



Report On

**“Analysis of Audit Frauds &
Roads to Detect, Prevent and
Respond: Real Cases Scenario”**



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Dear Madam,

It is an honor and great pleasure for me to present my project report on “**Analysis of Audit Frauds and Roads to Detect, Prevent and Respond: Real Cases Scenario.**” This report was assigned to me for the incomplete fulfillment of the requirement under BBA program of United International University. This analysis actually increased my knowledge a lot. This report has given me a different level experience. It might have huge uses in future.

I hope that it will satisfy your expectations. I respect your collaboration and I think you will call upon me with any queries caused by this report. Thanking you and looking forward to receive your gracious approval of my submission.

Sincerely Yours,



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Acknowledgement

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Executive Summary

Auditing is the word that means collecting and evaluating information and comparing that information with the established criteria. An independent and professional person should conduct audit. A professional and independent auditor always obeys to the audit standards and never takes any unethical decisions. But the real-life scenario is different. Most of the time audit procedures have not been done under proper ethical standards. After analysing most audit scandal cases, it was found that auditors had a lack of ethics and morality in their behaviour during the audit process. This report is prepared on audit scandals, frauds, and embezzlements. Prime concerns of this report are to figure out fraud conditions, types of fraud, auditor responsibilities, corporate governance, respond to risk, actions after fraud detections. As this report is made after analysing practical fraud cases like Enron collapse, WorldCom scandals, Tyco and American International Group (AIG), it will be useful for those who want to make them specialized in audit field.

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Introduction

Accounting profession is one of the top and reputed profession worldwide. But the word fraud sometimes makes it questionable and susceptible when huge amount of money laundering or making false financial statements intentionally. Shareholders and investors become the main victims. Some group of corrupt people are working together for this mischievous activities. It is very shameful and disappointing for the accounting professionals when they get to know someone is involved in frauds. So the main scheme of this report is to make analysis of auditing fraud on the basis of real fraud cases. Making a proper clarification about auditors' responsibilities and standards when they conduct any audit is another purpose of this report. Actually auditors are responsible for giving reasonable assurance. During audit, auditors main purpose is to detect material misstatement. It can be occurred by fraud or error. In this report management responsibilities and corporate governance guidelines are mentioned for prevention of fraud in organizations. Management can impose antifraud policies or arrange antifraud programme to reduce corporate frauds. After detecting any suspicious fraud, auditor should gather more evidence to generate a solid report. Most of the corporate fraud cases, internal auditors detect more frauds rather than external auditors. Auditors must give much more concern to detect material misstatement, because material misstatement is the major problematic issue for the company. When auditors prepare audit report, they should consult with expert audit team when they are facing indecisions. So it is important for the auditors when they face any doubtful situation they should consult with their seniors or expert audit team. This report is prepared after analysing some top fraud cases like Enron, WorldCom, AIG and Tyco etc.

Literature Review

Fraud actually describe any intentional deceit meant to deprive another party or person of their property and rights. Fraudulent of financial reporting means making an intentional mistake in amount or discloser to deceive the users. In most audit scenario, auditors have done mistake in amount intentionally rather than financial discloser. Misappropriation of assets means, theft of an organization assets or entities assets. In this case, mostly often internal employees have involved. [Alvin A. Arens, Randal J. Elder, Mark S. B easily; Auditing and Assurances services book]. Companies average loss five percent on its revenue. Most of the time externals parties are involved in that sort of frauds. [association of certified fraud examiners; 2007]. A recent study showed that accounting frauds cases are rising. Previously it was 294 from 1987-1997 and new 347 cases were added in the time of 1998-2007. The ratio of frauds was higher than previous period. [committee of sponsoring Organization of the Tredway Commission (COSO) 1998-2007]. Fraud of financial statement is not occurred newly. For the increasing rate of frauds, auditing professions set some standards. [McKesson-Robbins Fraud, 1938]. From another survey it was found that fraudulent of financial reporting is higher than assets misappropriation. [Association of certified fraud examiner]. Such as those fraud and false manipulation and misappropriation of assets are such a big shame for accounting and auditing world. But there is a question arise “why fraud occurs”? A recent study found that answer:

- Pressure to achieve personal aim and individuals gain 81%.
- Pressure to any task to achieve targeted goals 72%.
- Looking for personal achievement 70%.
- Thinking about not to be caught 41%.
- Not taking as unethical conditions 40%
- Believing passed by law easily 21%
- Fearing of losing job 20%
- Limited resources cause to be cut 8% [Oversight System Report on Corporate Fruad,2007]

US congress actually brought a new reward system to minimize fraud. And they imposed a new law. Most concerning issue is by violating this law that brings an immediate to section \$ 1million. [US. SEC Annual Report on the Dodd- whistle blower Program-2011].

