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**“Auditor’s Role in Financial Statements Fraud Detection in the Palestinian Business Environment”**

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**“Auditor’s Role in Financial Statements Fraud Detection in the  
Palestinian Business Environment”**

“دور مدقق الحسابات في كشف التزوير في البيانات المالية في بيئة الاعمال الفلسطينية”

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**Submitted in partial fulfillment of the requirements for the Masters  
Degree in Business Administration from the Graduate Faculty at Birzeit  
University**

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## ABSTRACT

Fraud is considered to be the most famous and the most dangerous economic crime that threaten the stability of any economy especially the emerging ones. The thesis is aiming at uncovering the fact that despite the low frequency of fraud crimes in Palestine, (the announced) the auditors are not applying the most sophisticated techniques to detect and deter fraud.

The purpose of this thesis is to uncover the fact that fraud in the Palestinian business is underestimated. The effect of the committed fraud is not shown to the public due to several reasons some of them political and the others are economic. Moreover, the study aims at getting to the bottom of the audit profession in Palestine which claims that the profession still not functioning as appropriate as possible.

The thesis also aims at providing auditors (external and internal) with the proper tools to fight the fraud and to take it into consideration when planning for audit job as stipulated by SAS 99.

The study used various methods to collect the data primary and secondary, and test the hypotheses, such as the literature review which consisted of analyzing 3 real fraud cases that took place from which we extracted the reasons behind passing the fraud right under the nose of the auditor without being detected. Several types of questionnaires were sent to the audit firms (International and Local) and individual auditors (internal and external).

These questionnaires were analyzed based on our main population (auditors, external and internal). A sample of 55 auditors were selected of which 48 responded positively which consists 87% of the population. Based on the analysis of the questions the following facts were revealed:

- a. None of the audit firms use the red flags test to identify the possible fraud in the audit,

- b. None of the audit firms provide fraud detection training to their employees,
- c. Only one audit firm use ACL to mine data,
- d. None of the auditees have any system in place to detect fraud, and
- e. The reasons behind not detecting fraud (as per the study) are directly related to auditors themselves

Also the study proposed several enhancements to the audit process that will help auditors planning more effective audit assignments and at the same time provide the clients with top quality services.

**Keywords:** Information System, Financial Statements Fraud, Audit Firms, Audit (External & Internal) Red Flags, EDP Audit, Data Mining.



## Abstract in Arabic

## الملخص بالعربية

يعتبر الإحتيال والتزوير في البيانات المالية الجريمة الأكثر شهرة والاكثر خطورة التي تهدد استقرار أيّ اقتصاد خصوصا في الدول الصاعدة او النامية، الإطروحة تستهدف كشف الحقيقة بأنه على الرغم من العدد المنخفض لجرائم التزوير في البيانات المالية في فلسطين، (المعلن) فان مدققي الحسابات لا يطبقون التقنيات الأكثر تطورا لإكتشاف وردع الإحتيال او التزوير.

إنّ غرض هذه الإطروحة أن تكشف الحقيقة بأنّ جريمة التزوير في البيانات المالية في بيئة الاعمال الفلسطينية مقلل من تقديرها، وان تأثير هذا التزوير لا يتم اعلانه إلى الجمهور لعدة أسباب البعض منها سياسية والآخرى إقتصادية. علاوة على ذلك، الدراسة تستهدف الوصول إلى جذور مهنة التدقيق في فلسطين والتي تدعي الدراسة بأنّ المهنة ما زالت غير مفعلة كما ينبغي.

الإطروحة كذلك تستهدف تزويد المدققين (خارجيين وداخليين) بالأدوات الصحيحة لمحاربة وكشف التزوير ولأخذة بعين الإعتبار عند تخطيط مهمة تدقيق كما هو مشترط من قبل معيار التدقيق الدولي رقم 99.

إستعملت الدراسة طرق مختلفة لجمع البيانات أساسية وثانوية، واختبار الفرضيات، مثل مراجعة الأدبيات والتي شملت تحليل 3 حالات تزوير حقيقية حدثت التي منها إنتزعا الأسباب وراء مرور التزوير والإحتيال في البيانات المالية على مقربة من المدقق بدون أن تكتشف. عدة أنواع من الإستقصاءات أرسلت إلى شركات التدقيق (دوليون ومحليون) و مدققون افراد (داخليين وخارجيين) كما تم مقابلة بعض المدققين شخصا وتم مراسلة البعض بالبريد الإلكتروني.

هذه الإستفتاءات حلت مستندة على مجتمع الدراسة الرئيسي (مدققون، خارجيين وداخليين). أي عينة من 55 مدقق تم اختيارهم من شركات عالمية ومحلية وكذلك ذوي خبرات متفاوتة تم الحصول على 48 ردا إيجابيا الذي يشكل 87 % من العينة.

استنادا على تحليل الأسئلة تم كشف الحقائق التالية:

a. لا تستعمل اي من شركات التدقيق الأعلام الحمراء لاختبار كشف التزوير والإحتيال المحتمل ،

- b. لا تزود اي من شركات التدقيق تدريبا لموظفيها لمساعدتهم في كشف الإحتيال والتزوير،
- c. شركة واحدة فقط تستعمل برامج لمراقبة نمط المعلومات المستخرج من أنظمة معلومات العملاء،
- d. لا أحد من زبائن شركات التدقيق عنده أي نظام مطبق او مكتوب لإكتشاف الإحتيال، و
- e. الأسباب وراء عدم اكتشاف التزوير (بموجب الدراسة) تتعلق بالمدققين أنفسهم مباشرة
- إقترحت أيضا الدراسة عدة تحسينات إلى عملية التدقيق التي ستساعد المدققين على تخطيط مهام التدقيق بأكثر فعالية وفي نفس الوقت يزودون الزبائن بالخدمات عالية الجودة.

## INTRODUCTION

## CHAPTER ONE

## CHAPTER ONE

## Overview

The study's main goal is to estimate the extent of the awareness enjoyed by the student teachers and lecturers in the Paichemba territories regarding the dangers of financial statement fraud, while providing the study parties (accountants, auditors, and managements) by the appropriate tools to fight the fire of fraud. This section begins by introducing the key concepts of the study, and then presents a complete definition for them.

## INTRODUCTION

## 1.1.1 Fraud

A deliberate deception in order to secure unfair or unlawful gain. False representation made to another relied on by another to their person's injury. Fraud include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud, and misappropriation of assets, sometimes called defalcations.

Fraud, like all crimes, is the product of three factors: a supply of motivated offenders; the presence of a prospective victim or target; and the absence of a capable guardian (Cohen & Felson 1979). This general rule applies whether one is referring to fraud against government benefit programs, fraud against elderly people, or misappropriation of corporate assets by a company director.

According to the Association of Certified Fraud Examiners, the cost of fraud incurred by American companies is approximately \$400 billion a year, which is equivalent to 50 per cent per employee. Technical behavior, such as computer fraud requires advance technology, as well as opportunities to be successful. The increased use of technology within firms can provide the resources and opportunities individuals need to successfully conduct an unethical behavior, such as fraud. Technological advances have

## CHAPTER ONE

### INTRODUCTION

#### 1.1 Overview:

The study main goal is to estimate the extent of the awareness enjoyed by the auditors (external and internal) in the Palestinian territories regarding the danger of financial statement fraud, while providing the needy parties (accountants, auditors, and management) by the appropriate tools to fight the fire of fraud. This section begins by introducing the key concepts of the study, and tries to present a complete definition for them.

#### 1.1.1 Fraud:

A deliberate deception in order to secure unfair or unlawful gain. False representation intended to deceive relied on by another to that person's injury. Fraud include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud, and misappropriation of assets, sometimes called defalcations.

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According to the Association of Certified Fraud Examiners, the cost of fraud incurred by American companies is approximately \$400 billion a year, which is equivalent to \$9 per day per employee. Unethical behavior, such as computer fraud requires advance technology as well as opportunities to be successful. The increased use of technology within firms can provide the resources and opportunities individuals need to successfully engage in unethical behavior such as fraud. Technological advances have

made it much easier and less costly, in terms of time and energy, to commit fraud. Additionally, the difficulty in identifying the perpetrator and the use of technology makes the detection of fraud much more difficult. For example, check fraud within organizations has been relatively easy to commit with technology (Tedrick 2000). The availability of laser printers, scanners, color copiers, and desktop publishing software has made it easier to alter existing checks as well as produce counterfeit checks that are identical to actual checks (Tedrick 2000).

In addition to the direct costs, fraud can also tie up valuable management resources, negatively impact the value of companies, and result in huge legal fees (Colbert and Turner 2000).

Expenses over the last few years defending cases filed by third parties which claim that they lost their investment because of the auditor's inability to detect fraud and a related material misstatement. The Big Six in USA (Big four now) alone between 1990 and 1993 paid out over \$1 billion to settle cases related to fraud including Ernst & Young (\$400 million in 1992) and Arthur Andersen (\$65 million in 1993) settlements to the Resolution Trust Corporation.

Litigation expenses according to the Big Six's 1992 joint statement entitled "The litigation crisis in the United States: impact on the accounting profession" equal up to 11 per cent of audit revenues. Litigation expenses along with practice management problems are noted to be the primary reasons for the demise of three national firms between 1990 and 1993 (Laventhol and Horwath, Spicer and Oppenheim, and Pannell, Kerr and Forster). Public concern for fraud detection began during the early 1970s when the famous Equity Funding and Penn Central cases occurred [1,2]. These cases raised public concerns which eventually led to the Senate commission directed by Senator Lee Metcalf known as the Metcalf Commission and the AICPA commission directed by Manuel Cohen known as the Cohen Commission. These two commissions made various recommendations which were eventually adopted by the Financial Accounting Standards Board (FASB) and the Auditing Standards Board (ASB) during the late 1970s. During this same time-period Congress was also responding to the public's general concern regarding ethics brought on by the Watergate hearings. This eventually led to the passage

of the Foreign Corrupt Practices Act (FCPA) in December 1977 under the Carter administration.

#### 1.1.2 Audit Firms in Palestine:

Palestine was one of the first Arab countries who adopted the profession of auditing. Saba & Co. the first Arab auditing company was established in Jerusalem in 1926. Due to the occupation, the company moved its premises to Jordan and Beirut. Since the signing of the peace treaty in Oslo (after the entrance of the Palestinian National authority) the big 4 audit firms entered the Palestinian market. The international audit firms signed association agreement with some local firms and some of them gave the membership privilege for the others. The presence of the big companies has improved the level of quality of the services provided to great extent, since these companies has to follow the guidelines of the international mother company. Moreover, the international companies demand high level of professional education by its employees and this also helped to develop the skills of the local employees to the benefits of the profession. The local audit firms in turn still suffer because of the improper management and the lack of efficient training. Moreover, the local firms do not adopt clear standards of quality and the only competitive aspect for them is the price.

#### 1.1.3 Auditing:

Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria (Arens & Loebbecke, 2000, 16). Normally, independent auditors, also known as certified public accountants (CPAs), conduct audit work to ascertain whether the overall financial statements of a company are, in all material respects, in conformity with the generally accepted accounting principles (GAAP).

Auditor's report expresses the opinion of an independent expert regarding the degree of reliability upon of the information presented in the financial statements. In other words, auditor's report assures the financial statements users, which normally are external

parities such as shareholders, investors, creditors and financial institutions, of the reliability of financial statements, which are prepared by the management of the company.

Due to the time and cost constraints, auditors cannot examine every detail records behind the financial statements. The concept of materiality and fairly stated financial statements were introduced to solve this problem. Materiality is the magnitude of an omission or misstatement of information that misleads the financial statement users. The materiality standard applied to each account balance is varied and depended on auditors' judgment. It is the responsibility of the auditors to ensure that all material misstatements are indicated in the auditors' opinion.

In business practice, it is more common to find an auditor as a staff of an auditing firm. Generally, several CPAs join together to practice as partners of the auditing firm, offering auditing and other related services including auditing and other reviews to interested parties. The partners normally hire professional staffs and form an audit team to assist them in the audit engagement. In this thesis, auditors, auditing firm and audit team are synonyms.

Auditors are caught on the horns of a dilemma. On one horn they are asked to do everything possible to prevent material financial statement fraud. On the other horn hangs the reality that auditing is a competitive business, subject to the same demands for profitability and the return on capital as other businesses. These economic demands create a conflict for auditors by constraining their ability to detect fraud. What then do auditors do when faced with the increased possibility of fraudulent financial reporting?

That is the issue examined in this thesis, the impetus for which was the issuance of Statement on Auditing Standards No. 82 (SAS No. 82), "Consideration of fraud in a financial statement audit" (AICPA, 1997). This statement describes fraud and its characteristics, indicates conditions under which fraud is more likely to occur, and requires the auditor to make an assessment of the risk of material misstatement due to fraud. The issue of how independent auditors respond to an increased likelihood of

financial statement fraud is important for two reasons. First, fraud induced material misstatements can have a substantial negative financial impact on users of financial information and the capital market system as a whole. Evidence of this impact is indicated by the current confidence crisis of investors over the credibility of financial reporting. Second, it reinforces the role of auditors in society to provide reasonable assurance about the reliability and dependability of financial information. The role of an audit and auditors is to reduce the information risk associated with financial statements.

#### 1.1.4 SAS 99:

The AICPA press statement included the following as the key provisions of SAS 99:

- **Increased Emphasis on Professional Skepticism.** Putting aside any prior beliefs as to management's honesty, members of the audit team must exchange ideas or brainstorm how frauds could occur. These discussions are intended to identify fraud risks and should be conducted while keeping in mind the characteristics that are present when frauds occur: incentives, opportunities, and ability to rationalize. Throughout the audit, the engagement team should think about and explore the question, "If someone wanted to perpetrate a fraud, how would it be done?" From these discussions, the engagement team should be in a better position to design audit tests responsive to the risks of fraud.
- **Discussions with Management.** The engagement team is expected to ask management and others in the organization as to the risk of fraud and whether they are aware of any frauds. The auditors should make a point of talking to employees in and outside management. Giving employees and others the opportunity to "blow the whistle" may encourage someone to step forward. It might also help deter others from committing fraud if they are concerned that a co-worker will turn them in.



- Unpredictable Audit Tests. During an audit, the engagement team should test areas, locations and accounts that otherwise might not be tested. The team should design tests that would be unpredictable and unexpected by the client.
- Responding to Management Override of Controls. Because management is often in a position to override controls in order to commit financial-statement fraud, the standard includes procedures to test for management override of controls on every audit.

#### 1.1.5 EDP Audit:

The proliferation of computers and microcomputers in recent years has increased both the opportunities for abuse and the number of people whose technical capabilities are adequate to intrude the information systems. What can companies do to protect their computer systems from fraudulent misuse and inadvertent human error? What role does the auditor play in fraud prevention, detection, and reporting? This project focused on the issue of identifying the auditor's role in fraud detection and reporting. The purposes of this project were to: (1) identifying the auditor's role in fraud detection; (2) identify the auditor's role in fraud reporting; (3) identify the current standards or guidelines available for auditors to reference.

#### 1.1.6 Red Flags:

When exploring the motivational basis of fraud, it is concluded that a number of psychological factors may be present in those persons who commit fraud, but they are also associated with entirely legitimate forms of human endeavour. Moreover, technologies of prediction remain imperfect. This thesis will look partly at what are commonly called "red flags" or indicators of fraud (Krambia-Kapardis 2001, pp. 49–52). These indicators are not inevitably or universally associated with fraud. Rather, their presence suggests a degree of fraud risk. Conversely, their absence is no guarantee that a situation or circumstance is "fraud-proof". But when these indicators are present, the risk of fraud is high, and a degree of caution or extra preventive measures may be appropriate.

At the appendices section, I have prepared a red-flags questionnaire to measure its importance in the audit profession which in my opinion suffers a lot in Palestine due to the inadequate training for the existing auditors who serve the clients in Palestinian business. The questionnaire is never done by any of the audit firms that I met due to the time constraint and also the cost associated with the implementation, however, using red flags as indicators of fraud was one of my recommendations to the audit firms.

#### 1.1.7 Data Mining Techniques:

Auditing is a relatively archaic field and the auditors are frequently viewed as stuffily fussy people. That is no longer true. In recent years, auditors have recognized the dramatic increase in the transaction volume and complexity of their clients' accounting and non-accounting records.

Consequently, computerized tools such as general-purpose and generalized audit software (GAS) have increasingly been used to supplement the traditional manual audit process. The emergence of enterprise resource planning (ERP) system, with the concept of integrating all operating functions together in order to increase the profitability of an organization as a whole, makes accounting system no longer a simple debit-and-credit system. Instead, it is the central registrar of all operating activities. Though it can be argued which is, or which is not, accounting transaction, still, it contains valuable information. It is auditors' responsibility to audit sufficient amount of transactions recorded in the client's databases in order to gain enough evidence on which an audit opinion may be based and to ensure that there is no risk left unaddressed. The amount and complexity of the accounting transactions have increased tremendously due to the innovation of electronic commerce, online payment and other high-technology devices. Electronic records have become more common; therefore, online auditing is increasingly challenging. Despite those complicated accounting transactions can now be presented in the more comprehensive format using today's improved generalized audit software (GAS), they still require auditors to make assumptions, perform analysis and interpret the results.

The GAS or other computerized tools currently used only allows auditors to examine a company's data in certain predefined formats by running varied query commands but not to extract any information from that data especially when such information is unknown and hidden. Auditors need something more than presentation tools to enhance their investigation of fact, or simply, material matters. On the other side, data mining techniques have improved with the advancement of database technology. In the past two decades, database has become commonplace in business. However, the database itself does not directly benefit the company; in order to reap the benefit of database, the abundance of data has to be turned into useful information. Thus, Data mining tools that facilitate data extraction and data analysis have received greater attention. There seems to be opportunities for auditing and data mining to converge. Auditing needs a mean to uncover unusual transaction patterns and data mining can fulfill that need. It is one of the recommendations presented by this thesis to try to explore the opportunities of using data mining as a tool to improve audit performance.

