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FINANCIAL STATEMENT FRAUD AND THE ROLE OF AUDITING

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1. ABSTRACT

The last decades have been characterized by multiple corporate crises, sometimes unexpected and unpredictable, on which attention has been paid by both academic and professional literature. Said economic recession, together with 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. The pressure from stock market expectations, analysts' forecasts and earnings targets has put yet another burden on management's shoulders, especially for what concerns the companies, which have been labelled as "blue chip" in their vigorous days (a blue chip is a broadly recognized, well-established, and fiscally solid company, said to be able to be be profitable even during periods of adverse financial conditions). In addition, the huge stock bonuses received by managers are regarded as another important incentive to push the firm to achieve 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 puts it in his so-called bible of the business world "Creative Accounting": "It is the biggest con trick since the Trojan horse."[1] In 2010, the Association of Certified Fraud Examiners (ACFE) estimated that the IRS has lost US$994 billion because of fraud, and a total of US$2.9 trillion world-wide was lost due to fraudulent financial statements, asset misappropriation, and corruption. Thus, financial statement fraud together with audit failures have been an increasingly hot issue during the past decades, especially because of the recent cases of Enron, Waste Management, Xerox and so on. The international auditing firm, Arthur Andersen, which audited Enron, as well as many other firms implicated in financial statement fraud cases, appears to be an example of a firm representing a major audit failure. The Enron case brought to light the weaknesses of the audit process.

[1] Ian Griffiths, Creative Accounting: How to Make Your Profits What You Want Them to Be (London: Unwin Hyman, 1986).

2. INTRODUCTION

This work, which can be divided into two parts, was conceived with the aim of deepening the theme of false accounting, to better understand the budget techniques most commonly used by management to achieve particular goals (often far from legality), and explain the role of auditors in anti-fraud function, to which their responsibilities are linked.

In the first part of the thesis we will discuss the different meanings of earnings management and after having thoroughly understood the purposes, we will examine the concept of creative accounting, trying to clarify the boundaries beyond which such budget policies turn into true accounting frauds.

We will answer the following question: when do earnings management and creative accounting become fraud?

Remember that in the development of the thesis the negative meaning of the earnings management has been favored, although obviously this is not the only way to interpret it.

It will also be worthwhile to explicate the real techniques put in place by top management to improve earnings. With these techniques we refer to all those *manoeuvres* concerning operating costs and revenues which aim to postpone the first and to anticipate the latter, thus deteriorating the earnings quality.

In the second part we will examine the role of auditors in detecting accounting fraud, as well as their purposes: to determine the reliability of internal control and the extent of audit risk, and to report whether the financial statements are presented fairly in accordance with Generally Accepted Accounting Principles.

After that we'll discuss of the auditors' responsibilities and their specific tasks, the audit risk (AR) and the audit risk model will finally be exposed, and therefore the ways in which it is more or less safe to control the financial statements and transactions.

Then there will be an explanation of the internal auditing and the risks and benefits that it entails, followed by a relevant example of a specific case of financial statement fraud in history, and the role that the auditors have had in it, which will make us understand how important it is for an healthy and functional economy to have a capillary and targeted inspection and control of the auditors, not spoiled by personal, economic or external pressures.

In the conclusions we make some remarks on the whole paper, making assumptions and considerations on the various topics analyzed during the drawing of this dissertation, finally leaving an interesting question for further research to elaborate on.

3. FINANCIAL STATEMENT FRAUD; EARNINGS MANAGEMENT AND CREATIVE ACCOUNTING

3.1 INTRODUCTION

To a certain degree, we can say that creative accounting in itself is fully legitimate, when we view such accounting as making choices among endorsed alternatives. It can although result in a powerful instrument for quantitative as well as qualitative manipulation of financial information, since accounting rules and regulations leave room to make choices among different accounting procedures. The grey area is, however, perhaps too large. So a company can choose the most appropriate rules which best suit its intentions. But the border between account management and fraud is very thin.

Although the change of International Financial Reporting Standards (IFRS) reduced the possibility of information mis-use, they still cannot totally eliminate the risk of financial statements manipulation. “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, pre-mature sales, reversal, or use of unjustified reserves”[2].

The main objective of the following chapter is to analyze what financial statement fraud really means, its determinants and implications. There is no unequivocal definition of financial statement fraud, and in the first paragraph of this chapter these different meanings will be examined. By examining the definition of financial statement fraud we come to ask ourselves what determines accounting fraud tendency; in the following paragraph we indeed examine the incentives behind fraud, followed by a discussion on the typical fraud patterns, meaning the common features in most or all financial statement fraud cases.

Next we analyze what is earnings management, with particular attention to the revenue recognition methods, and then the thin line between creative accounting and fraud.

[2] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

3.2 DEFINITION - FINANCIAL STATEMENT FRAUD

"Accounting fraud is the intentional, misstatement of financial statements or financial disclosures or the perpetration of an illegal act that has a material direct effect on the financial statements or financial disclosure"[3]. "The classification of an action as being fraudulent may depend on the motivation behind it".[4] Young suggests that "accounting fraud does not start with dishonesty; rather, it may begin with pressure to meet financial targets and the fear that failure to meet these targets will be viewed as unforgivable".[5] Nonetheless, the perpetrator of fraud may be pushed by dishonesty and the greed for personal gain rather than by pressure from the organization.

Unfortunately there is no single definition of financial statement fraud. The reason is that, until now, the term had never been defined. The accounting profession used the terms "intentional mistakes and irregularities"[6] instead. 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"[7].

Financial statement fraud is typically conducted by management or with their consent and knowledge. Elliott and Willingham view financial statement fraud as:

"The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements."[8]

In fact, "accounting fraud differs from other frauds in that it is usually committed by management to deceive financial statement users while misappropriation of assets is committed against an entity, most often by employees"[9].

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[3] S.M. Beasley, J.V. Carcello, and D.V. Hermanson, "Fraudulent Financial Reporting: 1987 -1997 - COSO," , https://www.coso.org/publications/FFR_1987_1997.PDF.

[4] Niamh Brennan and John Hennessy, *Forensic Accounting* (Dublin: Round Hall Sweet & Maxwell, 2001).

[5] Michael R. Young, Accounting Irregularities and Financial Fraud (San Diego: Harcourt, 2000).

[6] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

[7] *Consideration of Fraud in a Financial Statement Audit* (New York, NY: American Institute of Certified Public Accountants, 1997).

[8] Robert K. Elliott and John J. Willingham, *Management Fraud: Detection and Deterrence* (New York: Petrocelli Book, 1980).

[9] Dan M. Guy and Kurt Pany, Fraud in a Financial Statement Audit: What Every Auditing Student Should Know about SAS No. 82 (U.S.: AICPA, 1997).