Objectives of The Report

In accounting world many frauds are happening. The most concerned issue is global business patterns are changing due to globalization and so frauds patterns are also changing. This report is prepared by analysis of last couple of years' multibillion dollar audit scandal cases. The main objective of the report is to define audit frauds and find out different audit frauds occurred by manipulation of auditors and company. However, the more specific objectives are as follows: -

1. To state the conditions/ situations for fraud.
2. To explain auditors' responsibilities for assessing the risk of fraud and detecting material misstatement due to fraud.
3. To explore corporate governance oversight to minimize fraud risk.
4. To find out how the auditors respond to the risk of fraud.
5. To identify activities after fraud is suspected and detected.

Methodology

Several cases of audit frauds of last couple of years collected from internet were used as the sources of secondary data. This report has prepared under a descriptive analysis of the information collected from previous accounting fraud cases.

Review of Previous Audit Scandals

Enron: It was formed in 1985 by merging Houston Natural Gas company and Ohama based InterNorth incorporated. By following that merger Kenneth Lay became the CEO of Enron company. Very quickly Enron became the most energy trader and supplier in market. Very soon the company became the multibillion dollar business in USA. But that was the end because there had been huge frauds were working behind the actual scene of the company. The big reason behind that sort of fraud occurred was that time Enron followed the mark to market accounting to record. This method can work very well for trading business but it is too much disastrous for actual business. The Enron actually tried to show estimated profit instead of actual profit. On the other side Arthur Andersen was the one of the top five audit firm in USA worked side by side with Enron. Andersen was overlook Enron accounts for several years that created lack of independency for that audit firm.

WorldCom: It was not only the biggest accounting scandals in USA history but also it had biggest bankruptcy. WorldCom recorded their expenses as investment and reported profit instead of loss. They actually inflated their financial statements. WorldCom actually manipulates the investors and its shareholder by showing false financial statement. When Arthur Anderson was suspected for Enron collapse that time WorldCom was filed for bankruptcy. Arthur Andersen was reviewed WorldCom financial statements and later found that auditors of Andersen just skip the memos that found from the WorldCom executives.

Tyco Electronics: Tyco was the world largest electronics parts maker, fire protection parts maker and provided electronics security services. CEO of Tyco and some board of directors gave themselves without interest \$150 million and that loan was never approved by the board. They also sold \$600 million of assets without informing their investors. In 1999 SEC of USA received report which did not cover the policy of GAAP. After two years' investigation they found that total earnings of Tyco were not reported. Finally, they were caught and sentenced to pay \$1.6 billion to the investors. PWC was the auditors of Tyco electronics and lastly they had to pay \$225 million to Tyco investors.

HealthSouth Scenario: Encompass Health Corporation formerly known as Health South was one of the biggest post-acute health care services provider in USA. CEO of HealthSouth was accused to disclose falsely report and exaggerated company earnings to meet shareholder expectations. HealthSouth was accused by SEC for falsely inflated financial report by \$1.4 billion. CEO of HealthSouth sold \$75 million of stock before company faces a major loss. In 1998 CEO Scrushy was accused by SEC for violation of SEC Acts. However, after 4 years he was sued file to pay \$2.8 billion to the company.

American International Group: When it had handed a government bill about 150 billion dollars after that AIG frauds was occurred. According to Financial Oversight Council, AIG was too much risky to run their activities in SEC. Because for their massive debt it was not a wise decision to let them carry out their business. In 2013 they repaid their debt to their shareholders and investors and finally they were survived. Here the role of US government was also remarkable because when AIG hung on threat and it was determined that the company was so much important to play vital role on global economy, then US government decided to make \$22.7 billion interest payment for AIG.

