Chapter 4
Detecting Fraud in Financial Reporting

CHAPTER SUMMARY

Overview
Accounting experts continue to debate the role of auditors in uncovering fraud. In the following sections, the current role of the independent auditor; the role of the internal auditor, the audit committee, and management; and the role of the forensic accountant are outlined. The last sections of the chapter describe in more detail the forensic accountant's role and describe fraud detection guidance from authoritative sources.

Definitions of Fraud

What Is Fraud?
The chapter covers different definitions of fraud in the textbook. The instructor can discuss several of them.

Responsibilities and Roles in Financial Reporting

Independent Audit Procedures and the Auditor's Role
Analytical procedures are used to get a better idea of the client's business and to identify areas of audit risk. The auditor must understand the implications of various risk factors to plan the financial audit and must also determine whether any specialists are needed to assist the audit. Audit evidence is gathered in two fieldwork stages: (1) the internal control testing phase, and (2) the account balance testing phase. Auditors apply audit procedures to obtain reasonable assurance that the financial statements are free of material misstatement. Auditing procedures also must include procedures to detect fraud. The primary objective of the auditor's examination of financial statements is to express an opinion about whether the financial statements present fairly, in all material respects, values of assets and liabilities in terms of GAAP. Materiality, control risk, inherent risk, and detection risk must be considered.

External Auditors and Fraud Detection. Although auditors have previously had the responsibility to detect material misstatement caused by fraud, SAS No. 82 details much more precisely what is required to fulfill those responsibilities. Now, auditors must specifically assess and respond to the risk of material misstatement due to fraud and must assess that risk from the perspective of the broad categories listed in the SAS. In addition, the external auditor has to satisfy new documentation and communication requirements.

Limitations of Audits and Auditing Standards. Basically, generally accepted audit standards (GAAS) are not designed to catch fraud other than financial statement fraud. Independent auditors are not charged professionally with finding asset fraud, merely material misstatement of financial statements.

Panel on Audit Effectiveness Recommendations. In October 1998, the Public Oversight Board, at the request of the then SEC Chairman, Arthur Levitt, appointed the Panel on Audit Effectiveness. Its charge was to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest.

AICPA's SAS No. 99 Reflects Panel of Audit Effectiveness Recommendations. In response to the research and recommendations made by the Public Oversight Board's Panel on Audit Effectiveness, in 2002 the AICPA issued Statement on Auditing Standards (SAS) 99: Consideration of Fraud in a Financial Statement Audit. The main points of the standard are as follows:
• Increased emphasis on professional skepticism
• Discussions with management
• Unpredictable audit tests
• Responding to management override of controls

Maintaining Objectivity. SAS No. 1 states that auditors must plan and perform an audit to obtain "reasonable assurance" that the financial statements are free of material misstatements caused by errors or fraud. In the planning stage, the audit team must discuss the potential for material misstatement due to fraud. Such discussions should involve key members of the audit team from the significant locations. These discussions should consider the pyramid of external and internal variables affecting the entity that might (a) create incentives/pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud.

SEC and Public Company Accounting Oversight Board. The Sarbanes-Oxley Act of 2002 created a new, five-member oversight group called the Public Company Accounting Oversight Board (PCAOB). This group is a strong, independent, and full-time oversight board with broad authority to regulate auditors of public companies, set auditing standards, and investigate violations.

§4011 Internal Auditor's Procedures and Role

Today's internal auditor offers various consulting services within an organization and works to add value and improve operations. The focus is on evaluating and improving the effectiveness of risk management, control, and governance processes.

The Institute of Internal Auditors' Due Professional Care Standard (Section 280) assigns the internal auditor the task of assisting in the control of fraud by examining and evaluating the adequacy and effectiveness of the internal control system. However, Section 280 says that management has the primary responsibility for the deterrence of fraud, and management is responsible for establishing and maintaining the control systems. In general, internal auditors are more concerned with employee fraud than with management and other external fraud.

Standards for the Professional Practice of Internal Auditing No. 2 outlines the steps that an internal auditor should take in communicating the results of a fraud investigation.

§4021 Audit Committee's Role

The audit committee is the subcommittee of an organization's board of directors charged with overseeing the organization's financial reporting and internal control processes. The audit committee's biggest responsibility is monitoring the component parts of the audit process. The Sarbanes-Oxley Act of 2002 set out to help reform financial reporting and specific provisions address weaknesses in audit committees.

