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# **Financial Statement Fraud**

- Recognition of Revenue and the Auditor's  
Responsibility for Detecting Financial  
Statement Fraud -

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## **Abstract**

Financial reporting frauds and earnings manipulation have attracted high profile attention recently. There have been several cases by businesses of what appears to be financial statement fraud, which have been undetected by the auditors.

In this thesis, the main purpose is to identify some of the reasons why auditors have not detected financial statement fraud and to suggest possible solutions for improving the audit process in these areas. In order to achieve this target, some cases of the fraudulent financial statements of revenue recognition will be analysed.

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

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

Key-words: auditors, audit risks, financial statement fraud, internal control, earnings management, revenue recognition.



## **List of Abbreviations**

AICPA: American Institute of Certified Public Accountants

AR: Audit Risk

ASB: Auditing Standards Board

BTG: Brussels Translation Group N.V

CEO: Chief Executive Officer

CFO: Chief Financial Officer

COSO: Committee of Sponsoring Organizations of the Treadway Commission

CR: Control Risk

CRIME: Cooks, Recipes, Incentives, Monitoring, End Results

Dictation: Dictation Consortium N.V

DR: Detection Risk

ED: AICPA ASB Exposure Draft of a proposed Statement on Auditing Standards, “Consideration of Fraud in a Financial Statement Audit”

FAR: Föreningen Auktoriserade Revisorer in Sweden (Professional Institute For Authorised Public Accountants)

FSF: Financial Statement Fraud

GAAP: Generally Accepted Accounting Principles

GAAS: Generally Accepted Auditing Standards

IFAC: International Federation of Accountants

IR: Inherent Risk

L&H: Lernout & Hauspie Speech Products N.V

LDCs: Language Development Companies

NASDAQ: National Association of Securities Dealers Automated Quotation

POB: Public Oversight Board

SAB: Staff Accounting Bulletin

SAS: Statement of Auditing Standards

SEC: Securities and Exchange Commission

Sunbeam: Sunbeam Corporation

# Table of Contents

1	Introduction .....	1
1.1	Background .....	1
1.2	Research Problem.....	3
1.3	Purpose .....	4
1.4	Scope and Limitations.....	4
1.5	The Disposition of the Thesis .....	6
2	Research Methodology .....	7
2.1	Introduction .....	7
2.2	Research Approach .....	7
2.3	Data Collection.....	9
2.4	Case Study Methodology .....	12
2.5	Research Evaluation.....	14
2.6	Summary .....	16
3	Financial Statement Fraud: Earnings Management and Revenue Recognition .....	17
3.1	Introduction .....	17
3.2	Definition – Financial Statement Fraud.....	18
3.3	The Auditor’s Responsibilities for Detecting Fraud.....	19
3.4	Assessing Risks of Fraud .....	21
3.5	Definition – Earnings Management .....	27
3.6	Earnings Management – Revenue Recognition.....	28
3.7	Summary .....	31
4	Case Analysis. Why Auditors Have Not Detected Fraud? .....	33
4.1	Introduction to Three Case Studies.....	33
4.2	Analysis of the Three Cases.....	35
4.3	Reasons Why Auditors Have Not Detected Fraud .....	48
4.4	Summary .....	60
5	Recommendations For Improving the Audit Process.....	65
5.1	Introduction .....	65
5.2	Empirical Findings .....	66
5.3	Suggestions from the Existing Research.....	71
5.4	Summary .....	80
6	Summary and Suggestions for Further Research.....	81
6.1	Summary .....	81
6.2	Suggestions for Further Research .....	85
	References.....	87

## **Appendices**

Appendix 1. Cover Letter to the Audit Companies

Appendix 2. Questionnaire Sent to the Auditing Firms in Sweden

Appendix 3. Questionnaire Sent to FAR

## **Tables**

Table 1. The Audit Risk Matrix. ....24

Table 2. Categories of Risk Factors for Fraudulent Financial Statements. 26

Table 3. Summary of Three Financial Statement Fraud Cases.....65

Table 4. Summary of Reasons Why Auditors Have Not Detected Fraud and  
Suggestions for Improvement. ....80

## **Figures**

Figure 1. The Fraud Triangle. ....25

Figure 2. Financial Statement Fraud Interaction.....36

# **1 Introduction**

## ***1.1 Background***

Financial reporting frauds and earnings manipulation have attracted high profile attention recently. There have been several cases by businesses of what appears to be financial statement fraud, which have been undetected by the auditors. According to Joseph T. Wells (2002), one of the most remarkable cases in the twentieth century occurred in the 1970s, when an enterprising insurance salesman, Stanley Goldblum, managed easily to add 65,000 phoney policyholders to his company's – Equity Funding – rolls, along with \$800 million of fake assets – right under the nose of its independent audit firm (cited in Rezaee, 2002). Since then, financial statement fraud together with audit failures have been increasingly a hot issue, including the recent cases of Enron, Waste Management, Xerox and AOL Time Warner, just to mention a few.

The international auditing firm, Arthur Andersen, which audited Enron, appears to be an example of a firm entangled in a major audit failure. The case brought to light the weaknesses of the audit process. As a result, more people believe professional accountants have to learn how to detect financial statement fraud more effectively. One of the best ways is to profit from the mistakes of others. Enforcement actions against auditors have been rare (although we believe there will be more in the future), but the consequences of individual cases can be great and the cases offer the profession an opportunity to learn and grow (Beasley, Carcello and Hermanson, 2001).

In order to understand the problems in modern auditing, we will give a brief overview of auditing history. Auditing in one form or another has existed as long as commercial life itself. There has always been a need by those who entrust their property to others to have some checks and control over the latter. There is general agreement, that modern financial auditing began to take shape in the middle of the nineteenth century. The emergence of corporate entities in which ownership and control were separated provided a need for financial auditing and the development of increasingly detailed disclosure requirements

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

The difference in perception of responsibilities and reality was addressed in the case of *Kingston Cotton Mill Co (No 2)* (1896) 2 Ch 279 at 289, 290 Lopes LJ (FTMS, 2001) which said of auditors:

*“...He is a watchdog, but not a bloodhound... If there is anything calculated to excite suspicion, he should probe it to the bottom but, in the absence of anything of that kind, he is only bound to be reasonably cautious and careful...”*

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

When companies collapse, for whatever reason, but particularly in cases of alleged or actual fraud, public reaction focuses first on the auditors and the

possibility of their failure. Therefore, it is increasingly necessary for professionals to step up and take responsibility for continuing to improve their practices overall. The best use of a professional's time and talents is to prevent problems before they occur (Hunt, 2000).

## ***1.2 Research Problem***

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

According to a study published in 1999 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the use of fictitious revenues is the most popular method of committing financial statement fraud. As reported by the Securities and Exchange Commission (SEC) Commissioner, Isaac C. Hunt, Jr., in his speech "Current SEC Financial Fraud Developments," "Over half of financial report cases are directly related to revenue recognitions" (Hunt, 2000). Accounts receivable are attractive fraud targets, primarily because of the way receivables are viewed by lenders. Unlike inventory or fixed assets, accounts receivable – in the eyes of financiers – are the next best thing to cash. Because the mechanics are simple, sales/receivables fraud schemes lead the fraudulent financial statement pack (Wells, March 2001).

In this thesis, the main problem is to understand some of the reasons why auditors have not detected financial statement fraud and, if possible, to suggest some improvements in the audit process. In order to achieve this target, we will analyse some cases of the fraudulent financial statements of revenue recognition. The chosen cases are: Lernout & Hauspie, Sunbeam and Xerox. Since the companies we are going to study in the thesis applied US Generally

Accepted Accounting Principles (GAAP), we conduct our analysis in accordance with the US GAAP and appropriate regulations and laws.

### ***1.3 Purpose***

In our thesis, there are two main purposes. The first purpose, based on investigation of the fraudulent financial statement cases in the revenue recognition, is to identify the reasons why the auditors have not detected this fraud. The second purpose, based on the empirical findings about auditing methodology obtained from existing studies and interviews with various auditing firms in Sweden, is to suggest possible solutions for improving the audit process in the areas of detecting financial statement fraud.

### ***1.4 Scope and Limitations***

There are different types of financial statement fraud taking place in organisations. The COSO report (1999) lists common financial statement fraud techniques in the following categories:

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

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

well as the most interesting and has been discussed extensively in the accounting world.

In this thesis, we would like to emphasize the responsibility of the auditors for detecting frauds and errors. The study will be conducted from the perspective of the auditor.

Recently, the American accounting profession directly addressed the external auditor's responsibility for financial statement fraud detection in its Statement of Auditing Standards (SAS) No. 82 entitled "Consideration of Fraud in a Financial Statement Audit." The Statement requires auditors to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by fraud or error. SAS No. 82 makes it clear that the auditor's responsibility for detecting fraud is framed by the concepts of reasonable – not absolute – assurance and materiality and subject to cost/benefit decisions inherent in the audit process. Consequently, our arguments of requirements on auditors in the thesis, from the auditor perspective, will be limited within the framework of US Generally Accepted Auditing Standards (GAAS).

Although we study the companies that use US GAAP, we limit our interviews to accounting organisations in Sweden: firstly, because the thesis is written in Sweden and we do not have enough financial sources and time to interview the US institutions; secondly, even though the topic currently is not as relevant in Sweden as it is in the US, the public and press in Sweden are concerned as well.

We contacted ten Swedish auditing companies, the names of which are given in Section 2.3.2, Primary Data. However, we only managed to get one personal interview and one e-mail interview. Therefore the empirical evidence of the research is limited to the number of the respondents.

## ***1.5 The Disposition of the Thesis***

Our written thesis is structured in accordance with our working investigation. The whole process is presented briefly as follows:

**Chapter 1**  
Introduction.

**Chapter 2**  
Research Methodology.

**Chapter 3**  
Literature Review. Financial Statement Fraud: Recognition of Revenue.

**Chapter 4**  
Analysis. Case Studies: Lernout & Hauspie, Sunbeam and Xerox.  
Reasons Why Auditors Have Not Detected Financial Statement Fraud.

**Chapter 5**  
Recommendations for Improving the Audit Process. Empirical Findings and  
Suggestions From the Existing Studies.

**Chapter 6**  
Summary and Suggestions for Further Research.

## **2 Research Methodology**

### **2.1 Introduction**

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

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

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

### **2.2 Research Approach**

Our research approach is basically dependent on the elements of a normal research process. The elements of a research process mentioned by Brannick (1997), include:

- theoretical perspective,
- research question (research problem),
- research category,
- methodology strategy,

- data collection approach, and
- data analysis.

Any research must depend on a theoretical framework or existing concept. Since our research deals with the financial statement revenue recognition problem, we start our work by looking into the definition of financial statement fraud and the responsibility of auditors to detect fraud in the financial reports. This investigation provides us with the essential understanding to solve our research problem, “why have auditors not detected the financial statement fraud and how auditors can improve the audit process,” as described in our introductory chapter.

“The nature of the research question determines whether the study can be classified as an exploratory, a descriptive or an explanatory/causal type study” (Brannick, 1997, p.7). In conjunction with the research questions, “What,” “When,” “Where,” “Who,” “How,” and “Why,” the research approach will fall into the categories “exploratory,” “descriptive” and/or “explanatory/causal.”

As we have already defined our research problem and constructed our problem in the form of questions “who,” “why” and “how” in Chapter 1, we chose our research approach in this thesis as “descriptive” and “explanatory.”

“Descriptive study is undertaken in order to ascertain and be able to describe the characteristics of the variables of interest in a situation” (Sekaran, 2000, p. 125). In our research, we use the descriptive approach to describe the nature of fraudulent financial statements cases, which have happened recently, and to identify the possibilities for how the management in these cases could have manipulated their financial figures.