## 1.2 Importance of the study:

The audit itself is very vital to prove the credibility of the financial records of any organization (public, private,...etc.). The cost of fraud is relatively high in terms of money and also in terms of performance of the economy due to the adverse effect of the act of fraud on the industry. Palestinian territories is not an exception. The cost is very high and according to the latest statistics of the Palestinian Central Bureau of Statistics fraud and its derivatives (theft and forgery) forms more than 20% of the total reported criminal acts to the police department. Moreover, I think that the value of audit services paid by clients to auditors is overstated due to the low quality of services provided. For the above reasons the study of the financial statements fraud is very important to the external and internal auditors and also and the most important for the management.

### 1.3 Study objectives:

Fraud is considered to be the most famous and the most dangerous economic crime that threaten the stability of any economy specially the emerging ones. the thesis is aiming at uncovering the fact that auditors are not well equipped to detect financial statement fraud and at the same time to recommend and provide the suitable tools for the auditors to use to detect and deter financial statements fraud. Also, the study aims at measuring the most accepted fraud indicators for the Palestinian auditors.

### 1.4 Study Questions:

The study will try to find answers for the following questions based on the analysis and the responses of the auditors:

- 1) Why auditors have not detected fraud in the financial statements?
- 2) What are the most accepted fraud indicators by the Palestinian auditors?
- 3) What are the most accepted fraud indicators by the Palestinian auditors?
- 4) How to improve the audit process to detect these kinds of fraud? Which will be answered in chapter five.

To answer the above questions, a descriptive study to be conducted.

### Study limitations:

1. During the study stage the main problem I faced as an employee in one of the big 4 audit firms is the lack of cooperation from other audit firms. It was really difficult to convince them that the only reason to collect the information about their opinions and their work status is for study purposes only. They feared that the information submitted by them could be used for competition purposes. However, the positive responses I got to my questionnaire form about 87% of the

sample. The data received is enough to construct and paint an acceptable image for the status of auditing in the Palestinian territories.

2. The term fraud sounds to be new to the Palestinian business environment since they claim that the extent and the momentum of the fraud are low.
3. I found no resources and statistics to help me document and support my opinion.

#### Definitions of Terms:

For the purposes of the study, the following terms are to be used as stated as follows:

1. AUDIT: is the inspection of the accounting records and procedures of a business, government unit, or other reporting entity by a trained accountant for the purpose of verifying the accuracy and completeness of the records.
2. EDP "Electronic Data Processing": Processing of information by computer as opposed to handwritten records.
3. Fraud: a deliberate deception to secure unfair or unlawful gain. False representation intended to deceive relied on by another to that person's injury. Fraud include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud, and misappropriation of assets, sometimes called defalcations.
4. Information Systems consist of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data.
5. Fraud Detection: a process of which an auditor utilize his specialized skills and tools to identify the possibility of the occurrence of misappropriation of assets.

6. Auditor: a professional person who possess the qualifications and the required skills and capable of expressing a professional opinion about the fairness of the financial statement.
7. Auditing in Palestine: the audit in Palestine is relatively new in its professional look. It was introduced after the entrance of the big international audit firms in Palestine.

## CHAPTER 2

### LITERATURE REVIEW

## CHAPTER 2

# LITERATURE REVIEW

### 1.1 Historical Audit History

Identifying the roots of the system by which the past can join the present in form is a vital part of future development. It is the goal of this section to provide a broad scope of information to assist auditors in developing auditing functions into a self-responsible component of the company's mission and a world-class audit department. Thus this section is written to familiarize auditors with historical events that directly relate to auditing, and in particular the management of organizations and their financials.

The earliest history of auditing, the auditing left sparse documentation, but beginning around the invention of writing, circa 3,500 B.C. The earliest surviving records in Italy, the Medici family of Florence, Italy, from 1409. The modern bookkeeping dates from the year 1494, when a monk named Luca Pacioli published the first book on accounting. He became known as the "Father of Accounting" because of the widespread dissemination of his book and its information. However, Pacioli was a 15th-century man of the fifteenth century—educated

## ch2, Lite. review

### Introduction

In this chapter, the structure of the thesis will be exposed and discussed in details. First, we go through the historic aspects of the auditing and go to the roots of the profession to help us draw a clearer picture on the development of the profession and to understand the development the audit process related to fraud cases. Second, the financial statement fraud is what the study is all about. It needs to be discussed in more details in terms of types, cost, indications, detection, and prevention. The example of revenue recognition as a fraud option will be our main concern. Three actual fraud cases will be analyzed in the light of the fraud CRIME Broken down as follows (C) COOKS, (R) RECEIPES, (I) INCENTIVES, ((M) MONITORING, (E) END RESULTS. Each item will be discussed and applied to the analyzed actual cases.

#### 2.1 External Audit History:

Identifying the roots is the key title of this section, by which the past can join the present to form a solid base for future development. It is the goal of this section to provide a broad scope of information in assisting auditors in developing auditing function into a well-respected contributor to the company's mission and a world-class audit department. Thus this section is written to familiarize auditors with historical events that directly relate to audits, audit planning, and in particular the management of a world-class audit function.

The ancient history of accounting and auditing left sparse documentation, but possibly did predate the invention of writing, circa 8,500 B.C. The earliest surviving records in double-entry form are those of the Medici family of Florence, Italy, from 1397. The "modern" era of accounting dates from the year 1494, when a monk named Luca Pacioli published the first book on accounting. He became known as the "Father of Accounting" because of the widespread dissemination of his book and its information. However, Pacioli was a typical monk of the fifteenth century—educated



in a wide variety of disciplines, and served as tutor and mentor to the wealthy. In fact, the book itself contains more than accounting, including arithmetic. All Pacioli really did was to explain existing accounting principles. Auditing, too, is one of the oldest professions. Writing was invented in part to satisfy the need for audits. Zenon papyri record the application of audits on the Egyptian estate of the Greek ruler Ptolemy Philadelphus II as early as 2,500 years ago. Early Greek and Roman writers such as Aristophanes, Caesar, and Cicero make mention of accountants, auditors, and auditing accounts and audit rooms. As early as the Middle Ages, a form of internal auditing existed among the manor houses of England where the lord served as manager of the audit function.

The earliest external audit by an independent public accountant was in 1720 by Charles Snell as a result of the South Sea Bubble scandal in England. The total market value of the South Sea Company, chartered in 1710, eventually exceeded the value of all money in England. Thus when the company crashed, it was an extremely significant public event in the English economy. Fictitious entries were discovered in the books. This event set a precedent in the history of auditing. In fact, many, if not most, major auditing events, improvements, and standards tend to follow public exposure of scandals and/or fraud. Later, the industrial revolution in England resulted in factory systems that were financed by stockholders.

This situation necessitated the need for auditors, both internal and external. To protect the public, the British Companies Act of 1844 provided for mandatory audits. Soon afterward, in 1853, organizations of chartered accountants were formed in Scotland. Then in 1880, five organizations were melded into the unified Institute of Chartered Accountants in England and Wales.

By 1881, it had a membership of more than 1,000 members. The same industrial revolution was occurring across the Atlantic in the United States. By the late nineteenth century, British auditors were being sent to audit American companies. For example, the British firm Price Waterhouse was sending over auditors as early as

1873. Soon, New York offices existed for British firms Price Waterhouse, Peat Marwick & Company, and Arthur Young & Company. Thus it was the British who built the infrastructure for professional auditing in the United States. One of the first key events in the history of the U.S. audit profession was the establishment of what was the forerunner of the American Institute of Certified Public Accountants (AICPA) in 1887.

In 1896, New York law provided for the issuance of CPA certificates to those who could pass a qualifying examination. Initially, experienced practitioners were "grandfathered" in by being granted CPA certificates without having to take the examination. Eventually, all states passed CPA laws. At first, each state prepared its own CPA examination, but in 1917 the American Institute of Accountants began preparing a uniform CPA examination that could be used by all states. Another early event of note is the 1913 passage of the Sixteenth Amendment legalizing income taxes. One provision of the law required all companies to maintain adequate accounting records. Thus, even small firms that did not need accounting for management control purposes suddenly had to have accounting records.

The audits of the late 1800s and early 1900s were largely devoted to the accuracy of bookkeeping detail. In most cases, all vouchers were examined and all footings verified. Hence, items omitted from the records were overlooked by the auditors, and the result was an auditing profession that was viewed by outsiders as more clerical than professional. This view was to change between 1900 and 1917, because bankers became more important as sources of financing and because practice began to catch up with the auditing literature. The change in philosophy mirrored the recommendations in the leading auditing book of the time, which was written by Robert Montgomery. Bankers were less concerned with clerical accuracy than with balance-sheet quality.

Thus, as bankers became major users of audited financial statements, the objective of the audit became more concerned with the valuation of assets on the balance sheet.

This new direction culminated in the 1917 issuance of Uniform Accounting, a joint publication of the American Institute and the Federal Trade Commission, which also had the endorsement of the Federal Reserve Board. This publication was reissued, with minor changes, in 1918 under the title Approved Methods for the Preparation of Balance-Sheet Statements.

This document was the first formal declaration of generally accepted accounting principles and auditing standards. It outlined a complete audit program, instructions for auditing specific account balances, and a standardized audit report. In 1929, another revision included more emphasis on the income statement and internal controls. Still another revision in 1936 placed equal emphasis on the balance sheet and income statement. The 1917 document and its revisions became the bible of the auditing profession for more than two decades. The recent history of external auditing is more events-oriented. In other words, little has occurred in recent years that was not brought about by some catastrophic event such as a lawsuit, financial disaster, or a major fraud case.

One of the earliest important auditing cases was that of *Ultramares Corporation v. Touche, Niven & Company* (1931). Ultramares had loaned money to Fred Stern and Company in 1924 on the basis of financial statements prepared by Touche. On those statements, accounts receivable had been overstated. Subsequently, in 1925, Fred Stern and Company filed for bankruptcy. A lower court found Touche guilty of negligence, but the firm was declared not liable to Ultramares because there was no privity of contract between the auditor and Ultramares.

The New York Court of Appeals agreed that third parties could not hold an auditor liable for ordinary negligence, only for fraud. However, gross negligence could be construed as fraud, which opened up the auditor to lawsuits even though there was no way of knowing who was going to rely on the misleading financial statements. Thus, the auditor became subject to almost infinite third-party liability. This liability was further expanded at the federal level in the securities acts of 1933 and 1934. By the

time of the 1929 stock market crash, external auditing had become a somewhat standardized profession, but not a particularly large profession. Since bankers were the primary users of financial statements, the only companies needing audits were those that depended on banks for capital. Companies that depended on stockholder financing were not required to have audits. Consequently, even companies listed on the New York Stock Exchange often did not issue audited financial statements. That was to change because of Ivar Kreuger—one of the greatest swindlers the world has ever seen.

The most widely held securities in the United States—and the world—during the 1920s were the stocks and bonds of Kreuger & Toll, Inc., a Swedish match conglomerate. The company was founded and headed by Ivar Kreuger, supposedly the richest man in the world. Kreuger's securities were popular because they sold in small denominations and paid high dividends and interest (often 20% annually). Financial reporting as we know it today was in its infancy; stockholders based their investment decisions solely on dividend payments.

Kreuger's dividends were paid, however, out of capital, not profits. Kreuger was essentially operating a giant pyramid scheme, which was hidden from the investing public by Kreuger's insistence that financial statements not be audited. He advocated that financial secrecy was paramount to corporate success. In Kreuger's defense, some amount of secrecy was needed because he was often dealing with foreign kings and dictators about government monopolies and taxes on wooden matches. Subsequently, it was discovered that many of his companies' assets were in the form of intangible monopolies.

The stock market crash of 1929 made it more difficult for Kreuger to sell new securities to fuel his pyramid scheme. Thus, he committed suicide in March 1932. Within three weeks, his companies were in bankruptcy as it became apparent that there were few assets to support the unaudited financial statements that had been issued over the years. The bankruptcy was the largest on record up to that time and

resulted in numerous changes in financial reporting. Newspaper articles kept U.S. citizens aware of the extent of Kreuger's fraud at the same time that Congress was considering passage of the federal securities laws. Thus, the timing of the bankruptcy and the corresponding media coverage made it politically expedient to pass laws that would make similar schemes difficult in the future. A single event, the corruption of Ivar Kreuger, had shaken investors' confidence and provided the media event of the decade.

As a result, the Securities Act of 1933 was passed, and the New York Stock Exchange issued rules mandating audits of listed companies. Even a movement toward uniformity in accounting principles can be laid at the feet of Kreuger. Auditors thus owe much of their livelihood to the fraud perpetrated by Ivar Kreuger. In fact, some might say that because of the resulting improvements to financial reporting, Kreuger did more good than harm for the financial community. A person of his ilk was needed to show the world that auditors are necessary and can make a contribution to a regulated securities market.

The 1936 version of the American Institute's 1917 joint pronouncement with the Federal Trade Commission on auditing standards suggested that auditors might want to observe inventories and confirm receivables, but there was no requirement for these procedures. Many auditors had long opposed observing inventories under the theory that CPAs were not skilled appraisers and that a statement that they had physically inspected inventories might be construed as a guarantee of the inventory valuation. This lack of a requirement for inventory observations and receivable confirmations proved to be an embarrassment to the profession when the McKesson & Robbins scandal surfaced in 1938.

The senior management of McKesson & Robbins had used a facade of false documents to conceal the fact that \$19 million in inventory and receivables were nonexistent. A Securities and Exchange Commission (SEC) investigation concluded that Price Waterhouse & Company had adhered to generally accepted auditing

procedures as recommended in the 1936 Institute pronouncement. The auditors had obtained management assurances as to the value of the inventories and had test-checked the inventories to purchase orders (which were fabricated to conceal the fraud). But the SEC concluded that although general accepted procedures had been followed, those procedures were inadequate. As a result, in 1939 the American Institute issued Statement on Auditing Procedure (SAP) No. 1 that required auditors to observe inventories and confirm receivables.

The McKesson & Robbins case was a turning point in auditing history. No longer was the auditor responsible for auditing the accounts of management; responsibility was extended to an audit of the business itself. And the profession began to issue promulgated statements and standards related to the specific procedures and standards of audits. Other cases have influenced auditors in recent years, but none to the extent of the frauds associated with Ultramares, Kreuger, and McKesson & Robbins. Continental Vending Machine Corporation (1968) was unusual in that it marked the first instance of an external auditor being criminally convicted for fraud. The overriding conclusion of all of this activity is that the (external) auditing profession has long been reactive rather than proactive. On the whole, the recent history of auditing has been centered on reacting to adverse events affecting the profession.

## 2.2 Financial Statement Fraud

The second group of literature is related to financial statement fraud.

The financial statements fraud has possessed great deal of the attention of the auditors work and also the governmental bodies who are concerned with fraud due to its social and financial implications.

In this thesis, the main purpose is to identify some of the reasons why auditors in the Palestinian business environment have not detected financial statement fraud and to suggest possible solutions for improving the audit process in these areas. In order to

achieve this target, some cases of the fraudulent financial statements of revenue recognition will be analyzed.

The main reasons why auditors did not detect financial statement fraud from the technical side were application of analytical review procedures as “sufficient audit evidence;” weaknesses in audit risk model and risk assessment concerning internal control; and audit failure in revenue recognition and related-party transaction disclosure. The ethical issues that relate to the detection of fraud include auditor independence and the amount of non-audit services provided by the auditor.

Several solutions will be recommended to enhance the audit process in detecting the financial statement fraud in accordance with the reasons we have determined.

There have been several cases by businesses of what appears to be financial statement fraud, which have been undetected by the auditors. According to Joseph T. Wells, one of the most remarkable cases in the twentieth century occurred in the 1970s, when an enterprising insurance salesman, Stanley Goldblum, managed easily to add 65,000 phony policyholders to his company’s – Equity Funding – rolls, along with \$800 million of fake assets – right under the nose of its independent audit firm. Since then, financial statement fraud together with audit failures have been increasingly a hot issue, including the recent cases of Enron, Waste Management, Xerox and AOL Time Warner, just to mention a few.

The international auditing firm, Arthur Andersen, which audited Enron, appears to be an example of a firm entangled in a major audit failure. The case brought to light the weaknesses of the audit process. As a result, more people believe professional accountants have to learn how to detect financial statement fraud more effectively. One of the best ways is to profit from the mistakes of others.

Enforcement actions against auditors have been rare (although we believe there will be more in the future), but the consequences of individual cases can be great and the cases

offer the profession an opportunity to learn and grow (Beasley, Carcello and Hermanson, 2001).

In order to understand the problems in modern auditing, we will give a brief overview of auditing history. Auditing in one form or another has existed as long as commercial life itself. There has always been a need by those who entrust their property to others to have some checks and control over the latter.

There is general agreement, that modern financial auditing began to take shape in the middle of the nineteenth century. The emergence of corporate entities in which ownership and control were separated provided a need for financial auditing and the development of increasingly detailed disclosure requirements for financial statements.

Early audits focused on finding errors in balance sheet accounts and on stemming the growth of fraud associated with the increasing phenomenon of professional managers and absentee owners. The detection of fraud had a very important emphasis. As companies began to grow and become more complex during the nineteenth century, the detection of fraud became increasingly an unrealistic objective – although it was still generally perceived as one of the main objectives of a financial report audit, at least by the general public.

