Detecting Corporate Fraud in a Financial Statement Audit*

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ABSTRACT

기업의 재무보고서를 감사하는 감사인은 경영자의 책임인 기업의 재무보고서가 일반적으로 인정된 회계원칙에 따라 대체적으로 공정하게 작성되었는지에 대한 합리적 확신(reasonable assurance)을 얻기위해, 증거를 수집하고 평가한다. 그 과정에서 감사인이 감사대상기업의 경영자나 종업원의 오류나 부정을 적발할 책임이 있는가는 오랫동안 논란의 대상이 되어왔다. 오류와부정 모두 재무제표의 공정성을 훼손시키나 오류는 고의성이 없는 부주의로 인한 실수이기 때문에 감사에서 쉽게 적발이 되고 또한 재무 보고서에 미치는 영향도 적은 반면에, 부정은 고의성을 가지고 있으며, 은폐 혹은 근거서류를 조작하기 때문에 감사로도 탐지가 쉽지 않으며, 더욱이 중요한(material) 액수를 포함하고 있어 재무보고서의 공정성에 심각한 위해를 가한다. 미국공인회계사회의 감사기준 심의회(Auditing Standards Board)는 감사인에게 종업원이나 경영자의 부정에 대한 경각심을 일 깨우고, 감사절차를 계획하고 수행하는 것을 돕기 위해 감사기준서(Statement on Auditing Standards: SAS) 82호에 "재무보고서 감사에 있어서 부정탐지에 관한 고찰"을 발행했다. 본 연구는 경영자 부정탐지의 방법으로 감사인들에게 자료들간의 상관관계를 비교, 분석하는 분석적 절차의 적극적인 활용을 권하고 있다.

Key words: Corporate Fraud, Misappropriation, Embezzlement, Analytical Procedures

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Ⅰ. Introduction

While many companies in electronics industry were laying off hundreds of employees due to slow down of the nation's economy, the Big Mony Corporation announced its 13th consecutive record-breaking quarter in both sales revenue and net income. The Corporation's auditor noticed several peculiar aspects of the Corporation's financial information as he went through reviewing the Corporation's quarterly reports. Those the auditor noticed are:

- Receivables were increased to $180 million from $105 million, roughly 70 percent increase from the same quarter a year ago.
- Inventories were swollen to $141 million from $93 million of the same quarter a year ago, a dangerous movement considering quick obsolescence of electronic products due to rapid technology advancement in the electronic industry.
- Despite the increase of receivable to $180 million, the Big Mony reserved less than 1 percent in allowance which is significantly less than those of other companies engaged in the same industry, ranging from 4 percent to 10 percent of the receivables.
- The Corporation sped up as much twice shipments to customers as usual toward the end of the quarter.

In addition, the auditor has known the Corporation's Chief Executive Officer(CEO) for his idiosyncratic management style, such as stubborn leadership and exaggerative personal attitude from the past association with him. The CEO was very much motivated to make the Big Mony as a billion-dollar revenue generating company. The CEO sets up quarterly sales objective of at least 50 percent more than that of the previous quarter. The Corporation's salespersons are awarded bonus solely based on their sales achievements.

This hypothetical case illustrates a possible scenario of corporate (management) fraud. Such corporate fraud does harm not only the company's investors, but creditors and other stakeholders. Corporate fraud also has a more remote, potentially more dangerous impact: loss of public confidence to the integrity of the financial reports. Widespread media attention to even a single incidence of the management fraud can shake the public's confidence in the credibility of financial statements. Public's confidence in the fairness of financial reporting is critical to the effective functioning of the securities market. Loss of public confidence can increase the cost of capital for companies that have not been involved in corporate fraud. Innocent consumers ultimately bear these increased costs.

Ⅱ. Recent Cases of Corporate Fraud

CUC International, Inc. was merged to HFS Inc. to form a new corporation, named Cendant Corporation, in December, 1997. The stock price of the newly formed Cendant Corporation was pummeled 46 percent in one day during April of 1998 due to corporate financial fraud committed by former CUC International management. After the top management of the Cendant Corporation revealed that the former management of the CUC International, Inc. cooked accounting numbers deeper than initially estimated, the stock price was beaten another 20 percent, losing more than $14 billion market value in one day of July. The top management of CUC International had manipulated more than $500 million dollar of revenue and cooked up amounting $200 million of earnings during the past three years.