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."[10]

3.2.1 THE DETERMINANTS AND PREDICTORS OF ACCOUNTING FRAUD TENDENCY

Scott stated that "information asymmetry is a situation where some parties involved in a transaction may have more information than others."[11] It permits the manager to perform manipulation of the balance sheets to extend profits of the firm so as to get bigger compensation or rewards. Information asymmetry constitutes the basis for accounting fraud, and it is often considered as the abstract framework for understanding and detecting the so called "Fraud Triangle". Within said framework, the determination of corporate frauds is based on three main factors: opportunity, motivation and rationalization.

Motivation: relates to incentives on management that place pressure or stress on performance or external pressure to fulfill earnings or budget expectations.

Opportunity: relates to the circumstances that provide an opportunity to carry out material misstatement in the financial statements (implying a weak internal control environment that can easily be nullified by management);

Rationalization: reflects the ability of individuals who are involved in frauds to adopt an attitude that deflects blame or responsibility

Hogan, Rezaee, Riley and Velury[12] find 3 major points with which academic writings largely support the fraud triangle:

6. "Pressures to meet analysts forecast, rapid growth, compensation incentives, stock options, the need for financing and poor performance increase the likelihood of accounting fraud"[13]

[10] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).
[11] William Robert Scott, Financial Accounting Theory (Toronto: Pearson, 2014).
[12] Chris E. Hogan et al., "Financial Statement Fraud: Insights from the Academic Literature," *AUDITING: A Journal of Practice & Theory* 27, no. 2 (2008): , doi:10.2308/aud.2008.27.2.231.
[13] Timothy B. Bell and Joseph V. Carcello, "A Decision Aid for Assessing the Likelihood of Fraudulent Financial Reporting," *AUDITING: A Journal of Practice & Theory* 19, no. 1 (2000): , doi:10.2308/aud.2000.19.1.169.

7. "Effective corporate governance, including the board of directors, audit committee, and internal controls, and also the external auditor, play key roles in reducing the opportunity to commit fraud."[14] In addition, "external auditors play a role in reducing opportunities to manage earnings or commit fraud."[15]

8. Research is limited in the attitudes and rationalization area.

9. Carcello and Hermanson[16] extend the fraud triangle by including a fourth element, the ability of the potential fraud perpetrator that is cited by Wolfe and Hermanson.[17] By expanding the fraud triangle to the fraud diamond with the addiction of the element of the ability to commit fraud, it is recognized that although an individual may have both an incentive and an opportunity to commit the fraud, and may be also able to rationalize the behavior, fraud will not occur unless the potential culprit has the personal capability (knowledge, skill, position, ability to handle stress etc.) to commit the fraud. In other words, the potential perpetrator needs he proper skills to recognize and exploit a fraud opportunity.

Compensation can be seen as the last determinant of accounting fraud, together with management's morality. Compensation can be defined as any form of awards given as remuneration for individuals' contribution to the organization.

Johnson, Ryan, and Tian[18] all present similar comparisons between executives of firms accused of fraud and executives of firms not accused of fraud. They find that executives of firms accused of fraud had higher financial incentives to increase stock price than executives of firms not accused of fraud. Goldman and Slezak[19] developed an agency model in which stock-based compensation is a double-edged sword, acting in such a way to both incentive

[14] Patricia M. Dechow, Richard G. Sloan, and Amy P. Sweeney, "Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC," *Contemporary Accounting Research* 13, no. 1 (1996): , doi:10.1111/j.1911-3846.1996.tb00489.x.

[15] Connie L. Becker et al., "The Effect of Audit Quality on Earnings Management," *Contemporary Accounting Research* 15, no. 1 (1998): , doi:10.1111/j.1911-3846.1998.tb00547.x.

[16] J.V. Carcello and R.H. Hermanson, "Fraudulent Financial Reporting: How Do We Close the ...," , http://www.theifp.org/research-grants/IFP-Whitepaper-1.pdf.

[17] D. Wolfe and R.H. Hermanson, "The Fraud Diamond: Considering the Four Elements of Fraud," , http://wweb.uta.edu/faculty/subraman/EMBA-FTW2009/Articles/Fraud Diamond Four Elements.CPAJ2004.pdf.

[18] S. Johnson, H. Ryan, and Y. Tian, "Executive Compensation and Corporate Fraud,", https://www3.nd.edu/~finance/020601/news/Johnson_paper.pdf.

[19] E. Goldman and S. Slezak, "The Economics of Fraudulent Misreporting,", https://www.researchgate.net/publication/240298577_The_Economics_of_Fraudulent_Misreporting.

managers to exert productive effort but at the same time leading them to modify valuable resources, thus distorting performance. Finally, Peng and Roell[20], while examining how executive compensation relates to the management kind of behavior that triggers private securities dispute, found that stock options incentive pay by far increases the probability of lawsuit incidence.

3.2.2 FRAUD SCHEMES

Presently, and for what we know, standard auditing procedures rarely do detect fraud. “It is therefore essentially important that auditors and other stakeholders know the relative frequencies with which various types of fraud occur.”[21] Getting to understand patterns of fraud schemes, auditors, regulators, and investors could finally incorporate the notion that the process of management fraud is often conservative, not to say repetitive and obsolete. Gao and Srivastava analyzed fraud cases from the US SEC in Accounting and Auditing Enforcements Releases (AAERs) issued between 1997 and 2002, and summarized frequencies of fraud patterns at the level of both account schemes and evidence schemes:

“Account schemes are defined as those schemes that are relevant to manipulations of account balances such as revenue recognition on fictitious transactions.”[22]

Evidence schemes refer to the tendency used by managers to cover account schemes and deceive auditors. The most frequent evidence schemes are: fake or altered documents, collusion with third parties, altered internal documents, hidden documents and/or information, and management misrepresentation. Yet, managers underline significant relationships among evidence schemes, account schemes, and company characteristics.

First of all, the recognition of false revenues can underline the creation of fake documents and the collusion within a third parties such as customers and distributors. Second of all, the use of altered internal documents is related to premature revenue identification and hidden documents/information are related to both premature revenue recognition and undervalued

[20] Röell, Peng, and Lin, "Executive Pay, Earnings Manipulation and Shareholder Litigation," By Jikun Huang, Ruifa Hu, Scott Rozelle, Fangbin Qiao, Carl E. Pray :: SSRN, January 20, 2004, , https://papers.ssrn.com/sol3/papers.cfm?abstract_id=488148.

[21] Mark W. Nelson, John A. Elliott, and Robin L. Tarpley, "How Are Earnings Managed? Examples from Auditors," *SSRN Electronic Journal*, 2002, , doi:10.2139/ssrn.301518.

