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Can Audit Prevent Fraudulent Financial Reporting Practices? Study of Some Motivational Factors in Two Atlantic Canadian Entities

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Abstract

Much as has been written and done to prevent Fraudulent Financial Reporting (FFR) practices but FFR is still exists in the corporate world. It is common to think about FFR practices in large companies for its greater amount of consequences, though such practises have negative consequences in small companies as well. FFR practices raise questions about the legitimacy of contemporary financial reporting process, roles of auditors, regulators, and analysts in financial reporting. This empirical study attempts to investigate the motivational factors of the prevention and detection of FFR through the auditing process. The interviewees were carried out within the entity and proprietary theoretical framework with some accounting related management in two medium-sized organizations in Atlantic Canada in winter 2008. The findings of this research demonstrate that an audit is not enough to prevent and detect FFR. The audit structure needs to be revised and employees need to be educated in order for them to better understand their internal control process, and their own role. Companies need to evaluate their controls and internal audit process instead of relying on the yearly audit. This study found that the most common methods used for FFR are improper revenue recognition, understatement of expenses/liabilities, and overstated and misappropriation of assets.

Keywords: *Fraudulent Financial Reporting, Audit, Saint John*

1. Background

Auditors Role

It is generally held belief that auditors' job to find fraud and error as part of the scope of the engagement for auditing financial statements. Fraud can be de-

finied as intentional misstatements that can be classified into two types. The first is misstatements arising from Fraudulent Financial Reporting (FFR) and second misstatements arising from misappropriation of assets. Therefore errors are the unintentional acts that cause financial statements to be mis-

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stated. As Messier and Emby (2004) elicited a number of reasons of FFR. They are: (1). Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared. (2). Misrepresentation in, or intentional omission from, the financial statement of events, transaction, or other significant information. (3). Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure. (4). Management override of internal controls that otherwise may appear to be operating effectively. However, misappropriation is the result of theft of the company's assets and can include: embezzling cash receipts, stealing assets, causing the company to pay for goods or services not received.

Fraud can be committed in a number of ways. There are several 'red flags' mentioned in Warrick and Riner's (2004) study. According to Warrick and Riner (2004), an auditor should look for a number of issues when performing an audit, like: (I) Unusual or complex transactions, (II) Emphasis of management on short term earnings, (III) Pressure to meet stock analyst expectations, (IV). Accounting estimates for valuing things such as warranty expenses, (V). Weak internal controls, (VI). A weak or non-active board of directors, and (VII). Incentive compensation plans structured on high financial performance.

According to the Committee of Sponsoring Organizations (COSO, 1999), large adjusting entries at the end of the quarter or year that involve revenue or asset accounts should be considered carefully.

The National Commission on FFR (also

known as the US Treadway Commission) did an in depth study on FFR in 1987. The report outlined ways to prevent and detect FFR. "The prevention and detection of fraudulent reporting is important because the financial reporting process relies on the integrity of the reported information." (Warrick and Riner, 2004). The Treadway Commission identifies the control environment, 'tone at the top,' as the most important factor in preventing FFR, it will be senior management that is the first defense against FFR. Even though senior management is the first defense in many cases it is senior management who is involved in FFR. With increasing pressures from shareholders to maximize earnings it is often senior managers who feel the most pressure to make the organization more profitable. Ernst & Young (2000) issued the findings of its general international fraud study (not limited to FFR), which states that employees committed 82 percent of frauds with management being involved in one third of those.

In the business environment importance should be placed on internal controls as this is the first defense in preventing fraud on an individual level. Internal controls can be difficult to implement depending on the size of the organization. Large corporations with hundreds of administrative staff are more likely to have efficient segregation of duties than an organization that only has a few administrative staff. According to COSO, fraudulent reporting occurs most often in smaller corporations. There are five components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. The control environment sets the tone of the organization as it is the foundation of all other con-

trols. Several circumstances can affect the risk assessment of a corporation. They include (but are not limited) to: new personnel, rapid growth, new technology, and foreign operations. Control activities are the policies and procedures that help to ensure that the appropriate measures are taken to address the risks. The controls can include but are not limited to: segregation of duties, understanding of control activities and performance reviews. Information and communication refers to the information system relevant to the financial reporting objectives and communication is providing an understanding of individual roles and responsibilities. Pre-assumably, a well operating information system can reduce the risk of material misstatement when monitoring assesses the quality of internal control over time. During the course of an audit these and other internal controls will be evaluated by the auditor to ensure they are sufficient. The auditor will also establish materiality, the level of misstatement that will not affect the decision of a reasonable user of the financial statements.

