A Note on Fraud and the Auditors

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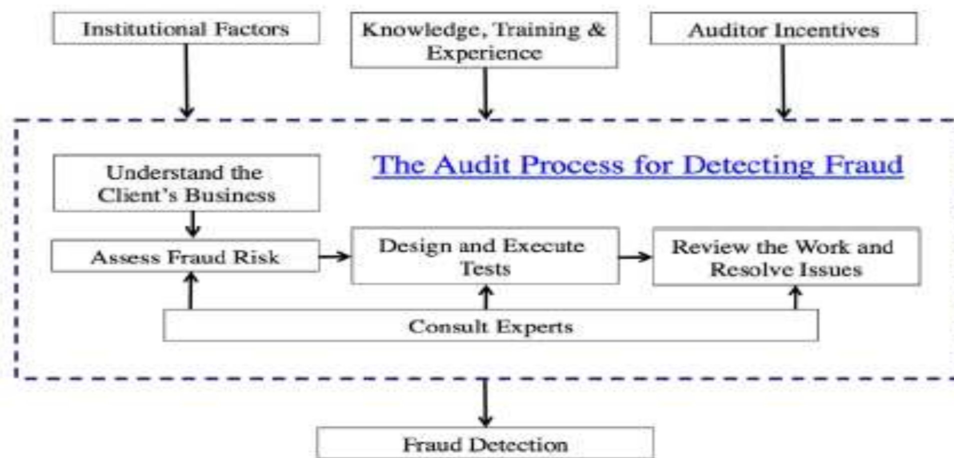
Fraud will normally involve misappropriation of assets. This would lead to 'creative' accounting to 'cover-up' for the missing assets. This implies the fraudelent financial statements will have misrepresentation. The clean audit opinion is an opinion that the financial statements are faithfully represented. Hence, the public view that auditors should detect fraud. Auditors are responsible for providing reasonable assurance that audited financial statements are free of material misstatements (due to fraud?). Nonetheless, prior research indicates that auditors detect relatively few significant frauds (Dyck et al. 2010, KPMG 2009).

Asare et al (2015) developed a framework that identifies four general factors, and elements within each factor, that may inhibit auditor fraud detection. The four factors are (1) the audit process, (2) institutional forces, (3) auditor incentives and (4) auditor KTE. The audit process is the methodology employed to search for and detect fraud. The effectiveness of the methodology is dependent on the three other factors in the framework. The factor labeled "institutional forces" includes the regulatory and legal environment. Auditor incentives include the financial and retention pressures faced by the auditor (e.g., expected litigation costs, loss of clients, etc.). Lastly, auditors' KTE includes the auditors' cumulative fraud knowledge and experience acquired through both formal and informal learning. (Asare et al page 65).

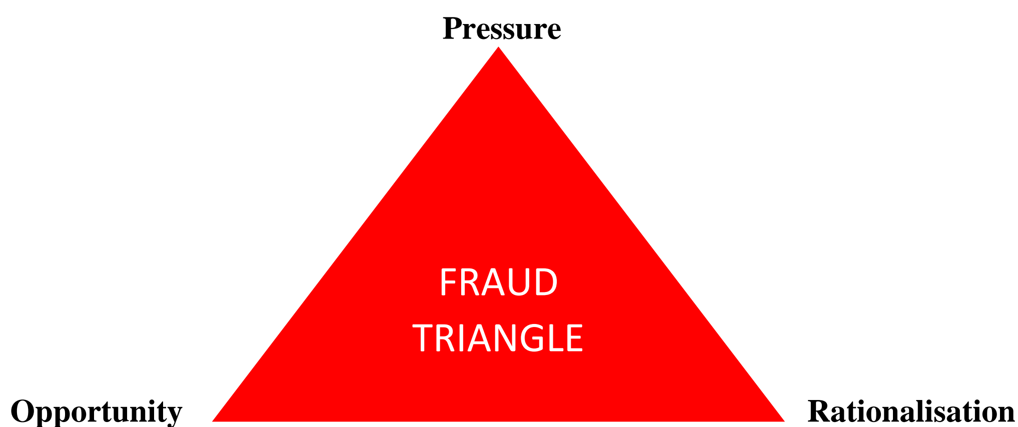


This paper looks at the Audit process factor and specifically 'assessment of Fraud Risk'. We argue that the Audit Fraud Triangle model (Cressey 1973) can be used for assessment of fraud risk. We look at two cases of fraud (Worldcom and Adelphia) to examine if the Audit Fraud Triangle could have helped in alerting the auditors to fraud risk. We then interviewed few accountants/auditors for their views on the use of the model.

Fraud Triangle

Donald R. Cressey (1973) has constructed a theory of fraud triangle to explain the factors behind the people who commit occupational fraud and it comprised of three key elements which leads to the fraudulent behaviour of the people, especially happening to those first-timers. They are the pressure, opportunity and rationalisation, which is shown below.

Diagram 1: The Fraud Triangle



Pressure

Pressure is the first factor that leads to fraud. People or employees are always facing different kinds of problems in their daily lives or even working fields. Mostly, employees receive so much of pressure from the superior to perform well and to get incentives. They wish to get things done to get promoted quickly. There is also pressure arising from bonus payments linked to company reported performance numbers. This is indeed pressure to manipulate reported earnings. Personal financial problems or debts or compulsive gambling addiction are pressures to commit fraud as well.