Investors in stocks are getting panicked by the word “accounting or corporate(management) fraud.” One stock analyst advised investors to watch for fire where there is accounting smoke. He mentioned, “There are no small problems in accounting when you hear small problems in accounting. They are all big problems.” Numerous companies, such as Enron, WorldCom, Waste Management, Sunbeam, Informix, and PharMor, were all involved in corporate financial fraud and their stocks were beaten badly. Recently stockholders of Computer Associate International sued management for accounting fraud, but the case is pending in a court. When a company is involved in corporate fraud, its dream of success may come to an abrupt end. In addition, corporate fraud destroys not only the company involved, but stability of the securities market and eventual destruction of the nation's economy.

Ⅲ. Auditor's Responsibility for Detecting Corporate Fraud

Management is responsible for preparing financial statements in accordance with Generally Accepted Accounting Principles(GAAP). The auditor's responsibility rests with examining whether the financial statements are fairly stated in accordance with GAAP. The auditor must gather sufficient and competent evidence to afford a reasonable basis for his audit opinion on the fairness of the financial reports. On the other hand, the auditor has responsibilities beyond merely satisfying his contract with a client, extending his duties to the public, client, fellow practitioners, and society. The purpose of audited financial statements is to provide public with reliable financial information for them to use on their decision making. If the audited financial statements are determined not to be reliable, those who were harmed by those information may sue auditors to recover financial loss they suffered.

Ernst and Young(at then), the former auditor of CUC International, Inc., paid $335 million to the shareholders of the Cendant Corporation, because the accounting firm could not find corporate fraud in conducting the audit. But corporate fraud is hard to pinpoint, because management is in a position to conceal his wrongdoing through creating fictitious documents or collusion among management, employees, or third parties. For example, management can create falsified documents for transactions to look like legitimate ones. In auditing accounts receivable, the auditor may receive falsified confirmations from third parties who are in collusion with management. Such collusion may cause the auditor to believe that evidence is persuasive when ,in fact, it is not. Because of concealment aspects of fraudulent activities, even a properly planned and performed audit may not detect material misstatements. The auditor can only offer reasonable assurance that material misstatements in the financial statements, whether caused by error or fraud, are detected. The concept of "reasonable", not absolute, assurance means that the auditor is not an insurer of the correctness of the financial reports. Several reasons why the auditor is responsible for reasonable assurance are as follows:

a) The auditor gathers evidence from a sample of population, resulting in inevitable sampling risk of not uncovering a material misstatement.
b) Accounting information in a financial report includes complex estimates, which involve uncertainties and contingency depending on the outcomes of future events.
c) Corporate fraud is extremely difficult to detect, especially when there is collusion among management.

Ⅳ. Description and Characteristics of Corporate Fraud

Fraud differs from error in that underlying action results in intentional misstatements. Two types of intentional misstatements are defalcations, often called employee fraud, and corporate fraud, often called management fraud or fraudulent financial reporting. Employee fraud involves theft of a company's assets. An example is a clerk taking cash at the time sale is made, while not entering the sale in a cash register. Misappropriation of assets may also take a form of stealing assets or causing a company to pay for goods or services not received. On the other hand, corporate fraud may often take a form of concealing wrongdoing by creating fictitious documents and records or through collusion. Management is often motivated to commit fraud for various reasons, such as achieving a company's goal, attempting to avoid financial difficulties his company may face, or personal greediness to obtain more bonus. Because of management's attempts to hide his intentional misstatements, the auditor may have extreme difficulties to detect those material misstatements during his routine audit procedures. In addition, the auditor is not trained to identify the authenticity of documentation.

To help the auditor deal with these matters, the Auditing Standards Board(ASB) of the American Institute of Certified Public Accountants (AICPA) issued the Statement of Auditing Standards(SAS) 82, entitled "Consideration of Fraud in a Financial Statement Audit."