“Explanatory study is undertaken in order to establish correlations between a number of variables” (Sekaran, 2000, p. 129). In our thesis, the explanatory part is presented through the relationship between the misstatement of financial reporting and the responsibility of the auditors. The investigation of this

relationship answers the question “why auditors have not discovered these frauds in a timely manner.”

Since we have chosen our research category as “descriptive” and “explanatory,” we define our methodology strategy as case-based research. Although we are going to discuss the choice of the study method in section 2.4, at this stage we affirm that with the objective of our research, a case-based study is appropriate. This selected method affects our data collection method, which is discussed below.

### ***2.3 Data Collection***

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

Data is either primary or secondary. The usage of both kinds of data has its advantages and disadvantages. In this thesis, we are combining both of these sources of data in order to obtain the most convincing evidence for our argument and conclusions.

It depends on the characteristics of the research whether “the researcher adopts a quantitative or qualitative approach for their data collection methods” (Ibert, et al., 2001, p. 172). Since our research is more descriptive and based on cases, we have chosen the qualitative approach for collecting our primary data. This means we plan to interview several accounting firms and one professional accounting organisation, Professional Institute For Authorised Public Accountants (FAR), in Sweden. We were less successful than we had hoped in obtaining interviews, as we explain in section 5. The result of these interviews will provide the basis for our conclusion on the research problem. We are going to discuss separately how we will gather the secondary and primary data for our qualitative research.

### **2.3.1 Secondary Data**

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

Regarding the collection of secondary data, in this research we look more at external sources rather than at internal sources. The external sources we use are annual reports of companies under investigation of having committed fraud. These annual reports are the most precise and official evidence to support our analysis because they were publicly issued to stockholders who suffered directly from their misstatement. Additionally, we use the litigation documents of the SEC against the companies we study.

Articles and books are also useful sources of information. Books are “primarily useful for historical background” (Fay, 1997, p. 220). They are critical in building our theoretical framework, especially in the definition of financial statement fraud and the identification of the responsibility of auditors for detecting fraud. In the discussion of auditors’ responsibility and the technical auditing skills, we will search for the regulations and rules on auditing standards in order to know the requirements under the generally accepted auditing standards. The source we rely on is the Statements of Auditing Standards (SAS) issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA), a trade association for the accounting industry.

Articles in professional literature, such as *The Journal of Accountancy*, *The Wall Street Journal* and *Journal of Accounting Research*, etc., as well as from the internet, are the main sources of information we use for our case study investigation. Additionally, we will use articles from other reliable business journals and newspapers. The more reflections we get from different professionals who have commented on the actual case studies, the more precise and unbiased view we will gain.

### **2.3.2 Primary Data**

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

Our interviews are conducted through two channels: interview by e-mail and personal interview. The interviewees are some Swedish auditing firms and the Swedish accounting professional institution.

The audit companies we contacted are listed below:

- Deloitte & Touche AB
- Ernst & Young AB
- KPMG Bohlins AB
- PriceWaterhouseCoopers AB
- BDO Revision Väst KB
- Frejs Revisionsbyrå AB
- Gothia Revision AB
- Gunilla Kolm Revisionbyrå AB
- Hallén & Samuelsson Revisionbyrå AB
- SET Revisionbyrå AB

We could get interviews with two companies: a personal interview with Ernst & Young and an e-mail interview with KPMG. The person in the auditing firm we chose to interview was the one who is in charge of technical aspects called “audit technical board” in the company. These persons should be knowledgeable and interested in the problems we are studying.

Before implementing the interviews, we studied the three cases thoroughly. From the result of the cases review, we pinpointed the issues, which we think are the most critical. We created a questionnaire based on our study and analysis (Appendix 2 and Appendix 3).

As the problem we are dealing with is judgmental and applicable to a case-to-case basis, the type of questionnaire we sent is in the form of open-ended questions. Therefore, we leave room for the respondents to provide feedback from their own views. There are three main issues, which we focus on in our questions. Firstly, we want to know the opinion from auditors about the increasing number of revenue recognition fraud cases recently. Secondly, we want to know from auditors, what lies behind these undetected errors: is it an ethical or technical issue? The other questions concern how “to improve the audit process” and “to avoid the threat of undiscovered errors in the financial report.” This list of questions was sent in advance to the accounting firms (who agreed to be personally interviewed) for their advanced preparation. The interview meeting was conducted, based upon the information previously provided by interviewee.

The questions we send to FAR, the Swedish professional accounting institution, mainly deal with the rules and regulations aspect. We chose to interview FAR, because it plays a leading role in the development of professional standards, education and information for the audit profession in Sweden ([www.far.se](http://www.far.se), 2002). However, we were unable to obtain a response from FAR.

## ***2.4 Case Study Methodology***

“In relatively less-known areas, where there is little experience and theory available to serve as a guide, intensive study of selected examples is a very useful method of gaining insight and suggesting hypotheses for further research, the case study method is often used for these types of study” (Ghauri, et al., 1995, p. 87).

Based on our topic research, it is undeniable that there has been extensive back and forth argument in the professional world and the general and business public about the reasons why auditors have not detected the financial statement revenue recognition problems recently. We realise this issue has not been investigated in our Accounting and Finance Master’s programme by former

students. Therefore, we consider that our topic is apparently new in our programme, and we have little experience and theory available to serve as guide, as mentioned above. That is why we chose the case study method as the most appropriate method for our research, which is explanatory and descriptive in nature.

A definition of the case study methodology, as proposed by Ghauri, et al. (1995) is useful. “As most case studies are done through a review of existing historical material and records plus interviews, the case study method is quite similar to historical review, but it is different in the sense that here we have a possibility of direct observation and interaction” (Ghauri, et al., 1995, p. 88).

In our case studies, we consistently use historical review (secondary data) as the main tool. We describe what happened in the past with the companies we chose so that we can understand the situation in conjunction with the theoretical framework given in the earlier section. We also implement interviews (primary data) to get the reflections of auditors who are legally supposed to detect financial statement fraud. This interview technique supports both our analysis in the Chapter 4 and our recommendations in Chapter 5.

Considering the limitations of time and scope, as well as the availability of research material, we have selected three recent typical cases for our case study. Based on these three cases, we believe that we have enough material to see some similarities and differences, which will strengthen our ability to make judgments in other and similar situations.

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

We have three criteria for selecting these three companies. Besides the obvious revenue recognition fraud issues, the first criterion we considered when

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

While most cases of suspected financial statement fraud have occurred in the United States, Lernout & Hauspie is of particular interest since it is a European company. Sunbeam and Xerox are both American companies. Lernout & Hauspie and Xerox’s books were audited by KPMG LLP while Sunbeam’s were audited by Arthur Andersen.

## ***2.5 Research Evaluation***

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

### **2.5.1 Validity**

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

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

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

Regarding the validity of interviews, we direct our interviews to the most knowledgeable group of people on the issues in the accounting organisations. The questions prepared for the interviews are designed on the basis of the thorough study of the cases.

### **2.5.2 Reliability**

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

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

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

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

## **2.6 Summary**

In connection with our research question, as stated in Chapter 1, we selected our research design as a combination of a theoretical framework and descriptive and explanatory research. The sources of information we explore are collected from primary and secondary data in which primary data is obtained from e-mail and personal interviews and secondary data from public sources. From the nature of research, we have decided to conduct the research in the form of the case study method. The analysis of case studies gives us the understanding of the issues in relation to the theories given. This also helps us to find the critical points to prepare the research questions. Our interpretation of the interview responses, as well as suggestions made, is subject to the researchers' own judgment.

## **3 Financial Statement Fraud: Earnings Management and Revenue Recognition**

### ***3.1 Introduction***

The economic recession, and even more, 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 piled another burden on management’s shoulders, especially in the companies, which have been regarded as “blue chip” in their vigorous days. In addition, the favourable stock bonuses received by managers are also the incentives for high earnings. As a result, many companies have used “aggressive accounting” as an “earnings management” tool in order to achieve those targets. As Ian Griffiths (1981, p. 1) puts it in his so-called bible of the business world “Creative Accounting:” “It is the biggest con trick since the Trojan horse.”

In a certain sense, we can say creative accounting in itself is totally legitimate, when we view such accounting as making choices among accepted alternatives. Accounting rules and regulations leave room to make choices among different accounting procedures. The grey area is, however, perhaps too large. So a company chooses the most appropriate rules that can benefit its intentions. But the line between managing accounts and fraud is very thin.

Several recent financial statement fraud cases have exposed various methods of earnings management, which have crossed that line. They can be illegitimate revenue recognition, inappropriate deferral of expenses, fictitious sales, premature sales, reversal, or use of unjustified reserves (Rezaee, 2002).

In this chapter, we will define financial statement fraud and examine the extent of the auditors’ responsibility to detect it. We will give an overview of audit risk model. Next we will discuss the concept of earnings management, by means of revenue recognition problems, and its relation with financial

statement fraud. In the next chapter, we investigate three financial statement fraud case studies: Lernout & Hauspie, Sunbeam and Xerox.

### 3.2 Definition – Financial Statement Fraud

Financial statement fraud has been defined differently by academicians and practitioners. The following are some examples of definition of fraud in general:

Encyclopædia Britannica	In law, the deliberate misrepresentation of fact for the purpose of depriving someone of a valuable possession.
Merriam Webster Unabridged	Intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right.
Oxford English Dictionary	Criminal deception; the using of false representations to obtain an unjust advantage or to injure the rights or interests of another.

Unfortunately there is no single definition of financial statement fraud. The reason is that, until recently, the term has not been defined at all. The accounting profession used the terms *intentional mistakes and irregularities* instead (Rezaee, 2002). In 1997 the AICPA, in its Statement of Auditing Standards (SAS) No. 82, “Consideration of Fraud in a Financial Statement Audit,” refers to financial statement fraud as intentional misstatements or omissions in financial statements (§ 4).

Financial statement fraud is typically conducted by management or with their consent and knowledge. Elliott and Willingham (1980, p. 4) view financial statement fraud as management fraud:

“The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.”

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

### ***3.3 The Auditor's Responsibilities for Detecting Fraud***

In this thesis we frame our discussion about auditor's responsibilities for detecting fraud within the US accounting standards. The fraud cases we will study in the next chapter are about the companies that used US GAAP and therefore all the framework and analysis will be based on the US accounting rules and principles.

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

The first of the AICPA Statement of Auditing Standards, SAS No. 1, states:

*The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.*

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

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

Next we will explain the key concepts of the SAS No. 1, based on the summary of Arens and Loebbecke (1997).

#### *Material versus Immaterial Misstatements*

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

#### *Reasonable Assurance*

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

#### *Errors versus Fraud*

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

#### *Professional Scepticism*

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

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

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

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

### ***3.4 Assessing Risks of Fraud***

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

#### **3.4.1 The Audit Risk Model**

##### **3.4.1.1 Overview**

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

The model allows auditors to take alternatives in selecting an audit approach. For example, the model calls for auditors to have an understanding of the client's business and industry, the systems employed to process transactions,

the quality of personnel involved in accounting functions, the client's policies and procedures related to the preparation of financial statements, etc.

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

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

#### 3.4.1.2 Technical Briefing of the Model

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

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

*Inherent risk* refers to the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when

aggregated with misstatements in other balances or classes, *assuming that there were no related internal controls* (FTMS, 2001). There is obviously a higher chance of an error occurring where there is high inherent risk.

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

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

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

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

$$\boxed{AR = IR \times CR \times DR.}$$

The audit risk model is generally used at the planning stage of the audit to determine the planned detection risk for an assertion. This is based on the auditor's planned level of control risk; however, the assessment can be revised as the audit progresses. 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.