The Conditions/ Situations for Frauds

Definition of Fraud

Actually fraud is occurred when there have any intentional and personals goals are involved. There are two types of frauds those are bellows:

1. **Fraudulent Financial Statement**
2. **Misappropriation of Assets**

Fraudulent Financial Reporting: It is an intentional misstatement or discloser to mislead the users. In most scenario intentional misleading of financial statements occurred more than disclosers. As example, WorldCom was showed fixed assets instead of recording those as expensed. From studying most frauds cases it was commonly found that most companies are showing overstate of their net income by hiding their actual income or loss. In private company this may be done by reducing the taxes. Sometime companies are willingly understating their income when their earnings were high because for that high income they have to create a reserve of earnings. Those practices are commonly known as smoothing the income and the earnings in future periods. Management usually takes some effective actions to manage earnings to achieve their organizations goals. Smoothing of income is one kind of earning management policy. In that system revenue and expenses are shifted between accounting periods to reduce probable fluctuations. One common method to make smooth income by reducing the value of inventories and assets during the time of acquisitions. It can generate higher earnings when assets are actually sold in market. Although less frequent several notable cases of fraudulent financial reporting involves inadequate disclosers. For example, in the case of Enron, that company adequately disclosed obligations to affiliates known as special purpose of entities.

Misappropriation of assets: It is recognized as stealing of an entity asset. There has some common stealing policy those are bellows:

- Making pay for goods and services that actually not occurred in real scenario.
- Trying to use companies' assets for personal purpose.
- Making embezzled payments or receipts.

There are various different types of misappropriation of asset frauds those are follows:

- **Skimming** – theft of cash before the funds have been recorded in the books of accounts.
- **Abusing Credit Cards** – using organizations credit card intentionally for personal use.
- **Showing False Payments:** In that case, employee of a company submits false invoices for payment.
- **Unknown Employees:** Here showing payroll checks at the name of unknown and not exist employees.
- **Showing False overtime:** Here employees claim and add extra false overtime hour.
- **Doubtful Expenses:** Showing some expenses that actually not occurred.
- **Stealing of assets:** At the name of company purchase some extra assets and finally stealing those.
- **Using assets for personal motive:** Using offices equipment like computer, printer, software for personal intension.

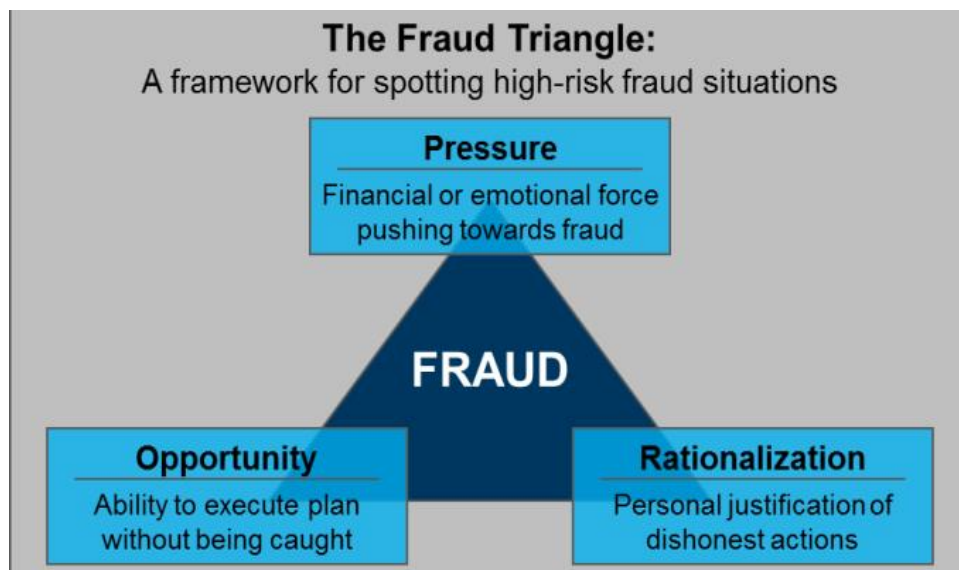
There are some circumstances that indicates misappropriation of assets those are follows:

- Missing some bank claques or miss out the sequences of bank checks.
- Recording bank reconciliation items without proper explanation.
- Some abnormal approval of checks and invoices.
- Missing cancelled or unauthorized checks.
- Some unusual transactions that have insufficient supporting documentation.
- Getting complaints from suppliers.
- Showing false attendance record.
- Unauthorized person signed the attendance records.
- Unusual suppliers or customers' names and addresses.
- Copies of invoices, purchasing etc. documents rather than the original.
- Insufficient quantities or amount of orders which are not consistent with the organization's objective.