Ⅴ. Synopses of SAS No. 82

The SAS No. 82 provides guidance to auditors in fulfilling their responsibilities to detect corporate fraud. The ASB issued SAS No. 82 in an attempt to enhance the auditor's performance related to fraudulent financial reporting. SAS No. 82 reaffirms the auditor's responsibility to plan and perform audit to obtain reasonable assurance that financial statements are free of material misstatements, whether caused by error or fraud. While fraud is legal concept, the auditor's interest in fraud specifically relates to fraudulent acts that could cause material misstatements in financial statements. SAS No. 82 makes it clear that the auditor needs to consider two types of risk factors in the assessment of fraud. They are:

- Risk factors relating to misstatements arising from fraudulent financial reporting(management fraud)
- Risk factors relating to misstatements arising from misappropriation of

assets(employee fraud)

Misstatements of the first case are intentional misstatements or omission of dollar amounts or disclosures in financial statements with the intention to deceive financial information users. They may include the followings:

- Manipulation, falsification, or alteration of accounting records or supporting documents and records from which financial statements are prepared.
- Misrepresentation in, or intentional omission from, financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to classification, manner of presentation or disclosures.

As possible symptoms of such intentional misrepresentation, SAS No. 82 lists the followings:

- Management's characteristics and influence over the control environment, such as management's personal attitude, pressures, and styles relating to internal control and financial reporting process.
- Industry conditions, such as the economic and regulatory environment in which the entity operates.
- Operating characteristics and degree of financial stability pertaining to the nature and complexity of the company and its transactions.
- The company's financial conditions and its profitability.

Misstatements of the second case, often referred to as employee fraud or defalcations, are employee thefts of company assets, which may cause the financial statements not to be presented in conformity with Generally Accepted Accounting Principles(GAAP). SAS No. 82 lists possible causes for employee thefts as follows:

- Susceptibility of assets to misappropriation and the degree to which they are subject to theft

- Lack of controls designed to prevent or detect misappropriation of assets

SAS No. 82 requires the auditor to assess the risk of material misstatements of the financial statements due to fraud and to reflect that assessment in the audit procedures. In considering assessment, the auditor should consider both risk factors arising from the fraudulent financial reporting and the misappropriation of assets.

The assessment of the risk of material misstatements arising from fraud is a cumulative process, because the auditor may identify risk factors while performing his audit procedures. The auditor's response to the assessment is influenced by the nature and significance of the risk factors identified. In some cases, the auditor may think that his planned audit procedures are sufficient to detect the fraud. But ,in others, the auditor may have to modify his audit procedures after considering the nature of the fraudulent misstatements. The auditor's response to the result of the assessment may affect the audit process in the following ways:

- Professional Skepticism

Due professional care may require the auditor to have such attitudes as questioning mind and critical evaluation of audit evidence

- Assignment of Personnel

The knowledge, skill, and ability of audit personnel assigned to fraud-prone engagement should be commensurate with the auditor's assessment of the risk level.

- Accounting Principles and Policies

The auditor may need to scrutinize management's adoption and application of accounting policies, particularly when they are related to revenue recognition, asset valuation, capitalization, and expense. The auditor needs to pay careful attention to whether accounting principles and policies are applied in an inappropriate manner to cause material misstatements.

- Controls

When a risk of material misstatements is related to the control environment, the audit procedures to assess the internal control procedures must be expanded.

In addition to the broad considerations mentioned above, the auditor may need to modify the nature of audit procedures to obtain more reliable evidence or additional corroborative information. This goal can be accomplished through modifying nature(for more effective test), timing(closer to the end of fiscal year), and extent(more samples for detailed test) of substantive tests to reduce the overall risk of material misstatements due to fraud. When fraud risk factors indicate risks to specific account balances or types of transactions, audit procedures may need to be modified at the account balance/class of transaction level. The followings are specific examples of the auditor's response:

- Visit locations or perform certain tests on a surprise basis, such as observing inventory count at a location where the auditor's presence was not announced or counting cash on a surprise basis.
- Request inventory counting at a date close to year end
- Perform a detailed review of the company's year end adjusting entries and investigate those that appear unusual
- Perform substantive analytical procedures at a detailed level. Conduct interview of personnel working in areas where a risk factor is present.

