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Forensic auditing in the age of ISA 240

Impact on sustainability reports and the future of AI

In this article, we touch on the main principles of two important auditing standards which help in the assessment of fraud risk and performing adequate audit procedures to address identified fraud risks. Additionally, we explore fraud in sustainability reports and the legal ramifications associated with such misrepresentations on a high level. Lastly, with the rapid advancements in AI across various departments, we recognize its growing potential to enhance selected fraud-related auditing processes and procedures, not only in terms of efficiency but also accuracy.

Fraud is a deceptive practice aimed at personal gain that becomes criminal when it involves knowingly misrepresenting the truth to harm another. The fraud triangle suggests that fraud is likely to occur when three elements converge, namely: pressure (in this context sometimes also referred to as incentive), opportunity, and rationalization. Pressure (or incentive) includes motivations such as financial bonuses, market expectations, and personal financial needs. Opportunity refers to circumstances that allow fraud to occur, often due to weak internal controls, poor leadership, and inadequate accounting policies. Rationalization is the justification individuals use for committing fraud, often stemming from feelings of resentment, or following poor examples from management.

Fraud can be broadly categorized into two main types: individual and organizational fraud. Fraud against individuals targets a single person and includes, for example, identity theft, phishing scams, and Ponzi schemes. Organizational (or occupational) fraud is split into three broad categories (corruption, asset misappropriation and financial statement fraud), according

to the Association of Certified Fraud Examiners (ACFE) and can be internal or external. Internal organizational fraud occurs when an employee or executive deceives the organization, such as through embezzlement. External organizational fraud involves outside parties defrauding an organization, for example, vendors lying about services, kickbacks to third parties, potentially involving bribery and corruption, and technology-based threats like intellectual property theft. A fourth fraud category, "non-financial reporting fraud", includes risks related to reporting on environmental, governance and social (ESG) matters, according to the AFCE publication "Managing fraud risks in an evolving ESG environment." The pressure to meet ESG standards leads to potential fraud, such as greenwashing and manipulating sustainability data in reports to make them appear better than they really are.

Auditing standards

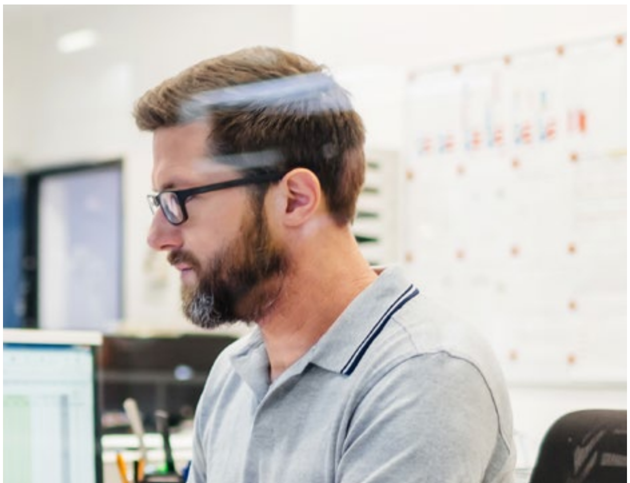
ISA 315, titled "Identifying and Assessing the Risks of Material Misstatement", provides auditors with a systematic methodology to assess the risk of material misstatements in the financial statements.[1] It instructs auditors on gaining a comprehensive understanding of the entity and its environment, including its internal control, to evaluate the risks of material misstatement and to design effective audit procedures.[2] In each of these steps in the methodology the auditor should apply a forensic lens and consider whether any potential fraud risks exist. Additionally, ISA 240, known as "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", mandates auditors to approach their responsibilities with an informed perspective on fraud.[3] This standard, recently revised in 2024, emphasizes the necessity of professional skepticism and vigilance against the potential for management to override controls, and calls on the use of forensic experts in certain audits to perform forensic-type procedures and provide relevant expertise.[4] By doing so, comfort can be obtained that the identified fraud risks have been adequately mitigated by existing controls or additional substantive testing performed.

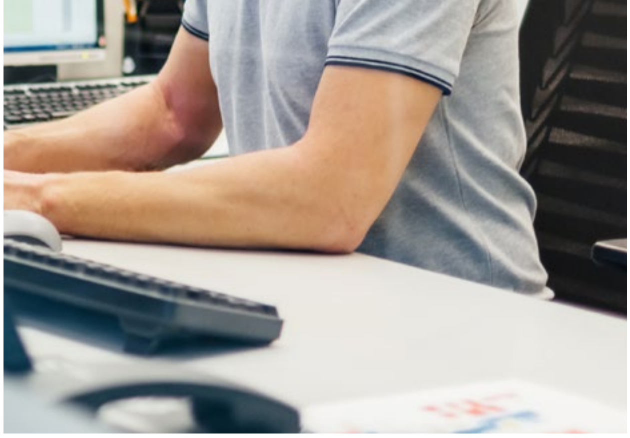
[1] International Auditing and Assurance Standards Board. "International Standard on Auditing 315 (Revised 2019)", 2019. https://www.ifac.org/_flysystem/azure-private/publications/files/ISA-315-Full-Standard-and-Conforming-Amendments-2019-.pdf