[22] L. Gao and R.P. Scrivastava, "The Anatomy of Management Fraud Schemes," , 2018, http://eycarat.faculty.ku.edu/myssi/_pdf/3-The-Anatomy-of-Management-Fraud-Schemes-IAR.pdf.

expenses/liabilities. Eventually, management representations either in oral or written form correspond to the account scheme of overvalued assets and undervalued expenses.

Furthermore, Gao and Srivastava found some interesting relationships between evidence schemes and company characteristics. In fact, companies in the IT industry are more likely to hide documents from auditors such as agreements with customers or distributors. The altered internal document scheme was deployed more in annual reports than in quarterly reports. Their analysis of the relationships among evidence schemes, account schemes and company characteristics could help the auditor to forecast evidence schemes used by management to conceal fraud. In addition, the analysis should help the auditor direct his/her attention to the audit indication that might have been manipulated to conceal fraud, and thus help in the design of special procedures in response to potential fraud schemes. Beasley et al. identified improper revenue recognition as "the most common fraud technique, followed by the overstatement of existing assets or capitalization of expenses."[23] As he reported, companies employed a variety of techniques to improperly recognize revenue including the following: sham sales, conditional sales, round-tripping or recording loans as sales, bill and hold transactions, premature revenues before all the terms of the sale were completed, improper cut-off of sale, improper use of the percentage of completion method, unauthorized shipments and consignment sales.

3.3 WHAT IS EARNINGS MANAGEMENT

Most accounting fraud schemes involve "earnings management" which does not always involve outright violations of rules set by GAAP. The contrast between non-violating-accounting-standards earnings management, and "earnings manipulation", which amounts to deceitful accounting, is strict. Nonetheless, earnings management is distinguished from fraudulent accounting. According to Healy's: "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."[24]

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[23] S.M. Beasley, J.V. Carcello, and D.V. Hermanson, "Fraudulent Financial Reporting: 1987 -1997 - COSO," , https://www.coso.org/publications/FFR_1987_1997.PDF.

[24] Paul M. Healy, "The Effect of Bonus Schemes on Accounting Decisions," *Journal of Accounting and Economics* 7, no. 1-3 (1985): , doi:10.1016/0165-4101(85)90029-1.

The reason why it is so difficult to measure earnings management is that it is difficult to measure it directly since it can't be observed directly. "Accounting standards are not meant to be a straight jacket, hence management is allowed flexibility of accounting which is essential to innovation"[25]. An unexpected consequence of admitting accounting flexibility is that it gives management the latitude to "manage earnings" by modifying its accounting policy to select those accounting principles that benefit it most.

Examples are many and include the following:

10. Changing devaluation method from an accelerated method to a more conservative straight line method and vice versa;

11. Changing the useful lives or the estimates of recover value of assets;

12. Determining whether/when assets have become impaired, and are required to be reserved against or written off.

13. Determining the appropriate allowance required for uncollectible accounts receivable;

14. Choosing an appropriate method of inventory valuation (FIFO, LIFO or specific identification).

15. Determining whether a decline in the market value of an investment is temporary, or permanent, and

16. Estimating the reductions required for investments.

While clear definitions of "earnings management" are difficult to recognize from practitioners' or regulators' statements or pronouncements; an extreme form of earnings management, that is, accounting fraud is well defined (again in terms of management intent) by the National Association of Certified Fraud Examiners, [NACFE].

"The intentional deliberate, misstatement or omission of material facts, or accounting data, which is misleading and when considered with all the other information made available would cause the reader to change or alter his or her judgment or decision."[26] In their speeches

[25] A. Levitt, "The "numbers Game" Speech," SEC Emblem, , accessed September 30, 2018, https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt.

[26] C*ooking the Books: What Every Accountant Should Know about Fraud* (Austin, TX: NACFE, National Association of Certified Fraud Examiners, 2009).

and writings, regulators, such as the Securities and Exchange Commission (SEC), seem to suggest that financial reporting choices that explicitly violate accounting standards can openly constitute both fraud and earnings management; while systematic choices made within accounting standards constitute earnings management. Certain techniques have been identified openly not being within the acceptable parameters of accounting rules. These unacceptable techniques are generally those that inflate earnings, create an enhanced financial picture, or inversely, mask a deteriorating financial picture. The techniques which constitute financial frauds include “big bath” charges, creative acquisition accounting, “cookie jar” liability reserves, use of materiality to record small but intentional misstatements in the financial statements and revenue recognition irregularities. The notion that earnings management can occur within the bounds of accounting standards is steady with the definition described by Dechow and Skinner[27]; who have differentiated between managerial choices that are fraudulent and those that even aggressive, are acceptable ways in which managers can exercise their accounting discretion. They point that there is a clear conceptual difference between fraudulent accounting practices (that plainly demonstrate intent to deceive) and those judgments and estimates that are within acceptable practice and which may include earnings management depending on managerial intent.

One of the most common practices influencing the financial reporting quality in the company’s financial statement is the earning management. Earning management concerns the process of showing the real performance of companies through the exploitation of accounting policies in the form of information that does not reflect the real performance of the companies.

3.3.1 REVENUE RECOGNITION

Revenue Recognition is one of the distinctive 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."[28]

[27] Patricia M. Dechow and Douglas J. Skinner, "Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators," *SSRN Electronic Journal*, 2000, , doi:10.2139/ssrn.218959.

[28] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

The study by COSO in 1999 has recorded 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."[29]

The improper revenue recognition issues are usually found in the following schemes:

17. Bill and Hold Sales Transactions

“Bill and hold is the term used to describe when a selling company holds merchandise to accommodate a customer.”[30] 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.”[31]

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 realized or realizable; and 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.”[32]

18. 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.”[33]

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.”[34]

19. Side Agreements

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[29] "Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies Research Commissioned by the," COSO, , http://www.coso.org/.

[30] Shantan Pesaru, "Tech Profs Expose Fuzzy Accounting.," Nique Master, August 23, 2002, , http://nique.net/master.php3?issue=2002-08-23&story=21.

[31] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

[32] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

[33] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

[34] Shantan Pesaru, "Tech Profs Expose Fuzzy Accounting.," Nique Master, August 23, 2002, , accessed, http://nique.net/master.php3?issue=2002-08-23&story=21.

Side agreements are used to alter the terms and conditions of recorded sales transactions to persuade 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 alleviate 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 a body 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."[35]

20. Illegitimate Sales Transactions

"Illegitimate sales transactions relate 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."[36]

21. Improper Revenue Recognition – Contract Accounting

This involves the inappropriate use of the percentage of completion method of accounting for long-term contacts. "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."[37]

22. Improper Related-Party Sales Transactions

"Related-party sales transactions" refers to a financial link or other relationship between the company and the customer.[38] The reason why 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 boost 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."[39]

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[35] "Audit Issues in Revenue Recognition (1999)," Accounting for the Cost of Pension Plans; :: AICPA Historical Collection, http://clio.lib.olemiss.edu/cdm/ref/collection/aicpa/id/109109.