Prevention of Fraud

The Treadway Commission cited that education as one way of preventing fraud by making those who are responsible for the everyday accounting duties and making aware of how fraud is committed and then educating them about detecting procedure. In addition to educating employees about how to prevent and detect fraud the board of directors can play a key role in preventing fraud. The board should support the 'tone at the top' or even set the tone of the organization. It is the board who can direct management to have certain prevention and detection controls in place.

These could include, according to Carpenter (2001): (I). Internal controls as the first line of defense. (II). Using internal auditors that report to an audit committee of the board of directors rather than senior management. (IV). Hold management accountable to the same standards of misconduct as non-management. (V). Use fraud detection software. (VI). Effectively communicate ethics and fraud programs to the employees to ensure that employees perceive the programs to be working. Moreover, Warrick and Riner (2004) suggested the appropriate segregation of duties, and the need of performing ratio analyses on firm account balances. Beasley (2000) argues that audit committees should meet at least quarterly, and according to NCFR (1987), Audit committee members should be of the firm.

Understanding why employees commit fraud is a key factor in being able to detect fraud. A study by Hollinger and Clark with 12, 000 employees in the workforce found that nearly 90% engaged in 'workplace deviance', which included behavior such as goldbricking, workplace slowdowns, sick time abuses and pilferage. On top of that, an astonishing one-third of employees actually had stolen money or merchandise on the job. (Wells, 2001) There are three factors that contribute to employees committing fraud they are: pressure, opportunity, and rationalization. If employees feel they are not being treated fairly and adequately they are more likely to compensate themselves in the form of "wages in kind". Fraud is also committed because of financial pressures. Cressey (in Wells, 2001) found that the employees "must perceive an opportunity to commit and conceal their crimes, and

be able to rationalize their offenses as something other than criminal activity” (Wells, 2001). Wells also lists a number of questions. Whenever they are answered positively, there should be a red flag for fraud motivation. The questions are follows:

- Is management compensation tied closely to company value?
- Is management dominated by a single person or a small group?
- Does management display a significant disregard for regulations or controls?
- Has management restricted the auditor’s access to documents or personnel?
- Has management set unrealistic financial goals?
- Does management have any [past history of illegal conduct?
- Is an employee obviously dissatisfied?
- Does that employee have a past history of dishonesty or illegal conduct?
- Does that employee have known financial pressures, such as excessive debt, bad credit or tax liens?
- Has that employee’s lifestyle or behavior changed significantly?

The growth of the modern corporation has given the rise to absentee owners (shareholders) and the use of managers (agents) to operate the corporation on a day-to-day basis. “The agency relationship between an owner and manager produces a natural *conflict of interest* because of the information asymmetry this means that, the manager generally has more information about the ‘true’ financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximize their own self-interest, it is

likely that the manager will not act in the best interest of the owner.” (Messier and Emby, 2004) By having the corporation audited the auditor adds value to information by increasing its reliability and credibility.

It is management’s duty to be aware of the consequences of fraudulent reporting whether it is legal, social or ethical. The news has been dominated in recent years by many scandalous tales of large corporations committing fraud. For example Enron has had to restate their financial statements for a total of eight billion dollars and some of the executives have been charged with committing fraud. Fraud is not limited to corporations. One of the Big Four firms Arthur Anderson, “was the auditor for a number if entities involved in FFR. The effect of Arthur Anderson was devastating. Their complicity with the scandals ultimately destroyed them.”(Warrick and Riner, 2004)

2. Methodology

Research Method

To develop a better understanding of the motivational factor on fraudulent reporting and how an audit can detect and prevent it from control fraud we turned to a prominent Saint John company (X), and an accounting firm (Z), in order to have a diversified view. Semi structured interviews were conducted with each interviewee on March 20, 2008 and April 4, 2008 respectively. The first interviewee is from Company X and the second interviewee is from Company Z. These two were selected to evaluate the opinion on auditing from the perspective of a large corporation and that of firm. The interviews were conducted on site

during an hour long pre-booked appointment. Notes were taken during the interviews and organizing the interview results immediate after the interviews. The first interviewee holds a CA and was chosen because of his extensive knowledge of business practices in large companies. The second interviewee has her BBA and was selected for her knowledge in accounting practices from the perspective of a large firm as well as her previous experiences in the industry. Following the interviews, secondary sources of information was scrutinized in order to find the consistency/inconsistency of provided information. However, the exact references of secondary source are not elicited here in order to not disclose information about the names of the organizations interviewed.