1. Evaluation of Audit Test Results

When the audit test results identify misstatements in the financial statements, the auditor must consider whether such misstatements imply presence of fraud. If it is, the auditor should consider further implications of those misstatements, even though the effect is not material to the overall level of the financial reports. For example, petty cash fund custodian's embezzlement of cash would be of little significance to the auditor, because the manner of operating fund and its size would be limited. On the other hand, when the matter involves management, it may indicate a more pervasive problem, even though the amount itself is not significant. In such cases, the auditor must reevaluate the risk of material misstatements due to fraud and its effect on the nature, timing, and extent of audit procedures and assignment of audit staff, such as more experienced audit personnel. If the auditor determines that the misstatements resulting from fraud involve material amounts or is unable to evaluate its effect, he should do the followings:

– Consider the implication for other aspects of the audit
– Discuss the matter with an appropriate level of management that is as least one level above those involved and with senior management
– Attempt to obtain additional evidential matter to determine its effect on the financial statements and the audit report thereon.

2. Communication about Fraud to Management and Audit Committee

Whenever the auditor has determined existence of fraud, he should bring the matter to the attention of an appropriate level of management, even though it might have involved immaterial amounts. The auditor must report and discuss that matter to the audit committee.

VI. Effective Means for Fraud Detection

SAS No. 82 requires the auditor to assess the risk that fraud may cause the financial statements to be materially misstated. The auditor may assess this risk in conjunction with inherent and control risk assessments. Based on the auditors assessment, he should design and perform the audit procedures to provide reasonable assurance that fraud which has material effects on the financial statements are detected, even though he is not an insurer or guarantor on the correctness of the financial statements. Even if the auditor concludes that existing procedures are sufficient to deter fraud, he should assess the risk on an ongoing and cumulative basis until he completes the audit.

KPMG Peat Marwick, one of Big Six accounting firms(at then), reveals the following symptoms for the accounting fraud:

- Poor or neglected internal control systems
- Large amount of inventory losses
- Managements overlooking on internal and external audit results
- Unusual banking activities
- Exceptionally large amounts of expenses and purchases

If the auditor notices any of the above warning signs, he should take appropriate audit procedures such as assigning experienced staffs to those suspected areas or performing more detailed tests.

If the auditor finds difference between the reported and audited amounts, he should find out the cause of difference, i. e., caused by errors or fraud. If the difference is caused by errors, the auditor may ask adjustment to the client. But if by fraud, its effect on the financial statements may go beyond the monetary effect. If he determined that fraud had been committed but its effect on the financial statements is immaterial, the auditor should bring the matter to the appropriate level of management which is at least one level above those involved and consider the implication of the fraud on the other aspects of the audit.

On the other hand, the auditor should do the followings if its effect on the financial statements is material:

- Consider its implications on the other aspects of the audit
- Discuss the matter and the approach to investigate with an appropriate level of management that is at least on level higher that those involved and with senior management
- Try to obtain evidence to determine the material effect on the financial

statements and the auditors report thereon.
- Suggest the client to consult with legal counsel.
- Bring the matter involving management fraud to the audit committee.

1. Means to Detect Management Fraud

The Treadway Commission reports that management fraud often occurs in response to the presence of certain environmental, institutional, and individual pressures. Those pressures make fraud different from randomly occurring unintentional errors. Most of fraud cases filed with the SEC show managements involvement in improper revenue recognition, asset overstatement, or improper deferral of expenses. Because fraud often entails forgery, creation of falsified documents, or collusion with third parties, the auditor may find it difficult to detect. The auditor needs to consider preventive and detective features to reduce the possibility of not uncovering fraud. Preventive measures are the procedures designed to prevent theft, misuse, or defalcations of assets, while detective measures are the ones to detect those incidences when occurred. But current study focuses on the detective measures.

1) Detective Measures

SAS No. 82 makes it clear that the auditor is responsible for detection of material misstatements in the financial statements, either caused by error or fraud. However, the auditor cannot obtain absolute assurance that all of material misstatements in the financial statements will be detected. Even a properly performed audit may not detect a material misstatement caused by fraud because of the managements concealment efforts of fraudulent activity through collusion or creation of falsified documents. Due to these natures, the auditor obtains only reasonable assurance that misstatements in the financial statements are detected. Nonetheless the auditing profession recognizes the usefulness of analytical procedures in detecting unusual circumstances.