[36] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

[37] Zabihollah Rezaee, Financial Statement Fraud: Prevention and Detection (New York: Wiley, 2002).

[38] Shantan Pesaru, "Tech Profs Expose Fuzzy Accounting.," Nique Master, August 23, 2002, , accessed October 01, 2018, http://nique.net/master.php3?issue=2002-08-23&story=21.

[39] "Audit Issues in Revenue Recognition (1999)," Accounting for the Cost of Pension Plans; :: AICPA Historical Collection, http://clio.lib.olemiss.edu/cdm/ref/collection/aicpa/id/109109.

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."[40]

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 specific consideration. Again, this fraudulent revenue recognition scheme requires the "substance over form" questions to be examined.

23. Channel 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."[41]

Distributors and resellers sometimes delay placing orders until the end of a quarter in an effort to negotiate a better purchase price 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.

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[40] "Audit Issues in Revenue Recognition (1999)," Accounting for the Cost of Pension Plans; :: AICPA Historical Collection, http://clio.lib.olemiss.edu/cdm/ref/collection/aicpa/id/109109.

[41] "Audit Issues in Revenue Recognition (1999)," Accounting for the Cost of Pension Plans; :: AICPA Historical Collection, http://clio.lib.olemiss.edu/cdm/ref/collection/aicpa/id/109109.

3.4 CREATIVE ACCOUNTING & FRAUD

Creative Accounting is a process in which a company estimates their financial position, but works backwards in order to achieve it. Creative Accounting can have two meanings: positive and negative; depending on whether the methods used fall outside the current financial reporting regulations, or not. Nevertheless, this term in practice has usually negative connotation and is also named “tax smoothing”, “income smoothing”, “cosmetic” accounting and “financial engineering”. The term “creative” is used to indicate the opposite of “consistent” and “conservative” in accounting principles, which is commonly used as a kind of ironic remark to managers who secretly embellish the financial statements.

The “negative” side of creative accounting is directed towards information in the financial statements concerned with either profitability or the level of indebtedness.

There are various "creative" devices to reduce a group's reported indebtedness. For example the misuse of Good-will and brand names. Brand names are a powerful marketing tool, in fact companies that have included them in their strategies have done it to increase their value assets when they would have seemed poor. Yet, an other problem is the valuation of a brand name which can be arbitrary judged. Or a company may capitalize its R&D expenditure. Instead of writing it off as cost, it could be added to assets in "know how". The approach is similar to the way brand names can be handled. Moreover, there’s the manipulation of depreciation methods. To cite a factual example, The British Airport Authority depreciates tracks over 99 years. This means that they ignore depreciation of the runways. However they are at least open and consistent. Yet another way is moving operating costs to reduced assets: e.g. a company had to renew the pipes in a major chemical complex. This was simply to replace old equipment. The company may not record this as an operating cost, but classify it as "environmental activity" and write it off against assets.

Something clearly a cost, and affecting the year's results, is being moved from the cash stream of the company. Creative accounting affects the value of assets and liabilities, and also the allocation of changes to assets/liabilities or profit/loss.

3.5 CONCLUSIONS AND CONSIDERATIONS

From the discussion carried out, we can infer that financial statement fraud incorporates multiple definitions, but the common thing of all is: it is an illegitimate act, committed by management, and damages other parties through misleading financial statements. The earnings management and creative accounting issues are of great concern to accounting and business professionals, especially given the relationship of these issues to the spectacular financial statement fraud cases of the last decade. Improper revenue recognition, one form of earnings management, is found to be the most common abuse by management in order to achieve their earning targets. The latter is certainly an exaggeration of creative accounting, which through the deception and the contravention of specific accounting standards obtains illicit financial advantages. Through the present dissertation emerges the existing border, represented by the regulatory framework of reference, between creative accounting and fraud. Although there is a common basis between the creative accounting and accounting fraud represented by the negative intent of the persons "editing" the financial statement, the aspect that allows to identify and frame the two policies in question is still that one is a legal and respectable practice, while the latter is not. Therefore, it is possible to argue the same for the context of the earnings management, where the editor of the financial statements complies with the regulations, unlike what happens in the context of fraud in which there is a violation of accounting principles and regulatory provisions. However, it is not always possible to identify with absolute certainty and extreme ease the border between the aforementioned policies, as the discretion left to management, with regard to the improvement of accounting data, can easily lead to fraud if said discretion becomes free will.

4 THE ROLE OF AUDITORS IN DETECTING ACCOUNTING FRAUD

4.1 INTRODUCTION: WHO IS AN AUDITOR?

The auditing profession has been placed in the spotlight because of recent corporate collapses and audit failures; but what is really the role of an auditor?

An audit is the examination of the financial report of an organization - as presented in the annual report - by someone independent of that organization. The financial report includes a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and notes comprising a summary of significant accounting policies and other explanatory notes.

The purpose of an auditor is to review and verify the accuracy of business records, i.e. whether the information presented in the financial report, taken as a whole, reflects the financial position of the organization at a given date, and to ensure compliance with tax laws. Financial statement auditors are not fraud examiners, but are to determine the reliability of internal control and the extent of audit risk, and to report whether the financial statements are presented fairly in accordance with Generally Accepted Accounting Principles.

When examining the financial report, auditors must follow auditing standards which are set by a government body. Once auditors have completed their work, they write an audit report, explaining what they have done and giving an opinion drawn from their work. Generally, all listed companies and limited liability companies are subject to an audit each year. Other organizations may require or request an audit depending on their structure and ownership. Accounting standard setters, including the Public Company Accounting Oversight Board (PCAOB), require auditors to adhere to the requirements of Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (PCAOB, 2007). The Standard "requires auditors to participate to brainstorming sessions and to consider the possibility that a material misstatement due to fraud could be present."[42]

[42] "EXPOSURE DRAFT - AICPA," , accessed October 1, 2018, https://www.aicpa.org/content/dam/aicpa/research/exposuredrafts/accountingandauditing/downloadableddocuments/20171128c-ed-auditor-reporting.pdf.

Under SAS No. 82, "the auditor's responsibility relates to the detection of material misstatements caused by fraud and is not directed to the detection of fraudulent activity per se."[43]

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."[44]

Specifically, SAS No. 82 defines the auditors' responsibility as follows:

24. Assess the risk of material misstatements due to fraud by considering fraud- risk factors.

25. Respond to the results of the risk assessment.

26. Document identified fraud-risk factors and the responses to those factors.

27. Communicate fraud to management.

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.

An auditor can be held liable for fraud when he or she acted with an intent to deceive.

Reasonable Assurance

[43] "Statement on Fraud, SAS No. 82, Is Released," Journal of Accountancy, February 01, 1997, , accessed October 01, 2018, http://www.journalofaccountancy.com/issues/1997/feb/auditing.html.

