Fraud, Collusion and the Financial Statements—A Refresher for Practicing Professionals

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ABSTRACT

Financial statement reliability is the cornerstone of business. Internally prepared company financial statements – the Balance Sheet, Income Statement, Statement of Cash Flows, and Statement of Owners Equity are the documents internal and external users review to determine the financial status of a business. Management, financial institutions, investors, and even competitors rely on this financial information. This reliance is based on the financial statements being accurate in all material respects. If financial statements that are deliberately altered by management, either through collusion of management or between management and the internal or external auditors, are relied upon, this affects a myriad of other entities.

Keywords: Audits, Auditors, Fraud, Collusion, Financial Statements, Discovery

INTRODUCTION

Ever since the accounting scandals of the early 21st century and the subsequent passage of the Sarbanes-Oxley act auditors have found themselves responsible for a much higher level of diligence when it comes to preparing financial statements. Even those accounting professionals who may or may not be doing auditing but rather client write-up work must be professionally aware of the increased emphasis on fraud detection required since the heavily fraud based environments at Tyco, Enron, WorldCom, and the other players in the pre-2002 accounting meltdown. Fraud, it seems, is the darling of the current accounting landscape.

While most business people and accountants would probably agree that the majority of fraud in organizations is perpetrated by ordinary employees who find themselves in extraordinary situations and consequently make bad decisions. Most business people and accountants would probably also agree that the majority of fraud in organizations is not material from a financial statement point of view. Most business people and accountants would probably also agree that the majority of fraud incidents are carried out by individuals were internal control may be weak or nonexistent.

The larger issue, if accountants are to learn anything from the major financial scandals and subsequent implosion of large companies, has to do with serious fraud that can attack the financial foundation of clients whether small, medium, or large. When looking at the highly publicized accounting disasters at the likes of Tyco, Enron, and WorldCom, collusion between multiple employees arguably played a major role in the subsequent events that damaged or destroyed those firms. Even in common small to medium-sized firms, the ability of employees to collude in perpetrating fraud against the employer probably occurs on a regular basis demanding that accounting professionals pay diligent attention when opportunities for such collusion exist.
This paper reviews a qualitative study of companies where financial statement fraud occurred and how it was revealed to auditors. It also reviews Statements on Auditing Standards and Audit Promulgations set forth by the AICPA Auditing Standards Board. Of course, not every SAS or AU could be reviewed for this paper; the authors presented the ones most pertinent to the current research. Additional written research was reviewed to determine not only how by why individuals commit fraud.

The Financial Statements

Reviewing fraud in financial statements, especially when collusion among management exists, requires a multi-pronged approach. This paper reviews the following questions:

1. If upper management colludes with the board of directors and/or internal auditors in financial statement fraud, is said fraud detectable by external auditors? We conclude that it often is detectable when auditors review the financial information with a critical eye, questioning and reviewing all appropriate data.

2. An auditor’s role is to review the financial statements that are the responsibility of management. The auditor must determine whether the financial statements fairly present the financial status of the company in all material respects. Will an independent auditor always find fraud in the financial statements? What is an auditor’s responsibility when engaged to audit the financial statements of a company? We conclude that the cornerstone of an auditor’s responsibility is based on materiality.

3. Why do these internal and external auditors collude to produce fraudulent financial statements? The easy answer is, of course, money. Is there more to this collusion than just the promise of additional revenue and profits to all involved? We conclude there are multiple rationalizations for why people commit fraud, and the more these rationales are understood by auditors, the more auditors can use this information to find fraud in the financial information.

The financial losses created in financial statement fraud are staggering. The Association of Certified Fraud Examiners (ACFE) recently published its 2013 Report to the Nations on Occupations Fraud and Abuse. According to this review by the Association of Certified Fraud Examiners, fraud and the losses caused by fraud can be broken down into three primary categories:

<table>
<thead>
<tr>
<th>Type of Fraud</th>
<th>Percentage of Cases</th>
<th>Median Loss of Fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Misappropriations</td>
<td>85%</td>
<td>$130,000</td>
</tr>
<tr>
<td>Corruption</td>
<td>37%</td>
<td>$200,000</td>
</tr>
<tr>
<td>Financial Statement Fraud</td>
<td>9%</td>
<td>$1,000,000</td>
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Financial Statement Fraud, although seen in the fewest number of cases, has the largest median loss by far. Because these numbers are so high, management, internal auditors and external auditors are always cognizant of fraud and the potential for fraud.