Theoretical Framework: Entity Theory

The entity theory is based on the simple equation that assets are equal to equities (liabilities plus shareholder's equity). Assets and liabilities are considered to be resources and obligations of the entity itself, but not the shareholders or proprietors. If management is committing fraudulent reporting, the number within this equation will not be correct. Management over valuing one or several assets can greatly change the company's financial statements. The difference between liabilities and shareholder's equity is that rights of the creditors can be determined independently of other valuations- if the firm is solvent. The stockholder's rights are measured by the valuation of the assets originally invested plus any reinvested earnings and revaluations. The equity holders of the firm have the right to receive dividends and share in net assets in the event that the firm should cease opera-

tions upon liquidation.

The entity theory is quoted as being "income centered". Any net income or loss of the firm within a given year belongs to the firm. In the event that the firm has a positive net income on the income statement for the year, will only be considered income to the shareholders if dividends are declared. In this example the amount of income to the shareholders will be the amount of the dividend that they receive from the firm. The remaining profit belongs to the firm.

It is the entity theory that contributes to fraud because when the company is successful, in terms of a positive net income, money can be distributed to shareholders. In this case, if fraudulent reporting occurs then this net income or loss has the potential to state in a way that goes far away from the truth and fairness. More successful a company is the one that distributed more money to the shareholders. If a company is successful they can raise additional capital based on the past distributions and the predicted future distributions. The proprietary theory can contribute to fraud on the basis that executives are tempted to record assets and liabilities inappropriately to increase their wealth. Shareholders are also seeking to invest in a company with an increasing net income so that they may receive higher dividends. Management may be pressured by shareholder to show a positive net income for this reason.

3. Empirical Findings and Analysis

We recently interviewed Kevin Hourihan who is a chartered accountant with

Company X and asked him his opinion on the prevention of FFR through auditing. Kevin's opinion is that "an audit is not an effective means of detecting or preventing fraudulent financial reporting within a large company" like the one he works for. "Audits usually run with the assumption that management has integrity. An auditor would not normally take a job if they suspected that management was corrupt." Auditors are more looking for errors and omissions that are honest mistakes. Kevin's take on the matter is that of course they do look through internal controls to see if the company has the proper controls and policies, however if fraud were happening it would be very hard for an auditor to detect through sampling and testing.

If the company is large with several employees it should be harder for fraudulent reporting to occur within the organization. Large scale companies often have well designed controls which make it harder for fraud to occur. Depending on how well planned and executed the fraud was (even if the auditor were to look at that) the particular entries involved may not catch fraud. Kevin believes that usually when management decides to peruse at fraudulent reporting action, it is generally well planned and executed which makes it harder for auditors to detect.

Kevin also points out that it would be very hard for one person to commit fraud within an organization. An example that he provided us with would be booking a sale. "If an employee booked a nonexistent sale it would most likely get noticed by someone in another group such as collections or banking." This would be much easier in a smaller company where one person does many ac-

counting functions. Kevin's opinion in short is that a company needs to have the proper controls in place to prevent fraud and not rely on their audit. Detecting fraud is not the main goal of the audit. The audit is done primarily to test the financial statements of the company for accuracy but not for investigating fraud. If the audit were to test fraud it would be cost prohibitive due to the great deal of time would possibly be involved in it.

A second interview was conducted with Shelly Roy a supervisor with Company Z. We asked for her opinion on whether FFR could be prevented through audit. She felt that audit was not an effective means to prevent FFR. Shelley elaborates by explaining "the main focus on an audit is not to detect or prevent fraud but is to provide reasonable assurance that financial statements are free from material misstatements". Shelley feels it is the controls that the company has and enforces that prevent fraud. She noted that "an audit examines evidence that supports the amounts and disclosures in the financial statements. As part of audit procedures, controls are reviewed to develop an understanding of risk that may be associated with amounts in the financial statements". An example of a control procedure is the Company having segregation of duties for banking. This means that there are two signing authorities and those who can prepare cheques are not signing authorities. This prevents the individual from issuing an unauthorized payment to themselves. During an audit, if there was not proper segregation of duties, control risk would be assessed at an elevated level and more sampling and testing on cash would be required.