[44] "Statements on Auditing Standards," AICPA, , accessed October 01, 2018, https://www.aicpa.org/research/standards/auditattest/sas.html.

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.

Errors versus Fraud

SAS No. 82 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

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.

4.1.2 ASSESSING RISK OF FRAUD - THE AUDIT RISK 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).

"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 "[45].

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). The three conditions correspond to the three components of audit risk.

"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

[45] "Audit Issues in Revenue Recognition (1999)," Accounting for the Cost of Pension Plans; :: AICPA Historical Collection, , accessed October 01, 2018, http://clio.lib.olemiss.edu/cdm/ref/collection/aicpa/id/109109.

other balances or classes, assuming that there were no related internal controls."[46] 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."[47] 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."[48]

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. Therefore, the larger the sample size (i.e. doing more audit work), the lower the detection risk.

The lower the assessments of inherent and control risks, the higher the acceptable level of detection risk. This ensures that audit risk is reduced to an acceptable level. The greater the inherent and control risks, the lower the detection risk needs to be.

One reminder to auditors is that the audit risk model does not include any other risks which should be counted. The "risks" are known as "engagement risk," "client risk" or "client continuance." "Engagement risk represents the overall risk associated with an audit engagement."[49] "Because of rapid changes in the business environment, active consideration of whether to continue to serve a client may help to protect auditors themselves"[50] (in order to avoid client risk).

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[46] *The Audit Framework* (Singapore: FTMS Consultants, 2001).
[47] *The Audit Framework* (Singapore: FTMS Consultants, 2001).
[48] *The Audit Framework* (Singapore: FTMS Consultants, 2001).
[49] "CPA Journal Online," Client Acceptance: What to Look for and Why. (tips for Accountants on Deciding Which New Clients to Accept) (Cover Story), , accessed October 01, 2018, http://archives.cpajournal.com/1996/mar96/depts/auditing.htm.
[50] "Quality Control for an Engagement Conducted in ... - AICPA," , accessed October 1, 2018, http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-C-00220.pdf.

4.2 AUDIT FEES AND FRAUD CLASSIFICATION - THE IMPACT OF THE SARBANES-OXLEY ACT

Recent studies have examined the “effects of the Sarbanes-Oxley Act (SOX) and its emphasis on internal control and corporate governance and their respective associations with audit fees.”[51] Some have identified an “inverse relationship between corporate governance and fraud”[52]; Hay et al. found that corporate governance, internal audit and concentration of ownership are positively associated with audit fees.

For the first time, beginning in 2001, firms were required to report non-audit fees, along with audit fees, for services performed in 2000. “These audit disclosures provided initial evidence that amounts paid for non-audit services were more than three times the amounts paid for audit fees: $2.65 billion for non-audit service fees compared to $909 million in audit fees.”[53]

The SOX Act of (2002) aimed to improve corporate transparency in two respects:

- enhancing auditor independence by limiting the type of services the auditor could perform for the client;

- requiring, as part of Section 404, that companies report on the effectiveness of their internal control systems.

As a result of SOX, audit work and correspondingly audit fees increased substantially as firms implemented more stringent requirements. These stronger internal controls and internal audit functions thus resulted in lower external audit fees.

Examining characteristics of companies that have been subject to fraud litigation during two distinct time periods, 2001 and 2005, along with the characteristics of companies in similar industries, Hay et al. (2008) found specific differences in that audit fees for fraud litigation companies in both 2001 and 2005 were significantly higher than those for non-fraud companies before, during, and after the fraud litigation year. The study also showed that in 2005, fraud companies were larger than non-fraud companies in their industry. In both years,

[51] David Hay, W. Robert Knechel, and Helen Ling, "Evidence on the Impact of Internal Control and Corporate Governance on Audit Fees," *International Journal of Auditing* 12, no. 1 (2008): , doi:10.1111/j.1099-1123.2008.00367.x.

[52] S.M. Beasley, J.V. Carcello, and D.V. Hermanson, "Fraudulent Financial Reporting: 1987 -1997 - COSO," , https://www.coso.org/publications/FFR_1987_1997.PDF.

[53] Robert W. Rouse, "Surprising Revelations about Audit Fees," *Journal of Corporate Accounting & Finance* 12, no. 6 (2001): , doi:10.1002/jcaf.1115.

size of company, the receivables to inventory ratio, the number of segments and in most cases, fraud litigation, were positively related to audit fees.

Non-audit fees were positively related to audit fees in both 2001 and 2005. However, in 2001 non-audit fees were significantly higher for fraud companies, but by 2005 there was no significant difference in non-audit fees between fraud and non-fraud companies. These results show that while a company's governance ranking within its industry had a positive association with audit fees, a company's corporate governance ranking within the stock market index had a negative association with audit fees. This indicates that to some extent, companies may seek higher quality, and therefore more expensive audits in order to maintain their position in their industry. Yet, their ranking may be relatively low compared to other companies in the stock market index, resulting in higher audit fees that reflect higher risk. The ratio of net income to total assets was also negatively related to audit fees. Having an auditor who is an industry specialist did not significantly contribute to audit fees in either year. Finally, a modified audit report was a significant indicator of higher audit fees in 2005 compared to 2001, as was a loss in any of the previous three years.

In terms of characteristics that lead to fraud litigation, in 2001, the absence of a Big N auditor (an auditor who comes from one of the four biggest professional services networks in the world: Ernst & Young, Deloitte & Touche, KPMG and PWC) was a likely indicator of fraud. In 2005, companies that had a lower debt ratio were more likely to incur fraud litigation, which would seem to indicate a less risky company. However, these companies had significantly higher audit fees from the outset, compared to non-fraud companies, indicating a strong investment in audit quality, perhaps as an attempt to mitigate risk. Yet, as noted by Krishnan and Lee, "litigation is more likely to occur for high-risk companies even if they try to mitigate risk by having a financial expert on the board of directors."[54]

In Summary, there is clear evidence of the influence of specific corporate governance structures on audit fees and the likelihood of fraud litigation. This information is important to auditors and both internal and external policy makers in determining the effectiveness of regulations such as SOX. Furthermore fraud and audit fees are found to be linked to specific details of audit independence, and in regards to different categories of internal control weaknesses among client companies.

[54] Jagan Krishnan and Jong Eun Lee, "Audit Committee Financial Expertise, Litigation Risk, and Corporate Governance," *AUDITING: A Journal of Practice & Theory* 28, no. 1 (2009): , doi:10.2308/aud.2009.28.1.241.

4.3 INTERNAL AUDITING

Most frauds occur when there is a weak or even no internal control. Physical storage of property, access to accounting records, and the knowledge or authority to refuse control are the main content of fraud in the general ledger and financial statements. According to a research conducted by ACFE, fraud in financial statements usually has a higher impact on corporate asset losses. In addition, it will also have a negative impact on shareholders and investment in general. Without internal deterrence or control, fraud will be very easy to happen. That is why internal audit adds a fundamental value to the firm.