From the 1930s until the 1980s, the focus of the audit changed. Today, the modern external audit has been described as an independent examination of, and an expression of opinion on, the financial statements of an enterprise by a qualified auditor (Power, 1997). The financial audit process was to culminate in an opinion on whether the financial statements of an enterprise gave a “fair” view (US auditing) or “true and fair” view (European auditing). Consequently, detecting fraud is not the primary objective of auditing, although it is generally perceived to be so by the public. This conflict in the objectives of auditing has been described in terms of an “expectations gap.” The gap is between what the public expects – the detection of fraud – and what auditors claim to be delivering – an opinion on the financial statements which appeals to notions such as “fairness” and “true and fair” (Power, 1997). Auditors typically argue that the main responsibility for prevention and detection of fraud lies with management and its systems. When companies collapse, for whatever reason, but particularly in cases of



alleged or actual fraud, public reaction focuses first on the auditors and the possibility of their failure. Therefore, it is increasingly necessary for professionals to step up and take responsibility for continuing to improve their practices overall. The best use of a professional's time and talents is to prevent problems before they occur (Hunt, 2000).

A series of big-name frauds in the past decade has been accompanied by lawsuits against auditors because of their suspected negligence in not detecting the financial statement fraud. As a result, auditors have risked the loss of money and what is even more influential, the loss of their reputations. This situation has pushed auditors and the related organizations and institutions to improve the audit processes in order to be more effective in identifying risk and collecting evidence for issuing audit opinions on financial statements.

According to a study published in 1999 by the Committee of Sponsoring Organizations of the Tread way Commission (COSO), the use of fictitious revenues is the most popular method of committing financial statement fraud. Accounts receivable are attractive fraud targets, primarily because of the way receivables are viewed by lenders. Unlike inventory or fixed assets, accounts receivable – in the eyes of financiers – are the next best thing to cash. Because the mechanics are simple, sales/receivables fraud schemes lead the fraudulent financial statement pack (Wells, March 2001). In this thesis, the main problem is to understand some of the reasons why auditors have not detected financial statement fraud and, if possible, to suggest some improvements in the audit process. In order to achieve this target, we will analyze some cases of the fraudulent financial statements of revenue recognition. The chosen cases are:

Lernout & Hauspie, Sunbeam and Xerox.

In our thesis, there are two main purposes. The first purpose, based on investigation of the fraudulent financial statement cases in the revenue recognition, is to identify the reasons why the auditors have not detected this fraud. The second purpose, based on the empirical findings about auditing methodology obtained from existing studies and

interviews with various auditing firms in Palestine, is to suggest possible solutions for improving the audit process in the areas of detecting financial statement fraud. There are different types of financial statement fraud taking place in organizations. The COSO report (1999) lists common financial statement fraud techniques in the following categories:

- Improper Revenue Recognition
- Overstatement of Assets other than Accounts Receivable
- Understatement of Expenses/Liabilities
- Misappropriation of Assets
- Inappropriate Disclosure
- Other Miscellaneous Techniques

The COSO Report states that the two most common techniques used by companies to engage in fraudulent activities are improper revenue recognition techniques, which overstate reported revenues, and improper techniques that overstate assets. It is unfeasible to study all of the mentioned fraud categories since the topic is too broad and the duration time of the thesis writing does not allow us to cover all of the techniques in depth.

Therefore we chose to study the revenue recognition area, because it is the most widely used fraud technique, as well as the most interesting and has been discussed extensively in the accounting world. In this thesis, we would like to emphasize the responsibility of the auditors for detecting frauds and errors. The study will be conducted from the perspective of the auditor.

Recently, the American accounting profession directly addressed the external auditor's responsibility for financial statement fraud detection in its Statement of Auditing Standards (SAS) No. 82 entitled "Consideration of Fraud in a Financial Statement Audit." The Statement requires auditors to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by fraud or error. SAS No. 82 makes it clear that the auditor's responsibility for detecting fraud is framed by the concepts of reasonable – not absolute –

assurance and materiality and subject to cost/benefit decisions inherent in the audit process. We contacted five auditing companies operating in Palestine; however, we only managed to get three personal interviews and one e-mail interview. The four of them filled our sent questionnaire. Therefore the empirical evidence of the research is limited to the number of the respondents. Also we contacted several companies in different business sectors and we were successful to arrange interviews with internal auditors

## 2.2.1 Financial Statement Fraud:

### Earnings Management and Revenue Recognition

No doubt that the current business environment, have pushed the top management of many companies into paying attention to “how to make the financial statements look better” in order to attract investors and to be rewarded. The pressure from stock market expectations, analysts’ forecasts and earnings targets has piled another burden on management’s shoulders, especially in the companies, which have been regarded as “blue chip” in their vigorous days. In addition, the favorable stock bonuses received by managers are also the incentives for high earnings. As a result, many companies have used “aggressive accounting” as an “earnings management” tool in order to achieve those targets.

As Ian Griffiths (1981, p. 1) puts it in his so-called bible of the business world “Creative Accounting:” “It is the biggest con trick since the Trojan horse.” In a certain sense, we can say creative accounting in itself is totally legitimate, when we view such accounting as making choices among accepted alternatives. Accounting rules and regulations leave room to make choices among different accounting procedures. The grey area is, however, perhaps too large.

So a company chooses the most appropriate rules that can benefit its intentions. But the line between managing accounts and fraud is very thin. Several recent financial statement fraud cases have exposed various methods of earnings management, which have crossed that line. They can be illegitimate revenue recognition, inappropriate deferral of expenses, fictitious sales, premature sales, reversal, or use of unjustified reserves

(Rezaee, 2002). In this section, we will define financial statement fraud and examine the extent of the auditors' responsibility to detect it. We will give an overview of audit risk model. Next we will discuss the concept of earnings management, by means of revenue recognition problems, and its relation with financial statement fraud. In the next section, we investigate three financial statement fraud case studies: Lernout & Hauspie, Sunbeam and Xerox.

### 2.2.1.1 Definition – Financial Statement Fraud

Financial statement fraud has been defined differently by academicians and practitioners.

The following are some examples of definition of fraud in general:

Encyclopedia Britannica: the deliberate misrepresentation of fact for the purpose of depriving someone of a valuable possession.

Merriam Webster Intentional: perversion of truth in order to induce another to part with something of value or to surrender a legal right.

Oxford English Dictionary: the using of false representations to obtain an unjust advantage or to injure the rights or interests of another.

Unfortunately there is no single definition of financial statement fraud. The reason is that, until recently, the term has not been defined at all. The accounting profession used the terms intentional mistakes and irregularities instead (Rezaee, 2002). In 1997 the AICPA, in its Statement of Auditing Standards (SAS) No. 82, "Consideration of Fraud in a Financial Statement Audit," refers to financial statement fraud as intentional misstatements or omissions in financial statements.

Financial statement fraud is typically conducted by management or with their consent and knowledge. Elliott and Willingham (1980, p. 4) view "The deliberate fraud committed by management that injures investors and creditors through materially misleading financial

statements.” financial statement fraud as management fraud: Accordingly, the terms management fraud and financial statement fraud are often used interchangeably. What is common in different definitions of fraud in general, and financial statement fraud in particular, is that it is intentional and injures other parties. Besides investors and creditors, auditors are one of the victims of financial statement fraud. They might suffer financial loss (e.g. loss of position, fines, etc.) and/or reputation loss (Rezaee, 2002).

## 2.2.2 The Auditor’s Responsibilities for Detecting Fraud

There is no clear obligation for auditors to detect any kind of fraud that may have occurred. As Heim (2002, p. 60) says: “absolutely not!” Under SAS No. 82 (§ 12), the auditor’s responsibility relates to the detection of material misstatements caused by fraud and is not directed to the detection of fraudulent activity.

The first of the AICPA Statement of Auditing Standards, SAS No. 1, 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. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected. Specifically, SAS No. 82 defines the auditors’ responsibility as follows:

- Assess the risk of material misstatements due to fraud by considering fraud risk factors (§12).
- Respond to the results of the risk assessment (§ 26).
- Document identified fraud-risk factors and the responses to those factors (§37).
- Communicate fraud to management (§ 38).

## Material versus Immaterial Misstatements

Misstatements are usually considered material if the combined uncorrected errors and fraud in the financial statements would likely have changed or influenced the decisions of a reasonable person using the statements.

## Reasonable Assurance

Assurance is a measure of the level of certainty that the auditor has obtained at the completion of the audit. The concept of reasonable, but not absolute, assurance indicates that the auditor is not an insurer or guarantor of the correctness of the financial statements.

SAS No. 82 (§ 3) distinguishes between two types of misstatements, errors and fraud. Either type of misstatement can be material or immaterial. An error is an unintentional misstatement of the financial statements, whereas fraud is intentional.

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should not assume that management is dishonest, but the possibility of dishonesty must be considered.

An auditor can be held liable for fraud when he or she acted with an intent to deceive. The plaintiff (third party) must prove the following (Messier, 1997):

- a false representation by the accountant,
- knowledge or belief by the accountant that the representation was false,
- the accountant intended to induce the third party to rely on the false representation, and
- the third party suffered damages.

Courts have held that fraudulent intent may be established by proof that the accountant acts with knowledge of the false representation or with reckless disregard for its truth (Messier, 1997).

## Assessing Risks of Fraud

In order to have an overview of what the auditor does and how current audit procedure works considering risks and detecting fraud, we provide the concept of the audit risk model and the risk factors of the financial statement fraud, which the auditor should have considered in his job.

### 2.2.3 The Audit Risk Model

The audit risk model is the model established by GAAS in 1983 for carrying out audits that require auditors to use their judgment in assessing risks and then in deciding what procedures to carry out (AICPA, 1999).

The model allows auditors to take alternatives in selecting an audit approach.

For example, the model calls for auditors to have an understanding of the client's business and industry, the systems employed to process transactions, the quality of personnel involved in accounting functions, the client's policies and procedures related to the preparation of financial statements, etc.

The model requires auditors to gain an understanding of a company's internal control, and to test the effectiveness of controls if the auditor intends to rely on them when considering the nature, timing and extent of the substantive tests to be carried out. For example, if controls over sales and accounts receivable are strong, the auditor might send a limited number of accounts receivable confirmation requests at an interim date and rely on the controls and certain other tests for updating the accounts to year end. Conversely, if controls are not strong, the auditor might send a larger number of accounts receivable confirmations at year-end. The model requires an assessment of the risk of fraud (intentional misstatements of financial statements) in every audit.

Based on the auditor's assessment of various risks and any tests of controls, the auditor makes judgments about the kinds of evidence (from sources that are internal or external to the client's organization) needed to achieve "reasonable assurance."

### Technical Briefing of the Model

Audit risk (AR) is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk (IR), control risk (CR) and detection risk (DR).

For an auditor to give an inappropriate audit opinion, i.e. giving a true and fair opinion when in fact the financial statements are not true and fair and vice versa, there must be three conditions present, which are: a material error must occur (related to IR); the company itself must not detect the error (related to CR); and the auditor must fail to detect the error (related to DR). Since the three conditions correspond to the three components of audit risk, we discuss each component specifically.

Inherent risk refers to the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls (FTMS, 2001). There is obviously a higher chance of an error occurring where there is high inherent risk.

Control risk is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and control systems (FTMS, 2001). Therefore, there is a higher chance of the error remaining undetected when there is high control risk. If the company has good internal controls, there is a high chance that the control system will detect a material error. That leads to lower control risk.

Detection risk is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes (FTMS, 2001).

Assuming the auditor performs appropriate audit work, he or she is more likely to detect a material error when he or she tests a large number of items than when he or she only tests a small number of items. Therefore, the larger the sample size (i.e. doing more audit



work), the lower the detection risk. From the descriptions of relationship among the audit risk components, the audit risk model is expressed in a mathematical way as follows:

$$AR = IR \times CR \times DR.$$

In reality it is highly judgmental. The objective in an audit is to limit AR to a low level, as judged by the auditor.

#### 2.2.4 Audit Firm Methodologies

Audit firms, at liberty, tailor their audit processes or methodologies in the manner that best suits their needs, so long as the processes or methodologies result in audits that comply with GAAS. Audit firms also take into consideration their clients' expectations, such as expectations that the auditor will inform them of matters that might benefit their businesses.

##### 2.2.4.1 The Risk Factors of Financial Statement Fraud

An important part of planning every audit is to assess the risk of errors and fraud. In making risk assessments for fraud, auditors should keep in mind that fraud typically includes three characteristics, which are known as the "fraud triangle." Although the idea of fraud triangle dates back to the late 1940's, the accounting rules address the issues for the first time in SAS No. 82 (§ 6). The three points of the fraud triangle may be explained as follows (Montgomery, Beasley, Menelaides and Palmrose, 2002):

- Incentive/Pressure: Pressures or incentives on management to materially misstate the financial statements.
- Opportunity: Circumstances that provide an opportunity to carry out material misstatement in the financial statements.
- Attitude/Rationalization: An attitude, character or set of ethical values that allows one or more individuals to knowingly and intentionally commit a dishonest act, or a situation in which individuals are able to rationalize committing a dishonest act.

#### 2.2.5 Earnings Management – Revenue Recognition

Revenue Recognition is one of the various forms of earnings management. The revenue recognition problem usually involves recording revenue before it is earned, which is before a sale is complete, before the product has been delivered, or while the customer can still void or delay the sale (Rezaee, 2002).

The study by COSO in 1999 has listed common financial statement fraud techniques in which improper revenue recognition was in first place of all the categories. Improper revenue recognition includes bill-and-hold sales, conditional sales, fictitious sales, and improper cut-off sales.

The improper revenue recognition issues, which have occurred recently, are usually found in the following schemes:

#### 2.2.5.1 Bill and Hold Sales Transactions

“Bill and hold” is the term used to describe when a selling company holds merchandise to accommodate a customer (Pesaru, 2002). In a bill and hold deal, the customer agrees to buy goods by signing the contract, but the seller retains possession until the customer requests shipment. An abuse of this practice occurs when a company (the seller) recognizes the early revenue of bill and hold sales transactions (Rezaee, 2002). The controversy and difficulty in identifying this kind of “earnings management” is that, in the bill and hold deal, the transactions meet two conditions of (1) realised or realisable; and (2) earned as required by GAAP. However, commonly the revenue is recognized only when the goods and services are delivered to the customers. Therefore, from the auditor side, it is necessary to understand the substance of the transactions to make sure that they are legitimate and arm’s-length transactions (Rezaee, 2002).

#### 2.2.5.2 Timing of Revenue Recognition

Timing of revenue recognition is manipulated by keeping the accounting records open beyond the reporting period to record sales of the subsequent reporting period in the current period. Many revenue frauds involve improper cut-offs as of the end of the reporting period (Rezaee, 2002).

The typical case of timing of revenue recognition is leasing transactions. Abuses of revenue recognition under leasing transactions can occur when a company overstates the amount of up-front revenue on sales-type leases (Pesaru, 2002).

#### 2.2.5.3 Side Agreements

Side agreements are used to alter the terms and conditions of recorded sales transactions to entice customers to accept the delivery of goods and services. They may create obligations or contingencies relating to financing arrangements or to product installation or customization that may relieve the customer of some of the risks and rewards of ownership. Frequently, side agreements are hidden from the entity's board of directors and outside auditors, and only a very few individuals within an entity are aware that they exist.

Side agreements appear to be prevalent in high technology industries, particularly the computer hardware and software segments. The terms they provide may preclude revenue recognition (AICPA, 1999).

#### 2.2.5.4 Illegitimate Sales Transactions

This relates to recording fictitious sales involving either unreal or real customers with fake/incorrect invoices, which are recorded in one reporting period (overstatement) and reversed in the next reporting period (Rezaee, 2002).

#### 2.2.5.5 Improper Revenue Recognition – Contract Accounting

This involves the inappropriate use of the percentage of completion method of accounting for long-term contracts. The management overestimates or misrepresents the percentage of completion when the project is less complete than the amount reflected on the financial statements and is often corroborated by fabricated documents (Rezaee, 2002).

#### 2.2.5.6 Improper Related-Party Sales Transactions

“Related-party sales transactions” refers to a financial link or other relationship between the company and the customer (Pesaru, 2002). The reason the company uses this

technique for boosting revenue is because the related-parties usually are difficult to identify. The undisclosed related-party transactions may be used to fraudulently inflate earnings.

A typical example includes the recording of sales of the same inventory back and forth among affiliated entities that exchange checks-periodically to “freshen” the receivables, and sales with commitments to repurchase (AICPA, 1999).

This type of fraud is usually found in unusual material transactions, particularly close to year-end. The other way for a company to mislead the users of financial statements is to present a series of sales, which are executed with an undisclosed related-party that individually are insignificant, but in total are material (AICPA, 1999).

This “accounting trick” is the big challenge to the auditor and requires professional skepticism. Any significant, unusual, or highly complex transaction resulting in revenue recognition that is executed with customers, who are not related parties, needs special consideration. Again, this fraudulent revenue recognition scheme requires the “substance over form” questions to be examined.

#### 2.2.5.6 Stuffing

Channel stuffing (also known as trade loading) is a marketing practice that suppliers sometimes use to boost sales by inducing distributors to buy substantially more inventory than they can promptly resell. Inducements to overbuy may range from deep discounts on the inventory to threats of losing the distributorship if the inventory is not purchased (AICPA, 1999).

Distributors and resellers sometimes delay placing orders until the end of a quarter in an effort to negotiate a better price on purchases from suppliers that they know want to report good sales performance.

This practice may result in a normal pattern of increased sales volume at the end of a reporting period. An unusual volume of sales to distributors or resellers, particularly at or near the end of the reporting period, may indicate channel stuffing.

Channel stuffing without appropriate provision for sales returns is an example of booking tomorrow's revenue today in order to window-dress financial statements. Channel stuffing may also be accompanied by side agreements with distributors that essentially negate some of the sales by providing for the return of unsold merchandise beyond the normal sales return privileges. Even when there is no evidence of side agreements, channel stuffing may indicate the need to increase the level of anticipated sales returns above historical experience.