Auditors are required to assess IR and CR at three levels: high risk, medium risk and low risk. GAAS requires that, if CR is to be assessed at less than the high level, the auditor must test the effectiveness of controls to support that assessment. A high risk assessment means that the auditor believes controls are unlikely to be effective, or the evaluation of their effectiveness would be inefficient (POB Panel on Audit Effectiveness, 2000).

The importance of the assessments of inherent and control risk is highlighted by their effects on detection risk (DR). The effects can be depicted in mathematical form by the equation  $DR = AR / (IR \times CR)$ . The greater the inherent and control risks, the lower the detection risk needs to be, resulting in “more” procedures (“more” includes their nature and timing as well as their extent) that the auditor would need to carry out.

The relationship of the assessment of risks is depicted in the audit risk matrix:

Auditor's Assessment of inherent risk	Inherent Risk	Auditor's assessment of control risk is:		
		High	Medium	Low
High	High	Lowest	Lower	Medium
Medium	Medium	Lower	Medium	Higher
Low	Low	Medium	Higher	Highest

Table 1. The Audit Risk Matrix.

Source: FTMS (2001, p.31).

From the matrix, the acceptable detection risk is the shaded area. Although the model and the matrix are illustrated in mathematical terms, in reality it is highly judgmental. The objective in an audit is to *limit AR to a low level*, as judged by the auditor.

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. (Colbert, Luehlfing and Alderman, 1996). Because of rapid changes in the business environment, active consideration of whether to continue to serve a client may help to protect auditors themselves (AICPA Practice Alert No. 94-3, 1994).

### 3.4.1.3 Audit Firm Methodologies

While all audits of financial statements of publicly held US companies are required to comply with GAAS, audit firms, at liberty, tailor their audit processes or methodologies in the manner that best suits their needs, so long as the processes or methodologies result in audits that comply with GAAS.

Audit firms also take into consideration their clients' expectations, such as expectations that the auditor will inform them of matters that might benefit their businesses.

### 3.4.2 The Risk Factors of Financial Statement Fraud

An important part of planning every audit is to assess the risk of errors and fraud. In making risk assessments for fraud, auditors should keep in mind that fraud typically includes three characteristics, which are known as the "fraud triangle:"

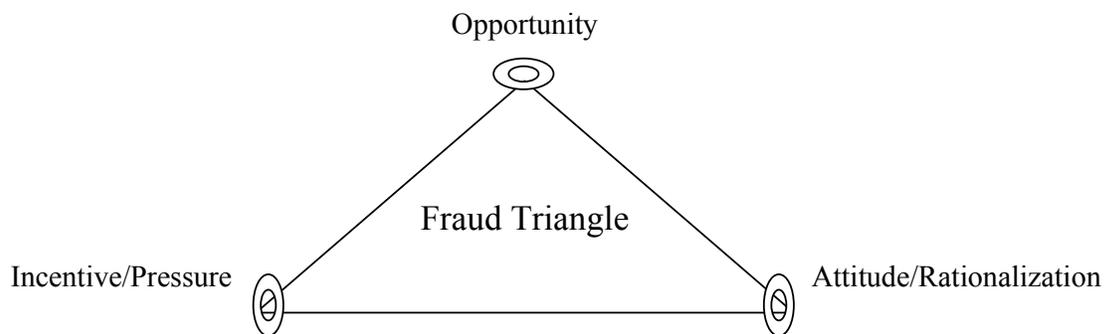


Figure 1. The Fraud Triangle.

Although the idea of fraud triangle dates back to the late 1940's, the accounting rules address the issues for the first time in SAS No. 82 (§ 6).

The three points of the fraud triangle may be explained as follows (Montgomery, Beasley, Menelaides and Palmrose, 2002):

- Incentive/Pressure: Pressures or incentives on management to materially misstate the financial statements,

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

Additionally, SAS No. 82 (§§ 16-17) has identified three categories of risk factors for fraudulent financial statements, summarised in Table 2.

<b>CATEGORY 1</b> <b>Management's</b> <b>Characteristics and</b> <b>Influence over the Control</b> <b>Environment</b>	<b>CATEGORY 2</b> <b>Industry Conditions</b>	<b>CATEGORY 3</b> <b>Operating</b> <b>Characteristics of</b> <b>Financial Stability</b>
<p>These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.</p> <p>Examples of Risk Factors</p> <ul style="list-style-type: none"> <li>▪ A motivation for management to engage in fraudulent financial reporting, such as an excessive interest by management to maintain or increase the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.</li> <li>▪ A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process, such as a domination of management by a single person or small group without compensating controls.</li> <li>▪ High turnover of senior management, counsel, or board members.</li> <li>▪ Unreasonable demands for auditor completion of the audit or report issuance and restrictions on auditor access to people or information.</li> </ul>	<p>These involve the economic and regulatory environment in which the entity operates.</p> <p>Examples of Risk Factors</p> <ul style="list-style-type: none"> <li>▪ New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.</li> <li>▪ Declining industry with increasing business failures and significant declines in customer demand.</li> <li>▪ Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.</li> </ul>	<p>These pertain to the nature and complexity of the entity and its transactions, financial condition and profitability.</p> <p>Examples of Risk Factors</p> <ul style="list-style-type: none"> <li>▪ Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity.</li> <li>▪ Significant, unusual, or highly complex transactions, especially those close to year-end, that pose difficult "substance over form" questions.</li> <li>▪ Overly complex organisational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.</li> </ul>

Table 2. Categories of Risk Factors for Fraudulent Financial Statements.

Adapted from Arens and Loebbecke (1997).

### 3.5 Definition – Earnings Management

The concept of earnings management has been explained differently by academicians, researchers, practitioners, and various authoritative bodies. Rezaee (2002) selected the most commonly accepted definitions of earnings management defined by academicians and researchers as follows:

Schipper:	...a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain.
Healy and Wahlen:	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.
Merchant:	Earnings management can be defined as any action on the part of management, which affects reported income and which provides no true economic advantage to the organization and may, in fact, in the long term, be detrimental.

The concept of earnings management is usually discussed in conjunction with financial statement fraud. The high profile of earnings management fraud hastens the need to define concretely “earnings management” since many people in the accounting profession acknowledge that some earnings management techniques are not fraudulent and many accountants, analysts, and investors believe that good business practice requires managers to manage earnings (Magrath and Weld, 2002).

A matter of fact is that management uses accounting choices consistent with GAAP to manage earnings in performing its assigned managerial functions. Most of this action involves judgments and estimates within GAAP. Since the

line between legitimate earnings management and fraudulent accounting practices is fragile, it is easy for the management to step over the line in order to meet the earnings expectations. The former SEC Chairman, Arthur Levitt, in his 1998 “Numbers Game” speech, expressed the view that “too many corporate managers, auditors, and analysts let the desire to meet earnings expectations override good business practices” and he called for “a fundamental cultural change on the part of corporate management and the entire financial community” (Magrath and Weld, 2002).

### ***3.6 Earnings Management – Revenue Recognition***

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

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

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

#### ***Bill and Hold Sales Transactions***

“Bill and hold” is the term used to describe when a selling company holds merchandise to accommodate a customer (Pesaru, 2002). In a bill and hold deal, the customer agrees to buy goods by signing the contract, but the seller retains possession until the customer requests shipment. An abuse of this practice occurs when a company (the seller) recognises the early revenue of bill and hold sales transactions (Rezaee, 2002).

The controversy and difficulty in identifying this kind of “earnings management” is that, in the bill and hold deal, the transactions meet two

conditions of (1) realised or realisable; and (2) earned as required by GAAP. However, commonly the revenue is recognised only when the goods and services are delivered to the customers. Therefore, from the auditor side, it is necessary to understand the substance of the transactions to make sure that they are legitimate and arm's-length transactions (Rezaee, 2002).

#### *Timing of Revenue Recognition*

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

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

#### *Side Agreements*

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

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

#### *Illegitimate Sales Transactions*

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

*Improper Revenue Recognition – Contract Accounting*

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

*Improper Related-Party Sales Transactions*

“Related-party sales transactions” refers to a financial link or other relationship between the company and the customer (Pesaru, 2002). The reason the company uses this technique for boosting revenue is because the related-parties usually are difficult to identify. The undisclosed related-party transactions may be used to fraudulently inflate earnings.

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

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

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

*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 (AICPA, 1999).

Distributors and resellers sometimes delay placing orders until the end of a quarter in an effort to negotiate a better price on purchases from suppliers that they know want to report good sales performance. This practice may result in a normal pattern of increased sales volume at the end of a reporting period. An unusual volume of sales to distributors or resellers, particularly at or near the end of the reporting period, may indicate channel stuffing.

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

### **3.7 Summary**

Financial statement fraud is defined in different ways, but the common definition includes: it is an illegitimate act, committed by management, and injures other parties through misleading financial statements. The auditor's responsibility to detect fraudulent financial statements relates to the detection of material misstatements caused by fraud and is not directed to the detection of fraudulent activity in itself.

The audit risk model is designed for carrying out audits and requires auditors to use their judgment in assessing risks. In the process of assessing risks, auditors should consider the risk factors of financial statement fraud.

The earnings management 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 various schemes of revenue recognition fraud include bill-and-hold sales transactions, timing of revenue recognition, side agreements, illegitimate sales transactions, improper revenue recognition – contract accounting, improper related-party sales transactions and channel stuffing.

## **4 Case Analysis. Why Auditors Have Not Detected Fraud?**

In this chapter we will analyse the three cases of financial statement fraud on improper revenue recognition. The analysis will be based on the theoretical framework we presented in Chapter 3. From the findings of the analysis we will derive the reasons why the auditors have not detected the fraud.

### ***4.1 Introduction to Three Case Studies***

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

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

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

The stock price of L&H was pretty high in early 2000 until the SEC became suspicious of a sudden surge in L&H's sales in South Korea and its links with thirty start-up companies that in total provided substantial revenue in the company's reports (Maremont and Eisinger, 2000). Not very long after the

decision of the SEC to investigate L&H, the company announced its “wrong accounting” in 1997, 1998 and 1999, and said the financial reports of those years would be restated. In 2002, the SEC sued the company with the charge of “fraudulent” on its financial statements.

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

The Sunbeam fraud story started in July 1996, when Albert J. Dunlap, 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 authorised unqualified audit opinions on the 1996 and 1997 financial reports. Presently, Sunbeam is in a reorganization proceeding under Chapter 11 of the U. S. Bankruptcy Code.

Xerox is a US document company, founded in 1906, which provides an array of innovative document solutions, services and systems including color and black-and-white printers, digital presses, multifunction devices and digital copiers, designed for offices and production-printing environments ([www.xerox.com](http://www.xerox.com), 2002).

Xerox was a leading technological innovator for most of the last half of the 20th century. But by the late 1990s, the company was confronting intense product and price competition from its overseas rivals. As a result, increasing revenues and earnings became more difficult. To improve operating results, Xerox disguised its true operating performance by using undisclosed accounting manoeuvres, most of which were improper, that accelerated the recognition of equipment revenue by over \$3 billion and increased earnings by approximately \$1.5 billion throughout the years from 1997 to 2000, according to the SEC accusations. Xerox's auditing firm from 1971 to 2001 was KPMG, which was replaced by PriceWaterhouseCoopers in 2001.

## ***4.2 Analysis of the Three Cases***

Our analysis of the three financial statement fraud cases is based on the structure by Rezaee (2002). He determines the five interactive factors that explain financial statement fraud cases (see Figure 2, p. 36). These factors are cooks, recipes, incentives, monitoring and end results, with the acronym of CRIME. The summary of the cases is presented in Table 3, p. 65.