Internal audit is defined as an objective assurance with the aim to evaluate and improve the effectiveness of risk management, control and governance processes. "'Assurance' is also used by the international accounting body in tandem with auditing standards"[55]. Although auditing standards are applicable for audits of financial information, the assurance standards are for other engagements. "Internal audit has also been described as an independent appraisal of the effectiveness of internal control within an entity of its management process in achieving set objectives and goals"[56].

So, to start with, there are three components worth looking one by one, i.e., internal, auditing and effectiveness:

- Internal

Internal auditors are typically employees of the organization for which they work. There can be arrangements in practice for co-sourcing or even for full outsourcing of IA services.

- Auditing

The Latin word 'audire' means 'to hear' in English. As Ridley states, "the right questions will always be the key to effective internal auditing. So will be right listening!"[57]

- Effectiveness

[55] "2010 Handbook of the Code of Ethics for Professional Accountants," IFAC, , accessed October 02, 2018, https://www.ifac.org/publications-resources/2010-handbook-code-ethics-professional-accountants.
[56] Gurdarshan Singh. Gill et al., *Modern Auditing* (Brisbane: John Wiley & Sons, 1999).
[57] Jeffrey Ridley, *Cutting Edge Internal Auditing* (London: John Wiley & Sons, 2008).

Ridley claimed that modern IA has been constructed upon the "three Es" of effectiveness, efficiency and economy. Chambers viewed effectiveness as "doing the right thing", while efficiency means "doing them well" and economy means "doing them cheaply"[58].

Internal Auditing demands compliance with its Code of Ethics, which requests that internal auditors "shall perform internal audit services in accordance with the International Standards for the Professional Practice of Internal Auditing" and "shall continually improve their proficiency and the effectiveness and quality of their services"[59].

Fadzil et al. looked at the internal auditing practices and its effect on the quality of internal control. They summarized the services performed by the Internal Auditor to cover four areas:

4. Review of adequacy and effectiveness of the control systems (accounting, financial, operational);

5. Ascertain the compliance to policies, rules and regulations which could impact significantly on the business operations;

6. Review the means of safeguarding the company's assets including efficiency and economy of resources employed;

7. Review operations or programs to determine that the results are as established by management.

Upon the conclusion of an audit, the report presented should give a 'reasonable assurance' on the state of matter that was investigated. The reliance on the reports or other opinions of internal auditors is very important as these reports will be referred to by management when they undertake continuous improvements. The work of internal auditors will also be assessed by external auditors who would determine whether reliance will be placed on such work in the conduct of financial audits or other engagements (e.g. AUASB, 2010). Upon the agreement of the process owners to take corrective actions or improvements, customarily the follow-up audit made by the internal auditors will also assess the effectiveness of such corrective actions in ensuring the root causes for the weaknesses have been addressed. The

[58] Andrew Chambers, "Assurance of Performance," *Measuring Business Excellence* 10, no. 3 (2006): , doi:10.1108/13683040610685784.

[59] "Pages - International Professional Practices Framework (IPPF)," The Institute of Internal Auditors North America, , accessed October 02, 2018, https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx.

report on the initial audit findings and the results of the corrective actions would be indicative of the effectiveness of the internal audit.

Researches show that there is a difference in the tendency of accounting fraud between the presence of internal control and absence of internal control, thereby underlining the importance of internal auditing.

4.4 SUNBEAM CASE ANALYSIS AND AUDITORS' ROLE

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, so-called "Chainsaw Al," 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 authorized 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.

There were enormous pressures on the management to meet the expectations and forecasts of the analysts. Like many other companies, Sunbeam faced the economic pressure to achieve its targets, show steady growth and perform better and better all the time in order to keep the investors happy and increase market value.

As for the auditors, they were also under the pressure of retaining their clients. Unfortunately this situation with an external auditor, anxious to retain a client, leads too often to an auditor's failure to resist client pressures. There has been plenty of discussion about auditors' independence in the financial literature. Some argue that auditors can never be independent, because of the current system, where auditors are hired and paid by the organizations that they audit. 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 first point emphasized by the SEC concerns “the illusion of a successful restructuring of Sunbeam in order to inflate its stock price and thus improve its value as an acquisition target”: the SEC complaint against Sunbeam states that “at least $62 million of Sunbeam’s reported income of $189 million came from accounting fraud”[60]. Among the many different fraudulent accounting techniques used by Sunbeam from October 1996 to June 1998, the SEC focused on “the improper recording of bill and hold sales”.

“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”[61]. 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.

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 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.

[60] "Securities and Exchange Commission," SEC Emblem, , accessed October 02, 2018, https://www.sec.gov/litigation/litreleases/lr17710.htm.

[61] "Securities and Exchange Commission," SEC Emblem, , accessed October 02, 2018, https://www.sec.gov/litigation/litreleases/lr17710.htm.

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.

As emphasized by the SEC in Release no. 1393, Al Dunlap's claimed reorganization was also based on several other improper practices such as the "cookie jar" reserves to create improper profits in 1997 and the "channel stuffing" (i.e. putting inventory onto the books of distributors and retailers) to reduce the value of inventory and to record large profits when the goods were sold.

"Sunbeam executives used "channel stuffing" to make its reported revenue look good"[62]. 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"[63].

Let us then recall how the events at Sunbeam developed in succession. "When Al Dunlap became Sunbeam Corp's CEO in July 1996, he implemented, from the outset, the same strategy he had already successfully applied when he headed other companies such as Scott Paper Co.: massive cuts to product lines, plants and employees"[64]. The new CEO enjoyed full powers: of the five board members, four were chosen by Dunlap himself (the fifth was Michael Price, as the main shareholder).

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.

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62 "Securities and Exchange Commission," SEC Emblem, , accessed October 02, 2018, https://www.sec.gov/litigation/litreleases/lr17710.htm.

63 "Securities and Exchange Commission," SEC Emblem, , accessed October 02, 2018, https://www.sec.gov/litigation/litreleases/lr17710.htm.

64 Martha Brannigan And and Joann S. LublinStaff Reporters of The Wall Street Journal, "Dunlap, Sunbeam Ready to Battle Over Ousted Executive's Severance," The Wall Street Journal, June 16, 1998, , accessed October 02, 2018, https://www.wsj.com/articles/SB897959179261396000.

Lack of internal auditing and monitoring of the top management by the board of directors is evident in this case. 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. 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.