Case Analysis.

#### 2.2.6 Why Auditors Have Not Detected Fraud?

In this section we will analyze the three cases of financial statement fraud on improper revenue recognition. The analysis will be based on the theoretical framework we presented. From the findings of the analysis we will derive the reasons why the auditors have not detected the fraud.

##### 2.2.6.1 Introduction to Three Case Studies

We chose three companies, Lernout & Hauspie, Sunbeam Corporation and Xerox, for our case studies. They had been leading companies in their fields with high stock prices on the NASDAQ (Lernout & Hauspie) and New York Stock Exchange (Sunbeam and Xerox). Lernout & Hauspie was in the IT industry. Sunbeam is a consumer products producer and Xerox is a technology innovator in the document management business. Under the pressure of Wall Street analyst expectations, earning targets as well as management incentives, they all used false accounting to mislead investors. We first review the basic facts for the three companies, in the order mentioned above.

It can be said that Lernout & Hauspie Speech Products N.V (L&H) is a typical example of a company making up its books, i.e. its reported revenue in the economically depressed situation of the IT industry. The company used various tools to boost its income in the financial statements.

L&H was a Belgian corporation formed in 1987. It operated as a developer, licensor and provider of speech and language technologies. The company was listed on the NASDAQ in 1995 and its auditor was KPMG.

The stock price of L&H was pretty high in early 2000 until the SEC became suspicious of a sudden surge in L&H's sales in South Korea and its links with thirty start-up companies that in total provided substantial revenue in the company's reports (Maremont and Eisinger, 2000). Not very long after the decision of the SEC to investigate L&H, the company announced its "wrong accounting" in 1997, 1998 and 1999, and said the financial reports of those years would be restated. In 2002, the SEC sued the company with the charge of "fraudulent" on its financial statements.

While L&H acts in the software industry, Sunbeam Corporation (Sunbeam) is a representative of the manufacturing industry. Sunbeam is a US maker of consumer products such as small appliances and camping gear, with a history dating back to 1910.

The Sunbeam fraud story started in July 1996, when Albert J. Dunlap was hired by Sunbeam's Board to restructure the financially ailing company. Together with the principal financial officer, Russell A. Kersh, Dunlap promised a rapid turn-around in the company's financial performance.

Working with three other top officers, they then employed improper accounting techniques to manage earnings, until the fraud was discovered in 1998.

According to the SEC, the earnings management seemed to begin innocently enough in the first quarter of 1997 with the usual "channel stuffing" at the end of the period to inflate the revenue results. But then the company had to run faster and faster just to stay even. The channel stuffing, explained more fully below, deteriorated from a normal business practice to means of improper revenue recognition.

The company was audited by Arthur Andersen, who expressed unqualified audit opinions on the 1996 and 1997 financial reports. Presently, Sunbeam is in a reorganization proceeding under Chapter 11 of the U. S. Bankruptcy Code.

Xerox is a US document company, founded in 1906, which provides an array of innovative document solutions, services and systems including color and black-and-white printers, digital presses, multifunction devices and digital copiers, designed for offices and production-printing environments (www.xerox.com).

Xerox was a leading technological innovator for most of the last half of the 20th century. But by the late 1990s, the company was confronting intense product and price competition from its overseas rivals. As a result, increasing revenues and earnings became more difficult.

To improve operating results, Xerox disguised its true operating performance by using undisclosed accounting manoeuvres, most of which were improper, that accelerated the recognition of equipment revenue by over \$3 billion and increased earnings by approximately \$1.5 billion throughout the years from 1997 to 2000, according to the SEC accusations. Xerox's auditing firm from 1971 to 2001 was KPMG, which was replaced by PriceWaterhouseCoopers in 2001.

#### Analysis of the Three Cases

Our analysis of the three financial statement fraud cases is based on the structure by Rezaee (2002). He determines the five interactive factors that explain financial statement fraud cases. These factors are cooks, recipes, incentives, monitoring and end results, with the acronym of CRIME.

#### Cooks

The first letter of Crime is C, which stands for Cooks. In most of the cases, the people who participate in financial statement fraud are senior management such as the Chief Executive Officer (CEO), Chief Financial Officer (CFO), directors, etc. In L&H, the cooks were the CEO and other top executives. In Sunbeam, the cooks were Chairman and CEO Albert J. Dunlap, and four other executives: the principal financial officer, controller, and two vice-presidents.

The SEC also sued the partner of Arthur Andersen for being aware of the fraud, but still issuing the unqualified audit opinion. In the Xerox case, the cooks were the former chairman, former president, and former CFO.

## Recipes

The second letter in Crime is R, which stands for Recipes. Recipes are fraudulent schemes, which the management of the companies have used for their cooking (Rezaee, 2002). Recipes vary from case to case. In the following sections, we illustrate typical recipes which L&H, Sunbeam and Xerox took.

We will discuss the fraudulent schemes with regard to improper recognition of revenue only.

## Lernout & Hauspie Recipes

### Improper Related-Party Sales Transactions

L&H has used the related-party transactions with insufficient disclosure to create its revenue. By using "related-party transactions," apparently L&H had successfully covered the auditor's eyes.

According to the SEC complaint (Litigation Release No. 17782, October 2002), between 1996 and 1999, L&H entered into some engagements with two Belgian entities: Dictation Consortium N.V. (Dictation) and Brussels Translation Group N.V (BTG). L&H later admitted in the SEC filings that Dictation had been a related party of L&H. Transactions between L&H and these two companies were arranged to allow L&H to fraudulently claim revenue from its own research and development activities, which otherwise would not have been recorded as revenue unless and until the projects resulted in marketed products, as the SEC said. L&H improperly recorded over \$60 million in revenue from transactions with these two entities.

To accomplish all this, L&H had the following transactions with Dictation (SEC Litigation Release No. 17782, 2002):•



- At the very date of creation of Dictation in 1996, L&H signed a \$5 million agreement with Dictation in which L&H gave Dictation license for certain technology and the right to develop applications from the technology.
- Around three months later, L&H entered another contract with Dictation. In this contract, Dictation agreed to pay L&H \$25 million to develop software using the technology previously licensed to Dictation. The contract gave L&H an "option" to buy back from Dictation the rights to the license and any software developed.
- This resulted in recognizing revenue of L&H from its software development with Dictation of \$7.5 million (24% of reported revenue); \$18.9 million (19% of reported revenue) and \$0.3 million (under 1% of reported revenue) in 1996, 1997 and 1998, respectively. Therefore, the total revenue for three years in a row that L&H derived from transactions with Dictation was \$26.7 million (\$7.5 million plus \$18.9 million plus \$0.3 million).
- In the middle of 1998, before L&H developed any marketable product for Dictation, L&H acquired Dictation for \$43.3 million.

From the illustrated transactions, the following hypothetical accounting journal entries in summary form are constructed to explain the L&H situation:

Dr. Receivable from Dictation \$26.7 m

Cr. Sales (1996, 1997, 1998) \$26.7 m

Dr. Dictation acquisition \$43.3 m

Cr. Receivable from Dictation \$26.7 m

Cr. Premium \$16.6 m

From the above accounting journal entries, it appears that L&H purchased the product of its own research and development at an excess of \$16.6 million.

The questions here would be whether the establishment of Dictation was for the purpose of L&H to record the false revenue, which in fact were "loans;" and whether the transactions were conducted at arm's length.

The same process happened with BTG (SEC Litigation Release No. 17782, 2002):

- Similarly, on the date of its creation, BTG signed an agreement on licensing valued at \$3.5 million, which was then amended to increase the amount of the license fee to \$5 million.
- Later on, another contract on research and development services was signed at \$30 million. L&H recognized totally throughout 1997, 1998 and 1999 for its revenue with BTG \$15 million (15% of reported revenue) and \$18 million (8.5% of reported revenue) and \$2 million (under 1% of reported revenue), respectively.
- In the middle of 1999, L&H purchased BTG for \$42 million.

We construct the following hypothetical accounting journal entries in summary form to explain the L&H situation:

Dr. Receivable from BTG \$35 m

Cr. Sales (1997, 1998, 1999) \$35 m

Dr. BTG acquisition \$42 m

Cr. Receivable from BTG \$35 m

Cr. Premium \$ 7 m

The situation is exactly the same with BTG. The revenue recognized by L&H actually were disguised “loans” as the SEC complained. This kind of recognition does not comply with GAAP, and therefore L&H did materially overstate its revenues in these years.

#### Illegitimate Sales Transactions

When the deals with Dictation and BTG were accomplished, L&H initiated a new game to boost its reported revenue. L&H created new customers named “Language Development Companies” (or Laces) which were established with different actual roles at the time of their creation. All Laces were private companies, incorporated in Singapore, although they had no actual operations in that country. The “managing director” of many of the Singapore Laces was a Belgian national associated with L&H, as revealed by the investigation of the SEC.

In its annual report, L&H disclosed that the Laces were formed to develop new markets for L&H technology by licensing the company’s basic code-generating software to start-up entities in different parts of the world. These entities were supposed to then develop

speech recognition and translation software applicable to various regional languages. In actual fact, the Laces were little more than shell companies created, like Dictation and BTG, as a means for L&H to improperly fabricate revenues (SEC Litigation Release No 17782, 2002). The Laces had few employees, and were dependent upon L&H personnel for research and development activities. None of the Laces produced any significant products.

L&H arranged for others to supply financing for some of the Laces. For example, in 1999, L&H asked an investment bank to seek investors for two Laces. The investment bank advanced L&H \$8 million for technology licenses for the Laces. The agreement tied L&H's obligation with the understanding that L&H would repurchase the licenses at a substantial premium if the investment bank was unable to locate investors to fund the Laces.

Hence, the SEC proclaimed that, to the extent L&H obtained funds from the Laces, some or all of these funds were subject to material conditions, imposing on L&H significant potential liabilities which were not reflected on its balance sheet, and which L&H did not disclose to its shareholders. Under those circumstances, the accounting applied to the Laces did not comply with GAAP.

These creations enabled L&H to recognize of \$110.5 million in license fees and prepaid royalties from the Laces in 1998 and 1999, giving the false impression of growth (SEC Litigation Release No. 17782, 2002).

#### Side Agreements Made by L&H South Korea

Between 1999 and 2000, L&H reported approximately \$175 million in sales revenue from its South Korean operations (L&H South Korea), the majority of which was fraudulent, as the SEC claimed.

This sale was considered "fraud" because of following factors (SEC Litigation Release No 17782, 2002):

- L&H South Korea entered into oral and written side agreements with customers in which they gave them no definite payment obligation.

- L&H South Korea made up the uncollectibility of the receivables resulting from some of these fraudulent sales by factoring the receivables to South Korean banks.

From all the above-mentioned schemes, we find that recognition revenue of L&H in these cases does not comply with US GAAP in which "recognition of revenue" is defined emphatically as "recognized when earned."

### Sunbeam Recipes

According to the SEC's complaint (Litigation Release No. 17710, September 2002), the executives employed improper accounting techniques and undisclosed non-recurring transactions to misrepresent Sunbeam's operation results. As a result, Sunbeam's financial statements and press releases reporting quarterly and year-end 1997 results, and first-quarter 1998 results were materially false and misleading. More specifically, various fraudulent schemes were alleged by the Commission, as described below.

### Bill and Hold Sales: Improperly Recognized Revenue

To boost income in 1997, the executives caused Sunbeam to recognize revenue for sales, including "bill and hold sales," that did not meet applicable accounting rules (SEC Litigation Release No. 17710, 2002). In the manufacturing industry, recognition of revenue critically depends on ownership of products or title to the goods held. The "ownership" which is not determined precisely in sales contracts or agreements is the trick that companies use to cook their books. This was successfully, if fraudulently, applied by executives of Sunbeam. In total, Sunbeam fraudulently booked \$62 million of its reported \$189 million in the fiscal year 1997; and at least \$7.1 million "wrong booking" resulted from improperly recognized revenue on bill-and-hold sales.

How did Sunbeam do this? Sunbeam had agreed with one wholesaler that they (the wholesaler) would hold barbecue grills without accepting any of the risks of ownership and that the wholesaler could return all of the merchandise if it did not sell products. The wholesaler did hold Sunbeam barbecue grills, but actually returned all of the grills to Sunbeam during the third quarter of 1997. •

This technique is a classic “bill and hold sale.” Essentially, there was no sale by Sunbeam.

This practice is not in compliance with IFRS and US GAAP, which does not allow recognition of revenue on transactions lacking economic criteria. In this situation, Sunbeam recorded the sale of the barbecue grills even though title had not passed to the wholesaler, and the wholesaler had the full right of return.

#### Channel Stuffing

Also in 1997, Sunbeam executives used “channel stuffing” to make its reported revenue look good (SEC Litigation Release No. 17710, 2002). And they did not disclose that revenue growth was, in part, achieved at the expense of future results. Sunbeam had offered discounts and other inducements to customers to sell products immediately that otherwise would have been sold in later periods, a practice known as “channel stuffing.” Sunbeam’s improper accounting and channel stuffing in 1997 created the illusion of reduced results in 1998. In early 1998, the executives took increasingly desperate measures to cover the company’s increasing financial problems. They again caused Sunbeam to recognize revenue for sales that did not meet the applicable accounting rules and to engage in acceleration of sales revenue from later periods. Sunbeam further misrepresented its performance and future prospects in its official first quarter report of 1998, in its press releases, and in its communications with analysts (SEC Litigation Release No. 17710, 2002).

#### Xerox recipes

##### Timing of revenue recognition: Lease agreement

Since Xerox manufactures expensive capital machines, subject to rapid obsolescence, the company sells most of its products and services under bundled lease arrangements. This means that Xerox entered long-term lease agreements in which customers paid a single negotiated monthly fee in return for the equipment, service, supplies and financing. Xerox refers to these arrangements as bundled leases and the monthly payment as “Total

Cost of Ownership” (Xerox Annual Report, 1998). Bundled lease transactions constituted the majority of its sales revenue.

In 1990s, the executives of Xerox took advantage of this type of transaction to accelerate its leasing revenue to recognize revenue immediately at the expense of future periods.

As alleged by the SEC (Litigation Release No. 17465, April 2002), Xerox repeatedly and improperly changed the accounting policy for recording lease revenue from the mid 1990s to 2000. This means that Xerox booked and recognized immediately revenues from leases of Xerox equipment that, under Xerox’s historical accounting practices, would have been recognized in future years. These accounting changes pulled forward nearly \$3.1 billion in equipment revenue and pre-tax earnings of \$717 million from 1997 through 2000, as the SEC claimed. Xerox never disclosed in its financial statements that these gains were a result of accounting changes only, not from operational performance.

There is nothing wrong in Xerox’s decision to change its accounting policies for recognizing revenue so long as IFRS or GAAP principles are followed. However, it is necessary to disclose the impact of this change since it has material impact on the decision making of the investors. Apparently, Xerox management had played games with concept of “recognition revenue.” This violated requirements that material changes in accounting methods must be disclosed separately from normal operating income.

### Incentives

The third letter in Crime is I, which stands for Incentives and explains the typical reasons and motivations why companies and their cooks have engaged in financial statement fraud (Rezaee, 2002).

In all the three cases, L&H, Sunbeam and Xerox, there were enormous pressures on the management to meet the expectations and forecasts of the analysts. Like many other companies, these three companies faced the economic pressure to achieve their targets, show steady growth and perform better and better all the time in order to keep the investors happy and increase their market value.

As for the auditors, they were also under the pressure of retaining their clients. All of the studied companies were large and certainly the auditors faced the risk of losing their top clients if they did not come to agreement with regard to questionable, even irregular, accounting practices. Unfortunately this situation with an external auditor, anxious to retain a client, leads too often to an auditor's failure to resist client pressures.

In many cases another strong incentive to manage earnings is executives' bonuses tied to company's performance. The bonuses for chief executives were very high, in these cases, although in the case of Sunbeam, the executives did not gain from the boosted stock market price, as they held their options and stock (SEC Litigation Release No. 17710, 2002). The main incentive behind the Sunbeam's fraudulent activities seems to be hidden in the personal character of the CEO Albert J. Dunlap who was the turn-around manager of Sunbeam.

A normal tendency of a turnaround manager at a new assignment is to overstate the problems ("A Corporate Rambo in Trouble," 1998). The executives might say that things in reality are much worse than they were told or believed when they first took the job. After that, even slight improvements seem like major events. In Dunlap's case, with his desire for publicity and inflated self-image, he promised more than was reasonable and set himself up for a fall. When Dunlap arrived at Sunbeam, he announced a plan within three months that included eliminating 50 per cent of the company's 12,000 employees, selling 39 of its 53 facilities, divesting several lines of businesses, and eliminating 6 regional headquarters in favour of a single one in Florida. ("A Corporate Rambo in Trouble," 1998). He had promised to turn the company around and he was not going to fail. In fact, Dunlap's turn-around formula was phoney, and it left no room for ethics.

### Monitoring

The fourth letter in Crime is M, which stands for Monitoring. Responsible corporate governance and the presence of adequate and effective internal control systems are the most important factors in preventing and detecting financial statement fraud (Rezaee, 2002). Lack of monitoring of the top management by the board of directors is evident in all the three cases. Sometimes too much trust between those entitled to check (board of directors and the company audit committee) and those to be checked (management) can

be a contribution to fraud. In Sunbeam's case, the CEO had very friendly relations with the principal owner of the company and the board (although the friendship ended when the actual fraud was discovered). The same was true in L&H's case, when the founders of the company were indeed themselves engaged in the fraud.

External auditors have a significant role in monitoring the company. But the external auditors' ability to detect fraud is somewhat limited to the extent of internal control system of the company (Rezaee, 2002). There is a possibility that in these cases auditors were probably to some extent aware of the misstatements of the financial figures, but under the environment of lack of oversight from the board and audit committee, decided they were not material.