### **4.2.1 Cooks**

The first letter of Crime is C, which stands for Cooks. In most of the cases, the people who participate in financial statement fraud are senior management such as the Chief Executive Officer (CEO), Chief Financial Officer (CFO), directors, etc. In L&H, the cooks were the CEO and other top executives. In Sunbeam, the cooks were Chairman and CEO Albert J. Dunlap, and four other executives: the principal financial officer, controller, and two vice-presidents. The SEC also sued the partner of Arthur Andersen for being aware of the fraud, but still issuing the unqualified audit opinion. In the Xerox case, the cooks were the former chairman, former president, and former CFO.



Figure 2. Financial Statement Fraud Interaction.

Source: Rezaee (2002, p. 62).

#### 4.2.2 Recipes

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

## 4.2.2.1 Lernout &amp; Hauspie Recipes

Improper Related-Party Sales Transactions

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

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

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

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

years in a row that L&H derived from transactions with Dictation was \$26.7 million (\$7.5 million plus \$18.9 million plus \$0.3 million).

- In the middle of 1998, before L&H developed any marketable product for Dictation, L&H acquired Dictation for \$43.3 million.

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

Dr. Receivable from Dictation	\$26.7 m
Cr. Sales (1996, 1997, 1998)	\$26.7 m
Dr. Dictation acquisition	\$43.3 m
Cr. Receivable from Dictation	\$26.7 m
Cr. Premium	\$16.6 m

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

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

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

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

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

Dr. Receivable from BTG	\$35 m	
Cr. Sales (1997, 1998, 1999)		\$35 m
Dr. BTG acquisition	\$42 m	
Cr. Receivable from BTG		\$35 m
Cr. Premium		\$ 7 m

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

#### Illegitimate Sales Transactions

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

In its annual report, L&H disclosed that the LDCs were formed to develop new markets for L&H technology by licensing the company’s basic code-generating software to start-up entities in different parts of the world. These entities were supposed to then develop speech recognition and translation software applicable to various regional languages. In actual fact, the LDCs were little more than shell companies created, like Dictation and BTG, as a means for L&H to improperly fabricate revenues (SEC Litigation Release No 17782, 2002). The LDCs had few employees, and were dependent upon L&H personnel for research and development activities. None of the LDCs produced any significant products.

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

Hence, the SEC proclaimed that, to the extent L&H obtained funds from the LDCs, some or all of these funds were subject to material conditions, imposing on L&H significant potential liabilities which were not reflected on its balance sheet, and which L&H did not disclose to its shareholders. Under those circumstances, the accounting applied to the LDCs did not comply with GAAP. These creations enabled L&H to recognise of \$110.5 million in license fees and prepaid royalties from the LDCs in 1998 and 1999, giving the false impression of growth (SEC Litigation Release No. 17782, 2002).

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

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

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

- L&H South Korea entered into oral and written side agreements with customers in which they gave them no definite payment obligation.
- L&H South Korea made up the uncollectibility of the receivables resulting from some of these fraudulent sales by factoring the receivables to South Korean banks.

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

#### 4.2.2.2 Sunbeam Recipes

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

##### *Bill and Hold Sales: Improperly Recognised Revenue*

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

How did Sunbeam do this? Sunbeam had agreed with one wholesaler that they (the wholesaler) would hold barbecue grills without accepting any of the risks of ownership and that the wholesaler could return all of the merchandise if it did not sell products. The wholesaler did hold Sunbeam barbecue grills, but actually returned all of the grills to Sunbeam during the third quarter of 1997. This technique is a classic "bill and hold sale." Essentially, there was no sale by Sunbeam.

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

### Channel Stuffing

Also in 1997, Sunbeam executives used “channel stuffing” to make its reported revenue look good (SEC Litigation Release No. 17710, 2002). And they did not disclose that revenue growth was, in part, achieved at the expense of future results. Sunbeam had offered discounts and other inducements to customers to sell products immediately that otherwise would have been sold in later periods, a practice known as “channel stuffing.”

Sunbeam’s improper accounting and channel stuffing in 1997 created the illusion of reduced results in 1998. In early 1998, the executives took increasingly desperate measures to cover the company’s increasing financial problems. They again caused Sunbeam to recognise revenue for sales that did not meet the applicable accounting rules and to engage in acceleration of sales revenue from later periods. Sunbeam further misrepresented its performance and future prospects in its official first quarter report of 1998, in its press releases, and in its communications with analysts (SEC Litigation Release No. 17710, 2002).

#### 4.2.2.3 Xerox Recipes

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

Since Xerox manufactures expensive capital machines, subject to rapid obsolescence, the company sells most of its products and services under bundled lease arrangements. This means that Xerox entered long-term lease agreements in which customers paid a single negotiated monthly fee in return for the equipment, service, supplies and financing. Xerox refers to these arrangements as bundled leases and the monthly payment as “Total Cost of Ownership” (Xerox Annual Report, 1998). Bundled lease transactions constituted the majority of its sales revenue.

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

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

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

### **4.2.3 Incentives**

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

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

As for the auditors, they were also under the pressure of retaining their clients. All of the studied companies were large and certainly the auditors faced the risk

of losing their top clients if they did not come to agreement with regard to questionable, even irregular, accounting practices. Unfortunately this situation with an external auditor, anxious to retain a client, leads too often to an auditor's failure to resist client pressures.

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

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

#### **4.2.4 Monitoring**

The fourth letter in Crime is M, which stands for Monitoring. Responsible corporate governance and the presence of adequate and effective internal control systems are the most important factors in preventing and detecting

financial statement fraud (Rezaee, 2002). Lack of monitoring of the top management by the board of directors is evident in all the three cases.

Sometimes too much trust between those entitled to check (board of directors and the company audit committee) and those to be checked (management) can be a contribution to fraud. In Sunbeam's case, the CEO had very friendly relations with the principal owner of the company and the board (although the friendship ended when the actual fraud was discovered). The same was true in L&H's case, when the founders of the company were indeed themselves engaged in the fraud.

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

#### **4.2.5 End Results**

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

##### **4.2.5.1 Lernout & Hauspie**

L&H has ceased to exist as an operating company. It has filed for bankruptcy protection. Investors in Belgium, the United States and elsewhere suffered a loss of at least \$8.6 billion dollars in market capitalization. The former CEO, as well as two founders and co-chairmen, were arrested and charged with fraud; another top executive is under investigation (German, 2001). After reviewing L&H's actual sales figures for Singapore and South Korea, auditor KPMG sued L&H for trying to subvert an audit that KPMG conducted into the company's operations (German, 2001).

#### 4.2.5.2 Sunbeam

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

To settle the SEC charges, Dunlap and Kersh agreed to permanent injunctions against ever violating federal antifraud statutes, and permanent barring for each of them from serving as officers or directors of any public company. They also agreed to pay a civil penalty of \$500,000 for Dunlap and \$200,000 for Kersh. In addition, Dunlap had paid \$15 million and Kersh \$250,000 to settle Sunbeam class-action suits (SEC Litigation Release No. 17710, 2002). Nevertheless, they did not admit or deny any wrongdoing.

Three other former executives and Sunbeam's former accounting partner from Arthur Andersen have refused to settle the SEC charges and are to be tried in January 2003 (SEC Litigation Release No. 17710, 2002).

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

#### 4.2.5.3 Xerox

The stock price of Xerox has dropped 63% from a 2002 high of \$11.45 (January 29, 2002) to the lowest of \$4.20 (November 10, 2002) (New York Stock Exchange, 2002). The company has lost many of its customers to the competitors since the time the fraud issues were discovered (Byrnes and Bianco, 2002).

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

#### **4.2.6 Detection**

Having dissected each case, we find that auditors had not taken their responsibilities fully for detecting fraud. The detection of fraud in these three cases came from the public press, various analysts, and the SEC, rather than from the auditors who are supposed to be the first to detect fraud. Looking back to L&H, the fraud story was discovered by an investigative team set up by The Wall Street Journal in 1999 since the team found the figures of L&H's financial statements did not make sense any more. A series of articles followed, suggesting that the CEO had cooked the books. In August 1999, following "discrepancies" between his explanations and the findings of the Journal's reporters, the CEO of L&H was forced out of his job. A month later, the SEC launched its own investigation. ("Business: Translation Errors," 2000). Very soon after the statement of L&H about its "wrong accounting" on its financial statements, on November 17, 2000, KPMG, as auditor of the company, announced its intention to withdraw its audit report of the company's 1998 and 1999 results, saying its prior clean opinion of the software maker's books "should no longer be relied upon" (Maremont, 2000). With the scandals of Xerox case, its auditor KPMG (which was replaced by PriceWaterhouseCoopers in October 2001) has recently become the subject of an SEC investigation. This situation resulted when a few other companies, for which KPMG audited and provided financial services, came under the SEC's suspicion of fraud.

In the Sunbeam case, several media reports questioned the company's performance and restructuring strategies in 1998. The critical article, "Dangerous Games" was published by Barron's, a Dow Jones & Company magazine, in June 8, 1998. The article examined the company's financial, production and quality problems, analysed the financial statements and declared that Dunlap had cooked Sunbeam's books. After the story, Sunbeam's board fired Dunlap as chairman and chief executive officer. Shortly thereafter, the SEC started the investigation (Laing, 2001).

After cases and cases of fraudulent financial statements, an obvious question is: “Where is the auditor? Why they did not discover the fraud?”

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

### ***4.3 Reasons Why Auditors Have Not Detected Fraud***

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

The increasing number of cases of financial statement fraud makes the professionals worry about the quality of audit work, i.e. its methodology and approach. The issue of how audits are done has been a source of concern at the SEC. In his 1998 letter to the AICPA, the former SEC Chief Accountant, Lynn Turner, said, “The recent combination of changes in the audit process and high-profile financial frauds have raised questions about the efficacy of the audit process” (Brown, 2002).

On the technical side, it is not an easy task to find the reasons behind why auditors (in the cases where fraud has been proven) have not detected the fraud. In theory, GAAP should have prevented most of the abuses in the studied cases. But the standards created by the Financial Accounting Standards Board are merely guidelines – and are subject to interpretation. That’s where the auditors are supposed to come in. But even officials of the AICPA say the auditors have to ensure only that a company’s financials are in accordance with GAAP (Greenberg, 1998). In all the cases, the auditors’ (and company’s) first answer to the accusation of fraud was: everything was in accordance with GAAP. And although some auditors have agreed to pay fines, they never agreed to any wrongdoing.

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

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

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

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

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

seemed to constitute the combination of testing the internal control system and the analytical review, with minimum substantive testing performed.

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

The analytical review procedure involves much “professional judgment.” This means whilst auditing the balances of items, auditors have an expectation of how the accounts should be. Referring to the “analytical procedure,” International Standards on Auditing No. 520.17 (1998) released by International Federation of Accountants (IFAC), we find stated that “the expected effectiveness . . . of an analytical procedure . . . depends on . . . the reliability of the data used to develop the expectation . . . (and) the precision of the expectation.”

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

It is precisely the problem that auditors have to trust in the information that the client provides. However, when applying only analytical procedure, excessive trust is too risky for auditors since such a level of trust depends highly on the reliability of the data given.

In addition, the analytical review procedure seems to emphasise investigations of “fluctuations” in the account balances, especially the analysis of discrepancies from the previous years (both budget and actual figures) (Brown, 2002). If the explanations of the discrepancies reasonably correspond to the

current business events “happening” in the company, through the observation of the auditors, it is likely that less testing work is performed.

We put “happening” within double-quotes because it is common sense that management who falls to the temptations of fraud, obviously tries to hide the “real situation” by making the accounts look normal. For example, the management discloses to auditors that in this year no critical issues occurred. The orientation of the management is to manipulate the financial statements to make them look similar to past years. Therefore, the auditors, with their analytical procedures, attempt to present evidence supporting the contention that everything is fine since no discrepancies with prior year financial statements are detected. This false interpretation can occur because it depends greatly on professional scepticism of the auditor (Cullinan and Sutton, 2001).

