.

5. Acting in response to assessed fraud's risks by performing the tests of details, substantive analytical procedures, and tests of control measures.

6. The accumulation of identified misstatements individually or in totality, depending on their content and commission as a result of a judgment or forecast, particularly: inaccuracies in collecting or processing of information, omissions of amounts or disclosures, incorrect accounting assessments, judgments on accounting assessments and policy, improper classification, generalization or detailing.

#### STAGE VI. Final procedures

1. Notifying the management personnel on identified misstatements with a proposal to check the class of operations, account balances or disclosures to determine the cause of the misstatement and its actual amount, as well as making

the appropriate adjustment to the financial statements.

2. Analysis of the influence of uncorrected misstatements and their consequences.

3. Studying the assertions and obtaining the explanations from management personnel on the distortions of financial statements with their subsequent assessment.

4. Assessing the adequacy of the received evidence of the excuses and explanations of management personnel related to distortions of the financial statements.

5. Reporting information on internal control deficiencies to senior management and assessing their response.

6. Systematization of received information and expression of professional judgment on distortions of the financial statements.

7. Additional verification of problematic issues in purpose to obtain more convincing evidence.

8. Preparation of a report and decision-making on informing the senior management and law enforcement agencies.

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## МЕТОДИЧНІ РЕКОМЕНДАЦІЇ З ІДЕНТИФІКАЦІЇ ТА ОЦІНЮВАННЯ РИЗИКІВ ШАХРАЙСТВА АУДИТОРОМ

Методичні рекомендації з ідентифікації та оцінювання ризиків шахрайства аудитором присвячено аналізу певних знань і навичок аудитора стосовно вміння виявляти шахрайство в межах проведення аудиту незалежно від позитивної характеристики управлінського персоналу. Чинники ризиків шахрайства набувають реальних детермінантів неправомірної поведінки не самі собою, а в результаті їх оцінювання конкретними суб'єктами з числа управлінського персоналу. Отже, для аудитора необхідним є вміння правильно оцінити реагування управлінського персоналу на чинники ризику шахрайства. З цією метою в методичних рекомендаціях розглянуто дев'ять важливих питань, які виступають передумовою такого оцінювання. Аудитор, спираючись на такі знання, може висловлювати гіпотетичне судження на основі професійного скептицизму стосовно наявності шахрайства у вигляді версії. Отже, логічним є подальше викладення порядку дій аудитора з виявлення шахрайства. Варто зауважити, що в методичних рекомендаціях наведено порядок, який розділено на етапи умовно, оскільки виконання аудиторських процедур взаємопов'язані і може здійснюватися на різних етапах.

**Ключові слова:** поведінка управлінського персоналу, професійний скептицизм, професійне судження аудитора, аудит, шахрайство, правова оцінка, викривлення фінансової звітності