

ACCA Members Survey: Fraud and the Smaller Company

Statement of Auditing Standards 'Fraud and Error' (SAS 110), issued in 1995, sets out the current responsibilities of external auditors. The Auditing Practices Board (APB) conducted research into whether, and how, SAS 110 and related Auditing Standards should be revised, which culminated in the publication of the discussion paper 'Fraud and audit: choices for society' in 1998.

The fundamental argument of 'Fraud and audit' is that the audit of financial statements is not a useful method of discovering fraud. The paper considers the cost of fraud, which includes intangible elements such as loss of confidence in the capital markets, as well as the financial costs of investigating and prosecuting frauds and the actual sums misappropriated. It also places great emphasis on the feedback received during the APB's earlier research, which showed that companies and some institutional investors would be unwilling to bear additional audit costs. 'Fraud and audit' also examines the boundaries of the auditor's responsibility in relation to fraud, and the problems which could arise in this area, along with shareholder, creditor and public expectations for auditors to uncover material fraud.

The key findings of APB's work are that:

- most material frauds invariably involve directors and/or senior management
- the majority of frauds involve misstated reports to the market but do not involve diversion of funds from the company

and

- management fraud, particularly if it also involves collusion with third parties, is unlikely to be detected as part of the statutory audit of financial statements.

One of the key elements of ACCA's response to this discussion paper was that it concentrated on large enterprises and did not adequately address the issue of fraud in the smaller company. There is pressure to reduce burdens on business by reducing the amount of regulation imposed, but the subsequent decrease in controls makes smaller businesses an increasingly attractive vehicle for crime. Fraud committed by, or on, smaller entities can have a serious impact on the parties with which they do business and in aggregate can cause as much economic damage as individual, high profile frauds in large enterprises.

As part of its continuing commitment to fight fraud and to maintain an understanding of how fraud affects small entities in particular, ACCA has undertaken research into the issue of fraud and the smaller company. As part of this research, ACCA sent out a survey to its members, which was distributed to 1,250 different accountancy firms.

The objectives of the survey were:

- to identify the impact of fraud on smaller entities
- to develop a list of fraud indicators
- to establish how often there is a link between control weaknesses and the occurrence of fraud

and

- to find out how fraud is detected.

While the APB's work reflected the view that the audit of financial statements is unlikely to be useful in unearthing the existence of fraud, the results of our survey show that, with respect to smaller entities, the regular audit of a company's accounts is an extremely useful method of detecting fraud. An audit of such a company's accounts can also enable management to identify and correct control weaknesses which could provide the opportunity for fraud. Of the frauds reported in our survey, 45% had been discovered by the auditor. One member commented "Push for keeping the audit - we have detected over £50k in fraud over the last three months".

In addition to this, the APB's work showed that a large percentage of fraud involved misstated financial reports, whereas the findings of our survey show that fraud within smaller companies does not involve fraudulent financial statements.

Taken together these main findings allow the conclusion to be drawn that, in general, within large enterprises, auditors do not detect management fraud, which is often directed at falsifying the financial statements. In smaller entities, auditors do not encounter false accounts and are often the ones who discover management fraud.

Key findings

59% of respondents claimed to have experienced, or suspected, fraud affecting their clients.

75% of respondents noted that the cases which they had encountered involved owner-managers only.

45% claim that the fraud was detected by the auditor.

123 encounters with fraud involving the falsification or alteration of accounting and/or computer records in order to suppress / remove transactions were reported by members.

58% of fraud experienced by respondents had been motivated by personal gain.

75% noted that 0–5% of turnover was involved.

76% noted that 0–5% of capital employed (net assets) was involved.

88% perceived the level of fraud to be the same over the last five years.