Colluding – Working Together to Commit Fraud

When upper management colludes with the board of director or internal auditors to instigate financial statement fraud, can this fraud be detectable by external auditors? An auditor’s role is to review the management-prepared financial statements, in all material respects. This review requirement does not mean an auditor will always find fraud in the financial statements. If an auditor does not detect the fraud, has the auditor performed a sub-standard job while auditing the financial statements? What is the auditor’s responsibility?
A review of collusion asks us first to review the actors in possible financial statement fraud. Three groups: management, the company’s board of directors, and the internal auditors, hold the ultimate responsibility for a company’s financial statements. These three groups act independently and together to create the financials. Management’s primary responsibility is to gather the accounting data and prepare and produce the financial statements. The Board of Director’s ultimate responsibility is to review management’s process and the final financial statement product. The Internal Auditor’s responsibility lies with assessing fraud risk and determining the functionality of the company’s internal controls.

What happens when one or more of these groups work together to produce false financial statement information? Barron’s Dictionary of Business Terms defines fraud as an “intentional deception resulting in injury to another.” The definition continues “Fraud usually consists of a misrepresentation, concealment, or nondisclosure of a material fact…” What if these groups agree to intentionally conceal or misrepresent a material fact, such as management deciding and the board agreeing to defer an expense that should be reported in a current time period to a future time period? By deferring this expense, bottom line profit will increase in the current financial period, which is seen as a good thing by management. If both management and the board agree to create the proper paper trail for this transaction, because they agree it is necessary, then it will appear on paper to external auditors that this is a legitimate expense in a future time period. How can an external auditor then discover this misstatement? The auditor has a responsibility to review all transactions with a critical eye. The auditor can and should ask questions of all financial personnel to gain an understanding of the timing of transactions. Any answers given by personnel that appear to lead to the changing of the timing of financial data should be brought to upper management or the audit committee.

The Material Misstatement

What is an external auditor’s responsibility for finding and reporting this misstatement? The American Institution of Certified Public Accountants, Audit Promulgation 316 (AU 316), Section 110, Responsibilities and Functions of the Independent Auditor, states “The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” Certified Public Accountants discuss their requirement is simply to determine that the financial statements are free from material misstatement, not any misstatement at all.

A real-world example may shed some light on materiality’s role in detecting fraud. If an audit team is assigned to audit a bank and if this bank as $50 million dollars in assets, the materiality threshold may be approximately $500,000. This bank usually counts and packages its dollar bills in groups of 50 or 100. At this bank, the teller manager and 2 tellers slide a one hundred dollar bill out of the packages, on a weekly basis. The manager and these tellers collude and each takes one or two one hundred dollar bills each week, for a total of $500 each week. They each know the others are doing this and no one is turning in anyone to management. Each teller and the manager are also falsifying all records to show their cash drawers balance. Are they committing fraud? Absolutely. The total cash reported as an asset of the bank is clearly wrong on the financial statements. Will this fraud be determined by the auditor? Maybe not. Auditors will count some of the bundles of bills, but not every bundle. Even if they picked one of the packages with one missing bill, is that enough to point to fraud, or would an auditor simply blame it on the automatic bundler being off one bill? If the cash count is only off by $100 and the materiality threshold is $500,000 the $100 is simply not material and may not require further investigation by the auditor. Without further investigation, would the auditor catch this collusion? Probably not, unless each
drawer was tested and a missing bill was found in each drawer. This type of pattern would lead an auditor to ask questions and seek additional information on these transactions.

What makes a misstatement material? This varies from company to company and auditor to auditor, making fraud perhaps even easier to cover as a manager. Barron’s Dictionary of Accounting Terms defines materiality as the “magnitude of an omission of misstatement of accounting data that misleads financial statement readers.” Materiality is judged by two factors – auditors must review both the amount and size of a transaction and the nature of an item. An example given by Barron’s is that even a small theft by the president of a company would be material. Additionally, a large misstatement of a revenue account whether by error or fraud would also be material, whereas an error of a small amount, caused by a mathematical mistake would not be material.