Analytical procedures focus on the overall reasonableness of reported amounts in relation to surrounding circumstances. Auditors use analytical procedures to identify misstatements by examining interrelationships among financial, operational, and other data. Three major types of analytical procedures are trend, ratio, and statistical analyses. Trend analysis is to examine the trend of account balances as a basis for determining whether the current period data are out of trend, which may signal misstatements. Trend analysis technique ranges from the simple two period comparisons to statistics-based time-series models. On the other hand, ratio analysis refers to procedure that involves simultaneous comparison of two or more accounts. The assumption behind ratio analysis is relatively stable relationships between or among accounts over time. A variation in ratio signals underlying unusual circumstances to the auditor. The unusual condition may indicate simple error, fraud, or result of changing environment. Ratio analysis is potentially a very useful method for detecting misstatements than trend analysis, because ratio analysis uses the stable relations between accounts, while trend analysis looks at the behavior of only a single account over time. Because of this nature, the auditor may find ratio analysis to be very much effective for detecting management fraud. The behavior of ratio is expected to be stable, even though a single account balance may fluctuate over time for a number of reasons without necessarily implying any error or fraud. A statistical modeling technique can be even more effective for fraud detection than trend or ratio analysis because of its ability to accommodate meaningful and stable relations among financial, operational, and other data. Statistical modeling aims at the reasonableness of an account balance by employing operating, financial, and other internal or external data. Especially a multiple regression modeling technique is a superb method to detect any misstatement

Ⅶ. Conclusion

Fraud occurs as the result of certain environmental, institutional, or individual forces and opportunities. These forces and opportunities add pressures and incentives to individuals and companies, and tempt them to engage in fraudulent activities. These temptations are present in all companies to some extent. A frequent incentive for fraud is the desire to obtain higher prices in stock or bond offering or to meet the expectations of the investors. Or the incentives could be personal gains, such as additional compensation, promotion, or escape from penalty for poor performance. These fraudulent activities may shatter the stock market or nation's economy by demolishing credibility of the financial reports. The Auditing Standards Board(ASB) of the American Institute of Certified Public Accountants(AICPA) issued Statement on Auditing Standards(SAS) No. 82 to help auditors assess the risk of material misstatements arising from fraudulent activities in their audit procedures.

SAS No. 82 specifically:

- describes fraud and its characteristics
- requires the auditor to assess the risk of material misstatements due to fraud
- provides categories of fraud risk factors to be considered in the assessment of financial statements
- provides guidance on how the auditor responds to the results of assessment
- provides guidance on the evaluation of audit test results arising from the fraud risk factors
- provides guidance regarding the auditor's communication about fraud to management and the audit committee

Although management is responsible for adopting sound accounting policies and procedures and for establishing and maintaining internal control, the auditor must plan and perform the audit procedures to obtain reasonable assurance that the financial statements are free of material misstatements, whether caused by errors or fraud. SAS No. 82 provides the auditor with guidance in fulfilling his responsibilities in relation to fraud in an audit of financial statements.

Even though the auditors responsibility for fraud detection is limited to material amounts, he should carefully plan and perform his audit procedures to detect fraud even involving immaterial amounts, because of its unforeseen effect on the integrity of the financial information. As a preventive measure for fraud occurrence, the auditor should consider the corporate environment from which financial information is developed. The corporate environment may include the managements integrity, control environment, effectiveness of internal audit systems, and audit committee. As a detective measure for fraud occurrence, the auditor can apply analytical procedures. Three major types of analytical procedures are trend, ratio, and statistical modeling analyses. The auditor can benefit from statistical modeling, especially a multiple regression model , in detecting material error or fraud because of the models capacity to embrace huge amounts of related data in predicting a specific account balance. Even if the auditor decides that misstatements due to fraud are not material to the financial statements, he should report the matter to appropriate level of management at least one level higher than those involved. For the case of material fraud, the auditor should discuss the matter and any further investigation with an appropriate level of management and determine its effect on the financial statements and the auditors report thereon. In addition, he should bring the matter to the audit committee.

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