There is another difficulty for auditors in applying analytical procedure. Most big companies have a long history of engagement with their auditor partners. We have discussed above that the analytical procedure involves many judgmental issues. The interpretation of findings is also affected somehow by the “independence” factor, which we are going to discuss in a separate section. The longer the auditors are engaged with their clients, the more loose the “professional scepticism” of the auditors could be. Once the auditors attempt to persuade themselves that the figures in the financial statements of their clients are fine, the interpretation for their analysis drives them in a manner toward supporting the conclusion, which they want to reach (Brown, 2002). Therefore, even in some cases where the auditors might have smelled something not satisfactory in the financial report, they did not consider digging it out.

Xerox’s auditor is a good example of misuse of analytical procedures. KPMG, as auditors, had been with Xerox since 1971 until replaced by PriceWaterhouseCoopers in 2001. KPMG has been criticised by the press (for example, Kay, 2002, Maremont, 2000, and Conlin, 2001) for not taking enough responsibility for Xerox’s accounts. It was said that Xerox’s manipulations should have been easy to detect if there was anyone interested in looking. The revenue numbers made up from the “lease agreement” are so large that “it’s

akin to auditors driving past Mount Everest and saying they never saw it... Corporate America has somehow gotten into the mindset that this is OK” (Kay, 2002). If one examines the annual reports of Xerox from 1995 throughout 2000, that comment is not too exaggerated. The revenues gradually and continuously increased from \$16,588 million in 1995 to \$19,228 million in 1999. It looks as if the “cooks” had put a certain percent of growth in each year. Assuming the auditors used the analytical procedures to investigate those consecutive increases in sales, from comparing the figures from year to year, the auditors would have noticed the increase and wondered about what had been going on. However, due to the constraints we discussed before in the chapter, the auditors allowed the situation to continue. KPMG did not say anything, even when they were fired by Xerox.

Analytical procedure applied to sales accounts normally involves the comparisons of recorded amounts, or ratios developed from the recorded amounts, to expectations developed by the auditor. This means that the auditor would use a variety of sources, including the financial information from comparable previous periods, budgetary results, and information regarding the industry in which the client operates, within the client’s normal business practices regarding sales and distribution in order to develop the auditor’s expectation (AICPA, 1999).

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

It is a similar situation with L&H's South Korea case. The company entered side agreements with customers who were not obliged to make definite payment. By this procedure, L&H recorded \$175 million revenue in 1999 and 2000. Although we described in Chapter 3.6 that the side agreements are often hidden from the external auditors, the auditor can still detect the fraud by performing further testing. For instance, in this case, the auditor could check whether the customer had made the payment in the subsequent year. With a further examination of the annual reports of L&H for the years ended 1997, 1998 and 1999, it is impressive that the revenues, (consisting of sales of technologies and solutions; applications; and consulting and services) especially of technologies and solutions were increasing rapidly: from \$ 99,371 million in 1997, to \$ 211,592 million in 1998 and to \$ 344,237 million in 1999. It means the revenues increased more than three times within two years. It could be that the auditors here have not addressed the revenue growth question with this sort of enormous increase in sales.

It is possible that the auditors in those cases did perform the analytical procedures, for instance, comparing this year's ratios to the previous year's, this quarter's to the last quarter's, etc., but it is possible that they did not bring their judgment of comparisons to the *actual situation of market and business* in which their clients were operating. The reason behind that could be that the auditors put their trust too high in the data provided by the management. "Channel stuffing" and "improper timing of revenue recognition" is often identifiable by using analytical procedure. But here we emphasize again, it depends to a great extent on the interpretation of discrepancies by the auditors. In the case of Sunbeam, according to its annual reports (1997, 1998) its sales in 1997 increased significantly as compared with 1996, whilst the cost of sales actually decreased. Conversely, the sales in 1998 decreased compared with the previous year, whereas the cost of sales increased. This shows that the company did allocate their expenses in 1998, which should have been recorded in 1997. While the analytical procedure technique works to identify discrepancies, however, it is in the hands of the interpreter to explain such differences.

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

Accompanying the innovation in the audit risk model of the 1980s, most of the main international public accounting firms have deliberately tailored their audit methodology in compliance with GAAS to improve the cost effectiveness of an audit and to focus on the value-added services for clients. These re-engineered audit processes generally focus on a client's business processes and on an evaluation of the information systems used by the client to generate financial information (Cullinan and Sutton, 2001).

Therefore, according to Brown (2002) auditors these days have gradually focused more on *how companies generate their financial data*, the computerised bookkeeping programmes, and the internal controls that are supposed to act as a check on the system, rather than on the numbers themselves. That is in contrast to the older style of auditing, under which accountants dissected corporate accounts deeply, looking at thousands of transactions to determine if the bookkeeping was correct. The shift in the way accountants audit their clients' books can be traced to two developments dating from the early 1980s. First, companies increasingly turned to computers to manage their finances. Second, intense competition caused the fees for auditing to fall as much as 50% from the mid-1980s to the mid-1990s. That forced auditors to cut costs themselves, and they did it by cutting back on the labour-intensive process of sifting through dozens, or even hundreds, of corporate accounts. In order to be more efficient, the auditors *put more reliance on internal controls*, which allowed them to do less work on account balances and transactions.

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

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

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

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

Principally the internal control system and the risk assessment have to be evaluated and upgraded every audit year since there could be changes in the

structure and business of the company. Once the control system of the company is considered to be effective enough to be relied upon, the auditor has to perform a substantial test of controls and a “walkthrough review<sup>1</sup>.” When the result of the test of controls gives a “yes,” as being effective for most of the critical control points, the auditor could draw the conclusion that the control system is “effective and reliable” and risk is assessed as low or moderate in the audit planning stage. Then the substantive tests should be minor in the audit execution stage. Although it is a must to evaluate the system every year, it could be the case that professional judgment and scepticism might diminish gradually once the auditor becomes too close with management and does not imagine that management would dare to falsify their books. At this moment, the auditor still assesses the control system of his or her client as effective and reliable, whilst in fact it no longer is. The danger here is that the failure in assessing the system of the company will lead to the inappropriate audit programme design. As the AICPA ASB investigation determined, audit programme design was a problem cited in 44% of cases studied (Beasley, et al., 2001). Audit programme design requires the auditors to consider the risk factors while engaging with their clients in order to identify these sorts of risks.

### **4.3.3 Audit Failure in Revenue Recognition and Related-Party Transactions Disclosure**

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

It is true that revenue recognition issues continue to pose significant audit risk to auditors. In some instances, auditors fail to correctly apply the accounting

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<sup>1</sup> Review to obtain an understanding of some aspects of the accounting system and certain control activities of the company. To perform the review, one or a few transactions within each major class of transactions is traced, and the related control policies and procedures are identified and observed (Boynton and Kell, 1996).

rules of revenue recognition. The criteria for revenue recognition based on existing accounting rules say that companies should not recognise revenue until it is *realised or realisable and earned*. According to the SEC, the revenue will only be recognised when a number of criteria has been met, including (Phillips, Luehlhing and Daily, 2001):

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

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

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

According to Beasley, et al. (2001), related parties' accounts, as alleged by the SEC, is another common problem for the auditor to fail to recognise or disclose transactions with related parties. The SEC found that the auditor was either unaware of the related party or appeared to cooperate in the client's decision to conceal a transaction with this party. Such transactions often resulted in inflated asset values.

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

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

#### **4.3.4 Conflict of Interest Issues**

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

##### **4.3.4.1 Auditor Independence**

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

There has been plenty of discussion about auditors' independence in the financial literature. Some authors argue (Greenberg, 1998, Bazerman, Morgan and Loewenstein, 1997) that auditors can never be independent, because of the current system, where auditors are hired and paid by the organizations that they

audit. That is the first apparent conflict. The company is free to change the auditors, who do not agree with its accounting practices. Therefore there are auditors who choose to close their eyes for the fear of being fired.

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

#### *Time and Cost Constraints*

If auditors suspect material financial statement fraud, GAAS requires them to conduct appropriate fraud investigation procedures (or to withdraw from the engagement). According to Caplan (1999), these actions require considerable effort, because auditors can no longer rely on client-prepared schedules<sup>2</sup> or management representations<sup>3</sup>. If auditors' suspicions are unjustified, the fraud investigation can damage the client relationship, and an honest client might not compensate the auditors for their additional effort. On the other hand, failure to detect fraud can be quite costly to both the company and the auditor.

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

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<sup>2</sup> Schedules, prepared by the client upon the requirement of the auditor in order to facilitate audit work.

<sup>3</sup> Assurance from company's management to the auditor that the management provides all information that they consider relevant to auditor (FTMS, 2001).

### *Relationship Between the Auditor and the Auditee*

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

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

#### 4.3.4.2 Non-Auditing Services

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

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

## **4.4 Summary**

In this chapter, we discussed two main issues. The first part dealt with three case studies: Lernout & Hauspie, Sunbeam and Xerox, which we have chosen to examine because of their fraud in the financial statements. We analysed the cases according to the factors with the abbreviation of CRIME, which stands for "Cooks", "Recipes", "Incentives", "Monitoring" and "End Results". For the summary of the case study, see Table 3, p.65.

In the second part, we discussed some causes, for why the auditors in the studied cases did not detect fraud. They are analytical review procedures; risk assessment in relation to the audit risk model; failure to apply GAAP in “revenue recognition,” and “recognition of related-party transactions” and conflict of interest issues.

The application of analytical procedures is insufficient because the analytical procedures employ too much professional judgment. In addition, these procedures rely on the data and information given by the company management, who, if tempted toward fraud, could fool the auditors.

Risk assessment process with audit risk model is also the cause. Over-reliance on internal control weakens the capability for detecting fraud (Brown, 2002). The internal control is built up by management to monitor employees, not themselves. A matter of fact is that in most of the fraud cases, top management is both conductor and creator of the fraud story. Therefore, if in the audit process, auditors focus on internal control, it only enhances the ability of finding errors at the lower employee level.

Revenue recognition and related-party issues are the most risky areas for auditors (AICPA, 1999). In some cases, the auditor fails to apply the accounting principles appropriately, although they have not admitted that their audits have not complied with GAAS.

One more reason which is critical and controversial in the professional world is the conflict of interests issues. This is represented through the auditor independence problem and the sales of non-auditing services by auditors.

The pressure of being paid by the management of the auditee as well as the time and cost constraint might affect the auditor’s judgments. The relationship between the auditor and its auditee creates the image of eroding independence in the public eye. The auditor apparently cannot help fearing losing its clients.

The higher profit margin obtained from the non-auditing services than from traditional audit services stimulates auditors to expand their various non-auditing services to serve their clients. It is a question of conflict of interests again because, on one hand, the auditor assists the company in upgrading its control system, for instance, and on the other hand, the auditor is also the one who examines the system.

The summary of three financial statement fraud cases: Lernout & Hauspie, Sunbeam and Xerox are presented in the following table:

<i>Company</i>	<i>Recipe</i>	<i>Cooks</i>	<i>Incentives</i>	<i>End Results</i>	<i>Detection</i>
L&H	Fraudulent scheme in recognition of revenue: improper related-party transactions in Belgium, illegitimate sales transactions in Singapore and side agreements in L&H South Korea.	CEO, CFO, all members of senior management	Pressures to meet the forecasts and achieve the targets.	So far the company and its auditor, KPMG, are being sued by the SEC.	The SEC and public press.
Sunbeam	Fraudulent scheme in bill and hold sales: improperly recognised revenue on a contingent sale and channel stuffing.	CEO, four executives, principal financial officer, controller and two vice-presidents.	Pressures to meet the forecasts and achieve the targets.	Management of Sunbeam agreed to pay the fine.	The SEC and public press.
Xerox	Fraudulent scheme in timing of revenue recognition: changing accounting policy in recognising lease revenue without disclosing to investors.	Chairman, president and CFO	Attitude of the CEO to failures.	Arthur Andersen paid \$ 110 million to settle claims but did not admit fault or liability	The SEC and public press.
			Pressures to meet the forecasts and achieve the targets.	Xerox agreed to pay the fine of \$10 million and restate the earnings from 1997 to 2000.	