Reasons Behind Fraud

The Fraud triangle is a framework that actually explain the reasons behind an employees or executive's decision to commit corporate fraud. Those three stages are given below: -

1. **Pressure:** Most of the cases, companies' employees are pressured to conduct unethical activities. It does not make any sense to the outside observers but it creates huge crisis internally. It can be showing bad debts, hiding profit, or showing extra profit etc. Personal greed or family pressure also can be involved.
2. **Opportunity:** In that case opportunity must be presented to commit the crime. Fraud situation always not occurred but there have some opportunities come that greedy management or employees can avoid. It happened mostly when employees get to know there is no chance to be caught because there have some companies who do not have any anti-fraud policies.
3. **Rationalization:** This means a person commit an illegal act. When employees involve any confidential task he or she must judge his or her personal willingness. Most of the time they just only think about money rather than morality.



Auditors Responsibilities for Assessing the Risk of Fraud & Detecting Material Misstatement Due to Fraud

Audit standards give the guidelines to the auditors in case of assessing the risk of fraud. Auditors must maintain a level professional scepticism when they consider a broad sense of information like risk factors of fraud to identify and respond to the fraud risk. Professional scepticism means auditors assume management/ governing body is dishonest or assumes unquestioned honesty. In real life case, to practice proper audit standards is quite difficult. It is more difficult when material misstatements are detected. Most auditors never face any material frauds in their life time.

Questions to Mind: In every audit process, audit team must set a question in mind or they can write down those in a note. They must do it before involving to find out fraud risk and evaluation of audit evidence. When pressure is huge that may be difficult for the audit team to detect proper reasons.

Effective evaluation of Audit evidence: When discovering other information and evidence that indicate there have chances have some material fraud in that cases auditor thoroughly have to probe that issue by analysing more deeply and collect more extra and solid evidence. They can consult with some expert team. Auditors always keep in mind that they never assume some misstatement as an isolated incident. The auditor must evaluate whether it is an intentional fraud or just errors and this misstatement are likely to be occurred or not.

Auditor Responsibilities Regarding Fraud

Due to frauds, accounting professions are affected and lost their reputation recently. Auditors and Management must understand their roles so that they can prevent it. According to ISA240, auditors must have some responsibilities that they must follow during their audit process. They must give concern whether this fraud is arising from intentional or unintentional circumstance. Point to be noted fraud is a criminal activity. So only auditor can play a major role to detect it. But auditors can not only prevent it. There needs a proper legal system.

There are two types of frauds: -

- **Fraudulent of Financial Reporting:** Here intentionally management hide the actual information and misstating the accounts.
- **Assets Misappropriation:** It means stealing companies' assets or using those for personal purpose.

Responsibilities of External Auditors

The main target of the external auditors to get reasonable assurance. When they are checking financial statements and other documents they should find out whether it was caused by fraud or error. Auditors must consider risk of material misstatements. To detect fraud auditors must maintain their professional ethics. When they faced any critical situations they must consult with their senior or expert audit team. After identifying fraud risk, they should discuss about it with the management or governing body before generating the report. When performing assessment risk, they should consult proper between them and try to gather accurate information. Sometimes they can do enquiry if they feel need of it. They can enquiry corporate governance, employees, management to gather the accurate and actual information. There has some unavoidable risk that auditors must consider those facts during audit process. Sometimes frauds are so organized that it is too difficult to detect because risk was higher than the errors or theft of some little amount that they may not notice.

Fraud Reporting

When auditors determine frauds they should inform it to the top level management. But if management involves in such frauds they should inform it to the governing body. If the governing body has lack of integrity they should consult with legal advisor for proper investigation. It is their huge responsibilities to report about suspicious activities to the authorized body. Because auditors are not being liable if they do such act. When any crisis arise then government cannot blame auditors. So auditors main task to clear their path by maintaining proper audit policies.

Responsibilities of Directors

The main responsibilities of directors to prevent and detect frauds. They can implement proper effective and efficient system in internal control. They can reduce possible frauds by implementing systems. They must be well conscious about to change procedures and features. They can modify the policies if they think to change it.

- To estimate the potentiality of frauds
- To evaluate fraud consequences
- To give recommendations about fraud preventions

Sources of Information to Assess Fraud

Communication among Audit Team: Auditing Standards require the audit team to make communication with other audit expert and sharing the information and the initial result they got from the investigation and sitting group to do some brainstorm to find out the excellent idea from the members.

Inquires of Management: Audit standards also require to inquire with the management if they got any suspect information and for further evaluation they need more solid answers. Sometimes they can communicate with company employees or can talk with governing body to find out proper and solid statement. Audit team plays a vital role to assess risk and inquiry process. External auditors can consult with internal auditors to detect any intentional performance.