#### End Results

The last letter in Crime is E, which stands for End Results. Financial statement fraud always has consequences, even if it is not detected.

#### Lernout & Hauspie

L&H has ceased to exist as an operating company. It has filed for bankruptcy protection. Investors in Belgium, the United States and elsewhere suffered a loss of at least \$8.6 billion dollars in market capitalization. The former CEO, as well as two founders and co-chairmen, were arrested and charged with fraud; another top executive is under investigation. After reviewing L&H's actual sales figures for Singapore and South Korea, auditor KPMG sued L&H for trying to subvert an audit that KPMG conducted into the company's operations.

#### Sunbeam

Public investors who bought and held Sunbeam's stock in anticipation of a true turnaround lost billions of dollars.

To settle the SEC charges, Dunlap and Kersh agreed to permanent injunctions against ever violating federal antifraud statutes, and permanent barring for each of them from serving as officers or directors of any public company. They also agreed to pay a civil penalty of \$500,000 for Dunlap and \$200,000 for Kersh.



In addition, Dunlap had paid \$15 million and Kersh \$250,000 to settle Sunbeam class-action suits (SEC Litigation Release No. 17710, 2002).

Nevertheless, they did not admit or deny any wrongdoing.

Three other former executives and Sunbeam's former accounting partner from Arthur Andersen have refused to settle the SEC charges.

The new management dismissed the independent auditor, Arthur Andersen, in 1998 and replaced them with Deloitte and Touche LLP. Arthur Andersen paid \$110 million to settle claims but did not admit fault or liability (Weil, 2001).

Xerox

The stock price of Xerox has dropped 63% from a 2002 high of \$11.45 (January 29, 2002) to the lowest of \$4.20 (November 10, 2002) (New York Stock Exchange, 2002).

The company has lost many of its customers to the competitors since the time the fraud issues were discovered (Byrnes and Bianco, 2002).

The SEC has warned KPMG and the partner who headed its audit of Xerox that it may file civil charges against them. Xerox has agreed to pay a \$10 million civil penalty and to restate its financial accounts back to 1997 after booking false revenues (Greenemeier, 2002).

### 2.2.7 Detection

Having dissected each case, we find that auditors had not taken their responsibilities fully for detecting fraud. The detection of fraud in these three cases came from the public press, various analysts, and the SEC, rather than from the auditors who are supposed to be the first to detect fraud.

After cases and cases of fraudulent financial statements, an obvious question is:

“Where is the auditor? Why they did not discover the fraud?”

In order to understand why the auditing firms in these cases have not detected the various frauds, an examination and discussion of both technical and ethical issues are required. We are going to analyze these issues in the next section.

### Reasons Why Auditors Have Not Detected Fraud

In this section, we are not trying to judge or criticize any auditors who audited the companies accused of committing false accounting. Instead, we want to find the underlying reasons why the auditors in these cases did not discover the fraud.

The increasing number of cases of financial statement fraud makes the professionals worry about the quality of audit work, i.e. its methodology and approach. The issue of how audits are done has been a source of concern at the SEC. In theory, IFRS or GAAP should have prevented most of the abuses in the studied cases. But the standards created by the Financial Accounting Standards Board are merely guidelines – and are subject to interpretation. That's where the auditors are supposed to come in. But even officials of the AICPA say the auditors have to ensure only that a company's financials are in accordance with IFRS or GAAP (Greenberg, 1998). In all the cases, the auditors' (and company's) first answer to the accusation of fraud was: everything was in accordance with IFRS or GAAP. And although some auditors have agreed to pay fines, they never agreed to any wrongdoing.

Beasley, et al. (2001) summarized the SEC enforcement actions against auditors in the period from 1987 to 1997. These showed the top ten audit deficiencies made by auditors. The most common problem was the auditor's failure to gather sufficient audit evidence. The SEC also alleged the auditors failed to apply IFRS or GAAP pronouncements, or applied them incorrectly. In addition, audit programme design was an issue. Lack of professional skepticism, over-reliance on inquiry as a form of audit evidence, deficiency in confirming accounts receivable, failure to recognize related-party transactions and assuming internal controls exist when they may not, are the main audit problems which the SEC considered.

Next we discuss the most critical problems – analytical review procedures, risk assessment in relation to the audit risk model, failure of applying accounting standards in “revenue recognition,” as well as “recognition of related-party transactions” and conflict of interest issues – which have been highlighted by the accounting literature (Beasley, et al., 2001, Cullinan and Sutton, 2001). In order to find the reasons why auditors have not detected the fraud in the studied cases, we compare and analyze the above-mentioned problems with the information available about the auditors involved in the cases we studied.

#### Analytical Review Procedures Used as “Sufficient Audit Evidence”

The withdrawal of the audit report of KPMG in the L&H case implied that, to some extent, the auditors had not obtained the sufficient evidence for their conclusion. In some measure, the insufficient evidence resulted from the audit approach itself (Cullinan and Sutton, 2001).

Due to the time constraints, cost benefits and value-added services, the audit approach has been modified to overcome these audit problems. The “great discovery” in the audit process in 1988, which has opened the floodgates to auditors, was the acceptance that analytical procedures were capable of not only being used in the planning of an audit, but also were now a valid substantive testing procedure (Cullinan and Sutton, 2001). Therefore, the audit seemed to constitute the combination of testing the internal control system and the analytical review, with minimum substantive testing performed.

A survey conducted by Loebbecke, Eining, and Willingham in 1989, which was taken by KPMG Peat Marwick partners who had encountered management fraud, disclosed that 61% of the fraud cases were discovered through substantive tests while only 19% were discovered through analytical review procedures (Cullinan and Sutton, 2001).

The analytical review procedure involves much “professional judgment.” This means whilst auditing the balances of items, auditors have an expectation of how the accounts

should be. Referring to the “analytical procedure,” International Standards on Auditing No. 520.17 (1998) released by International Federation of Accountants (IFAC), we find stated that “the expected effectiveness . . . of an analytical procedure . . . depends on . . . the reliability of the data used to develop the expectation . . . (and) the precision of the expectation.”

In conjunction with the cases we studied in last section, L&H’s auditor is an example of the auditors putting their trust too high in the client data. Soon after the fraud story of L&H was discovered by The Wall Street Journal and the resulting SEC probe decision, KPMG defended themselves by accusing the former top management of L&H of lying about the key business structures within the company and giving false information (Conlin, 2001).

It is precisely the problem that auditors have to trust in the information that the client provides. However, when applying only analytical procedure, excessive trust is too risky for auditors since such a level of trust depends highly on the reliability of the data given! In addition, the analytical review procedure seems to emphasize investigations of “fluctuations” in the account balances, especially the analysis of discrepancies from the previous years (both budget and actual figures) (Brown, 2002).

If the explanations of the discrepancies reasonably correspond to the current business events “happening” in the company, through the observation of the auditors, it is likely that less testing work is performed.

We put “happening” within double-quotes because it is common sense that management who falls to the temptations of fraud, obviously tries to hide the “real situation” by making the accounts look normal. For example, the management discloses to auditors that in this year no critical issues occurred.

The orientation of the management is to manipulate the financial statements to make them look similar to past years. Therefore, the auditors, with their analytical procedures, attempt to present evidence supporting the contention that everything is fine since no discrepancies with prior year financial statements are detected. This false interpretation can occur because it depends greatly on professional skepticism of the auditor (Cullinan and Sutton, 2001).

There is another difficulty for auditors in applying analytical procedure. Most big companies have a long history of engagement with their auditor partners.

We have discussed above that the analytical procedure involves many judgmental issues. The interpretation of findings is also affected somehow by the "independence" factor, which we are going to discuss in a separate section.

The longer the auditors are engaged with their clients, the more loose the "professional skepticism" of the auditors could be. Once the auditors attempt to persuade themselves that the figures in the financial statements of their clients are fine, the interpretation for their analysis drives them in a manner toward supporting the conclusion, which they want to reach (Brown, 2002). Therefore, even in some cases where the auditors might have smelled something not satisfactory in the financial report, they did not consider digging it out.

Xerox's auditor is a good example of misuse of analytical procedures. KPMG, as auditors, had been with Xerox since 1971 until replaced by PriceWaterhouseCoopers in 2001. KPMG has been criticized by the press (for example, Kay, 2002, Maremont, 2000, and Conlin, 2001) for not taking enough responsibility for Xerox's accounts. It was said that Xerox's manipulations should have been easy to detect if there was anyone interested in looking. The revenue numbers made up from the "lease agreement" are so large that "it's akin to auditors driving past Mount Everest and saying they never saw it...Corporate America has somehow gotten into the mindset that this is OK" (Kay, 2002). If one examines the annual reports of Xerox from 1995 throughout 2000, that comment is not too exaggerated. The revenues gradually and continuously increased from \$16,588 million in 1995 to \$19,228 million in 1999. It looks as if the "cooks" had put a certain percent of growth in each year.

Assuming the auditors used the analytical procedures to investigate those consecutive increases in sales, from comparing the figures from year to year, the auditors would have noticed the increase and wondered about what had been going on. However, due to the constraints we discussed before in the section, the auditors allowed the situation to continue. KPMG did not say anything, even when they were fired by Xerox.

Analytical procedure applied to sales accounts normally involves the comparisons of recorded amounts, or ratios developed from the recorded amounts, to expectations

developed by the auditor. This means that the auditor would use a variety of sources, including the financial information from comparable previous periods, budgetary results, and information regarding the industry in which the client operates, within the client's normal business practices regarding sales and distribution in order to develop the auditor's expectation (AICPA, 1999).

We will look into the cases, which we have studied, beginning with Sunbeam.

In the last section of Sunbeam's "recipes" we wrote that Sunbeam was blamed by the SEC for taking advantage of "bill and hold sales" to increase its reported revenues in 1997. The company executed an "incomplete contract" with its wholesaler to record about \$7.1 million revenue in 1997. In the contract, Sunbeam had agreed that the wholesaler would hold barbecue grills without accepting any of the risks of ownership and that the wholesaler could return all of the merchandise if it did not sell products. The wholesaler did hold Sunbeam barbecue grills, but actually returned all of the grills to Sunbeam. The auditor might have detected this fraud if they warily examined the contract simultaneously with the inventory stock count at the year-end. In this situation, the analytical procedures would have not helped the auditor in detecting the fraud.

It is a similar situation with L&H's South Korea case. The company entered side agreements with customers who were not obliged to make definite payment. By this procedure, L&H recorded \$175 million revenue in 1999 and 2000. Although we described earlier that the side agreements are often hidden from the external auditors, the auditor can still detect the fraud by performing further testing. For instance, in this case, the auditor could check whether the customer had made the payment in the subsequent year. With a further examination of the annual reports of L&H for the years ended 1997, 1998 and 1999, it is impressive that the revenues, (consisting of sales of technologies and solutions; applications; and consulting and services) especially of technologies and solutions were increasing rapidly: from \$ 99,371 million in 1997, to \$ 211,592 million in 1998 and to \$ 344,237 million in 1999.

It means the revenues increased more than three times within two years. It could be that the auditors here have not addressed the revenue growth question with this sort of enormous increase in sales.

It is possible that the auditors in those cases did perform the analytical procedures, for instance, comparing this year's ratios to the previous year's, his quarter's to the last quarter's, etc., but it is possible that they did not bring their judgment of comparisons to the actual situation of market and business in which their clients were operating. The reason behind that could be that the auditors put their trust too high in the data provided by the management.

“Channel stuffing” and “improper timing of revenue recognition” is often identifiable by using analytical procedure. But here we emphasize again, it depends to a great extent on the interpretation of discrepancies by the auditors.

In the case of Sunbeam, according to its annual reports (1997, 1998) its sales in 1997 increased significantly as compared with 1996, whilst the cost of sales actually decreased. Conversely, the sales in 1998 decreased compared with the previous year, whereas the cost of sales increased. This shows that the company did allocate their expenses in 1998, which should have been recorded in 1997.

While the analytical procedure technique works to identify discrepancies, however, it is in the hands of the interpreter to explain such differences.

#### Weaknesses of Audit Risk Model and Risk Assessment

Accompanying the innovation in the audit risk model of the 1980s, most of the main international public accounting firms have deliberately tailored their audit methodology in compliance with GAAS to improve the cost effectiveness of an audit and to focus on the value-added services for clients. These re-engineered audit processes generally focus on a client's business processes and on an evaluation of the information systems used by the client to generate financial information (Cullinan and Sutton, 2001). Therefore, according to Brown (2002) auditors these days have gradually focused more on how companies generate their financial data, the computerized bookkeeping programmes, and the internal controls that are supposed to act as a check on the system, rather than on the numbers themselves. That is in contrast to the older style of auditing, under which accountants dissected corporate accounts deeply, looking at thousands of transactions to determine if the bookkeeping was correct. The shift in the way accountants audit their

clients' books can be traced to two developments dating from the early 1980s. First, companies increasingly turned to computers to manage their finances. Second, intense competition caused the fees for auditing to fall as much as 50% from the mid-1980s to the mid-1990s. That forced auditors to cut costs themselves, and they did it by cutting back on the labour intensive process of sifting through dozens, or even hundreds, of corporate accounts. In order to be more efficient, the auditors put more reliance on internal controls, which allowed them to do less work on account balances and transactions.

The auditor's reliance on internal controls has been criticized as a weakness in the audit procedure. The perspective of most accounting firms regarding the reengineered audit approaches is that fraud is something lower level employees are responsible for (Cullinan and Sutton, 2001). In essence, the internal control system is established to control the lower level employees rather than the upper management. It hardly works as an effective control system at the management level since the control system is built by the management themselves to scrutinize their inferiors only.

Beasley, et al. (2001) summarized the report of the AICPA ASB, 2000 titled "Fraud-Related SEC Enforcement Actions Against Auditors: 1987-1997" on accounting and auditing financial statement fraud instances announces that in most of the cases the very top levels of management, i.e. CEO or equivalent level, are the conductors of the "fraud story." Our case studies with Lernout & Hauspie, Sunbeam and Xerox in the "Cooks" part in our previous section also support this conclusion. The question here will be raised whether the transformation in the audit process, which focuses on risk assessment of internal control system, is the right direction regarding fraud detection. The problem becomes more critical since in most international organizations as big as L&H, Sunbeam and Xerox, the controls and systems should be effective and adequate.

Since the top management never creates the controls and systems to monitor themselves, the fraud committed by top management is only left for the audit committee and the auditor to detect. The reform in the audit process, which emphasizes internal control systems, has worsened the possibility of top-level fraud detection.



In the three cases we studied, we found it is truly hard for auditors to detect the “cooking” with this audit approach, especially with “earnings management” fraud. For instance, in the L&H case, the company is accused of having manipulated its accounting books from 1996 and 1999 by using its related parties to record sales (improper related-party sales transactions) and creating its start-up companies in other countries to boost its revenues. Detection of this sophisticated earnings management is unlikely unless the auditor has dug into the single, unusual transactions. Obviously it would take substantially extra time while assuming the auditor already performed tests of control and assessed the system was fine in earlier stages of the audit (Brown, 2002). The fear of double work and over-auditing is the main concern for auditors in this aspect of effectiveness and efficiency.

Principally the internal control system and the risk assessment have to be evaluated and upgraded every audit year since there could be changes in the structure and business of the company. Once the control system of the company is considered to be effective enough to be relied upon, the auditor has to perform a substantial test of controls and a “walkthrough review”. When the result of the test of controls gives a “yes,” as being effective for most of the critical control points, the auditor could draw the conclusion that the control system is “effective and reliable” and risk is assessed as low or moderate in the audit planning stage. Then the substantive tests should be minor in the audit execution stage. Although it is a must to evaluate the system every year, it could be the case that professional judgment and skepticism might diminish gradually once the auditor becomes too close with management and does not imagine that management would dare to falsify their books. At this moment, the auditor still assesses the control system of his or her client as effective and reliable, whilst in fact it no longer is. The danger here is that the failure in assessing the system of the company will lead to the inappropriate audit programme design. As the AICPA ASB investigation determined, audit programme design was a problem cited in 44% of cases studied (Beasley, et al., 2001). Audit programme design requires the auditors to consider the risk factors while engaging with their clients in order to identify these sorts of risks.

Audit Failure in Revenue Recognition and Related-Party Transactions Disclosure

Recent investigations have revealed that the audit failures in revenue recognition have increased. The study of the AICPA ASB, as summarized by Beasley, et al. (2001), in the enforcement actions stated that almost half of the cases investigated showed the auditors failed to apply GAAP or applied it incorrectly, especially in revenue and related-parties' accounts.

It is true that revenue recognition issues continue to pose significant audit risk to auditors. In some instances, auditors fail to correctly apply the accounting rules of revenue recognition. The criteria for revenue recognition based on existing accounting rules say that companies should not recognize revenue until it is realized or realisable and earned. According to the SEC, the revenue will only be recognized when a number of criteria has been met, including (Phillips, Luehlfing and Daily, 2001):

- persuasive evidence of an arrangement;
- delivery occurred or services rendered;
- seller's price fixed or determinable; and
- collectibility reasonably assured.

While these criteria are general, they provide guidance for revenue recognition relating to most traditional business models. The companies that do not employ traditional business models, such as e-commerce companies and companies with a large percentage of Internet transactions, are the challenges to auditors in deciding when and how the revenue should be recorded, although extra guidance of revenue recognition is provided by the SEC Staff Accounting Bulletin (SAB) No. 101 (Beasley, et al., 2001).

We return to the case of L&H, a software developer. The SEC made the accusation that transactions between L&H and two Belgian companies, Dictation and BTG, in fact were sort of "loans" since L&H claimed revenue from its own research and development activities, which otherwise would not have resulted in reported revenue unless and until the projects resulted in marketed products. Apparently in this case, the auditors did not detect the false sales recorded by its client since the sales had not met the criteria of "delivery occurred."