Table 3. Summary of Three Financial Statement Fraud Cases.



## **5 Recommendations For Improving the Audit Process**

### ***5.1 Introduction***

It does not make sense for any research project to have the researchers spend pages on finding the reasons which caused the issues, and yet not give any suggestions or solutions for these problem issues. Therefore, in this chapter, as the result of our study, we present various comments and ideas directed toward finding such solutions, based upon the interviews with the auditors and the research done by the US accounting professionals. The solutions for a more effective audit procedure in order to enhance the audit quality have become the core topics in the accounting profession recently. They draw much attention from academics and professionals as well as various accounting and auditing authorities.

The endeavour to improve audit quality has a practical meaning to auditors who now really need to recover their image, which has been partly damaged in the public's eyes due to the increasingly high profiles of fraudulent financial statements exposed.

Two programmes focusing on improvement of the audit process and the enhancement of detection of fraud in financial statements were launched recently. Both programmes originate from the USA and apply to the companies using US GAAP. The first one is the Panel on Audit Effectiveness (also known as the O'Malley Panel) which was implemented by the Public Oversight Board (POB) in October 1998. The Panel was established in response to a request by the SEC over its concern for improving audit quality. The Panel conducted a comprehensive review and evaluation of the way independent audits of financial statements of publicly traded companies are performed and assessed the effects of recent trends in auditing on the quality of audits and on the public interest. On the basis of the research, the Panel made several recommendations to improve the conduct of audits and governance of the profession. The final report and recommendations were issued on August 31, 2000.

The Panel's recommendations are summarized into the following areas:

- Conduct of audits, including the auditor's responsibility for the detection of fraud;
- Leadership and practices of audit firms;
- Effects on auditor independence of non-audit services provided to audit clients;
- Governance of the auditing profession;
- Strengthening the auditing profession internationally.

The second programme is the Exposure Draft (ED) of a proposed Statement on Auditing Standards, "Consideration of Fraud in a Financial Statement Audit," which was issued by the AICPA ASB on February 28, 2002. This statement would supersede SAS No. 82. In essence, the ED does not change any of the auditor's current responsibilities for fraud in a financial statement audit. However, it introduces new concepts, requirements and guidance to assist auditors in meeting those responsibilities in an audit of financial statements conducted in accordance with GAAS (Montgomery, et al., 2002).

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. To be practical and objective, we have asked accounting firms in Sweden for their advice on the improvement of the audit process. The suggestions we give here are a combination of our interpretation resulting from the research and recommendations by professional institutions, AICPA and POB. The recommendations are summarised in Table 4, p. 80.

## ***5.2 Empirical Findings***

In order to conduct our research and obtain an extended understanding of the topic we contacted several audit companies in Gothenburg, Sweden.

First we sent a preliminary e-mail (see Appendix 1) to nineteen of the Swedish audit companies located in Gothenburg, as well as to the Swedish Professional Institute For Authorised Public Accountants (FAR), to ask their consent to answer our questionnaire. Next we telephoned the companies and got contacts with ten. To those who agreed to answer the questionnaire, we sent it by e-mail.

Eight of the companies declined to answer the questionnaire. The main response was that the person responsible did not have enough time to deal with it. PriceWaterhouseCoopers responded that they cannot answer those types of questions. FAR's answer was similar:

“... The questionnaire consists of numerous very broad and open questions, some of which cannot be answered without extensive explanations and reservations. Furthermore, some of the questions on complicated professional issues ask us to state the institute's opinion, which can be done only after full due process. We regret, therefore, that our resources do not allow us to respond to your questionnaire.”

It seems the topic is too sensitive, and since Swedish GAAS does not include the fraud consideration, some auditors (especially smaller firms, who do not audit international companies) do not have an opinion on the issues. The two audit companies we had interviews with were Ernst & Young AB and KPMG Bohlins AB: a personal interview with Ernst & Young and an e-mail interview with KPMG.

Next we present the outcome of the interviews with Ernst & Young and KPMG.

### **5.2.1 Conduct of Audits**

Concerning the conduct of audits, Bengt Petersson from KPMG Bohlins replied that they try to audit the processes to get an opinion how effective the processes are to avoid financial fraud. Dan Brännström from Ernst & Young AB said that their current audit procedures are not 100% effective. Swedish GAAP does not

include detecting fraud and thus auditors in Sweden are not looking for fraud. Although, when auditing the clients listed in the US stock markets, they have to include fraud issues. They have to fill out the checklist of questions on fraud, designed by the company.

Answering the question about the use of analytical review as the “conclusive audit evidence,” both interviewees suggested that the analytical review must be supplemented with substantive testing of important balance sheet items. Brännström added that they often start with an analytical review. After conducting the review, they decide with which substantive tests they have to complement it.

To the question “What do you do to protect yourself from the possibility of receiving false information given by the management?” Petersson answered that it is a big problem. He added that the auditor has to trust in the information given by their client and in order to achieve good auditing, there must be trust between the auditor and the top management in the company: “We must believe that the information we receive is correct.” Petersson believes that KPMG has effective systems to detect “false information.” Brännström said that all companies are different and have different internal control levels. If the auditor cannot rely on the internal control system and accounting policies of the company, he/she must rely on analytical procedure. If the auditor is not certain about the management information, he/she has to conduct his/her own tests.

In order to detect false information, which might exist in revenue and related accounts, one of the procedures suggested by Brännström is comparing the sales of each month with the budget. If there is deviation, they ask questions and make judgments about the answers.

When asked what was the most important task for an auditor, even beyond the analysis and comparison of the figures, Brännström suggested the following: “To ask the questions is the most important.” The auditor should consider himself a journalist, he added.

Regarding the revenue recognition issues, Brännström answered that it is likely that there is no right or wrong answer for when or how the revenue is realised and earned, especially in an IT company. As an example, one of the Swedish IT companies, Prosolvia AB, went bankrupt. The investigation of Prosolvia is underway, however, and the auditor is suspected of having made mistakes in detecting the “revenue recognition” fraud. This is similar to the case of L&H, which was also operating in the IT industry.

Lastly, Brännström suggested that in order to detect fraud the auditor should make changes every year on the audit work approach. The recommendations are to vary the audit, change the members of the audit team, and do new sorts of testing. All this helps an auditor to look at the client from a different angle and reveal new issues.

### **5.2.2 Auditor Independence/Non-Audit Services**

According to Brännström, in the eyes of general public and stakeholders, extended non-audit services threaten the independence of audit firms. This is why the new regulations concerning minimizing non-audit services are advisable. Nevertheless, it really doesn't threaten a person's independence as an auditor, because on making the decision and signing the auditor's report, he/she is on his/her own and wants to be as independent as possible. Petersson argues that some non-audit services can affect auditor's independence. KPMG has a system to avoid these problems. They have a checklist, and if there are any conflicts found they will withdraw from consulting. The similar system is in Ernst & Young, where they have to document any conflict of interest. If necessary, they ask for a second opinion from outside parties and/or stop certain consultancy work.

### **5.2.3 Internal Controls**

Regarding the internal control system assessment, Petersson stated that the system assessment must be evaluated and upgraded every year. A company is a living process and its programmes can be affected for many reasons, for instance, new management or owners, new accounting system, new personnel

and new policies. However, Brännström argued that the internal control assessment might depend on the client. Nevertheless, in order to update the internal control assessment, the auditor has to carry out additional tests. If the auditor wants to rely on the internal controls of the company, he or she has to make a large number of test of controls and walkthrough reviews. If not, the auditor must make substantive tests. Also, the auditor should focus every year on different processes.

#### **5.2.4 Effect of Audit Risk Factors on Audit Procedures**

We asked the interviewees to state which risk factors they consider to be the ones that most change their ordinary audit procedures. Petersson replied that the main risks are accompanied with the company's anxiety to meet the results:

- The company has problems with the result;
- The result is far below the budget;
- The price of the shares will fall when the result is published and to avoid the fall the top management can "fix" the result.

Alternatively, Brännström's main risk factors are concerned with changes in the company's attitude:

- New owners that may implement new accounting principles;
- New management, especially that the CEO may also make changes;
- New attitude towards internal control and audit work.

After identifying the risk factors, the following changes in the audit procedures are suggested by the interviewees:

- More analytical reviews;
- Identify unusual accounting transactions by the end of the accounting period (Petersson).
- More audit work to be more observant;

- More substantive testing to find out if changes in the company's accounting are reasonable (Brännström).

### **5.2.5 Audit Rotation and Sarbanes-Oxley Act**

The new legislation in the USA (Sarbanes-Oxley Act, July 30, 2002) requires the lead audit or coordinating partner and the reviewing partner to rotate off the audit every five years. We asked the interviewees' opinion whether this regulation strengthens auditor independence.

Petersson replied that if you are an auditor for a long time there can be a risk that the independence can be affected and he hopes that the rule helps to enhance auditor independence. On the other hand, Brännström thinks that this rule strengthens auditor independence only in the eyes of general public and stakeholders. In auditing a new company, the first year is not effective, because an auditor has to make himself or herself acquainted with the company to really understand its business. The best year for auditing is said to be the third.

## ***5.3 Suggestions from the Existing Research***

### **5.3.1 Analytical Procedures**

As we have discussed in the last section, where we asked the question, "why auditors have not detected fraud," it has been suggested that "analytical procedure" does not provide enough evidence for the auditor upon which to base an opinion. The main reason is because the procedure depends greatly on the interpretation of findings and the professional scepticism involvement of the issues. The interpretation of findings is directly affected by the information and data given by the client. This procedure is hardly considered as effective in detecting financial fraud at the top management level since the management, with their temptation to commit fraud, could fool auditors cleverly.

As we mentioned before, analytical procedure involves much "judgment." Only auditors can do it. There is nobody who can judge the judgment of auditors. Despite the fact that there is the audit committee, its members often may not

have the expertise in the technical issues that auditors do, and some people serving on audit committees have very little accounting or financial background at all (Bean, 1999). In order to overcome this subjectivity, the auditor should use analytical procedure as a tool to identify areas that may represent specific risks relevant to the audit, such as the existence of unusual transactions and events, and amounts, ratios, and trends that might indicate matters that have financial statement impact. When the auditor finds any unusual events in the accounts, based on analytical procedures, the auditor decides immediately to extend the detailed testing. This is a comment from the Ernst & Young interviewee.

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

- The most effective and common analysis the auditor should do is to compare monthly and quarterly sales by location and by product line with sales of the preceding comparable periods and for comparable periods in prior years. This comparison will consider whether the results are consistent with other known information, such as expanding or declining markets, changes in sales price mix, and new or discontinued product lines. To identify some of the unusual transactions which might happen at the year end, the auditor can compare revenues recorded daily for periods shortly before and after the end of the audit period, looking for unusual fluctuations, such as an increase just before and a decrease just after the end of the period.
- The comparison of gross profit ratio, overall and by product line, to previous years and to budget, considered in the context of industry trends, is also the common tool to use.
- To identify the “channel stuffing,” the auditor can compare the number of weeks of inventory in distribution channels with prior periods for unusual increases. The comparison of revenue deductions, such as discounts and

returns and allowances, as a percentage of revenues with budgeted and prior period percentages for reasonableness in light of other revenue information and trends in the business and industry could identify the “bill and hold sales.” The comparison of sales credits for returns subsequent to year end with monthly sales credits during the period under audit to determine whether there are unusual increases may indicate contingent sales or special concessions to customers.