Opportunities

When there is such kind of pressure existing, fraudsters would start to seek for opportunities in whatever ways which they think possible and convenient. When the internal controls of management are weak, opportunities to commit fraud would tend to occur as fraudsters would think that internal control is weak and that no one would review their works, and thus they start to find loopholes to deceive others. The 'believe' that the external (or internal) auditors will not discover the fraud adds to the 'perceived' opportunity. A good system of corporate governance with adequate control procedures would reduce the opportunity.

Rationalisation

Hence, rationalisation starts to emerge when opportunity appears. People or employees would start to think that the things they do would not give any impact resulted from their fraudulent behaviour. To some cases, employees think that they are justified to get a higher pay for themselves or for their families or they may need urgent funds to settle before anyone notices. For the loyal employees, they think that they should do something to rescue the company from losses that company is facing without knowing that they are actually crossing redlines towards occupational fraud.

CASE STUDY

WorldCom

WorldCom first started as a small enterprise in 1983. Under the leadership of the founder, Bernie Ebbers, the company went public after several large acquisitions. WorldCom merged with Brooks Fiber Properties Inc. and CompuServe Corp in 1998, and Sprint Corp. in 1999. However, the merger with Sprint was ended by regulators in US and Europe to prevent the company from growing too fast (FOX News Network., 2016). The company announced that it had committed accounting fraud involving misstatement of $11 billion in June, 2002 (Javiriyah Ashraf., 2011).

Ebbers was obsessed with expanding his business through continuous acquisitions of other companies. Such an acquisition required a huge budget. Towards the end, Ebbers altered his company's financial details through portraying continuous growth to escape margin calls on WorldCom's stocks that were used to obtain loans (Theodore F. di Stefano., 2005).

The fraud scandal came to light when WorldCom was found to have committed improper transfers accounting for $3.8 billion in expenses that were not based on Generally Accepted Accounting Principles (GAAP). The $3.8 billion of operating expenses were discovered to have been recorded as capital expenditures that enabled WorldCom to spread its expenses over multiple years, thus allowing them to display an excess in net income and cash flows (Matthew D. Somerville., 2013).

Apart from that, personal loans of $341 million was found to be in Ebbers' account. Edders was then sentenced to jail for instructing the previous CFO, Scott Sullivan to alter the financial statement for the sake of achieving Wall Street's expectations, and to obtain personal loans that were backed by company shares (CBS, 2016).

The main influence that led WorldCom to commit fraud were motivation and pressure. Altering financial accounts brought in personal bonuses of $7.5 million for Ebbers and $2.76 million for Sullivan (Kristin A. Kennedy., 2012). By applying the fraud triangle attest mechanism, we can identify that WorldCom faced high risks of fraud. If auditors had adopted and applied the concept of the fraud traingle, they would have been alerted to this fact, and thus could have put more effort into identifying discrepancies in the companies' financial statements.

Aldephia

Aldephia was one of the five biggest United States cable companies before its bankruptcy in 2002. Aldephia was founded by John Rigas with his brother, Gus, in 1972. The business model was that of a family business, where the Rigas held major voting rights, and were majority members in the board of directors. The father, John was the founder and Chairman, while his three son and son-in-law, Tim, Michael, James, and Peter Venetis respectively, were the CFO, EVPs and board members of this business. The Rigas family held five out of a total of nine seats in the board of directors (Jerry Markon and Robert Frank, 2002).

The Rigases were allerged to have abused company funds for personal purpose. Some of the accusations against them included using the company's private jet for personal outings, using $252 million of company reserves to buy back company stocks as private stocks, and withdrawing company money to cover personal debts. Besides these, the Rigases also consumed an estimated amount of $12.8 million from company reserves to build a golf course. In the years 2001 and 2002, Rigases announced to their shareholders that the family would be buying back company stock in order to reduce pressures caused by company debts. However, this purchase involved funding that exceeded $400 million, which was taken from company reserves. Tim, as the CFO, had requested his employees to create false receipts that displayed payment made by the family to purchase the stocks (Jerry Markon and Robert Frank, 2002).

Fraud in this incidence occurred due to Adelphia being under the control of the Rigas family. Despite being one of the top five companies in the cable industry, its management ran similarly to a small-scale family business, where the CEO controlled every move by the company, and his children and in-law were part of the board of directors. Such ownership entitled the Rigases a unique class of balloting shares, and offered them plenty of good opportunities to commit fraud.

THE INTERVIEWS

Several interviews (8 in total) were conducted through face-to-face and via emails. The interviewees were all accountants, and 6 were in auditing. The salient points raised in the interviews are summarised in the discussion.

DISCUSSION

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Fraud can happen anytime at every level of a company. Audit requirements related to fraud have continued to increase and auditors are responsible to consider how fraud may occur. Audit testing and pre-audit have to be designed well to find out the possibility of fraud. It may be useful to do more unannounced audits that its element of surprise that can catch intentional misstatements of any companies when awareness is low. By performing hard close audit, auditors are able to identify potential issues and leave enough time before year end for the client to resolve, but this is only applicable to larger clients with better processes and systems. However, users of the financial statements seem to believe that auditors are able to detect fraud due to their reliable integrity and independence. Therefore, auditors should consider how fraud might occur and design audit tests to address. Fraud triangle may be quite useful to determine the “What Could Go Wrong” (WCGW). Auditors should always exercise professional scepticism to identify which staff would have opportunity. In doing so, possibilities are identified and then the fraud risk can be covered.

Using the fraud triangle model to assess fraud risk could identify high risk companies where additional testing can be done on the financial statements. More research is however required on the effectiveness of the Fraud Triangle Model and possibly testing other factors to arrive at a predictive model along the lines of the *z score* model.

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