According to Beasley, et al. (2001), related parties' accounts, as alleged by the SEC, is another common problem for the auditor to fail to recognize or disclose transactions with related parties. The SEC found that the auditor was either unaware of the related party or

appeared to cooperate in the client's decision to conceal a transaction with this party. Such transactions often resulted in inflated asset values.

Having looked back to the case of L&H, it is found that the company in its financial reports from 1996 to 1999 did not disclose any information suggesting that Dictation was a related party. The company only admitted the relationship when the SEC made its probe of the company's financial figures. It could be the risk for auditor that the company did not provide sufficient information for the auditor to decide whether they are related parties or not. L&H also is under suspicion with its operation relations with the 30 Laces, "start-up companies" in Singapore, which enabled L&H to recognize of \$110 million in license fees and prepaid royalties in 1998 and 1999.

Revenue recognition and related-party issues are certainly risky areas for auditors (AICPA, 1999). In some cases, the auditor fails to apply the accounting principles appropriately. It could be the result of lack of involvement of audit partners in the audit engagement. In addition, it could be the consequence of revenue recognition and related-party transactions too broadly defined in GAAP.

#### Conflict of Interest Issues

In recent years, particularly 2002, there has been discussion on the issues of conflict of interest, particularly on auditor independence and non-audit services offered by auditors to their clients. We find these issues connected to the reasons why auditors have not detected financial statement fraud. In the next section, firstly, we will discuss auditor independence – its relationship with the auditee and time and cost constraints. Secondly, we will write about the non-audit services.

#### Auditor Independence

##### Pressures by Auditee's Management (Who Pays the Bill?)

There has been plenty of discussion about auditors' independence in the financial literature. Some authors argue (Greenberg, 1998, Bazerman, Morgan and Loewenstein,

1997) that auditors can never be independent, because of the current system, where auditors are hired and paid by the organizations that they audit. That is the first apparent conflict. The company is free to change the auditors, who do not agree with its accounting practices. Therefore there are auditors who choose to close their eyes for the fear of being fired.

The study of the cases revealed that the auditors did find out some of the irregularities, but could not resist client pressure and perhaps relied too much on the management statements. KPMG is blamed in the Xerox case because the auditing firm knew the problem, which had been going on in the entity, but they did not speak up (Bandler and Maremont, 2002). Instead, KPMG resigned when the management of Xerox asked for a new engagement partner.

#### Time and Cost Constraints

If auditors suspect material financial statement fraud, GAAS requires them to conduct appropriate fraud investigation procedures (or to withdraw from the engagement). According to Caplan (1999), these actions require considerable effort, because auditors can no longer rely on client-prepared schedules or management representations. If auditors' suspicions are unjustified, the fraud investigation can damage the client relationship, and an honest client might not compensate the auditors for their additional effort. On the other hand, failure to detect fraud can be quite costly to both the company and the auditor.

The auditors' decision on how much effort to expend investigating for fraud should be based on their assessed risk of fraud. However, it is difficult to assess this risk. Also, routine audit procedures may not distinguish between errors and fraud, since most audit exceptions result from errors; and the auditor's prior beliefs are weighted in that direction. Consequently, even when fraud is the actual cause of an audit exception, the auditor may simply assign an error interpretation, and the fraud will not be detected. (Caplan, 1999).

#### Relationship Between the Auditor and the Auditee

Too close relations between the auditor and the auditee can be a source of potential conflict of interests. For example, when a company hires their previous auditor as a top manager and the same auditing firm continues to audit the company, there is apparently too close relationship and a possible conflict of interests (Rezaee, 2002). As a result, an auditor might lack the professional skepticism always required.

In the Xerox case, the auditor KPMG audited the company for thirty years. It is possible that the auditors had too close a relationship with the auditee.

### Non-Auditing Services

Today, auditors collect more fees for non-auditing services than from traditional audit services. These non-audit services include bookkeeping, technology design and implementation, approval or valuation services, actuarial services, and internal audit services (Rezaee, 2002).

There are two main fears concerning the non-audit services and auditor's independence. First, non-audit service fees make auditors financially dependent on their clients, and hence less willing to stand up to management pressure for fear of losing their business. Second, the consulting nature of many non-audit services puts auditors in managerial roles, potentially threatening their objectivity about the transactions they audit. (DeFond, Raghunandan and Subramanyam, 2002).

To summarize what we have talking about, we discussed two main issues. The first part dealt with three case studies: Lernout & Hauspie, Sunbeam and Xerox, which we have chosen to examine because of their fraud in the financial statements. We analyzed the cases according to the factors with the abbreviation of CRIME, which stands for "Cooks", "Recipes", "Incentives", "Monitoring" and "End Results". In the second part, we discussed some causes, for why the auditors in the studied cases did not detect fraud. They are analytical review procedures; risk assessment in relation to the audit risk model; failure to apply GAAP in "revenue recognition," and "recognition of related-party

transactions” and conflict of interest issues. The application of analytical procedures is insufficient because the analytical procedures employ too much professional judgment. In addition, these procedures rely on the data and information given by the company management, who, if tempted toward fraud, could fool the auditors. Risk assessment process with audit risk model is also the cause. Over-reliance on internal control weakens the capability for detecting fraud (Brown, 2002). The internal control is built up by management to monitor employees, not themselves. A matter of fact is that in most of the fraud cases, top management is both conductor and creator of the fraud story. Therefore, if in the audit process, auditors focus on internal control, it only enhances the ability of finding errors at the lower employee level. Revenue recognition and related-party issues are the most risky areas for auditors (AICPA, 1999). In some cases, the auditor fails to apply the accounting principles appropriately, although they have not admitted that their audits have not complied with GAAS.

One more reason which is critical and controversial in the professional world is the conflict of interests issues. This is represented through the auditor independence problem and the sales of non-auditing services by auditors. The pressure of being paid by the management of the auditee as well as the time and cost constraint might affect the auditor’s judgments. The relationship between the auditor and its auditee creates the image of eroding independence in the public eye. The auditor apparently cannot help fearing losing its clients. The higher profit margin obtained from the non-auditing services than from traditional audit services stimulates auditors to expand their various non-auditing services to serve their clients. It is a question of conflict of interests again because, on one hand, the auditor assists the company in upgrading its control system, for instance, and on the other hand, the auditor is also the one who examines the system.

## CHAPTER 3

# METHODOLOGY

## Research Methodology

### 3.1 Introduction

This research aims at investigating the degree of awareness of the fraud issue among the auditors working in Palestine, and also to try to overcome the weaknesses suffered by the auditors specifically in these areas of expertise. The main objective stated to this study is to highlight the fraud issue to the auditors (internal and external) and to provide the auditors with the appropriate tools to fight the fraud and at the same time to take the fraud consequences into consideration when planning for audit job.

Research is a complex process, which constitutes “data collection, coding, all other processes of preparing and analyzing data, including the presentation of the results...” (Drucker-Godard, Erlanger and Crankier, 2001). Therefore, at the beginning of research, once the research problem is identified, the choice for research methodology to direct this complex process in an orderly manner is a necessity.

According to one source on research procedure, “Research methodology can be conceived as a system of rules and procedures. Such rules and procedures are important in research for the purposes of reasoning i.e. a specific logic to acquire insights; inter-subjectivity i.e. reporting how the researcher has obtained the findings and communication i.e. reporting in manner to enable others to replicate or criticize...” (Ghuri, Gronhaug, Kristianslund, 1995, p.24).

In this chapter, we present our methodology with a purpose consistent with the above-stated rules. Our methodology consists of: what research approach we follow; which data collection (secondary and primary data) we select; which case study method we choose; and finally, how we establish the validity and reliability of our research results.



The study will try to find answers for the following questions based on the analysis and the responses of the auditors:

1. Why auditors have not detected fraud in the financial statements?
2. What are the most accepted fraud indicators by the Palestinian auditors?
3. What are the most accepted fraud indicators by the Palestinian auditors?
4. How to improve the audit process to detect these kinds of fraud? Which will be answered in chapter five.

In order to answer these questions, 3 different types of questionnaires have been prepared and sent to the targeted population. From the analysis of the answers received from the sample, the answers for the above questions will be identified.

### 3.2 Study Population

There are about 256 audit and accounting firms working in Palestine as stipulated by the Palestinian Central Bureau of Statistics (PCBS). This number includes the big 4 audit firms with the highest quality service standards as required by the mother companies. As a matter of fact, 3 types of questionnaires were sent to the study population, the first was directed to the audit firms to measure their awareness and reaction to fraud, the second and the third were directed to the individual auditors regardless of the place of work (Big or Small, Local or International) to measure the personal perception of these auditors to fraud issue and in particular to identify the most and the least accepted fraud indicators by these auditors as will be discussed in further details.

The names, addresses, emails of the population of the Palestinian audit firms and auditors were collected by myself and through my colleagues at Deloitte based on our personal knowledge and relations of these auditors. All of these auditors are located in Ramallah due to the fact that, Ramallah is the biggest center in Palestine to absorb this number of auditors.

## Study Methodology

Our research approach is basically dependent on the elements of a normal research process which includes:

- theoretical perspective,
- research question (research problem),
- data collection approach, and
- data analysis.

Any research must depend on a theoretical framework or existing concept. Since our research deals with the financial statement revenue recognition problem, we start our work by looking into the definition of financial statement fraud and the responsibility of auditors to detect fraud in the financial reports.

This investigation provides us with the essential understanding to solve our research problem, "why have auditors not detected the financial statement fraud and how auditors can improve the audit process."

As we have already defined our research problem and constructed our problem in the form of questions, we chose our research approach in this thesis as "descriptive" and "explanatory."

"Descriptive study is undertaken in order to ascertain and be able to describe the characteristics of the variables of interest in a situation" (Sekaran, 2000, p. 125).

In our research, we use the descriptive approach to describe the nature of fraudulent financial statements cases, which have happened recently, and to identify the possibilities for how the management in these cases could have manipulated their financial figures.

"Explanatory study is undertaken in order to establish correlations between a number of variables" (Sekaran, 2000, p. 129). In our thesis, the explanatory part is presented through the relationship between the misstatement of financial reporting and the responsibility of the auditors. The investigation of this relationship answers the question "why auditors have not discovered these frauds in a timely manner."

Since we have chosen our research category as “descriptive” and “explanatory,” we define our methodology strategy as case-based research.

Although we are going to discuss the choice of the study method, at this stage we affirm that with the objective of our research, a case-based study is appropriate. This selected method affects our data collection method, which is discussed below.

#### Data Collection

“Data collection is crucial to all research. Through this process, researchers accumulate empirical material on which to base their research” (Ibert, Baumard, Donada and Xuereb, 2001, p. 172).

Since our research is more descriptive and based on cases, we have chosen the qualitative approach for collecting our primary data. This means we planed to interview several accounting firms and, internal auditors and top managements of several business types in the Palestinian business environment, including Banks, Hotels, all types of companies and NGOs. The result of these interviews and questionnaires will provide the basis for our conclusion on the research problem. We are going to discuss separately how we will gather the secondary and primary data for our qualitative research.

#### Secondary Data

It is true that “secondary data is data that was developed for some purpose other than helping to solve the problem in hand” (Fay, 1997, p. 215). This process is essentially the literature review. We use secondary data for our conceptual foundation. This secondary data also serves our purpose of describing the situation of the cases, and the arguments among the professionals about them.

Regarding the collection of secondary data, in this research we look more at external sources rather than at internal sources. The external sources we use are annual reports of companies under investigation of having committed fraud.

These annual reports are the most precise and official evidence to support our analysis because they were publicly issued to stockholders who suffered directly from their

misstatement. Additionally, we use the litigation documents of the SEC against the companies we study.

Articles and books are also useful sources of information. Books are "primarily useful for historical background" (Fay, 1997, p. 220). They are critical in building our theoretical framework, especially in the definition of financial statement fraud and the identification of the responsibility of auditors for detecting fraud. In the discussion of auditors' responsibility and the technical auditing skills, we will search for the regulations and rules on auditing standards in order to know the requirements under the generally accepted auditing standards. The source we rely on is the Statements of Auditing Standards (SAS) issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA), a trade association for the accounting industry. Articles in professional literature, such as *The Journal of Accountancy*, *The Wall Street Journal* and *Journal of Accounting Research*, etc., as well as from the internet, are the main sources of information we use for our case study investigation. Additionally, we will use articles from other reliable business journals and newspapers.

The more reflections we get from different professionals who have commented on the actual case studies, the more precise and unbiased view we will gain.

### Primary Data

Among the choices for collecting the primary data such as "observations, surveys (questionnaires) and interviews" (Ghauri, et al., 1995), taking into account the research problem we are dealing with, we have selected interviews and sent questionnaires as the best alternative for our research.

Our interviews are conducted through two channels: interview by e-mail and personal interview. The interviewees are Palestinian auditing firms and Palestinian companies (auditees).

The audit companies we contacted are listed below:

Table No. 1

Audit Firms Participated in the Sample

Audit Firm	Location	Response
– Deloitte & Touche	Ramallah	Positive
– Ernst & Young	Ramallah	Positive
– KPMG	Ramallah	Negative
– PriceWaterhouseCoopers	Ramallah	Negative
– Talal Abu Ghazaleh	Ramallah	Positive
– El-Wafa and Co.	Ramallah	Positive
– Hanna and Associates	Ramallah	Positive

Also several banks, companies and NGOs were contacted and we were successful to arrange for interviews and obtain responses to our queries for few of them.

We could get interviews with two companies: a personal interview with Ernst & Young and with Deloitte. The person in the auditing firm we chose to interview was the one who is in charge of technical aspects in the company. These persons should be knowledgeable and interested in the problems we are studying.

Before implementing the interviews, we studied the three cases thoroughly.

From the result of the cases review, we pinpointed the issues, which we think are the most critical. We created a questionnaire based on our study and analysis.

There are three main issues, which we focus on in our questions. First, we want to know the opinion of auditors about the fraud in the Palestinian business. Second, we want to know from auditors, what lies behind these undetected errors: is it an ethical or technical issue? The other questions concern how “to improve the audit process” and “to avoid the threat of undiscovered errors in the financial report. Thirdly, the evaluation of the proficiency of the auditors who are working in Palestine.

## Case Study Methodology

We selected three well-known cases, Lernout & Hauspie, Sunbeam and Xerox, for our investigation. In all these three cases, companies were charged with earnings management fraud. The three cases have in common that the companies were recognized as “blue chip” companies before being charged criminally for cooking their books. And they were all audited by major international accounting firms.

We have three criteria for selecting these three companies. Besides the obvious revenue recognition fraud issues, the first criterion we considered when choosing the cases is that they must have happened recently. The second criterion is that these cases are representatives from different industries:

Lernout & Hauspie (a software developer); Sunbeam (a consumer products manufacturer); and Xerox (a manufacturing company producing document machines). Therefore, the way they manipulated their figures could be various due to the different nature of their businesses. The third criterion is that, of the three cases, there should be at least one case that has been resolved. Therefore, we can see the whole case from the beginning, “being indicted,” to the end, “guilty of committing fraud.” That is the case of Sunbeam and Xerox, while the Lernout & Hauspie case is still on-going.

From the analysis of the above mentioned cases, we extracted the most independent variables that affect directly to the undetected fraud in the financial statement presentation. We have sent a questionnaire to the most famous audit firms to measure the awareness of the fraud problem enjoyed by these firms. In addition, we sent the red flags questionnaire to the external auditors and also it was to measure the extent of usage of these flags as indicators of fraud. As we see in the findings none of the audit firms responded to these red flags uses these indicators when detecting fraud. From the analysis of the above combination we extracted our final version of the questionnaire or what I would like to call the indicators of the audit deficiency that related directly to the alternative hypothesis, summarized in the table below:

Table No. 2

The listed reasons for not detecting fraud included in the questionnaire

1	Analytical Procedures are Insufficient for Audit Evidence
2	Risk Assessment and Internal Control Testing is not Absolutely Effective
3	Audit Failure in Applying Revenue Recognition and Related Parties Transactions
4	Conflict of Interest Issues
5	The competency Issue of the Auditors
6	Failure of Audit Firms to Apply Fraud Detection Training Workshops periodically
7	Lack of Professional Institutions that Deal with the Fraud Issue
8	Lack of Auditors Oversight (Who Watches the Watchdog?)

### 3.3 Hypotheses

H0: The above mentioned variables have no direct effect on not detecting financial statement fraud

H1: The above mentioned variables have direct effect on not detecting financial statement fraud

To test these two hypothesis I used the SPSS software to analyze the responses of the auditors (both external and internal) to the last questionnaire consisted of eight variables based on Likert scale. To make it possible to tests the hypothesis to measure the relationship between the variables and the failure to detect fraud as an absolute value I gave a weight of 40 to each filled questionnaire (5options X 8 questions). And we extracted the R2 (coefficient of Correlation). Since R2 is not sufficient to explain the relationship between the independent and the dependent variables. I used the ANOVA test (level of convincing) (see chapter 4 for the findings of the analysis).

## Research Evaluation

For any research work, obviously the validity and the reliability are considered at the end. The validity and reliability are the measuring instruments, which are used to assess the credibility of the research. In this section, we describe our research's validity and reliability by stating our research method path. We consider this as a means to strengthen our research's credibility.

### Validity

Validity is the term used to express the exemption from "non-random error" in the application of a measuring instrument. "Non-random error" (also called "bias"), refers to a measuring instrument producing a systematic biasing effect on the measured phenomenon" (Drucker-Godard, et al., 2001, p. 202). In qualitative research, this bias is affected by the methodology used.