Audit standards also need to inquire with those people who actually work inside and outside both of the corporation. When auditors inquire with the supplier, employees or managers, they should find out the answer tactfully whether there is any financial crime fact hided or not. By consulting with various employees they can understand about the risk of fraud. When there is lack of evidence or information they should gather more solid and accurate information for further analysis.

Risk Factors: Auditors must find out the reasons behind frauds. It can be created from pressure or can be created from opportunities. They make employees to do some unethical actions. Sometimes fraud illusions can be occurred, but there have not any fraud after all.

Analytical Procedure: Auditors must perform analytical procedure to identify actual risk and fraud that made within the financial report. When results from analytical procedures are different from auditor estimations auditors should use those information as a light with other information. Because occurrence of fraudulent financial reporting often involves manipulation of revenue, in that situation the auditor need to perform analytical procedures on accounts.

Other Information: When auditor conduct audit they should consider all information that they gather from valid sources. Sometimes invalid information can create a major problematic issue. Before risk evaluations they should be well informed about some specific issue and then create decisions.

Corporate Governance Oversight to Minimize Fraud Risk

Management actually responsible for implementing corporate governance and steps for further minimization the risk of fraud. Fraud risk can be minimized through combination of prevention, deterrence and detection process. Because collusion and false documentation make detection of fraud very much challenging and complicated. By establishing anti frauds programmes and controls management can prevent internal accounting fraud in their company. There has some guidance by AICPA those are: -

1. Culture of honesty and ethics
2. Responsibilities of management to evaluate fraud risk
3. Audit committee oversight

Culture of Honesty and Ethics: Most recent research showed that to detect and prevent fraud company should impose some antifraud programmes. Those programmes should follow the pattern of company code of conduct. Those code employees can use as their guidance. It was found that those provides a culture of honesty and ethics. There have six elements that create honesty and ethics culture those are:

1. **Setting environment at top level:** Management and governing body should set corporate environment in such a way so that it gives a mirror picture of corporate ethics. Management should reward those who follow the honesty and integrity. That actually work as a motivation among employees. Management has to behave in unbiased way. Guidelines should be more specific that employees can easily understand what should be prohibited or permitted.
2. **Creating Positive workplace:** There have some internal and artificial pressure that is created inside the company. Those pressure creates a fear among employees so they sometimes involved in fraud unintentionally. So management has to ensure a positive workplace. A positive work environment can improve the ethical conduct among employees. They do not have to face the fear to loss their job. Employees should take advices from higher authority before making any decisions.

3. **Hiring and Promotion for employees:** Every company must employ such effective and efficient policies so that frauds in work life minimize and proper implementation works to reduce the likelihood of hiring and promoting individuals with low levels of honesty, especially those of hiring and get promoted with low level integrity and whom holding positions of trustworthiness. So before offering such valuable positions their background should be well checked.
4. **Training:** Employees should get proper training about ethical code of conduct. The duties should be well informed to the employees and they need to understand properly. In addition, company can conduct fraud awareness training programs for their employees.
5. **Confirmations:** Company should set some responsibilities timely basis and they should inform to the employees. Company should arrange some seminar programed so that they can consult with their code of conduct with the employees
6. **Discipline:** Employees should keep in mind that if they violate company code of conduct they will be accountable. So this way they should be in discipline manner. When any of them violates the rule they should be punished, because that give others a clear message to compliance with the rules and regulations.

Responding to the Risk of Fraud

Response According to Fraud Risk

The auditor must have to discuss the findings of fraud risk with the governing body to obtain their opinions of the potential for fraud and existing controls designed to prevent or detect a material misstatement.

Responses to Address at the Beginning Level:

- Design appropriate procedure and process
- Changing the nature and time
- Extent bigger evidence and proof properly
- Timing the conduct substantive testing and evidence at the end of period rather than based on intermediate data (timeliest evidence)
- Nature obtain more reliable and relevance evidence

Responses to Address Management proper controls:

- Examine all the journal entries and other adjustments for evidence of possible misstatements due to fraud.
- Review accounting estimates for accrual and cash basis
- Evaluate the business rationality for significant unusual transactions
- Update Risk Assessment Process and procedure

Concerning issue during audit:

- Lack of accounting records.
- Missing audit information.
- Unusual relationship among auditors and management.
- Suspicious information at the stage of analytical procedure.
- Inconsistent inquiries that are completely against the collected information.