Well (2002) says, "I don't think an auditor could uncover fraud if he stepped on

it". Such opinion may be a negative opinion on our audit system, but according to Craig A. Latshaw, in his article on FFR, he mentions that the Government and Accounting Profession React, there may be some truth to it. The report highlights that although the Sarbanes-Oxley Act and initiatives that have been started by the AICPA attempt to reduce fraud but they are not enough. There are still some large issues unresolved as far as FFR is concerned. Management can still override internal controls in order to produce FFR. As stated in Latshaw's article "unfortunately, the majority of work carried on by auditors using the current system concentrates on the discovery of unintentional errors which, with an adequate system of internal control, will be detected by the company's accounting system" (Latshaw, 2002). After conducting the interviews and based on the empirical findings both Kevin and Shelly are correct in stating that internal controls play a large role in the prevention of FFR but not the audit. It is however evident that when the internal controls fail and managements greed blinds them to their ethical duties, auditors should be looking for 'red flags' even in the most prominent companies. The audits performed by Arthur Anderson did not detect or prevent fraud in many companies but may in fact have contributed to it.

The Enron financial scandal perhaps the most discussed case of fraudulent reporting revealed in late 2001 which led to its bankruptcy. This scandal also caused the dissolution of Arthur Anderson, i.e. Enron's accounting firm (which at the time was one of the world's top five accounting firms), when it was discovered that they had destroyed important audit

documents. Enron used offshore entities to create the illusion that they were more profitable than they actually were which drove up the stock price even though they were actually losing money. Only the executives knew of the existence of these offshore accounts that were actually hiding the losses, the investors knew nothing about it. At the same time those executives were working on insider information and trading millions of dollars worth of Enron stock. This took several years to unravel and went undetected by auditors. The Enron scandal brought to light potential conflicts of interest between consultancy and auditing work and the need for tighter regulation on financial derivatives trading. Enron is proof that an audit cannot prevent fraud when the accounting firm is in collusion with the company committing fraud.

After the fall of Enron some of the other companies that Arthur Anderson represented were investigated. Qwest Communications was subsequently reviewed and it was found that they had inappropriately recognized revenue and four executives including the CFO were charged with conspiracy to commit an offense against the U.S., securities fraud, making false statements, and wire fraud affecting a financial institution. Another communication giant (WorldCom) also fall victim to fraudulent reporting in June of 2002. WorldCom announces that they have been over stating profits by classifying routine expenses as capital expenditures a month later WorldCom has filed for bankruptcy. CEO, Bernie Webbers is tried and convicted of falsifying regulatory filings with the U.S. Securities and Exchange Commission in 2001 and 2002.

4. Conclusion and Recommendation

Empirical evidence demonstrates that audit cannot solely detect and prevent FFR, or say, an audit is not enough to prevent and detect fraudulent reporting. It appears that although fraud has higher audit risk and can cause an audit to fail but it still receives the least amount of attention. Empirical evidence supports that the audit structure needs to be revised in light of the numerous fraud cases that are being exposed. Employees need to be educated so that they can better understand internal controls and their role in the organizations. Companies need to evaluate their controls and scrutinize their internal audit, or audit committees, to ensure that gaps that cause 'red flags' are filled. It is found in the empirical evidence that companies should not just simply rely on the yearly audit to detect fraud but should take preventive control measures.

The research results, i.e. empirical evidence, do not seem to be consistent with the entity theory but more in line of the arguments of proprietary theory. Management continuously experiences outside pressures to increase profits. Such pressures mostly come from the shareholders in order to receive the benefits of their proprietorship/shareholdings, though a business organization is an independent entity. Moreover, competitive tendency of companies - not just simply want to maintain their current size but they want to grow, also creating the pressure on management to increase and maintain higher stock value.

The objective of the proprietary theory is the determination and analysis of the proprietor's net worth. In the case of fraudulent reporting -if in fact fraud has

occurred, the company's net worth on the financial statements will likely not be correct. Represented by the equation, i.e. $\text{Assets} - \text{Liabilities} = \text{Proprietor's Equity}$. The proprietor owns the assets and liabilities, and therefore, the liabilities are negative assets of the proprietor making such equation balance sheet centered. Bookkeeping can be viewed as the proprietor accounting for his own property, and such a view can be adapted to corporations as well because they are accountable to shareholders for the profitability of their investment. When the corporation is profitable and retained earnings are high then shareholders are having access to higher amount of wealth (as form of dividends).

The origins of the proprietary theory have been traced, in Britain, to Malcomb (1718) who distinguished transactions that produced profit and subsequently increased proprietors' capital, from those which did not. The theory was further developed by Stephens (1735) and Fulton (1800), and was fully fledged by Conhelm (1818). He added the algebraic approach to transaction analysis with transactions affecting the accounting equation (by increasing or decreasing capital, assets and liabilities) and this study finds the evidence to support that notion rather than the consideration of business entity that prevent FFR.

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