Moreover, in the following year half of Sunbeam's 12,000 jobs were eliminated, approximately 90% of the products were discontinued, and 18 of the 26 plants were closed. The implementation of these same actions excited analysts' expectations for higher profits, pushing the stock to over $45 per share in September 1997. Dunlap decided then to use his company's inflated stock to acquire other companies: in early March 1998, Sunbeam declared it planned to buy three other companies, i.e. Coleman, Signature Brands and First Alert (Kadlec, 1998). In the following days the stock price plunged again to close to $50 per share. (when Dunlap took over Sunbeam in July 1996, the company's stock was trading at $12.50). On April 3, 1998, Sunbeam completed also the cash acquisitions of First Alert, Inc. ("First Alert"), a leading manufacturer of smoke and carbon monoxide detectors, and Signature Brands USA, Inc. ("Signature Brands"), a leading manufacturer of a comprehensive line of consumer and professional products. In connection with the purchases of the three companies, Al Dunlap obtained new contracts for himself and for Kersh too: in this way, Dunlap and Kersh doubled their salaries and beneficially owned, respectively, 5% and 1% of the company. So, under these new agreements, they had even greater incentives "to raise the price of Sunbeam's stock and sell the Company to cash in all of these holdings".

"In many cases a strong incentive to manage earnings is executives' bonuses tied to company's performance, although in the case of Sunbeam, the executives did not gain from the boosted stock market price, as they held their options and stock"[65]. 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

[65] "Securities and Exchange Commission," SEC Emblem, , accessed October 02, 2018, https://www.sec.gov/litigation/litreleases/lr17710.htm.

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.

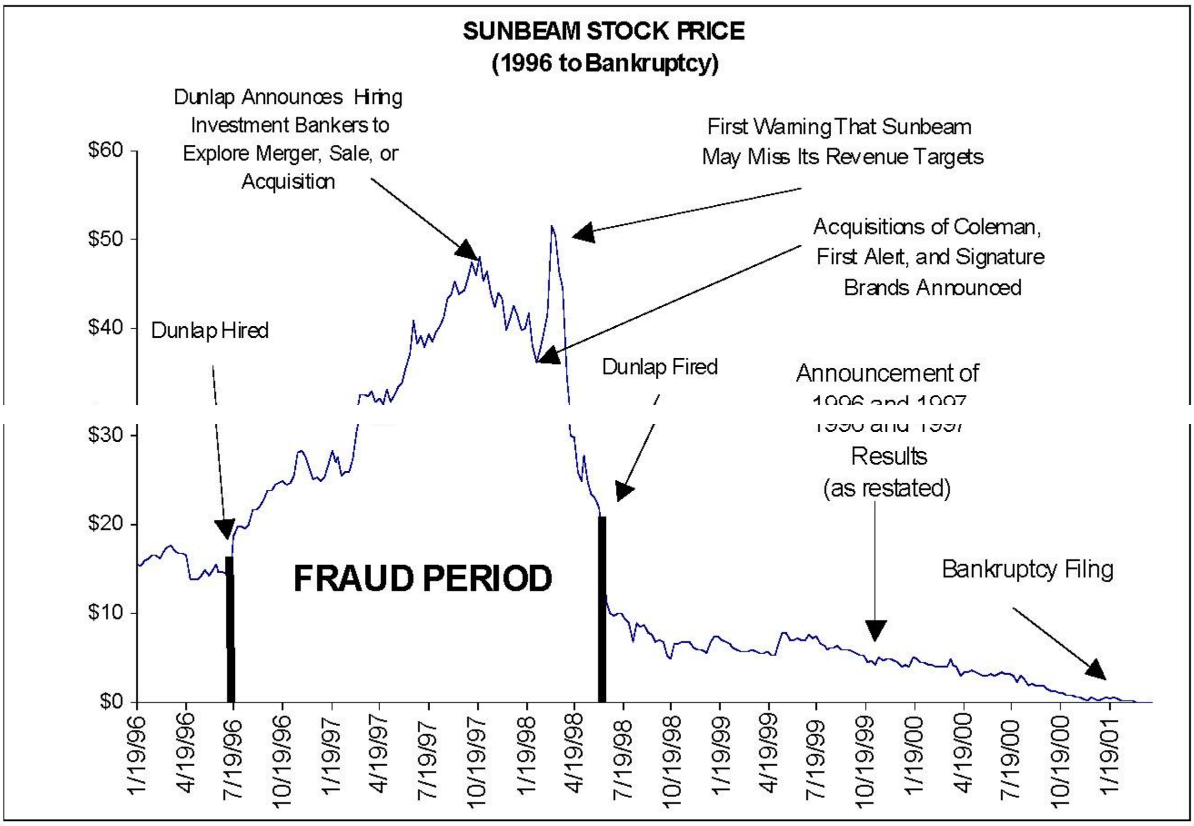

FIG. 1 - SUNBEAM'S STOCK SCHEME.

In April 1998 it emerged, when Sunbeam restated its financial results, that the company's CFO Russell Kersh moved $21,500,000 from reserves into income and shifted part of operating expenses into a 1996 restructuring charge in order to hide the reduction in profits due to the hard discounts, credit extensions and "bill-and-hold" contracts used in order to inflate revenues with sales that should not have already been wholly counted in.

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

After the story, Sunbeam's board fired Dunlap as chairman and chief executive officer. Shortly thereafter, the SEC started the investigation.

"This announcement raised some questions also about external auditors' position: on December 1, 1998, several months after Dunlap's discharge, Sunbeam dismissed Arthur

Andersen and named Deloitte & Touche as its new outside auditors"[66]. In most of the fraud cases, auditors declared that they had no knowledge of the improper accounting practices used by the company. The Sunbeam case is different because Phillip E. Harlow, the Arthur Andersen partner in charge of the Sunbeam audit, discovered some of the fraudulent transactions and asked the company to change its financial statements.

In particular, Harlow focused on a specific fraudulent method of creating fake profits, the so-called spare-parts gambit: Sunbeam owned a lot of spare parts, used to fix its blenders and grills when they broke. Those parts were stored in the warehouse of a company called EPI Printers, which sent the parts out as needed. The improper method consisted in selling the parts for $11 million to EPI and booking an $8 million profit. Unfortunately, EPI thought the parts were worth $2 million. But Sunbeam found a way around that. EPI was persuaded to sign an "agreement to agree" to buy the parts for $11 million, with a clause letting EPI walk away in January. In fact, the parts were never sold, but the profit was posted. Harlow claimed to have effectively discovered that and concluded the profit was not allowed under generally accepted accounting rules, but the company's management refused to make most of the requested changes: Sunbeam agreed to cut it by just $3 million. After that, before deciding to sign, Mr. Harlow analyzed Sunbeam financial statements thoroughly and understood that the remaining profit was not material: this was the same as saying that the part, which was not presented fairly, was not material, so it did not matter.