§4026 Board of Directors' Role

The board of directors should oversee the financial reporting process, internal control structures, and audit functions.

§4031 Management Role

Sarbanes-Oxley Act mandates that CEOs and CFOs certify in periodic reports containing financial statements filed with the SEC the appropriateness of financial statements and disclosures.

§4041 Forensic Accountant's Role

A forensic accountant may or may not be a permanent member of an audit engagement. An inhouse forensic accountant may be brought into an external audit for purposes of complying with SAS No. 99. A report by the AICPA Fraud Task Force states that the forensic accountant is required to follow auditing standards. Where the forensic accountant finds that indicia of fraud are clearly present, the audit may change to a forensic or fraud investigation. Thus, investigative techniques may be performed by the forensic accountant that are outside the scope of a traditional audit. Because litigation may be possible, such an investigator is required to follow both the Statement of Standards for Consulting Services and the Code of Professional Conduct.
If, instead, a forensic accountant is brought into an audit engagement to perform a separate investigation (and not as an adjunct to an audit), such an engagement is consulting, and consulting standards must be followed. Because litigation may occur in the future, the forensic investigator may eventually be an expert or lay witness.

In some situations the forensic accountant will be brought in to investigate the minute any irregularities surface. In other situations the independent auditors may measure risk factors and create policy that brings the sleuths in when certain scores are attained. In still other situations, the internal audit function may call for bringing in the forensic accountant at random times as a matter of routine.

Some companies use creative accounting techniques to disguise damaging information, to provide a distorted picture of the financial health of the business, to smooth out erratic earnings, or to boost anemic or lack of earnings. Forensic accountants should adopt a healthy skepticism in reading and evaluating financial reports.

Howard R. Davia divides fraud auditing into two types: reactive and proactive. In proactive auditing, the auditor has few clues that fraud has occurred, so audit procedures for conducting proactive fraud-specific auditing are different from procedures used to practice reactive fraud-specific auditing.

An auditor should perform either tests of details or precise substantive procedures, not merely tests of controls. Because management can override controls, tests of controls may not be effective in detecting fraud. Because of the attitudinal shift in professional skepticism, the external auditor should not use the work of the internal auditors in performing the tests for searching for fraud. External auditors, however, may consider the results of internal auditors' test results designed to detect fraud in deciding which of their own tests to perform.

Financial Statement Fraud Categories and Red Flags

4051 Overstated Revenues

Overstated revenues pose such a huge fraud problem that the issue is covered in some detail in the following section. AICPA Statement on Auditing Standards No. 99 provides helpful suggestions for uncovering improper revenue recognition.

4061 Management Estimates

Management estimates is another area for fraudulent misstatements, such as asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of a business), bad debt allowance, and pension and other postretirement benefit obligations. Compare current management judgments and assumptions with prior periods and with those of other companies in the same industry.

4071 Pro Formas Can Mislead

Pro formas (or cash earnings or operating earnings) are often issued with many expenses excluded, resulting in "hide and seek" earnings. Accountants must focus on the earnings figures that are prepared according to GAAP.

4081 Earnings Problems: Masking Reduced Cash Flow

The trend in operating income is just as important as the trend in earnings. The accountant can use the cash flow statement to check the reliability of earnings. If net income is moving up while cash flow from operations is drifting downward, something may be wrong. (Cash from operations should not increase or decrease at a different rate than net income.) Ideally, net cash from operations grows steadily.

4091 Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)

EBITDA is a popular valuation method for capital-intensive industries. Capital-intensive companies (for which fixed assets are a large part of the balance sheet) offer the best opportunities for shifting expenses onto the balance sheet by aggressive, unethical companies. Auditors should look at the capitalized accounts because of the possible fraud and abuse. Unless amounts paid out will create a long-lasting asset, the expenditures must be expensed.
Excessive Debt

Companies burdened by too much debt lack the financial flexibility to respond to crises and to take advantage of opportunities. Investment professionals pay special attention to a company’s debt-to-equity ratio. Whereas the optimum ratio varies from industry to industry, the amount of stockholders’ or owners’ equity should significantly exceed the amount of debt. Debt should grow proportionately with sales and earnings.

Inventory Problems

Forensic accountants uncover inventory problems by looking at the ratio of accounts receivable to sales and the ratio of inventory to cost of goods sold. If accounts receivable exceeds 15 percent of annual sales and inventory exceeds 25 percent of cost of goods sold, red flags are raised. If customers are not paying their bills and/or the company is saddled with aging merchandise, problems will eventually arise. SAS No. 99 covers some suggestions such as observing inventory counts on an unannounced basis or conducting inventory counts at all locations on the same date.