To improve the validity in research, we attach special importance to the usage of qualitative tools in our methodology. These include documentary sources and questionnaires and interviews.

Regarding the validity of documentary sources, we study newspapers, articles, and statements relating to the cases selected and by interpreting them within the framework of the theoretical background, we believe that our analysis remains true to the reality of the facts/cases being studied.

Regarding the validity of interviews, we direct our interviews to the most knowledgeable group of people on the issues in the accounting organizations.

The questions prepared for the interviews are designed on the basis of the thorough study of the cases.



## Reliability

"The reliability of a measure indicates the extent to which the measure is free from "random error" and hence offers consistent measurement across time and across the various items in the instrument. In other words, the reliability of a measure indicates the stability and consistency with which the instrument measures the concept and helps to assess the "goodness" of a measure" (Sekaran, 2000, p. 204)

While the "stability" is presented through "low vulnerability to the changes in the situation" (Sekaran, 2000, p. 205), the "consistency" is assessed through the research method constructed.

We agree with Drucker-Godard, et al. (2001, p. 210) that "It is important for researchers to precisely describe their research design, so as to aim for a higher degree of reliability." As discussed above in the research approach, we have constructed our methodology approach to solve our research problem. Our research design is conducted consistently throughout the research, meaning here, the case studies selected, and the questionnaires and interviews prepared.

Therefore, the possibility of replicating the factual analysis of the study is probable. However, as we previously stated, our research analysis is judgmental. Conclusions and suggestions are our own, and are dependent on the results of our investigations. Other researchers, using the same investigative techniques, might form different conclusions and suggestions. From our point of view, however, with our clear purpose of study, well-structured research design, and the maintenance of a good research trail, we believe that we have taken important assurances to give our research reliability.

Moreover, the results revealed by the study can form just a starting point and also a motive for the interested researchers in this field to develop more complicated schemes and or research procedures to dig deeper to produce more interesting results that fits the nature and the specialty in the Palestinian market.

The special characteristics of the Palestinian market makes it even more difficult to identify steadily the reasons behind committing the fraud due to the several reasons can be summarized in social, political, and economical reasons.

## CHAPTER 4

### FINDINGS OF THE STUDY



## Chapter 4

### Introduction

The purpose of this thesis is to uncover the fact that fraud in the Palestinian business is underestimated, and the effect of the committed fraud may be is not shown to the public due to several reasons some of them political and the other is economic. Moreover, the study aims at getting to the bottom of the audit profession in Palestine which claims that the profession still not functioning as appropriate as possible and at the same time to provide the auditors with the appropriate ideas when planning for an audit job. Three related questions were stated to meet the objectives of this study, related mainly to the fraud and its components and the fertile environment to grow, the characteristics of a high quality audit job.

Accordingly, this chapter will be organized into three sections, and each section is devoted to answer one of the related questions. These sections are:

Section 1: Why auditors have not detected fraud in the financial statements?

Section 2: What are the most accepted fraud indicators by the Palestinian auditors?

Section 3: What are the most accepted fraud indicators by the Palestinian auditors?

### Data Collection approach and Questionnaires Development

Since the population of the study was the auditors, we managed to send a condensed questionnaire to the audit firms working in the Palestinian business environment and also the red flags test was sent to a sample of 55 auditors of them 48 cases responded positively. Also, after the analysis of the three cases we limited our findings of the reason why auditors do not detect fraud in the financial statement to eight variables (see table No. 3). The variables were formed in a table and transformed into a Likert test. Each variable was given to each case in order to measure the direct relation between the variables and the undetected fraud. The famous statistical SPSS was used to analyze the results of the questionnaire.

## 4.2 Findings of the study

In this section we will address the answers for the study main questions, and we will comment on the findings thereon:

### 4.2.1 Why auditors have not detected fraud in the financial statements?

The hypothesis of the study was sent to a sample of 55 auditors (external and internal) of which 48 positive responses were obtained. After using the SPSS the following results were revealed:

Table No. 3

#### Statistical Analysis and Results

R	0.998
R2	0.995, very strong relationship between variables and dependent

#### Regression Analysis

The regression analysis proved that there exist a linear relationship between the eight variables and the fraud detection, the analysis also showed that R2 (coefficient of correlation)=0.995 which means that the eight variables are responsible for not detecting fraud in the financial statements by 99.5% and 0.5% from other factors.

#### ANOVA Analysis

Many consider that the R2 is not sufficient to explain the relationship between the independent variables and the dependent variable so ANOVA (Level of convincing) tests were employed which revealed a score of 0.0000 less than .005 which means that the alternative hypothesis is accepted and the null hypothesis is rejected. For further analysis

for the direct relation between the independent and the dependent variables see the following table which shows the significance of each variable:

Table No. 4

## The Opinion of Auditors Related to the Fraud Detection

Independent Variables	Significance	Explanation
Analytical Procedures are Insufficient for Audit Evidence	0.431 > .05	The relation is not strong to the dependent variable
Risk Assessment and Internal Control Testing is not Absolutely Effective	0.003 < .05	The relation is strong to the dependent variable
Audit Failure in Applying Revenue Recognition and Related Parties Transactions	0.000 < .05	The relation is strong to the dependent variable
Conflict of Interest Issues	0.000 < .05	The relation is strong to the dependent variable
The competency Issue of the Auditors	0.002 < .05	The relation is strong to the dependent variable
Failure of Audit Firms to Apply Fraud Detection Training Workshops periodically	.627 > .05	The relation is not strong to the dependent variable
Lack of Professional Institutions that Deal with the Fraud Issue	0.000 < .05	The relation is strong to the dependent variable
Lack of Auditors Oversight (Who Watches the Watchdog?)	0.000 < .05	The relation is strong to the dependent variable

## Analytical Procedures

As we have discussed in the last section, where we asked the question, "why auditors have not detected fraud," it has been suggested that "analytical procedure" does not provide enough evidence for the auditor upon which to base an opinion. The main reason is because the procedure depends greatly on the interpretation of findings and the professional skepticism involvement of the issues. The interpretation of findings is directly affected by the information and data given by the client. This procedure is hardly

considered as effective in detecting financial fraud at the top management level since the management, with their temptation to commit fraud, could fool auditors cleverly.

As we mentioned before, analytical procedure involves much "judgment." Only auditors can do it. There is nobody who can judge the judgment of auditors.

In its study "Audit Issues – Revenue Recognition" (1999), AICPA presents some guidelines on what kind of analysis the auditor should conduct in order to be more effective with analytical procedure in the sales account:

- The most effective and common analysis the auditor should do is to compare monthly and quarterly sales by location and by product line with sales of the preceding comparable periods and for comparable periods in prior years.

This comparison will consider whether the results are consistent with other known information, such as expanding or declining markets, changes in sales price mix, and new or discontinued product lines. To identify some of the unusual transactions which might happen at the year end, the auditor can compare revenues recorded daily for periods shortly before and after the end of the audit period, looking for unusual fluctuations, such as an increase just before and a decrease just after the end of the period.

- The comparison of gross profit ratio, overall and by product line, to previous years and to budget, considered in the context of industry trends, is also the common tool to use.

- To identify the "channel stuffing," the auditor can compare the number of weeks of inventory in distribution channels with prior periods for unusual increases. The comparison of revenue deductions, such as discounts and returns and allowances, as a percentage of revenues with budgeted and prior period percentages for reasonableness in light of other revenue information and trends in the business and industry could identify the "bill and hold sales." The comparison of sales credits for returns subsequent to year end with monthly sales credits during the period under audit to determine whether there are unusual increases may indicate contingent sales or special concessions to customers.

Combining the suggestions of auditors interviewed with the existing studies on analytical procedure for sales, in our opinion, in order to make analytical procedures effective, there should be supplementary substantive tests performed. We also believe that making inquiries is an effective tool for auditors to detect fraud as well.

## Risk Assessment

The assessment of the risk of material misstatement due to fraud is an ongoing process (Heim, 2002). Risk assessment processes such as planning, assessing risk, and gathering and evaluating evidence should be continuous throughout the audit rather than only performed in separate phases of the audit. Fraud risk factors may come to the auditor's attention while performing procedures relating to acceptance or continuance of clients, during engagement planning, in obtaining an understanding of a client's internal control, or while conducting fieldwork. Other conditions identified during field work may change or support a judgment regarding the assessment, such as unavailability of other than photocopied documents, or situations when auditors are denied access to records, facilities, certain employees, customers and/or vendors from whom audit evidence might be sought (Heim, 2002).

## Understanding the Fraud Triangle

There are three conditions generally present when fraud occurs – incentive/pressure, opportunity and attitude/rationalization. Understanding and considering the likeliness of fraud in the context of these three conditions will enhance the evaluation of information about fraud (Montgomery, et al., 2002). This will provide the auditor with more professional skepticism when assessing fraud risk. Auditors are advised to consider the client's receptiveness to fraud, regardless of the auditor's past experience with the client or prior assessments about management's honesty and integrity (Heim, 2002).

## Evaluation of Programmes and Controls

When the auditor identifies risks of material misstatements due to fraud, the ED requires that he or she consider management's programmes and controls to address those risks. They might include broader programmes or specific controls designed to prevent, deter or detect fraud. The auditor would consider whether such programmes and controls would mitigate or exacerbate those identified risks. Also, the auditor would evaluate whether these programmes and controls have been suitably designed and placed in operation. The



auditor's ultimate assessment of the risks of material misstatement due to fraud would take this evaluation into account. (Montgomery, et al., 2002).

#### Further Procedures to Improve Risk Assessment

Management is in a unique position to perpetrate fraud because it can override established controls that would appear to be operating effectively. This risk exists in virtually all audits and can occur in a number of unpredictable ways.

Currently, the auditor's planned procedures in response to inherent and control risks and the auditor's assessment of the risk of material fraud should consider, at least implicitly, the risk of management override (Montgomery, et al., 2002).

The auditor should also consider whether or not audit procedures need to be modified. In some cases, even when some of the fraud-risk factors are identified as being present, the auditor's judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors, individually or in combination. In other circumstances, the auditor may conclude that the conditions indicate a need to modify procedures. The auditor also may conclude that it is not practical to modify the procedures sufficiently to address the risk, in which case withdrawal and communication to the appropriate parties may be appropriate. (Heim, 2002).

- Examining journal entries and other adjustments

The auditor should understand the auditee's financial reporting process, including automated and manual procedures used to prepare financial statements and related disclosures, and how misstatements may occur. This understanding provides a basis for determining the nature, timing and extent of testing of journal entries and other auditor adjustments for evidence of possible material misstatement due to fraud. This testing would be a matter of professional judgment and would be based on the auditor's assessment of

the fraud risks, whether effective controls have been implemented over one or more aspects of the financial reporting process, the nature of the financial reporting process and

the evidence that can be examined (for example, the extent of manual vs. electronic evidence) and the nature and complexity of the accounts.

- Reviewing accounting estimates for bias

Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. Existing auditing standards already require the auditor to consider the potential for management bias when reviewing significant estimates. In addition, the ED requires the auditor to perform a retrospective review of significant prior-year estimates for any potential bias that might signal inappropriate earnings management (for example, recorded estimates clustered at one end of an acceptable range in the prior year and at the other end of an acceptable range in the current year).

- Evaluating the business rationale for significant unusual transactions

Companies extensively use complex business structures and sophisticated transactions, especially transactions involving special purpose entities or related parties. The auditor has to place emphasis on understanding the rationale behind such unusual transactions. Unusual transactions are those that come to the auditor's attention that are outside the normal course of business for the company or that otherwise appear unusual.

#### Audit Failure in Revenue Recognition and Related-Party Accounts

There are various ways which are suggested for auditors to avoid audit failure in applying GAAP or IFRS in revenue recognition and related-party accounts.

Regarding revenue recognition issues, the recommendations specifically tell auditors to be aware of changes in revenue growth trends, non-standard journal entries (particularly at the end of the reporting period) and side agreements that might affect proper revenue recognition (Phillips, et al., 2001). Once the auditors are aware of this issue, the auditors are able to open the question as to whether this recognition complies with GAAP.

It is suggested by Wells (September, 2001) that an auditor can identify the fraud in sales and receivable accounts by comparing financial statements over a period of time. Various questions are included in his study. The more “yes” answers, the more likely there is something more for the auditor to consider.

Some examples of his questions are:

- Is the company negotiating financing based on receivables?
- Have receivables grown significantly?
- Have receivables increased faster than sales?
- Is the ratio of credit sales to cash sales growing?
- Compared with sales and receivables, has cash decreased?
- Compared with sales, has the cost of sales fallen?
- Have shipping costs dropped, compared with sales?
- Has accounts receivable turnover slowed?
- Are there unusually large sales toward the end of the period?
- Have there been substantial sales reversed in the first period following the increase?

In the study of “Audit Issues – Revenue Recognition” by AICPA in 1999, it is also advised that the auditor should understand the entity’s business: how it earns revenue, who is involved in the revenue process, how it controls the possibility that revenue transactions may be overridden, and what the motivation to misstate revenue may be.

Auditors need to be aware that transactions with related parties usually require special consideration because related parties may be difficult to identify and related-party transactions may pose significant “substance over form” issues.

Undisclosed related-party transactions may be used to fraudulently inflate earnings. In order to cope with this potential problem, “significant, unusual, or highly complex transactions resulting in revenue recognition that are executed with customers who are not related parties similarly require special consideration” (AICPA, 1999). The reason is because they may also pose “substance over form” questions and may involve the collusion of the entity and the customer in a fraudulent revenue recognition scheme (AICPA, 1999).

There are very few procedures which are guided by AICPA for auditors to consider the transactions with their client's related parties. The guidance emphasizes that the auditor should consider whether he or she has obtained sufficient competent evidential matter to understand the relationship of the parties and the effects of related-party transactions on the financial statements.

Furthermore, in order to avoid this failure, the auditing firm should have its partners seriously involved in the engagements where some judgments need both experience and knowledge in the issues (Landen, 2001), especially "substance over form" in the case of related parties transactions since it is the partner who signs off the auditor's report. The training of the staff is necessary and should be taken seriously in order to make the audit team aware of the importance of the issue.

## Conflict of Interest Issues

### Auditor Independence

Independent auditors should provide reasonable assurance that the audited financial statements are free of material errors and fraud. In order to effectively accomplish this responsibility, auditors should be objective, impartial, and unbiased toward the client, investors, creditors, and other users of financial statements (Rezaee, 2002). However, if the auditor has too close relationship with the auditee, this can threaten his independence (Rezaee, 2002). Therefore we address several new rules and recommendations, which deal with this concern.

The new legislation in the USA (Sarbanes-Oxley Act, July 30, 2002) requires the lead audit or coordinating partner and the reviewing partner to rotate off the audit every five years. The rule is believed to help to alleviate the possible independence threats for the auditors, as in so little time as five years, too close ties between the company and the auditor are less likely to occur.

Another rule in the Sarbanes-Oxley Act is "Restrictions on employment of auditor personnel." This is to prohibit registered public accounting firms from providing audit services to clients whose CEO, CFO, or chief accounting officer was employed by the

audit firm and participated in the issuer's audit in any capacity within one year of audit initiation.

This rule is really what an audit firm has to consider. When a top manager of an auditee has worked with the auditor before, the relationship is apparently too close and there is a possibility of conflict of interests. The recommendation to the auditors is to consider seriously every potential threat on their independence and, if necessary, to ask for a second opinion from independent outside parties.

If there are any conflicts of interest found, the audit work should be abandoned.

### Non-Audit Services

There are controversial views on the effect of the non-auditing services on the independence of the auditor. The regulatory authorities in the USA (SEC) are concerned about the amount of non-auditing services performed by auditors and have taken steps to minimize the range of these services.

However, according to the study by DeFond, et al. (2002), contrary to regulators' concerns and general opinion, there cannot be found any association between non-audit service fees and the auditor's inclination to issue a going concern opinion. In addition, they found no relation between audit fees and the auditor's propensity to issue a going concern opinion. The findings suggest that market-based institutional incentives, such as reputation loss and litigation costs, promote auditor independence and outweigh the economic dependency created by higher fees.

Cote (2002) argues that an auditor's ability to resist client pressure depends on the firm's dependence on the client, whether from size, amount of fees, or the services it provides. The greater the dependence, the stronger the pressure.

Moreover, the smaller the accounting firm compared to the client, the more vulnerable it is to pressure. Pressure may be associated with any service, including audit. There is no way to avoid it, as long as auditing is a commercial transaction.

Different opinions described above on non-audit work reveal that auditors can offer the non-audit services. However, an auditing firm should evaluate the threats on non-audit services provided thoroughly. One guiding principle for evaluating the appropriateness of

particular services is whether the services facilitate the performance of the audit, improve the client's financial reporting processes or are otherwise in the public interest.

To support our opinion, a questionnaire of fraud indicators that should be taken into consideration by all auditors was answered by the same 48 auditors (internal and external). I used the SPSS to analyze the secondary data collected in terms of descriptive analysis i.e. mean and the frequencies. I divided the results of the questionnaire which consisted of 75 questions into two groups, the first under the label, the most acceptable fraud indicators to the Palestinian auditors.

The Competency issue of the auditors:

During our investigation of the targeted population we noted that large portion of the sample comprised of auditors who holds university degrees, however, we faced great difficulty in the spoon feeding that we had to do to these auditors. I mean that high percentage of them did not know what fraud means, especially those who work for the local firms. Moreover, the red flags testing they never heard about these flags and once again we were forced to explain what the test means and what importance does it hold.

Fraud detection techniques provided by the audit firm:

Despite the fact that fraud is the most important thing that the auditor should think about and to take into consideration as stipulated by the auditing standards, none of the audit firms working in the Palestinian market provide the fraud detection training to its employees and still work under high risk - in my opinion- and may harm to great extent the reputation of that audit firm.