Activities after Fraud is Suspected and Detected

Fraud is actually detected by the management, internal auditors, or by an incident. Research showed that 47% fraud actually detected by tip and a little portion actually detect by the external auditors. Throughout the whole audit process auditors mainly figure out whether there is any sign of material misstatement due to fraud within the information they accumulated. When fraud is suspected then auditors give one more step for evaluation to investigate actually that fraud incurred or not. There has some process for further evaluation those are given below: -

Use of Inquiry: Inquiry is an effective technique to gather evidence. Through that process auditor can figure out some non-disclosing issue or get the idea from the posture or gesture of the speaker. For further evaluation auditors can modify the question by watching the initial expression of the interviewees. Categories of Inquiry: - there have also some other types of Inquiry process that helps auditors to collect proper information during the time of investigation, those are: -

- **Informational Inquiry**
- **Assessments Inquiry**
- **Interrogative Inquiry**

Other responsibilities when fraud is detected:

When fraud is detected and auditors may assure about that the chances ratio of fraud is high then with the side of inquiry auditors may use other techniques for gathering more information those are:

Audit Software: there have some software like ACL, IDEA those are used to detect frauds. Auditors can use that software by sorting out account transactions or balances into subcategories for further investigations.

Other Audit Implication: Audit standards require the auditors to consider implication for other aspects of the audit. Suppose auditor found a little imbalance occurred in petty cash amount but it's not a big deal for them until it does not reach to the management committee. But still it is the responsibility for the auditor make proper evaluations and justification to give any decisions.

Findings and Analysis

1. According to first objective of this report, the conditions/situations for fraud that have incurred on the basis of practical fraud cases like Enron, WorldCom and Tyco scandals have been identified. From the first objective it is targeted to know why management and employees are involving in fraud and cheat with their shareholders and investors. After giving a deep thought on some previous cases it is found out that there has some external pressure or there have some opportunities created that make them greedy or lack of ethical values.
2. Second finding is that auditors' responsibility for assessing the risk of fraud and detecting material misstatement due to fraud when they are involving in investigation. From real life case analysis, it has been found that auditors actually did not give proper response when they were assessing fraud such like world recognize audit firms like Arthur Andersen, PWC, E&Y. They performed less when they audited those billion-dollar company and some of them were involved in corruption.
3. Third one is corporate governance oversight to minimize fraud risk. Actually a company is created and controlled by the rules and regulations and that is known as corporate governance. Governing body of the company should impose such guidelines so that employee and managements are liable for any types of unethical activities or errors. From real case scenario it has also been found that many types case filed against those frauds and new acts were imposed; specially Sarbanes Oxley Act (2002) was created after the major fraud of Enron.
4. The fourth objective is how the auditors respond to the risk of fraud. From the real life case scenario, it has been analysed that Enron scandal risk was so high, on the other side AIG fraud scenario was different. So on the basis of the risk of fraud auditor has to change their responds and process of planning to conduct audit process.
5. Last one is identifying activities after fraud is suspected and detected. For making audit process more perfect according to audit standards, auditors must collect justified data on the basis of the evaluation. Because on the basis of that evaluation, whole company and shareholders' destiny will be determined.

Recommendation

From that analysis, it has been found that fraud was occurred and it will be. But giving a little effort an auditor can save thousands of employees, shareholders and their families. After identifying conditions/situations for fraud audit team first determines whether it is fraudulent financial statement or misappropriation of assets. On the basis of it, they should design their audit procedure. They should evaluate the reasons behind fraud, because it is very much important in an audit report. After evaluation, audit team must assess the risk of fraud and they should collect accurate information from accurate sources. Auditors also have some responsibilities when fraud is detected and suspected and there have some audit standards what they must obey and follow during audit process. And to minimize fraud is not only the duty of auditors but the governing body should also come forward to detect and minimize fraud. Policy maker and International accounting and auditing association should bring some remarkable policies so that in future the cases like Enron, WorldCom, Tyco will not occur again.

Conclusion

During the audit period, there have only two types of fraud can be occurred that is Fraudulent of financial statement and another one is Misappropriation of Assets. After analysing practical fraud cases, there have most cases where auditors and management both have involved in fraud. In this report, the roles and responsibilities of auditors have clearly been mentioned when they deal with fraud. To understand the fraud according to the situation and identify the risks are the big important issues in audit procedure. Auditors must collect solid and accurate information from valid sources so that they do not take any wrong decision during audit analysis.

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