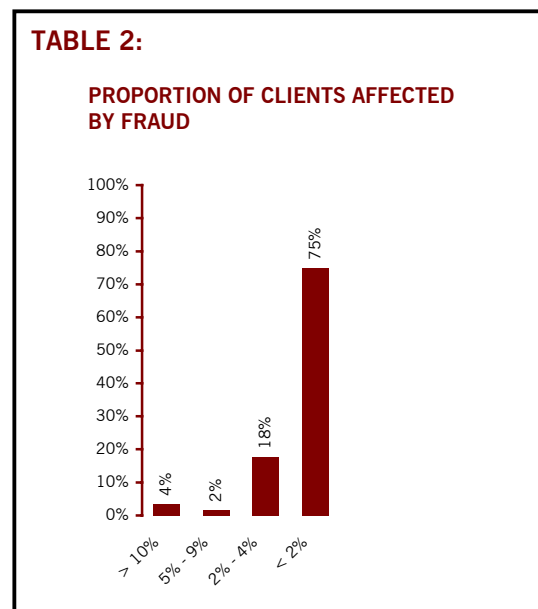
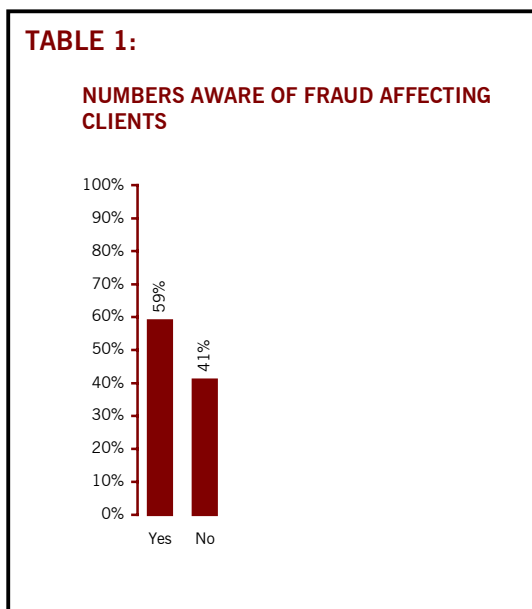
87% were not aware of any change in fraud levels caused by e-commerce.

34% of respondents claim that instinct had led them to be suspicious of fraud.

42% noted that management override of controls enabled the fraud to be perpetrated.

Objective 1: To identify the impact of fraud on smaller entities

We asked our members whether they had ever been aware of, or suspected, the existence of fraud affecting any of their clients. 59% of respondents noted that they had encountered fraud affecting one or more of their clients (see Table 1).



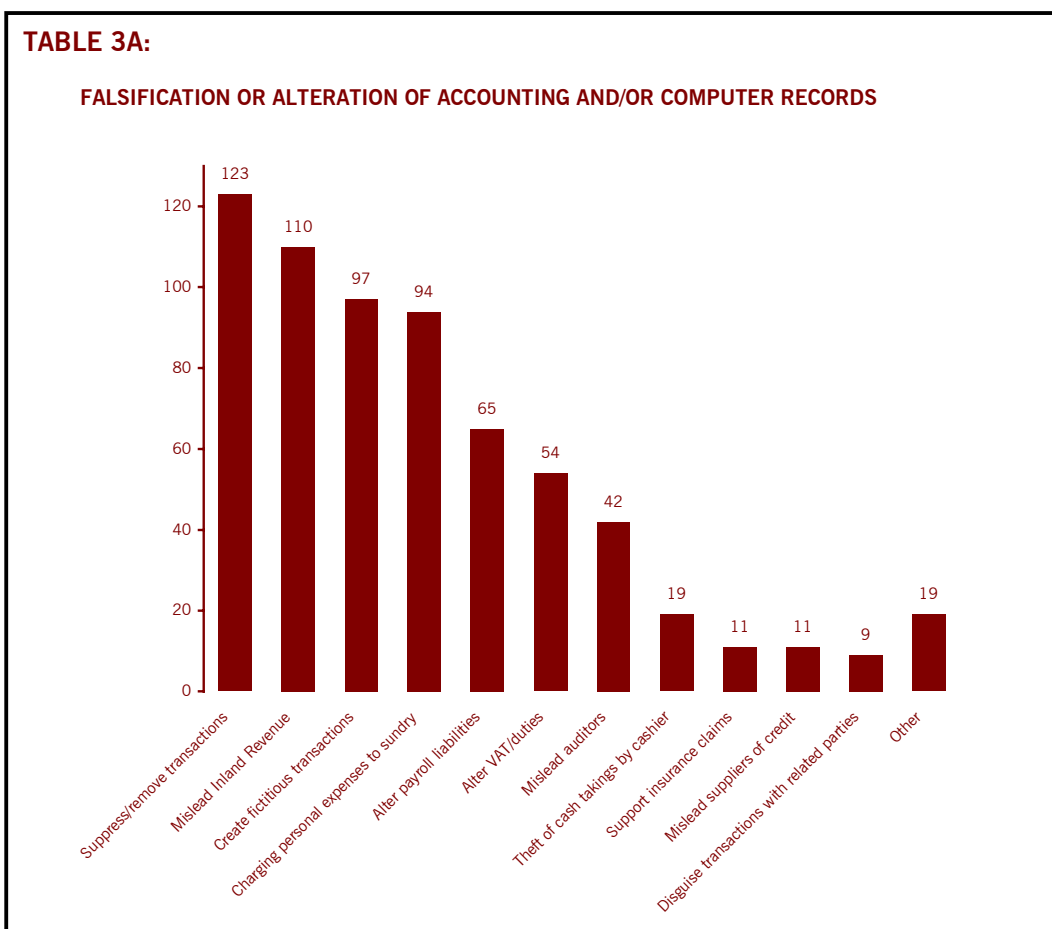
The size of respondents' client base ranged up to 2500 clients, with the average number being around 215 clients.