CPA Problems

Auditor switching and the financial condition of a company are correlated to a certain extent. Firms in the midst of financial distress switch auditors more frequently than healthy companies.

Sales and Expenses Problems

Sales figures may be inflated in several ways that are difficult to detect. Forensic accountants should compare the trend in sales with the trend in net income. Special-purpose entities present special opportunities for masking problems in sales and expenses, offering the means to manipulate stock prices, create nonexistent assets, and disguise expenses.

Big Bath

Forensic accountants should beware of companies making write-offs directly against earnings—especially large amounts. This is called the “big bath.” Profits are depressed for that year, but future earnings look much better. If accounts receivable are written off, sales may have been inflated.

Balance Sheet Account Problems

Because the balance sheet is a snapshot of a business’s financial position at one moment, management may be tempted to manipulate balance sheet accounts to be listed.

Pension Plan Problems

Under pension plan accounting, the expected long-term rate of return (not the actual rate of return or the dollars actually received) is what impacts net income. During rising stock markets, pension fund investments can inflate the bottom line. Small changes in assumptions can make a huge difference in net earnings.

Reserve Estimates

Companies may play around with reserve estimates that are found on most balance sheets. Reserves are established to cover future adverse developments, such as warranty claims and bad debts. Because companies have huge discretion as to their size, the smaller the reserve, the less costly to the bottom line.

Personal Piggy Bank

Family member owners may use a corporation as a personal piggy bank at the expense of public investors and creditors. Forensic accountants must be especially careful with companies that are controlled by a few family members.

Barter Deals

A number of Internet companies used barter transactions (or noncash transactions) to increase their revenues. The problem is how to value this funny money.
Fraud can be found in many ways: by accident, interviewing officers and witnesses, percentage analysis, ratio analysis, using checklists, tips, physical and electronic surveillance, undercover operations, laboratory analysis of physical and electronic evidence, and by accident.

**Interviewing the Executives**

One way to detect fraud is to interview company personnel. The AICPA Fraud Task Force provides an interviewing template of 13 questions for CEOs, CFOs, and controllers. While interviewing executives or suspects, a forensic accountant must try to determine whether the individual is lying or being deceptive.

**Analytics**

Analytical procedures involve the study or comparison of the relationship between two or more measures for the purpose of establishing the reasonableness of each one compared. Five types of analytical procedures help find unusual trends or relationships, errors, or fraud:

- Horizontal or percentage analysis,
- Vertical analysis,
- Variance analysis,
- Ratio analysis or benchmarking,
- Comparison with other operating information.

Analytics reveal where to go to audit and for what to search. Analytics can lie, however, and many people do not understand them.

**Percentage Analysis**

Many financial statement fraud identifiers or red flags are detected by percentage analysis (both horizontal and vertical) and by ratio analysis. Horizontal analysis assists in the search of inequalities by using the financial statements of some prior year as the base and expressing the components of a future year as percentages of each component in the base year.

Vertical analysis (often referred to as common-size statements) presents every item in a statement as a percentage of the largest item in the statement. When vertical analysis is used to compare financial statements from several periods, changes in the relationships between items can easily be determined.

Ratio analysis is a subset of trend analysis that can be used to compare relationships among financial statement accounts over time to find the fakes. A number of ratios may be used to spot red flags and fraud identifiers.

**Using Checklists to Help Detect Fraud**

It is helpful to look at the fraud risk factors developed over time and create checklists that can be used as part of the fraud fighter's arsenal. See §4231 for checklists on attitudes and rationalizations, audit test activities, miscellaneous fraud indicators, and other issues from AICPA SAS No. 99.

**Behavioral Approaches**

Some fraud schemes cannot be effectively detected using data-driven approaches. Searching relevant transaction data for patterns and unexplained relationships often fails to yield results because the information may not be recorded, per se, by the system. It is sometimes necessary to inspect employees' attitudes, feelings, values, norms, interaction, supportiveness, and satisfaction to detect fraud.

**Conclusion**

The SEC seems to be moving the traditional players in line, but despite improvements in fighting fraud on all sides, there will be a need for forensic accountants who are specially trained and more suited personality-wise to remain independent and detect and fight fraud.