In an article entitled “Auditors’ New Procedures for Detecting Fraud,” (Montgomery, et al., 2002, p. 64) the authors commented that “Forensic experts know inquiry is a highly effective tool in fraud investigations and that people who are reluctant to volunteer information about known or suspected fraud will more likely do so when asked directly.” The suggestion of expanded inquiries is also encouraged by the recent AICPA Exposure Draft. The ED requires auditors to query management on its views of the risks of fraud in the entity and knowledge of any known or suspected fraud. It is good for auditors to ask not only the management, but also others, for example, individuals outside the entity’s accounting or financial reporting areas or employees with varying levels of authority. However, the questions should not be too difficult. The nature and extent of these inquiries would be based on the auditor’s professional judgment and generally directed to employees with whom the auditor comes into contact during the course of the audit (Wells, September 2001).

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

### **5.3.2 Risk Assessment**

The assessment of the risk of material misstatement due to fraud is an ongoing process (Heim, 2002). Risk assessment processes such as planning, assessing risk, and gathering and evaluating evidence should be continuous throughout

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

#### *Understanding the Fraud Triangle*

There are three conditions generally present when fraud occurs – incentive/pressure, opportunity and attitude/rationalization (see Figure 1, “The Fraud Triangle,” p. 25). The concept is also explained in the ED (described in section 5.1). Understanding and considering the likeliness of fraud in the context of these three conditions will enhance the evaluation of information about fraud (Montgomery, et al., 2002). This will provide the auditor with more professional scepticism when assessing fraud risk. Auditors are advised to consider the client's receptiveness to fraud, regardless of the auditor's past experience with the client or prior assessments about management's honesty and integrity (Heim, 2002).

#### *Evaluation of Programmes and Controls*

When the auditor identifies risks of material misstatements due to fraud, the ED requires that he or she consider management's programmes and controls to address those risks. They might include broader programmes or specific controls designed to prevent, deter or detect fraud. The auditor would consider whether such programmes and controls would mitigate or exacerbate those identified risks. Also, the auditor would evaluate whether these programmes and controls have been suitably designed and placed in operation. The auditor's ultimate assessment of the risks of material misstatement due to fraud would take this evaluation into account. (Montgomery, et al., 2002).

*Further Procedures to Improve Risk Assessment*

Management is in a unique position to perpetrate fraud because it can override established controls that would appear to be operating effectively. This risk exists in virtually all audits and can occur in a number of unpredictable ways. Currently, the auditor's planned procedures in response to inherent and control risks and the auditor's assessment of the risk of material fraud should consider, at least implicitly, the risk of management override (Montgomery, et al., 2002).

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

Next we will give an overview of the procedures, as proposed by the ED, to better address the risk of management override of the controls.

- Examining journal entries and other adjustments

The auditor should understand the auditee's financial reporting process, including automated and manual procedures used to prepare financial statements and related disclosures, and how misstatements may occur. This understanding provides a basis for determining the nature, timing and extent of testing of journal entries and other auditor adjustments for evidence of possible material misstatement due to fraud. This testing would be a matter of professional judgment and would be based on the auditor's assessment of the fraud risks, whether effective controls have been implemented over one or more aspects of the financial reporting process, the nature of the financial reporting process and the evidence that can be examined (for example, the

extent of manual vs. electronic evidence) and the nature and complexity of the accounts.

- Reviewing accounting estimates for bias

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

- Evaluating the business rationale for significant unusual transactions

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

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

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

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

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

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

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

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

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

### **5.3.4 Conflict of Interest Issues**

#### **5.3.4.1 Auditor Independence**

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

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

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

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

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

#### 5.3.4.2 Non-Audit Services

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

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

Cote (2002) argues that an auditor's ability to resist client pressure depends on the firm's dependence on the client, whether from size, amount of fees, or the services it provides. The greater the dependence, the stronger the pressure. Moreover, the smaller the accounting firm compared to the client, the more vulnerable it is to pressure. Pressure may be associated with any service, including audit. There is no way to avoid it, as long as auditing is a commercial transaction.

Different opinions described above on non-audit work reveal that auditors can offer the non-audit services. However, an auditing firm should evaluate the threats on non-audit services provided thoroughly. One guiding principle for evaluating the appropriateness of particular services is whether the services facilitate the performance of the audit, improve the client's financial reporting processes or are otherwise in the public interest (POB Panel of Audit Effectiveness).

#### 5.4 Summary

We summarised the findings and suggestions in the following table, so the reader can more easily, in a compressed version, find the reasons why auditors have not detected fraud as well as the recommendations for how to improve this process.

<b><i>Reasons for not Detecting Fraud</i></b>	<b><i>Recommendations/Suggestions</i></b>
<ul style="list-style-type: none"> <li>Analytical Procedure is insufficient for audit evidence.</li> </ul>	<ul style="list-style-type: none"> <li>Supplemented testing required.</li> <li>Make inquiries.</li> <li>Interpret findings within the context of current business and market.</li> <li>Compare of ratios for "bill-and-hold sales," "channel stuffing" and "side agreements."</li> </ul>
<ul style="list-style-type: none"> <li>Risk assessment and Internal Control is not absolutely effective.</li> </ul>	<ul style="list-style-type: none"> <li>Vary the audit procedures.</li> <li>Understand auditee's financial reporting process.</li> <li>Review accounting estimates for bias.</li> <li>Understand significant unusual transactions.</li> </ul>
<ul style="list-style-type: none"> <li>Audit failure in applying "revenue recognition" and "related-party transactions."</li> </ul>	<ul style="list-style-type: none"> <li>Compare financial statements over a period of time.</li> <li>Understand the entity's business.</li> <li>Understand the relationship of the parties.</li> <li>Partners more involved in the audit engagements.</li> </ul>
<ul style="list-style-type: none"> <li>Conflict of interest issues is controversial.</li> </ul>	<ul style="list-style-type: none"> <li>Auditor rotation.</li> <li>Restrictions on the employment of the auditing staff.</li> <li>System of evaluating the independence risks.</li> </ul>

Table 4. Summary of Reasons Why Auditors Have Not Detected Fraud and Suggestions for Improvement.

## **6 Summary and Suggestions for Further Research**

### **6.1 Summary**

Financial reporting frauds and earnings manipulation have attracted high profile attention of both the professional world and the public. Most people are interested in the questions “where auditors are?” and “what is going on with audit quality?”. We found it would be interesting to study the problem and learn about it.

At the beginning of our research, we set out the research purpose, which contains two questions “why auditors have not detected fraud in the financial statements?” and “how to improve the audit process to detect these kinds of fraud?”

To achieve and fulfil these purposes, we first have studied the theories, which are relevant to the area we are researching. The theoretical framework which we have studied relates to the subject of financial statement fraud, earnings management and revenue recognition problem. In auditing theory technically, we studied the audit risk model in the risk assessment process and the risk factors of financial statement fraud which auditors should consider.

The theories have given us the concrete base to analyse the case studies, which we have selected: Lernout & Hauspie, Sunbeam and Xerox. We studied three financial statement fraud cases, based on the structure by Rezaee (2002). The structure is created to identify the financial statement fraud. It arises from five factors: cooks, recipes, incentives, monitoring and end results, which is abbreviated as “CRIME.”

In our cases, the “cooks” or the authors of the fraud story were either the CEO, CFO or members of senior management. The auditors, KPMG (Lernout & Hauspie and Xerox) and Arthur Andersen (Sunbeam) were accused by the SEC and public press of either being aware of fraud but still releasing a clean opinion or not having discovered the manipulation of their client’s earnings

figures. So far, Arthur Andersen paid the fine in the Sunbeam case, but has not admitted the fault.

“Recipes” in the fraudulent schemes are the most diversified. They are the methods, which the cooks have used. Lernout & Hauspie used three various recipes, which were improper related-party sales transactions, illegitimate sales transactions and side agreements. Sunbeam’s recipes were bill and hold sales and channel stuffing. Xerox was consistent with its one recipe of timing of revenue recognition.

“Incentives” are the motivations for why the companies and their cooks have engaged in financial statement fraud. Most companies with high growth rates like Lernout & Hauspie, Sunbeam and Xerox faced economic pressure to attain their targets and meet the expectations of the analysts as well as to keep the investor happy. From the auditor’s side, the fear of losing their important clients was enlarged in this current highly competitive environment.

“Monitoring” means both internal and external monitoring in and out of the corporation. Internal monitoring is represented through the corporate governance’s control over the corporate system. External monitoring is believed to be done by the independent auditors. The three cases showed us there was lack of monitoring of the top management by the board of directors, and in Lernout & Hauspie case, the founders of the company themselves were involved in fraud. The auditors in these cases did not take their full responsibility in playing the role as the external monitor.

The final factor is “End results” or the consequences of the financial statement cases. The consequences typically ranged from filing for bankruptcy to substantial decline in stock value. The cooks suffered by being forced to resign or being fired or being sanctioned with fines or jail sentences. The consequences for the auditors, who have not spotted the cooking, were fines and loss of their reputation. The investors were the heaviest sufferers on the economic side.

Having possession of these findings, we studied the reasons lying behind the cases why auditors have not discovered the frauds, which answered the first question in our research purpose, in both technical and ethical terms. Technically, we discussed three main reasons which we found related to our case study. They were: application of analytical review procedures as “sufficient audit evidence;” weaknesses in audit risk model and risk assessment concerning internal control; and audit failure in revenue recognition and related-party transaction disclosure.

Regarding application of analytical review procedures as “sufficient audit evidence,” the study revealed that the most critical point in analytical procedure is the auditor’s failure in interpretation of findings, and the lack of high involvement of professional judgment.

The internal control is typically designed by the top management to facilitate their monitoring over their employees. The cases revealed that it was top management who were the authors of the financial statement fraud. Therefore, over-reliance on the assessment of internal control system does not help to detect higher-level fraud. Audit failure in detecting revenue recognition fraud and related-party issues was also common. These were truly the most dangerous areas for auditors. According to the AICPA (1999), the auditor’s failure to apply the accounting principles could be the result of either the lack of involvement of audit partners in the engagement or too general definition of the issues in the GAAP itself.

Conflict of interest issue was the core ethic issue we studied. This involved auditor independence and non-audit services. Auditor independence has been historically controversial ever since the audit service was born. To some extent, audit service is still a commercial industry and the auditors are being paid by the companies they audit. Therefore, this is one of the causes of the pressures and constraints on the auditors. In addition, in the trend of decreasing or standstill audit fees, the auditors have suffered time and cost constraints. Another cause for conflict of interest is a too close relationship between auditor and auditee. For example, KPMG had thirty years of engagement with Xerox. All of these factors might have heightened the suspicion of the auditor’s

independence, at least in the public eyes. Non-audit services have exacerbated the conflict of interest issue. The auditing firms cannot help neglecting the higher profit margin, which consulting and other non-audit services have brought to the firms. The audit services in some ways were the base for the auditing firm commercialising its other services.

Having answered question one of the research purpose, we suggest some solutions or improvements in audit process to address the weaknesses in detecting financial statement fraud. In other words, we have answered question two of our purpose. The solutions were obtained with the assistance of two auditing firms in Sweden, which we collected from our interviews, and the existing studies of professional organisations.

