Financial Statement Fraud Control: Audit Testing and Internal Auditing Expectation Gap

Norazida Mohamed [1, *]
[1] University Technology MARA Malaysia
* Corresponding Author. Norazida Mohamed. E-mail: n.mohamed@tees.ac.uk.

Abstract. This research aims to make recommendations to improve financial statement fraud control in the context of auditing financial statements in commercial companies. The two case study companies were examined and the information gleaned from interviews used to understand the roles and responsibilities of the internal and external auditors. The research found a gap in the perceived responsibility of financial statement fraud detection and control. Therefore, the research further examined the issue of audit testing in relation to financial statement fraud detection and control. The findings suggest that internal auditing of financial statements is a complementary method to strengthen financial statement fraud control. The research contributes to the study of financial statement fraud control and provides practical recommendations for financial statement auditing theory. The research focuses on the contribution gained from the PhD thesis entitled „financial statement fraud control: Experience in Malaysia commercial companies".

Keywords: Financial Statement; Fraud; Internal Auditor.

1. Introduction

The 12th Global Fraud Survey (Ernst & Young, 2011) revealed that fraud remained one of the most problematic issues for businesses worldwide. Globally, the number of companies reporting fraud increased by 22% since 2003 (PwC, 2007). Financial statement fraud in particular is a major risk to businesses and can completely drain the long-term success of the business. Consequently, the level of financial statement fraud should be controlled and reduced among the corporations world-wide. Businesses have taken all measures and controls to ensure security and truthful acts. However, unfortunately, these have failed to raise the necessary 'red flags'. The question now is what else needs to be done to fight fraud cases? It seems that the actions taken by the authorities in the aftermath of fraud cases are insufficient to stop another fraud case from happening. It is now timely to address whether the deterrence strategies put in place by industry are adequate in today's business environment. In accordance with the above scenario, it is anticipated that the results of this research will identify ways to reduce financial statement fraud, and, accordingly the research will make recommendations to improve financial statement fraud control in commercial companies.

2. Financial Statement Fraud and Controls

Financial statements or financial reports are considered as tools upon which users can rely when making investment decisions. Hence, financial statements should be free from any misleading information, and must be of high quality and reliable in order to safeguard the interests of shareholders, investors, etc. However, in reality, the reliability of financial statement information seems to be questioned by both investors and the public. As a matter of fact, the reliability of information provided by financial statements remains one of the most problematic issues for businesses worldwide (PWC 2007). In general, Summers (2008) documents that fraud is a massive and growing problem. According to a UK Study of fraud and financial risk Management 2009, two thirds of businesses perceived fraud to be a risk in their industry; however, less than one third of businesses had a fraud awareness programme or any educational programme relating to the threat of fraud. The issue is serious as the actual level of economic crime and the associated financial and non-financial damages have been reported to be on the rise (PWC 2007), and the number of financial statement fraud cases has increased since 2003 (PWC 2007). The impact is that companies suffered significant 'collateral damage', such as loss of reputation, decreased staff motivation and declining business relations (PWC 2005). The question is what is lacking in the internal control system adopted by the companies?

3. Literature Review

The research has identified that the issue of financial statement fraud has become a focus of the public, investors, regulators and practitioners due to the huge losses resulting from the reported fraud worldwide. In the US, 2,494 cases involving financial crime were investigated by the Federal Bureau of Investigation (2009). The present research has viewed financial statement fraud from the perspective of both the legislation and academic literature. According to the Fraud Act 2006, one element of financial statement fraud is that "a person is guilty of fraud if he is in breach of any sections listed in subsections (2), which includes (2a) false by representation, (2b) fraud by failing to disclose information, and (2c) fraud by abuse of position". The Theft Act 1968 defines false accounting as "where a person dishonestly with a view to gain for himself or another or with intent to cause loss to another which includes (1) destroys, (2) defaces, conceals or falsifies any accounts or any record or document made or required for accounting purposes; or (2) in furnishing information it is found to be misleading, false or deceptive and cause losses to another".

From an academic perspective, Grazioli, et al (2006) defines financial statement fraud as an intentional process of deception by the company management. Another definition of financial statement fraud, provided by NCFFR (1987), argues that it is reckless conduct by act or omission that results in materially misleading financial statements. However, KPMG (2005) explains that financial statement fraud occurs when financial records have been falsified or manipulated or altered. Therefore, the disclosures will definitely be false. Razaee (2002) further identifies the two different ways that a company may commit financial statement fraud, that is by misapplication and interpretation of accounting standard or manipulating the accounting practices. Although there are a number of motives for financial statement fraud, the most common motives arise due to the weak financial conditions of companies. Reinstein et al. (2006) document that financial statement fraud begins with financial and morale problems in the company, in which the company's control environment is lacking which encourages inefficiency within its auditing procedures. These findings were supported by Carcello and Palmrose (1994), Dechow et al. (1996) and Lys and Watts (1994) who found that financial distress and poor financial performances are the most important reason for financial statement fraud occurrences. Therefore, the companies have a propensity to mislead in terms of their financial information and the probability of financial statement fraud is raised.