Materiality is an elusive concept. The theory behind materiality is that a small error or misstatement will not cause a large problem with the financial statements. For example, transposing numbers and recording an expense for $15 instead of $51 would only create a $36 dollar error in the financial statements. In most publicly traded companies requiring an audit by an independent accounting firm, this $36 error is not material and would not create such an error in the financial statements such that they financial statements could not be relied upon.

The Financial Accounting Standards Board (FASB) does not give any specific definition as to what is or is not material. When planning an audit, accountants look at significance or size of a transaction, and likelihood or probability it will occur. Auditors reviewing materiality usually begin with a size calculation. For example, if total assets are $1 million, an auditor could determine anything over 1% ($10,000) or perhaps 5% ($50,000) or even 10% ($100,000) of that number could be the threshold for materiality. This materiality number is at the discretion of the auditor, based on past experience, probability of fraud, and size of the company. An auditor does not review every transaction, but instead picks a sample of each type of transaction, again based on size and probability of fraud. Once determined, that threshold is the number an auditor will use to determine what size transaction to review, how many transactions to review, what not to review, and what changes, if any, should be made.

Reliance on the materiality threshold creates an issue in determining fraud, especially if there is collusion among management or management and auditors. If an auditor has audited the company’s financial statements in the past, management has knowledge of how the auditing firm will determine the materiality threshold and what that number should be. Very often auditors simply look to “what they did last year” and make the materiality determination similar to the prior audit’s threshold. If management knows this threshold from prior years, management can easily make any journal entries, transactions, or falsify accounts under that materiality threshold. The odds are, if the transactions are spaced apart, not rhythmic or in a pattern, and are under the materiality threshold, the auditors may not even question those transactions. The only way those transactions might get pulled for review is if they are chosen in a random sampling. One of the tests auditors perform is to randomly choose transactions to confirm their existence and check any back-up documentation. However, usually those transactions are chosen randomly by a computer and are a small percentage of the overall transactions. If a company has a large number of transactions each year, odds are slim that the false transactions will be randomly chosen.

What can an auditor do to combat this materiality conundrum? Auditors should ascertain at every audit that the materiality threshold chosen in the audit is not just picked because it was done the same as last year, but rather than the transactions, assets, and size of the company match with the materiality number. An auditor firm should be savvy enough to change the materiality and look at extra transactions
from year to year. Unusual transactions need also be identified each year and reviewed, even if they fall outside of the materiality threshold.

The Auditor’s Responsibility

When a company unexpectedly declares bankruptcy or is found guilty of fraudulently preparing financial statements, one of the first questions external users ask is “why didn’t the auditors catch this?” What is an auditor’s responsibility to detect fraud? In 2002, in response to the many large companies who failed after falsifying their financial statements, the AICPA’s Auditing Standards Board issued the Statement on Auditing Standards (SAS) 99 – Consideration of Fraud in a Financial Statement Audit. This standard, effective beginning 2003, provided additional guidance to auditors in how to detect material fraud in financial statements. Some of the items emphasized in SAS 99 are the importance of exercising professional skepticism, the discussion among engagement personnel regarding the risk of material misstatement due to fraud, and communicating fraud to the audit committee and management.

Alan Reinstein in his article “SAS No. 99: new auditors’ responsibilities for detecting fraud” found in the July-August 2003 volume of The RMA Journal, noted SAS 99 requires auditors to do what auditors thought they were doing all along, most presumably detecting fraud. According to SAS 99, auditors need to exercise more professional skepticism. The entire audit team needs to be aware of the possibility and potential for fraud. Auditors have a duty to ask questions, dig deeper into transactions, and seek errors and misstatements, even if this client is someone they have known for years and someone with whom they have a good working relationship. Auditors should also conduct more thorough inquiries of management by discussing fraud directly with management and report any findings. Reinstein outlines that under SAS 99, auditors need to assume fraud is occurring and determine a system for detection.

Another responsibility of auditors is their need to consider management’s ability to override internal controls. An accounting internal control is defined by the Public Company Accounting Oversight Board as

“those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.” PCAOB, Auditing Standard No. 5, 2007.

In theory, internal controls provide a framework that maintains records and ascertains the only authorized transactions are being made. Auditors need to test internal controls and determine whether any can be overridden by management. If these controls can be overridden by management, this should be a red flag to auditors to conduct further testing.