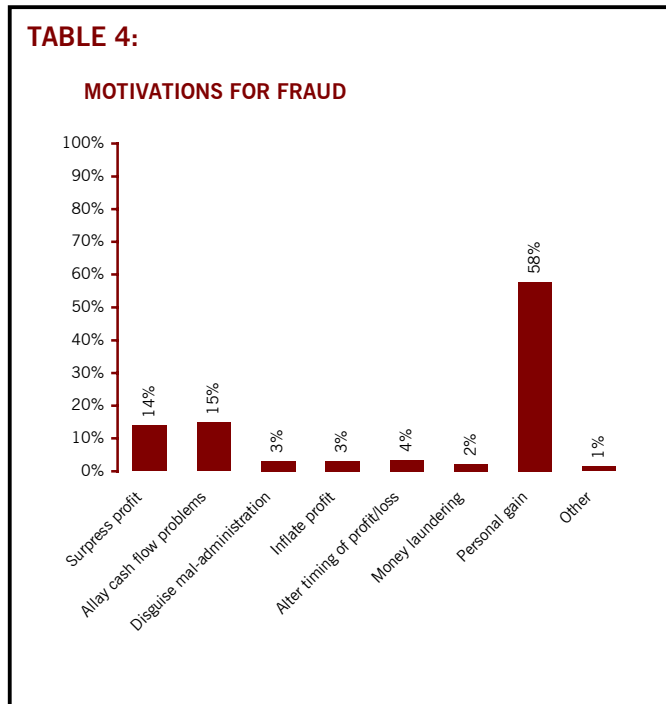
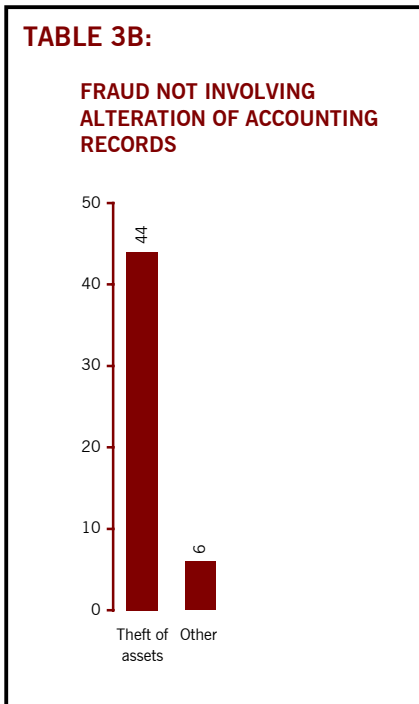
We asked what the approximate proportion of those affected by fraud was. As illustrated by Table 2, 75% of respondents noted that fewer than 2% of their clients had been affected, with 18% noting 2%-4% of clients, 2% noted 5-9%, and 4% noting that over 10% of their clients had been affected.

We wanted to find out the nature of the frauds encountered by our members, and their motivations.

Table 3A shows the number of times respondents have experienced different types of fraud involving the falsification or alteration of accounting and/or computer records, while Table 3B illustrates the number of times respondents have experienced fraud not involving such alterations.