According to the auditing standard, SAS 99, auditors and management have the ultimate responsibility for establishing controls and procedures to protect the organization's assets. The most important elements consist of (1) creating and maintaining a culture of honesty and high ethics among the employees, (2) evaluating the risk of fraud, and implementing risk mitigation in relation to the financial statement and (3) developing an appropriate oversight process by internal and external parties towards financial statement fraud. The US government enacted the Sarbanes Oxley Act 2002 to address the monitoring mechanisms to control financial statement fraud by improving the company's corporate governance, enhancing the accountability and the transparency of financial statements (Razaee, 2002). The enactment of SOX 2002 is expected to improve independence, objectivity, and effectiveness of audit committee. The research by Chen et al. (2006) suggests that a large number of outside directors would contribute to control financial statement fraud in the company. The large proportion of outside directors would be helpful in monitoring the firm's activity and deterring company fraud. Specifically, Beasley (1996) refers to the outside directors as all nonemployee directors. He suggests that the longer the tenure of the directors in the company the better would be the control and mitigation of financial statement fraud. Deachow et al. (1996) add that directors or chairman with shorter tenure have less company experience and, therefore, are unable to deter fraud in the company. The board of directors is possibly the highest internal control mechanism for monitoring the actions of top management. In addition, an effective internal control structure and audit functions are found to be important in controlling financial statement fraud. NCIR (1987) documents the management responsibilities to design adequate and effective internal controls in the financial statement process. In reality, internal auditors of the company have to promote or encourage the management to develop a detailed fraud prevention programme (Carpenter and Mahoney, 2001). Kang (2001) suggests that more frequent meetings of the audit committee, at least five times a year, would enhance the monitoring process of the effectiveness of the company's internal control. Zhang et al. (2007) state that the effective role of the audit committee contributes to better internal control of the company. In addition to the competency of the audit committee, they are also expected to be independent in overseeing the company's internal control. The audit committee is also responsible for ensuring that management does not engage in fraudulent conduct.

Altanmuro and Beatty (2010) found that internal control is significant in producing a quality financial statement and preventing financial statement fraud. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) 1992 defined internal control as a process system that affected every level of individual in the organization. The purpose of the designed internal control is to provide reasonable assurance concerning the (1) business operation and (2) issued financial statements. KPMG (1999) states that the responsibilities of company directors is to provide an effective system of the internal control in organizations. In the meantime, Fadzil et al. (2005) found that the professional proficiency of internal auditors influences the effectiveness of the internal audit function. Therefore, the scope of internal audit work has an effect on the risk assessment aspect of the company's internal control system. The conventional duties of internal audit functions include the assurance of the compliance of the operating policies and procedures with those determined by the company management as well as with the laws and regulations.' In addition to these duties, the internal audit function has the responsibility for reviewing the completed financial statement, thereby giving assurance concerning the reliability of the financial reporting (Schleifer and Greenawalt, 1996). However, the Statement on Internal Auditing Standard No 3 added the new roles of the internal auditor to emphasize fraud deterrence and investigation. In relation to this, Flesher (1996) suggests that the internal auditor should consider the indicators of fraud, identify the possibility of fraud in business operations and evaluate the control environment and reporting of the recognized fraud to the audit committee. According to Ratcliffe and Landes (2009), the internal control over financial reporting is aimed at producing reliable financial reporting. Reliable financial reporting has been defined as having (1) encountered the financial reporting objectives, (2) involved the applicable financial reporting framework, and (3) complied with the laws and regulations. The research further states that reliable financial reporting should be guarded by stricter control on financial statement information in relation to the recognition, measurement, presentation and disclosure.

The responsibility of company management is to design a programme for fraud prevention and detection. However, the internal auditors need to play their role in ensuring compliance with such controls. The IIA's Practice Advisory 1210.A2 explains that "internal auditors are responsible for assisting in the deterrence of fraud by examining and evaluating the adequacy and effectiveness of the system of internal control, commensurate with the extent of the potential risk exposure in the various segments of the organization's operation". Ebaid (2011) indicates that the internal audit function in public listed companies is actually based on conventional functions rather than adding value for good company governance. In relation to this, internal auditors are called upon to be more rigorous and possibly enhance the value of good conduct. Hillison et al. (1999) add that the role of internal auditor is to prevent, deter and detect fraud in an organization instead of independent auditors, and Schleifer and Greenawalt (1996) emphasise the critical thinking skills required in internal auditing work. Three key factors are considered important for fraud prevention and detection. These include internal control, risk assessment and management process. These reflect the accountability of the internal auditors and improvement in the internal audit process in respect of overall governance process

(Leung, Cooper and Perera, 2011). In tailoring the position of the internal auditor as the company‟s watchdog, Soh and Benni (2011) also suggest a new expansion and refocus of the role and the effectiveness of internal auditors in meeting the stakeholders‟ expectations.