[2] Ibid

[3] International Auditing and Assurance Standards Board (IAASB). "International Standard on Auditing Proposed International Standard on Auditing 240 (Revised) the Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements and Proposed Conforming and Consequential Amendments to Other ISAs Exposure Draft", February 2024. https://ifacweb.blob.core.windows.net/publicfiles/2024-02/IAASB-Exposure-Draft-Proposed-ISA-240-Revised-Fraud.pdf

[4] Ibid





Fraud in connection with sustainability reports

The push for companies to show efforts toward ESG goals is growing stronger day by day. This is evident by the increasing number of legal proceedings with an ESG background in Switzerland, even though there are no Swiss ESG regulations in force yet (as opposed to in the EU which has introduced several ESG regulations in connection with greenwashing). Therefore, non-compliance with ESG principles poses significant risks, including personal liability for board members and potential reputational and financial damage to the company. The rush to meet ESG standards can also open the door to fraud, such as greenwashing, artificial inflation of carbon credit values, and bribes to circumvent regulations designed to protect the environment or public welfare.[5]

ESG fraud in sustainability reports occurs when a company, for example, deliberately withholds, fabricates or distorts significant non-financial information to mislead stakeholders or gain other advantages. This can involve for instance misstatements, misrepresentations, and exclusions related to any ESG key performance indicators (KPIs).[6] Executive bonuses tied to ESG benchmarks and the disclosure of taxonomy ratios, which influence investment decisions, can inadvertently incentivize such fraud.[7]

According to the Swiss Code of Obligations Art. 964a-c[8], listed entities must prepare a report on non-financial matters each year if they meet specific criteria, including having a minimum of 500 full-time employees annually over two consecutive years, and either a balance sheet total of at least CHF 20 million or a turnover of CHF 40 million or more. These thresholds are designed to exempt smaller companies for whom such reporting requirements could be excessively onerous. Despite this, and driven by investor expectations, an increasing number of smaller companies are voluntarily publishing non-financial reports, although these reports may not always be subject to shareholder approval.[9]

The non-financial report should cover environmental concerns (e.g., CO_2), social and employee-related matters, adherence to human rights, and efforts to counteract corruption. The report should provide the necessary details to grasp the enterprise's operational performance, financial outcomes, the condition of the business, and the impact of its activities on these non-financial aspects and vice versa (double materiality).[10] The Swiss Penal Code stipulates criminal liability for inaccuracies within the report. Individuals who deliberately provide false information, fail to produce the mandated reports, or do not adhere to the legal requirements for maintaining and storing the report, may face penalties with fines reaching up to CHF 100,000.[11]

[5] ACFE. "Managing Fraud Risks in an Evolving ESG Environment." Accessed July 24, 2024. https://www.acfe.com/-/media/files/acfe/pdfs/grant-thornton/esg2022/acfe_gt_esgreport-digital.pdf
[6] Ibid
[7] Ibid
[8] Fedlex. "Federal Act on the Amendment of the Swiss Civil Code", January 1, 2024. https://www.fedlex.admin.ch/eli/cc/27/317_321_377/en#fn-d7e37939
[9] Weber, Annette. "ESG Reporting in Switzerland: An Initial Assessment, One Year in | IFLR." IFLR, March 26, 2024. https://www.iflr.com/article/2d0ucv8gtn49bh592pv5s/sponsored/esg-reporting-in-switzerland-an-initial-assessment-one-year-in
[10] Fedlex. "Federal Act on the Amendment of the Swiss Civil Code", January 1, 2024. https://www.fedlex.admin.ch/eli/cc/27/317_321_377/en#fn-d7e37939
[11] Swiss Corporate Sustainability Reporting", June 27, 2024. https://www.homburger.ch/en/insights/swiss-corporate-sustainability-reporting

Furthermore, the board of directors may find themselves accountable. For director liability to be invoked, it must be established that the individual either intentionally or through negligence breached their duties, leading to harm at the company level and/or to the shareholder directly.[12] This can result in reputational damage, diminished market appeal, and possible constraints on business operations. To mitigate the risk of board member liability associated with the endorsement of sustainability reports containing fraudulent information, it is advisable to implement rigorous verification processes to ascertain the accuracy of the information presented. Additionally, prior to signing and publication, it is recommended to conduct comprehensive audits and continuous testing of input going into the reports in order to ensure the integrity of disclosures made.