Another aspect to be considered by auditors in evaluating the audit findings is the likelihood of fraud. This means the audit team needs to review any findings of misreporting or errors and determine if they might point to fraud, or if put together, all errors point to fraud. A cornerstone requirement of SAS 99 requires that the auditors report any fraud findings to key parties. These key parties must be a level of management at least one level above where the fraud occurred. Sometimes that means reporting fraud directly to the Board of Directors.
Finally, management along with their auditors and accounting professionals must accept the fact that even the most diligent and well-planned audit program, or the most diligent preparation of client write-up documents simply cannot detect every instance of fraud that may have occurred within a company. Understanding the statistical underpinnings of the auditing profession makes this perfectly clear because in order to catch every instance of fraud every transaction would have to be examined, something that would be both financially and practically unfeasible. When all is said and done the performance of a fraud audit, which specifically examines financial records for fraudulent activity, may be the only way “to satisfy the expectation that financial statement auditors always detect material financial statement fraud.” (Albrecht & Hoopes, 2014)

However, even with these stronger audit functions, the underlying determination for an audit is materiality. The Independent Auditor’s Report will state that in the opinion of the auditor, the financial statements present fairly, in all material respects, the financial position of the company as of a certain date. The report also clarifies that the financial statements are the responsibility of management. The auditor’s responsibility is merely to express an opinion on the financial statements based on the audit. They have no actual responsibility to detect fraud, and if it is hidden by management, the auditors may have no ability to detect fraud.

**Why Do People Commit Fraud?**

In reviewing collusion and the financial statements, auditors must consider what motivates employees, management or the board of directors to work together to create fraudulent financial information. Is it because of the increased revenue the company is making or is it simply to keep the company afloat during troubled times? Is there more to this collusion than just the promise of additional revenue and profits to all involved?

The Center for Audit Quality produced an article “Deterring and Detecting Financial Reporting Fraud – A Platform for Action” in October 2010. In this document, it reviewed individuals’ rationalization for committing fraud. The articles outlines that usually individuals agree to prepare fraudulent financial statements when there exists an “extreme pressure to meet corporate financial goals.” (5). Employees or management may determine they have no other choice but to commit fraud to save the company, and therefore their jobs and livelihood.

With the advent of Sarbanes-Oxley and the subsequent examinations of internal control required by the act there may be a misperception on everyone's part that fraud in collusion are somehow a thing of the past. In reality the opposite may be true. Even in a perfect internal control atmosphere the lack of controls aimed at the top level of management rarely exist which from a practical standpoint may render management fraud unstoppable (Tipgos, 2002). This was clearly illustrated by the transgressions at WorldCom involving the CFO and lower level accounting employees. According to Tipgos (2002) the best way to reduce upper management collusion is through the development of a better system of corporate governance rather than the imposition of more internal controls. As Curtis Verschoor pointed out, the fraud perpetrators' place in the organizational hierarchy has a direct correlation on the amount of loss suffered from a fraudulent activity. He reports that while owner or executive involved fraud represents less than 20% of all of the cases reported, the median loss from each incident was $500,000 or more (2014).

In companies where intentional misstatements or fraud in their financials are discovered, more probing will usually find the fraud started small with a few transactions meant to carry the company until “things turned around.” For example, management chose to report revenue earlier than Generally
Accepted Accounting Principles allowed, so the income statement looked appropriate for a certain time frame. Once management or the board realized that the “misstep” was not reported on by the auditors, they falsified a larger transaction, again waiting to determine if it will be caught by the auditors. Unfortunately, fraud is a slippery slope that once started is difficult to stop.

When reviewing why people collude, the factors necessary for fraud must be reviewed. Fraud requires the same things that are necessary for any crime – motive and opportunity. Thomas P. DiNapoli of the State of New York Office of the State Comptroller in his article “Red Flags for Fraud” outlined elements that must be present for a person or employee to commit fraud:

- Opportunity
- Low chance of getting caught
- Rationalization in the fraudsters mind, (DiNapoli, 2011)

Opportunity comes in many different forms. An employee who is not well-supervised or who wears many different hats in the organization has opportunity to falsify accounting information without anyone checking behind them. Management may see opportunity in an employee who is known as a team player or who needs the job. These types of employees rarely will tell management that they will not participate in a misleading journal entry or other falsifying act. A low chance of getting caught goes hand-in-hand with opportunity. An employee or management usually will not perceive there is opportunity to commit fraud unless there is a low chance of actually getting caught.