Lack of Professional institutions that deal with the fraud issue

During our data collection stage we tried to find any professional institution that is concerned with the fraud detection issues by auditors such as the Palestinian Auditors Association but we were not surprised that the association is not concerned in providing

the training to its members regarding that issue due to the lack of people who are involved in fraud detection (only one person holds the CFE degree in the Palestinian territories).

Lack of auditors oversight

Who watches the watch dog? A question should be directed to those who are concerned with the audit profession in Palestine. Who is ensuring that the fees being paid to auditors matches the quality of the product provided by the auditors? Actually, the answer for the above two question is identical, NONE. Despite the fact some of the big audit firms are subject to the quality review of their mother companies but still this is for internal reasons only.

#### 4.3 The Most Acceptable Fraud Indicators by the Palestinian Auditors

We sat with the same 48 auditors who responded to our first questionnaire and asked them to rank 75 fraud indicators - in their opinion- in accordance to their importance, and we summarized the most acceptable indicators by them, however these indicators do not cancel the importance of the others.

Table No. 5

The most Accepted Fraud Indicators to the Palestinian Auditors

	Indicator	Mean	Score (240 Max)
1	Several losses from major investments.	4.83	232
2	Lack of adequate and effective internal control structure.	5.00	240
3	Nonexistent or ineffective internal control function.	5.00	240
4	Poor reputation of management in the business community.	5.00	240
5	Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.	5.00	240
6	Board member(s) and/or senior manager(s) have personal or other close relationships with officers of the company's	5.00	240

	major bank		
7	Ineffective board of directors or audit committee oversight over the financial reporting process and internal control system.	5.00	240
8	Significant portions of management's compensation, represented by bonuses and stock options, being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.	5.00	240
9	Domination of management by a single person or small group in a nonowner-managed business without compensating controls.	4.73	227
10	Significant, unusual, or highly complex transactions, especially occurring close to year end that pose difficult 'substance over form' questions.	5.00	240
11	Excessive pressure on operating management or personnel to meet financial targets (sales and profitability incentive goals) exerted by board of directors or chief executive officers.	5.00	240
12	An interest by management employing inappropriate means to minimize reported earnings for tax-motivated reasons.	5.00	240
13	High turnover rates or employment of ineffective accounting, internal audit, or information technology staff	4.65	223
14	Formal or informal restrictions on the auditor that inappropriately limit his access to people or information or limit his ability to communicate effectively with the board of directors or the audit committee	5.00	240
15	Large and/or unusual transactions at or near the end of the period that significantly improve the company's reported financial performance.	5.00	240

From the above table we can note that the main concern of the auditors to detect fraud is related to the constraint over auditors imposed by management, the domination of management by one personality, unusual transactions at year end, also the internal control structure effectiveness. In my opinion, the secondary data and results supports to great extent the results reached in the primary questionnaire which mainly related to the internal control structure, and the conflict of interest with the auditors, and the related parties transactions.



#### 4.4 The Least Acceptable Fraud Indicators by the Palestinian Auditors

We sat with the same 48 auditors who responded to our first questionnaire and asked them to rank 75 fraud indicators - in their opinion- in accordance to their importance, and we summarized the least acceptable indicators by them.

Table No. 5

The Least Accepted Fraud Indicators to the Palestinian Auditors

	Indicator	Mean	Score (240 Max)
1	Significant declines in customer demand and increasing business failures in the industry or overall economy.	1.54	
2	Management and/or board directors have personally guaranteed significant debts of the entity.	1.62	
3	New accounting, statutory, or regulatory requirements	1.92	
4	Need to obtain additional debt or financing of major research and development or capital expenditures to stay competitive.	1.98	
5	Overly complex organizational structure involving unusual legal entities or managerial lines of authority.	2.00	
6	Lack of performance evaluation	2.04	
7	Significant litigation, especially between shareholders and management.	2.21	
8	Rapid growth or unusual profitability, especially compared to that of other companies in the same industry.	2.23	
9	Threat of imminent bankruptcy or foreclosure, or hostile takeover.	2.33	
10	High vulnerability to rapid changes in technology, product obsolescence, or interest rates	2.50	
11	Continually operating on crisis basis.	2.52	
12	Inadequate collectibility reserves.	2.54	
13	Overemphasis on one or two products, customers, or transactions	2.58	
14	Decentralized organization structure without adequate monitoring.	2.67	
15	Irresponsible corporate governance	2.75	

The above represents the least accepted indicators by the Palestinian auditors. To interpret the results, being the least accepted indicators does not mean that it is not an indicator, so it should be taken into consideration when conducting an audit job. The least accepted indicators mostly related to the vulnerability of the establishment to the new litigations and operations, however, in my opinion still these are important indicators.

#### Summary

In this chapter we presented the answers for the main questions raised by the study. Findings or answers of the questions were grouped and shown by question. We identified 8 factors that may affect the detection of fraud by the auditors, we commented on these factors. Also, as per the opinion of the auditors, we identified the most and the least acceptable fraud indicators on which we also commented on.

## CHAPTER 5

# Summary and Conclusions

### 5.1 Summary and Conclusion

In summary, the study revealed several factors that should be considered. These factors represent the following data:

1. None of the respondents was directly involved in the possible fraud in the company.

2. Most of the respondents had a good working relationship with their employees. They are confident that they can detect any fraud.

3. None of the addresses had a system in place to detect fraud, and

4. The reasons for not detecting fraud (in the study) are directly related to the auditors themselves.

Although the respondents are not directly involved with fraud, rather, their presence suggests a degree of fraud risk. However, their absence is no guarantee of a situation or circumstance as "fraud-proof". Therefore, when conditions are present, the risk of fraud is high, and a degree of fraud prevention measures may be

## Chapter 5

Introduction *Summary and conclusions*

As we stated earlier, our approach in collecting data was based on the descriptive and analytical approach. First, we analyzed 3 recent actual fraud cases that happened outside Palestine. However, we can generalize our findings of the analysis to be benefited from by the Palestinian auditors. The analysis of these cases revealed the reasons behind the fact that the fraud had happened and the public asked where the auditor was. These reasons were tabulated and sent to the auditors of a sample of 55 (external and internal) to be tested as the null hypothesis of them 48 responded positively and results were statistically analyzed and we identified the correlation between the fraud detection and these independent variables. Moreover, the red flags (fraud indicators) test (consisted of 75 questions) was also sent to our population and by which the trend of concentration of the auditors when considering fraud in their audit jobs.

## 5.1 Summary and Conclusion

To summarize, the study revealed more than one factor that should be considered. These factors represent the following notes:

- 1) None of the audit firms uses the red flags test to identify the possible fraud in the audit.
- 2) None of the audit firms provide fraud detection training to their employees.
- 3) Only one audit firm use ACL to mine data.
- 4) None of the auditees have any system in place to detect fraud, and
- 5) The reasons behind not detecting fraud (as per the study) are directly related to auditors themselves

Although, the red flag are not inevitably or universally associated with fraud. Rather, their presence suggests a degree of fraud risk. Conversely, their absence is no guarantee that a situation or circumstance is "fraud-proof". But when these indicators are present, the risk of fraud is high, and a degree of caution or extra preventive measures may be

appropriate. In my opinion, the red flags are underestimated by the auditors who should take these tests into consideration.

Furthermore, auditing is a highly competitive profession, training is the fuel that drives this vehicle at a reasonable speed, and we urge audit firms to continuously train their employees especially for the detection of probable fraud areas. Concerning the auditees themselves, we urge them to consult the experts to install the defense lines to minimize the possibility of being a victim of fraud.

## 5.2 Recommendations

Based on our observations, our main concern was to provide the auditors with the proper weapons to fight the fire of fraud, in the following table we summarized the reasons for not detecting fraud and the suggested weapon for each case:

Table No. 7  
Summary of reasons for not detecting fraud and the recommendations

	Reason	Recommendation
1	Analytical Procedures is insufficient for audit evidence	<ul style="list-style-type: none"> <li>• Supplemented testing required.</li> <li>• Make inquiries.</li> <li>• Interpret findings within the context of current business and market.</li> <li>• Compare of ratios for “bill-and-hold sales,” “channel stuffing” and “side agreements.”</li> </ul>
2	Risk Assessment and Internal Control testing is not absolutely Effective	<ul style="list-style-type: none"> <li>• Vary the audit procedures.</li> <li>• Understand auditee’s financial reporting process.</li> <li>• Review accounting estimates for bias.</li> <li>• Understand significant unusual transactions.</li> </ul>
3	Audit Failure in Applying Revenue recognition and related parties Transactions	<ul style="list-style-type: none"> <li>• Compare financial statements over a period of time.</li> <li>• Understand the entity’s business.</li> <li>• Understand the relationship of the parties.</li> <li>• Partners more involved in the audit engagements.</li> </ul>
4	Conflict of interest issues	<ul style="list-style-type: none"> <li>• Auditor rotation.</li> <li>• Restrictions on the employment of the auditing staff.</li> </ul>

		<ul style="list-style-type: none"> <li>• System of evaluating the independence risks.</li> </ul>
5	The competency issue of the auditors	<ul style="list-style-type: none"> <li>• Attending online training for fraud.</li> <li>• Analyzing more cases of fraud.</li> <li>• Try to obtain fraud related certificate.</li> </ul>
6	Failure of audit firms to apply fraud detection training sessions periodically	<ul style="list-style-type: none"> <li>• Invest more in its valuable assets (employees).</li> <li>• To treat each audit as case by case issue.</li> </ul>
7	Lack of professional institutions that deal with the fraud issue	<ul style="list-style-type: none"> <li>• Encourage the bodies that are concerned with the audit profession to concentrate on the fraud issues, specially the universities</li> </ul>
8	Lack of auditors oversight	<ul style="list-style-type: none"> <li>• Establishing regulatory body that watches the auditors and make sure that the fees paid matches the effort exerted and quality being provided.</li> </ul>

### 5.3 Suggestions for Further Research-Financial Statement Fraud

This thesis deals with the financial statement fraud in improper revenue recognition area. We suggest that the further study can be taken in the other areas of the financial statement fraud such as overstatement of assets other than accounts receivable; understatement of expenses/liabilities; misappropriation of assets; inappropriate disclosure; and other miscellaneous techniques.

As we mentioned earlier, we did the research from the perspective of the auditor. The other suggestion is that the study can be conducted from the perspectives of other responsible persons such as management and government. From the management side, the study would be in the light of management in antifraud issues. We suggest the website, which might be helpful if there is anyone interested:

<http://www.aicpa.org/antifraud/management.htm>.

Our last suggestion for further research is to study fraudulent financial statement cases to find the reasons and the improvements in audit process.

To sum up, our suggestions for further research consist of:

- Study other kinds of fraud;
- Study from the perspectives of others such as management and government; and
- Study fraudulent financial statement cases to find the reasons and improvements within the audit framework

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## APPENDICES:

A

## Audit Firms Questionnaire

1. Do You Employ a special IT professional that can provide assurance in regard to the vulnerabilities of networks of your clients?

Yes

 No

2. Is the technical training within your office policy of your employees in regard to the rapid change of technology is "Actually" done:

Yes

 No

3. Is the training for the fast changing methods of fraud for your staff is done:

Yearly

 Every two years More than that

4. As part of your audit service, do you provide information security service?

Yes

 No

5. In your opinion, Is there any relation between technology advancement and tendency to commit fraud?

Yes

 No

6. Is there a CISA employed by your office (Local)?

Yes

 No

7. If the answer is "Yes" for question 6 above, Was this CISA helpful in detecting fraud cases?

Yes

 No

8. Do you apply CAAT (Computer Assisted Audit Techniques) for data analysis and data mining to search for fraud indications?

Yes

 No

9. Do you think that the undiscovered white-collar crimes (fraud) intensity in Palestine is high?

Yes

No

10. If the answer is "Yes" for question 9 above, what reason do you think is behind this?

	In competency of auditors	Inefficiency of used CAAT	Others (please specify)
1. Inadequate monitoring of significant financial controls.			
2. Management is overly aggressive when responding to audit inquiries.			
3. Critical assets of the company have been pledged as collateral for risky loans.			
4. Management is implementing a significant change in technology and/or processes.			
5. High turnover of chief executive officers or board of directors.			
6. Significant difficult-to-audit transaction.			
7. Inadequate collectibility reserves.			
8. Lack of or ineffective mechanisms for reporting management violations of company policy.			
9. Key executives with low moral character.			
10. Significant off-balance sheet or contingent liabilities.			
11. Several losses from major investments.			

B

## Red Flags Used to Detect Fraud

Please check the most appropriate number that rates the fraud detecting effectiveness of each red flag.

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
1	Inadequate monitoring of significant internal controls.					
2	Management is overly evasive when responding to audit inquiries.					
3	Critical assets of the company have been pledged as collateral on risky loans.					
4	Management displaying a significant disregard for regulatory authorities.					
5	High turnover of chief executive officers or board of directors.					
6	Significant difficult-to-audit transactions.					
7	Inadequate collectibility reserves.					
8	Lack of or ineffective mechanisms for reporting management violations of company policy.					
9	Key executives with low moral character.					
10	Significant off-balance sheet or contingent liabilities.					
11	Several losses from major investments.					

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
12	Continually operating on crisis basis.					
13	Lack of management oversight.					
14	Difficulties in collecting accounts receivable.					
15	Irresponsible corporate governance.					
16	The company fails to require top executives to take at least a week's vacation at a time					
17	The need for additional collateral to support and satisfy existing obligations					
18	Lack of vigilant board of directors' oversight.					
19	Significant litigation, especially between shareholders and management.					
20	Management overrides.					
21	Frequent changes of external auditors.					
22	Lack of adequate and effective internal control structure.					
23	Significant tax adjustments by the Tax Authorities.					
24	Nonexistent or ineffective internal control function.					
25	Progressive deterioration in earnings					
26	Poor reputation of management in the business community.					
27	Ineffective leadership.					

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
28	Overemphasis on one or two products, customers, or transactions					
29	Lack of performance evaluation					
30	Inexperienced and aggressive personnel in key management positions					
31	Struggling to gloss over a temporary bad situation.					
32	Highly rapid expansion through new business or product lines					
33	Lack of cooperation and coordination between internal and external auditors					
34	Lack of adequate working capital.					
35	Use of several legal counsels.					
36	Decentralized organization structure without adequate monitoring.					
37	Unusual results or trends.					
38	Use of different banks for specified purposes.					
39	Threat of imminent bankruptcy or foreclosure, or hostile takeover.					
40	Conflict of interests within company management.					
41	Employee or manager personality anomalies.					
42	Management and/or board directors holding significant financial interests in the entity.					
43	High vulnerability to rapid changes in technology, product obsolescence, or interest rates					

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
44	New accounting, statutory, or regulatory requirements					
45	High degree of competition or market saturation, accompanied by declining margins					
46	Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.					
47	Earnings deterioration resulting from significant decreases in revenues or substantial increases in expenses.					
48	Management and/or board directors have personally guaranteed significant debts of the entity.					
49	Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.					
50	Board member(s) and/or senior manager(s) have personal or other close relationships with officers of the company's major bank					
51	Management failure to correct known reportable conditions in internal controls in a timely basis.					
52	Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.					



		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
53	Ineffective board of directors or audit committee oversight over the financial reporting process and internal control system.					
54	Recurring negative cash flows from operations or an inability to generate cash flows while reporting earnings and earnings growth.					
55	Non financial management's excessive participation in the selection of accounting principles or the determination of significant estimates.					
56	Significant portions of management's compensation, represented by bonuses and stock options, being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.					
57	Assets, liabilities, revenues or expenses based on significant estimates that involve subjective judgements or uncertainties that are difficult to corroborate					
58	Rapid growth or unusual profitability, especially compared to that of other companies in the same industry.					

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
59	Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.					
60	Need to obtain additional debt or financing of major research and development or capital expenditures to stay competitive.					
61	A practice used by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts					
62	Significant related-party transactions not in the ordinary course of business or with related entities are not audited or audited by another firm.					
63	Domination of management by a single person or small group in a nonowner-managed business without compensating controls.					
64	Significant, unusual, or highly complex transactions, especially occurring close to year end that pose difficult 'substance over form' questions.					

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
65	Excessive pressure on operating management or personnel to meet financial targets (sales and profitability incentive goals) exerted by board of directors of chief executive officers.					
66	Significant declines in customer demand and increasing business failures in the industry or overall economy.					
67	An interest by management employing inappropriate means to minimize reported earnings for tax-motivated reasons.					
68	Overly complex organizational structure involving unusual legal entities or managerial lines of authority.					
69	Ineffective communications, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.					
70	High turnover rates or employment of ineffective accounting, internal audit, or information technology staff					
71	Formal or informal restrictions on the auditor that inappropriately limit his access to people or information or limit his ability to communicate effectively with the board of directors or the audit committee					

		Somewhat effective	Mostly effective	Seldom effective	Not Effective	Very effective
72	Large and/or unusual transactions at or near the end of the period that significantly improve the company's reported financial performance.					
73	Difficulty in determining the organization or individuals that have controlling interest in the entity.					
74	Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.					
75	Ineffective accounting and information systems, including situations involving reportable conditions.					

## Appendix

## C

## Reasons for not Detecting Fraud

Dear Sir

Please rank the following as per your opinion as problems identified for the auditors failure to detect fraud

		Strongly Disagree	Disagree	No Opinion	Agree	Strongly Agree
1	Analytical Procedures is insufficient for audit evidence					
2	Risk Assessment and Internal Control testing is not absolutely Effective					
3	Audit Failure in Applying Revenue recognition and related parties Transactions					
4	Conflict of interest issues					
5	The competency issue of the auditors					
6	Failure of audit firms to apply fraud detection training session periodically					
7	Lack of professional institutions that deal with the fraud issue					
8	Lack of auditors oversight					



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