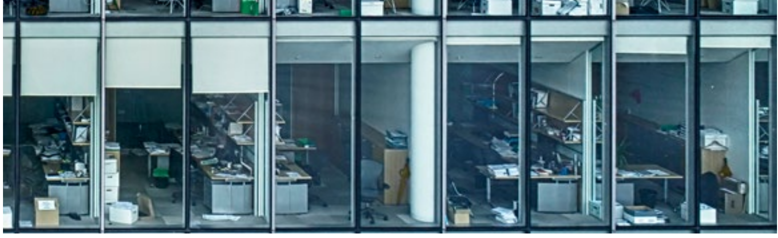
How AI can be leveraged to increase efficiency and accuracy of auditing areas with potential fraud risks

As AI continues to weave itself into the fabric of our daily existence, its capabilities present significant opportunities to enhance the way in which fraud detection and prevention is approached, enabling practitioners to arrive at conclusions more efficiently and with greater accuracy. For board members, leveraging AI in auditing is particularly relevant as it strengthens the potential detection and prevention of fraud, thereby reducing the possible risk of financial misstatements and protecting the company's reputation. In alignment with the recommendations of ISA 240 regarding the incorporation of forensic specialists into audit engagements, AI is a powerful tool for these professionals to use, helping to identify fraud risks and mitigate potential fraud.

There are various facets of where and how AI can be implemented within an organization's information/ financial system in order to assist in addressing the detection and prevention of fraud:

- **Fraud detection and prevention:** AI algorithms are adept at pinpointing transactions that stray from established patterns, thereby flagging possible fraudulent activities. Furthermore, AI's capability to conduct sentiment analysis allows for the scrutiny of organizational behavior, identifying potential fraud-indicative patterns.
- **Unique data repository:** Advanced AI platforms such as Relativity (a platform which provides e-discovery and legal technology solutions) can amalgamate data from diverse sources, including emails, financial systems, and isolated documents to construct an integrated perspective. This facilitates a more efficient review process (before or during investigations) and enhances the ability to detect inconsistencies or unusual transactions.
- **Enhanced investigations and document review:** AI-powered tools like Relativity are instrumental in navigating through extensive data sets of documents, correspondence, and other forms of communication to detect signs of fraud, as well as to discern patterns, trends, and irregularities that could point to significant misstatements. AI's proficiency in recognizing specific keywords, phrases and patterns expedites the data analysis process.
- **Contract and document analysis:** AI-powered tools are equipped to examine contracts and legal agreements for atypical clauses or stipulations that might signal fraudulent activities.
- **Relationship mapping:** AI possesses the capability to delineate the network of relationships and interactions among various entities and individuals, revealing concealed affiliations and potential collusive schemes.
- **Visual analytics:** AI tools, including Relativity, offer data visualization features that simplify the task of identifying suspicious networks and interactions through graphical representations.

[12] Weber, Annette. "ESG Reporting in Switzerland: An Initial Assessment, One Year in | IFLR." IFLR, March 26, 2024. https://www.iflr.com/article/2d0ucv8gtn49bh592pv5s/sponsored/esg-reporting-in-switzerland-an-initial-assessment-one-year-in



Based on the above, it becomes obvious that the practical applications and benefits of leveraging AI in the detection and prevention of fraud risks during an audit are vast. There is augmented precision in fraud detection, with AI improving the accuracy in identifying potential fraud risks as well as enabling time and cost efficiency gains from the automation of data analysis and document examination processes which diminish both the duration and expense incurred in audit procedures. Furthermore, AI delivers deeper insights as well as more profound and actionable intelligence regarding potential risks and fraudulent conduct, thereby elevating the audit's overall comprehensive quality.

What boards should do

- Leverage forensic specialist expertise in the annual audit process so that robust fraud risk assessments are performed each year.
- Utilize AI-powered tools to analyze large data sets, detect unusual transactions, and perform sentiment analyses.
- Employ AI for document and contract reviews to identify atypical clauses and potential fraud indicators.
- Conduct comprehensive audits and reviews of sustainability reports to verify the accuracy of disclosed information.
- Ensure continuous monitoring and updating of AI and forensic methodologies to stay ahead of emerging fraud tactics.

By implementing these actions, either internally or with the help of external consultants, board members can significantly enhance their organization's ability to prevent, detect and respond to fraud, ensuring robust audit practices and maintaining stakeholder trust.

Our expertise:

KPMG Forensic focuses on preventing, detecting, and investigating fraud, aligning with the required auditing standards, and leveraging artificial intelligence (AI) to improve fraud investigation and audit quality where possible.

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