Rationalization is a necessary element to review in determining why people commit fraud. They perpetrator usually rationalizes a reason to commit the fraud, either to benefit himself or the company or organization as a whole. DiNapoli listed some of the most common rationalizations used by individuals. People who commit fraud think “I need it more than the other person”. This rationalization has nothing to do with the company, but rather the individual’s viewpoint. I need my job and this money more than anyone else so I am doing what must be done. Sometimes perpetrators believe they are simply borrowing the money and will pay it back later. Employees and management often see falsifying financials or taking money as a “temporary fix” they will correct on the next reporting period. Unfortunately the company or individual often has to again rely on falsifying information to keep things afloat. (5)

Another rationalization given for perpetrating fraud is the thought that everybody does it so we should, too. This is true in the employee level, management level, board of director’s level, and auditor’s level. There is a pervasive thought that if “everyone” is doing this to get ahead it must be perfectly fine to also do it. Often, employees and managers believe the company is big enough that any fraud or misstatement won’t really matter. Although management and the board of directors are probably not thinking about materiality when they use this rationalization that is what they mean. The prevailing thought is if the fraudulent transactions are small then no one is really getting hurt and the company is so big no one will notice.

Another rationale for fraud given by perpetrators is that nobody gets hurt with what they do, and in fact this fraud may help the company as a whole. Management and the board of directors often see financial fraud as a victimless crime, with the thought process that if no one really suffers, then the fraud is not a problem. However, falsified financial information does affect end users of all types, creating lost investments.

Finally, often groups collude to create fraudulent financial information because they perceive the fraudulent information is for the greater good. Perpetrators of fraud often rationalize their actions by stating it is necessary for the company to stay open, the employees to keep their jobs, people to maintain their livelihoods. (DiNapoli, 14) Although none of these reasons are valid reasons to perpetrate financial
statement fraud which is a crime punishable by fines or jail time, many individuals use these excuses to rationalize their actions. Auditors should study the rationalization for fraud because if an auditor knows what pressures lead employees, management, the board of directors, internal auditors and sometimes even external auditors to collude, then can uncover the fraud more quickly. That is, if auditors understand why then that may lead to when and how.

Where is Fraud Likely to Occur?

Ordinary fraud often occurs as a result of inattention to the concept of segregation of duties whether by design or by necessity. Clearly there are small to medium-sized companies that simply cannot afford to hire enough employees to fully segregate job activities which should be conducted by different individuals. This is especially true in companies that have long-term employees who are highly trusted and operate with a large degree of impunity and independence. This may be magnified when there are multiple long-term employees who have developed a close personal relationship allowing them to collude when opportunities for fraud present themselves, and who could easily hide the transactions in their daily work.

Fraud, whether individual or colluded, also tends to occur in small to medium-size businesses because owners do not take the threat a financial loss very seriously and choose not to implement internal controls to make fraudulent activities more difficult, if not impossible. Chris Gagliardi (2014, 11) posited five misconceptions that are commonly made by small business owners:

1. "I have complete control over my business"
2. "My company is so small it is not at risk"
3. "My loyal employees would not commit fraud"
4. "I don't need internal controls"
5. "Fraud would not cause my business very much"

Based on this information, auditors and accounting professionals can be invaluable in educating their clients about where internal controls are weaker missing, and how to implement necessary internal controls in the most efficient manner.

CONCLUSION

As long as people continue to commit fraud and rationalize they are doing the right thing, fraud will be difficult to detect without the help of outside sources. Collusion among management, the board of directors, and inside and outside auditors who all believe they are doing the “right thing” to either help the company survive or line their own pockets makes a difficult wall for an auditor to penetrate. Couple that with the auditor’s requirement to find only material misstatements, instead of all misstatements, and the fraud could continue until someone either turns in the company or the house of cards simply falls down.

The general take-away from this paper should be that auditors and other accounting professionals must diligently investigate issues with internal control that could allow collusion to occur, go undetected, and damage the financial health of their accounting clients. Accounting professionals need to understand the signposts of collusion as well as understand where such activities could be present in the client's financial statements. Armed with this knowledge, and a sensitivity to the possibility of conclusion, auditors and accounting professionals can design specific activities and tests which may detect fraud in the financial statements caused by collusion.
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