4. Data and Research Methodology

The methodology of the research has been guided by case studies. The case studies methodology is aimed at understanding the phenomenon in which the data can be collected through various research techniques, namely, interviews and document observation. Therefore, the findings are a mixture of description and analysis that resulted in the identification factors. However, the analysis does not encompass the theory building in grounded theory studies. As such, multiple case study research methods have been conducted, which are supported by interviews with five selected groups of respondents. Therefore, both methods focus on (1) companies‟ experience and practices and (2) interviewees‟ perceptions, beliefs, experience and action activities.

5. Results, Discussion and Analysis

Internal control has been considered as the most important mechanism for ensuring proper adherence to the company's policies, procedures, standards and regulations. In addition, to achieve efficient and effective operations, adherence to internal controls is assumed to protect the companies from any misconduct, wrongdoings or, in particular, financial statement fraud. The case study companies have placed sufficient internal controls across the companies. However, in relation to the financial statement process, the internal controls of both case study companies only focus on adherence to the policies and procedures and compliance with the rules and regulations. The case study findings support the non-auditing financial statement by the internal auditors of the case study companies. The internal auditors of the case study companies have not given any assurance on the financial statement process and financial information. The internal auditor of the case study companies should be the first filterer or gate keeper of financial statement fraud in the companies before it has been audited by the external auditors. The findings of the case study companies have shown that a lack of accounting expertise among the internal auditors is the main reason for their not auditing the financial statement. The role of the internal auditor is presumably significant in ensuring the company has been equipped with financial statement fraud mitigation controls.

5.1. The Financial Statement Fraud Detection and Control Responsibiliti

The case study companies have fully relied on the designed internal control as financial statement fraud prevention. However, the assurance of financial statement control has not been relevant to the scope of internal auditing, which covers the adherence of the company's internal control and the compliance of the rules and regulations. In contrast, the research findings have shown the perception of the internal auditors of the case study companies to external auditors‟ responsibility to detect any fraud during the external auditing works. This indicates the existence of an internal auditing gap among the internal auditor, external auditor and the management of the company in relation to financial statement fraud control and deterrence.

5.2. The Internal Auditing Expectation Gap

The research identified the presence of the internal auditing gap when company management has fully relied on the internal control system to prevent financial statement fraud. However, the scope of internal auditing work is not relevant to the accuracy of the final published financial statement. In addition, the internal auditors of the case study companies perceive that the external auditor's responsibilities include the detection of financial statement fraud. In contrast, the external auditors perceive that the responsibilities of the internal auditor include detecting financial statement fraud.

The concept of an internal auditing expectation gap is supported by the present duties of the internal auditors in the two case study companies. Presently, the internal auditors have the responsibility to audit the operating procedures, standards and regulation compliances in relation to the financial statement process. However, the detailed checking of the financial transactions and financial statement fraud controls has not been included in the present duties of the internal auditors.

The research found that the present duties of internal auditors of both case study companies focus on control testing of compliance with operating procedures. A control test is intended to verify that the present control of the financial statement process is operated and complied with. However, a control test is not relevant in providing assurance of financial statement accuracy. Therefore, the research found that the substantive internal auditing test in relation to financial information is an unmet expectation of the internal auditor's present duties. The role of the internal auditor is found to be significant to control financial statement fraud in companies and the substantive test on financial information is required in order to reduce the internal auditing expectation gap. Substantive testing within the internal auditing process is recommended to enhance the accuracy of the accounting records. This involves the detailed testing of the transaction and account balances and analytical procedures.

Aligned with the International Standard of Internal Auditing, the reliability and integrity of financial results would be best achieved by the internal auditing process. Even though the role of the internal auditor is not primarily to detect any fraud in the financial statement, it involves ensuring the reliability and the integrity of the financial statement. Another assurance of financial statement fraud control was reviewed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO defined the internal control as „a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding achievement of effectiveness and efficiency of operations, reliable financial reporting and compliance with the applicable laws and regulations‟. The phrase of providing the "reasonable assurance of reliable financial reporting and compliance with the applicable laws and regulations" is highly pertinent to this research. Two issues of concern were found, namely, reliable financial reporting, and, secondly, compliance with the laws and regulations. The assurance of reliable financial reporting might not be achieved without the substantive testing of internal financial statement auditing.

6. Conclusion

The research has made recommendations to improve financial statement fraud control in commercial companies. The new findings of the research would assist commercial companies, in particular, the public companies in reducing financial statement fraud cases. Internal auditing of the financial statement is found to be the most important control in reducing the internal auditing expectation gap. The research found that in-depth control of financial information through a substantive audit test is required to reduce the internal audit expectation gap, and, therefore, increase the mitigation efforts of financial statement fraud in commercial companies.

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