As emphasized by Norris[67], after the Sunbeam fraud disclosure, Harlow was supported by his partner (Arthur Andersen), who stated this case involved not fraud, but "professional disagreements about the application of sophisticated accounting standards": "in the typical accounting fraud case, the auditors say they were fooled. Here, at least according to the SEC, the auditors discovered a substantial part of what the commission calls sham profits". We may say that stating the immateriality of a part of improper profits, they used their professional knowledge, the asymmetrical access to information and the flexibility inside auditing rules to distract other stakeholders' attention from news which would not be welcome. For these reasons, we may affirm that Sunbeam represents a case of creative auditing implementation. In fact, after Dunlap was fired, Arthur Andersen (Harlow's partner),

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[66] Bloomberg News, "Sunbeam Dismisses Longtime Auditors," The New York Times, December 01, 1998, , accessed October 02, 2018, https://www.nytimes.com/1998/12/01/business/sunbeam-dismisses-longtime-auditors.html.

[67] Floyd Norris, "They Noticed the Fraud but Figured It Was Not Important," The New York Times, May 18, 2001, , accessed October 02, 2018, https://www.nytimes.com/2001/05/18/business/they-noticed-the-fraud-but-figured-it-was-not-important.html.

along with another accounting firm, re-audited the books and concluded that the 1997 profits should have been far lower, but also that Sunbeam's external auditors acted better than the typical auditor in the typical accounting fraud.

5. CONCLUDING REMARKS

This document aimed at clarifying the economic-corporate aspects of financial statement fraud and then analyzing the main regulatory steps concerning the role of auditors in general as well as in specific fraud situations.

We went from defining what accounting fraud means, to the understanding of its concerns to the business community, going from its effects on the auditors, who are engaged to render an opinion as to whether the financial reports fairly present the company's financial position and results of operations in conformity with established standards; to the board of directors, the investors, corporate managers and the general public, and as a result, regulators, legislators and other public policy makers. These parties all have an interest in preventing and detecting fraud before investment decisions are made on materially misstated financial statements. This paper critically analyses financial statement fraud based on the factors, motivation and antecedents of fraudulent financial reporting. The overall objective for the review is to improve understanding of the anatomy of fraud and of auditor's responsibilities, risks and tools; thereby improving the ability to detect fraud.

First and foremost we analyzed the determinants of accounting fraud tendency, regarding *information asymmetry* as the basis and conceptual framework on which fraud is constructed, then we went on explaining and supporting the discussion on the fraud triangle and finally considering executives' compensation as the last major determinant, hand in hand with morality. However, we concluded that due to the growing complexity and creativity in financial markets and white collar crimes, some frameworks may not fully capture the antecedents and factors of fraud.

That's why we went on with an analysis on fraud schemes, since currently, auditing procedures can rarely detect fraud. I therefore regard it as essentially important that auditors know the relative frequencies with which various types of fraud occur. The presented analysis should help the auditor direct his/her attention to the audit evidence that might have been manipulated to conceal fraud, and thus help in the design of special procedures in response to potential fraud schemes.

We then focused on the *earnings management* procedures, and after having clarified the nature of this fiscal policy, giving particular attention to the negative meaning of the term, and highlighting the main incentives (which push the top management to the implementation of the aforementioned policies) and the techniques most commonly used by management, aimed at altering accounting data, we understood when earnings management becomes fraud.

Particular regard was given to *revenue recognition,* the recording of a revenue before it is earned; a form of earnings management which is better elaborated later on in the analysis of the Sunbeam Corp. fraud case.

We conclude our first chapter with an explanatory paragraph on creative accounting policies and their exaggeration: the deception and contravention of specific accounting procedures with the aim of obtaining an illicit profit. Through the present dissertation emerges the existing border, represented by the regulatory framework of reference, between creative accounting and fraud. However, it is not always possible to identify with absolute certainty and extreme ease the border between the aforementioned policies, as the discretion left to management, with regard to the improvement of accounting data, can easily lead to fraud, if said discretion becomes free will.

In the second chapter we introduced the auditing profession; going in depth through auditors' responsibilities, as they are often misunderstood by the general public, and thus referring to the Statements of Auditing Standards. In this thesis, we have no ambitions to discuss the whole procedure for improving the audit process. Instead we focus on the practical ways in applying analytical procedure, risk assessment, avoiding audit failure in applying accounting principles, and conflict of interest issues. That is why we discuss the audit-risk model, which assesses the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated; analyzing its key features and components. The risks encountered by auditors have been noticeably reduced since the emission of the Sarbanes-Oxley Act, but that is not the only audit-feature the act has changed. In this dissertation we provided an insight into the characteristics of companies that have been subject to fraud litigation both before and after the emission of SOX, in order to assess whether these characteristics influenced companies' audit fees. The paper presents evidence of the influence of specific corporate governance structures on audit fees and the likelihood of fraud litigation. This information is important to auditors and internal and external policy makers in determining the effectiveness of regulations such as SOX. Future research could explore in more detail the role of corporate governance the effect on corporate fraud and audit fees. Future studies could also continue to examine fraud and audit fees as they are linked to specific details of audit independence, and in regards to different categories of internal control weaknesses among client companies.

The last feature of the auditing profession that was analyzed is the effectiveness of internal audit control: our research underlines the importance of an efficient internal control, as it enhances corporate governance and adds value to the firm, as well as playing a key role in preventing accounting fraud, whose prime determinant, as explained by in the fraud triangle examination, is lack of internal control.

We end this paper with the study and analysis of an exceptional case of revenue recognition: the Sunbeam Corp.'s case. From this analysis we inferred the enormous pressures that were constantly put on independent auditors, especially before SOX (when this case took place). Nonetheless some implications can be drawn from our analysis: one is that the investigation of a single, statistically extraordinary case, made it possible to explain the succession of the events in a way that couldn't have been done with a larger dataset, shedding light on a whole series of complex connections between accounting manipulation, market performance, M&A choices, auditing, and the reactions to fraud disclosure. Our most important consideration is though represented by the fact that the unusual factors explaining Sunbeam's exceptionally long time to macro-failure make it evident that auditors do not always distance themselves from the fraudulent practices. Another implication regards the collapse of Arthur Andersen which represented a sort of "historical turning point" for auditing and generated a series of doubts about the extent to which the financial audit function is controllable and responsible in firms' fraud. But the last implication concerns the fact that Sunbeam's case was made of an unusually successful fraudulent strategy, even though it could not avoid fraud detection by selling the company and thereby concealing financial statements manipulation. Therefore my question is, how many undetected cases of fraud could be found by studying the budgets of companies that have been sold?

Concluding, the point of this thesis is to show the fundamental interconnections between financial statement frauds and the auditing profession, highlighting both the favorable and negative points about it, and providing new stimuli for the detection of fraud and the importance of alleviating the responsibilities of auditors; from which sometimes they cannot escape.

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