Each reason in question one was followed by the suggestions for improvement in question two. Turning to the analytical procedure, the study revealed that in order to make the procedures effective, supplementary testing should be performed, because analytical procedure alone does not provide sufficient evidence for audit conclusion. Besides, using inquiries is an effective tool for auditors to detect fraud. Inquiries give the auditor additional information to interpret the findings in an objective manner. Referring to the sales and related accounts, it was also suggested by the AICPA (1999) that some critical ratios and procedures should be taken when using analytical procedure. Risk assessment is a complex area which requires the high technical skill involved. The suggestions from AICPA Exposure Draft are to understand the fraud triangle, evaluate programs and controls, as well as take some additional procedures to improve risk assessment. Most important, practical and effective ways to detect fraud are to make changes every year on the audit approach and members of the team, and also to perform new sorts of testing. This definitely helps auditors to look at the client from a different angle and expose the underneath issues.

To avoid audit failure in revenue recognition and related-party issues, various authors' recommendations were presented. The general suggestions included understanding the internal and external usual and unusual changes in the entity's business. The audit partner has to be deeply involved in the audit

engagements to identify the risky issues as the partner is usually the one who possesses experience and knowledge particularly about the “substance over form” issues in the related-parties transactions.

Concerning conflict of interest issues, auditor rotation, under the audit independence issue, is the spotlight with the birth of the Sarbanes-Oxley Act on July 30, 2002 in the USA. However, the rule might cause some troubles for rotated auditors in getting familiar with the client system in the first year. Hence the audit quality in the first year might not be very effective in meeting the purpose of detecting fraud as expected. In order to prevent auditors from overlapping the services between audit and non-audit ones, the suggestions given are the restrictions of the employment of the auditing staff and consideration of a system of evaluating the breach of independence concept.

We have to restate one of sentences we wrote at the very beginning of our thesis. It is “one of the best ways is to profit from the mistakes of others.” It is absolutely true. We believe that auditing firms have learnt and been alarmed by what their peers have not done. Studying the reasons lying underneath the financial statement fraud cases from the auditor’s side, as well as seeking for the improvements on the audit process in order to detect fraud, will gradually enhance audit quality and recover the trust of the public in auditors. This endeavour is apparently on the way to reaching a more effective and efficient audit.

## ***6.2 Suggestions for Further Research***

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

As we mentioned in Chapter 1 of this thesis, we did the research from the perspective of the auditor. The other suggestion is that the study can be conducted from the perspectives of other responsible persons such as

management and government. From the management side, the study would be in the light of management in antifraud issues. We suggest the website, which might be helpful if there is anyone interested:

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

Although the fraudulent financial statement cases in Sweden in particular and in Europe in general are not as many as discovered in the United States, fraud cases still exist with the suspected involvement of the auditor. The case of Prosolvias AB, a Swedish IT company who went bankrupt, is an example. The investigation is on-going. However, the auditor is suspected of having made mistakes in detecting “improper revenue recognition” fraud. Our last suggestion for further research is to study fraudulent financial statement cases in Sweden to find the reasons and the improvements in audit process within the framework of Swedish GAAP and Swedish GAAS.

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

- Study other kinds of fraud;
- Study from the perspectives of others such as management and government; and
- Study fraudulent financial statement cases in Sweden to find the reasons and improvements within the framework of Swedish GAAP and Swedish GAAS.

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## **Cover Letter to the Audit Companies**

Dear Sir or Madam,

We turn to you with a request to help us in conducting our Master's thesis in the Graduate Business School in Handelshögskolan, Göteborg University. The thesis is entitled "Financial Statement Fraud: Recognition of Revenue and the Auditor's Responsibility for Detecting Financial Statement Fraud."

We believe the findings of our research could also be useful to you. The main purpose of our thesis is to identify the reasons why auditors have not detected certain types of fraud, based upon an investigation of several well-known fraudulent financial statement cases which involved the overstatement of revenue. The second purpose of our thesis is to suggest possible solutions for improving the audit process in order to assist auditors in identifying instances of overstatement of revenue.

In order to accomplish the research, we would like to ask you some questions about the current audit process and your views concerning the possibilities of improving that process. We will send you the questionnaire after your consent. The questionnaire is relatively brief and will take no more than one hour of your time. Of course, all responses will be held anonymously if that is your wish.

We hope that your assistance can benefit us mutually. Thank you in advance for your time and consideration. We look forward to hearing from you.

Thank you for reading our letter in English. We are from the countries of Vietnam and Estonia, and English is our second language, which is the language of our Master's programme.

Yours faithfully,

Linh Thuy Do  
Tiina Intal



## **Questionnaire Sent To The Auditing Firms In Sweden**

### **Auditing Procedures Regarding Financial Statement Fraud**

#### **1. Conduct of Audits**

**1.1** There are diverse opinions regarding the issue of improvement of audit process for detecting financial statement fraud. The O'Malley Panel on Audit Effectiveness<sup>1</sup> concludes that "current audit conduct is not ineffective" and "the audit risk model is appropriate," but some enhancement should be implemented. However, another study by Cullinan and Sutton<sup>2</sup> criticised that the new audit approach which places emphasis on system internal control assessment rather than "direct testing of the underlying transactions and account balances," is at odds with the profession's position regarding fraud detection because most material frauds originate at the top levels of the organization, where controls and systems are least prevalent and effective.

**What is your opinion of these contradictory conclusions? In your company, which audit procedures are used in order to detect fraud?**

**1.2** The key change in the audit process which has been reengineered by most auditing firms in the last decade is that analytical review is used as the main tool for substantive testing and becomes "conclusive audit evidence." Cullinan and Sutton claim, "The greatest difficulty in the effective application of analytical review procedures is in the interpretation of findings." "However, the use of analytical procedures is almost always focused on the analysis of differences from the previous years." They conclude that this methodology is

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<sup>1</sup> The O'Malley Panel on Audit Effectiveness was established at the request of former chairperson of the SEC, Arthur Levitt, to study the prevailing audit model in 1998.

<sup>2</sup> Charles P. Cullinan and Steve G. Sutton, from Bryant College and University Of Connecticut/University Of Melbourne, School Of Business (U-41a), University Of Connecticut Storrs, Ct 06269-1041, USA, have studied "Defrauding the Public Interest: a Critical Examination of Reengineered Audit Processes and the Likelihood of Detecting Fraud."

not effective in detecting fraud because auditors rarely stop to consider that an upper level manager who falls to the temptations of fraud is most likely to attempt to cover up such a fraud by making the accounts look normal.

This conclusion reflects the response from auditors in the accounting fraud cases discovered recently where auditors usually claimed that the management lied about the information structure (Lernout & Hauspie).

**1.2 (a) What is your opinion of this argument? What do you do to protect yourself from the possibility of receiving false information given by the management?**

**1.2 (b) In order to place emphasis on detecting “false” information which might exist in revenue and related accounts, do you think it is necessary to have extra steps, besides analytical review procedure, in your current audit programme for those accounts? If so, which steps should be taken?**

1.3 From the recent case studies of fraudulent financial statements, the companies boosted their revenue by using “one-time actions,” “one-offs,” “accounting opportunities” and “accounting tricks” to achieve earnings targets. For instance, pulling forward and recognizing revenues immediately from equipment leases that, under company's historical accounting practices, would have been recognised in future years (Xerox)<sup>3</sup>. Other case like Lernout & Hauspie used “related-party transactions” as the tool for similar revenue falsification.

**It seems the companies committing accounting fraud often play tricks with the concept of “revenue recognition”<sup>4</sup>. What is your opinion on this controversy?**

<sup>3</sup> Securities and Exchange Commission complaint v. Xerox Corporation, Civil Action No. 02-272789 (DLC).

<sup>4</sup> SAB 101 spells out the criteria for “revenue recognition” based on existing accounting rules, which say that companies should not recognise revenue until it is realised or realisable and earned. (Thomas J. Phillips Jr., Michael S. Luehlhing and Cynthia M. Daily, “The Right Way To Recognise Revenue,” June 2001, *The Journal of Accountancy*).

## 2. Auditor Independence/Non-audit services

There have been a number of discussions on independence of auditors. Auditing companies often provide non-audit services (consulting) to their clients. For example, auditors collect consulting fees significantly larger than audit fees or a company hires an auditor, who was previously the company's audit manager, for its top executive position.

In our opinion, auditors cannot be independent if they provide extended consulting services to their clients.

**Do you agree with us? How does your company avoid such conflict of interests?**

## 3. Internal controls

**In the planning stage of a current audit year you, as external auditor, assess that the internal control system of the client is effective and the test of controls draws the conclusion that it is reliable. As the result, the extent of the substantive tests in the executing stage will be minimised. If so, how are you going to perform the internal control system assessment in the next audit year? Do you upgrade/roll forward the previous year's assessment? If yes, in what way are you going to do it?**

## 4. Effect of audit risk factors on audit procedures

**4.1 There are different risk factors, or "red flags" that can indicate financial statement fraud. Which are the risk factors which you consider would most change your ordinary audit procedures?**

**4.2 What are the changes in audit procedures you would make after you have identified these risk factors?**

## 5. Audit Rotation and Sarbanes-Oxley Act

On July 30, 2002, the president of the USA G. W. Bush signed the Sarbanes-Oxley Act. This legislation impacts corporate governance of public companies, affecting their officers and directors, their Audit Committees, their relationships with their accountants and the audit function itself. The act states that the lead audit or coordinating partner and the reviewing partner must rotate off the audit every five years.

**In your opinion, does this new regulation strengthen auditor independence?**

**6. Kindly add any additional suggestions on detecting financial statement fraud and any comments on the topic.**

## **Questionnaire Sent to FAR**

### **Auditing Procedures Regarding Financial Statement Fraud**

#### **1. Conduct of Audits**

From the recent case studies on fraudulent financial statements, some companies boosted their revenue by using “one-time actions,” “one-offs,” “accounting opportunities” and “accounting tricks” to achieve earnings targets. For instance, pulling forward and recognising revenues immediately from equipment leases that, under company's historical accounting practices, would have been recognised in future years (Xerox). Other case like Lernout & Hauspie used “related-party transactions” as the tool for similar revenue falsification.

**It seems the companies committing accounting fraud often play tricks with the concept of “revenue recognition.” What is your opinion of this controversy?**

#### **2. Auditor Independence/Non-audit services**

There have been a number of discussions on independence of auditors. Auditing companies often provide non-audit services (consulting) for their clients. Following the Xerox case, it was found that “PriceWaterhouseCoopers, which replaced KPMG as auditor after the accounting problems surfaced, charged the company USD 20.4 million in large measure for so-called forensic accounting to help identify the alleged fraud, but just half that amount to do the most recent audit.”

In our opinion, the auditors cannot be independent if they provide extended consulting services to their clients.

**Do you agree with us? How do you think the auditors should avoid such conflict of interests? Should auditors be forbidden to do non-audit work?**

### 3. Governance of the Auditing Profession

**Who is watching the watchdog (auditors)? In Sweden? In Europe? Do you feel that the current governance system of the auditing profession is effective, or should changes be made? What changes would you recommend?**

**4. Most of the cases of fraudulent financial statements have been found in the United States. Is it possible that this 'wave' could also occur in Europe? Please explain. Are there any official statistics about the fraudulent financial report cases in Sweden so far?**

### 5. Audit Rotation and Sarbanes-Oxley Act

On July 30, 2002, the president of the USA G. W. Bush signed the Sarbanes-Oxley Act. This legislation impacts corporate governance of public companies, affecting their officers and directors, their Audit Committees, their relationships with their accountants and the audit function itself. The act states that the lead audit (or coordinating) partner and the reviewing partner must rotate off of the audit every five years.

**In your opinion, does this new regulation strengthen auditor independence?**

**6. Kindly add any additional suggestions for detecting financial statement fraud and any comments on the topic.**