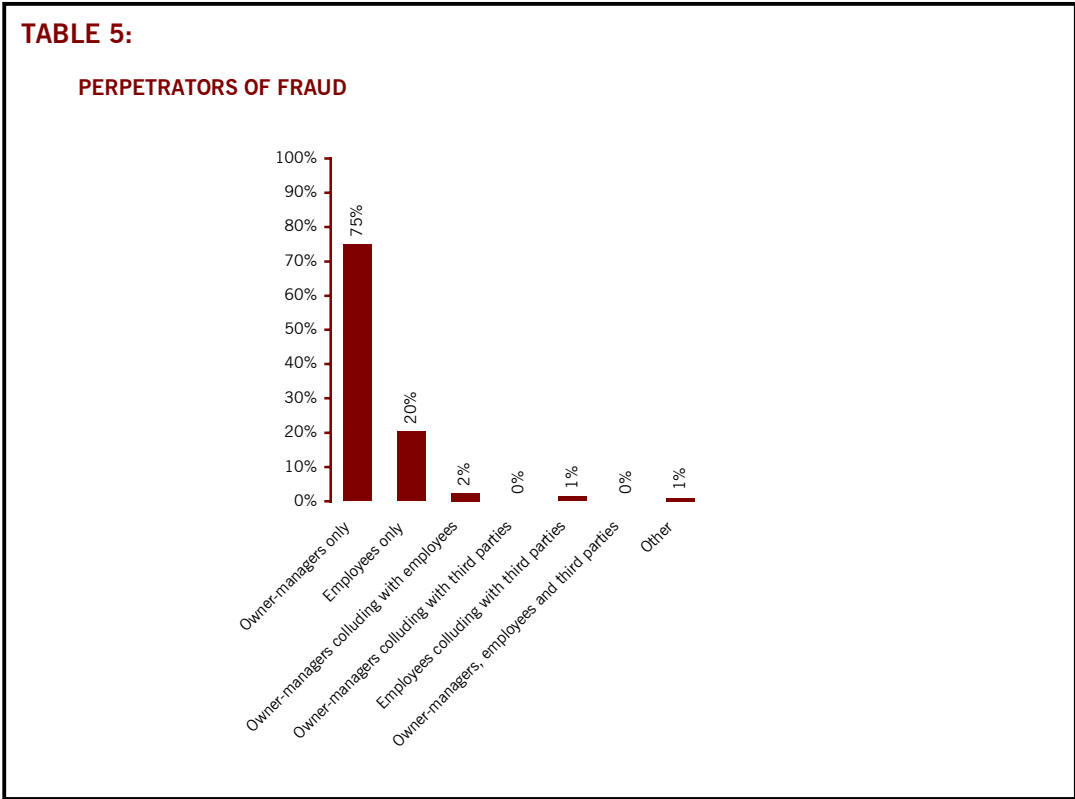
Results show that the fraud which members had come across the most (123 times) was the falsification or alteration of accounting and/or computer records in order to suppress/remove transactions. The falsification or alteration of accounting and/or computer records to mislead the Inland Revenue had been encountered 110 times, with the creation of fictitious transactions encountered 93 times.





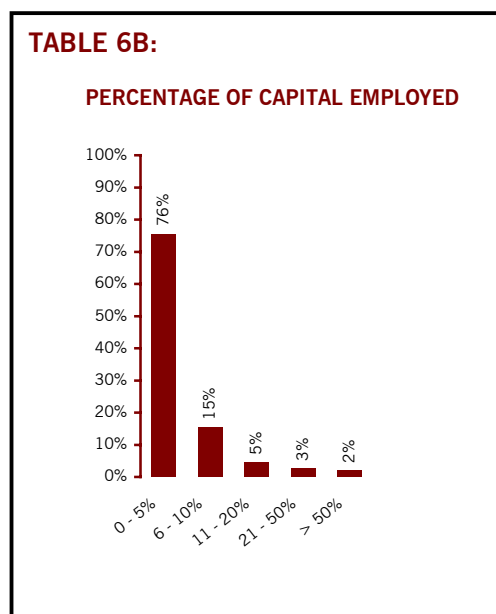
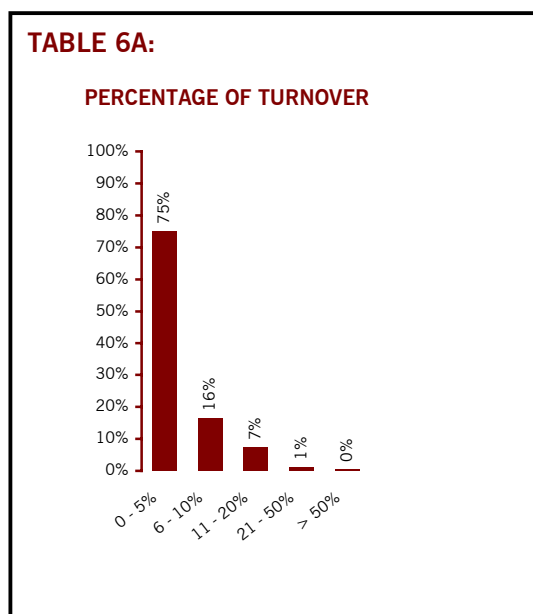
We asked members to note the motivations they believed were behind the frauds they had encountered. As illustrated in Table 4, 58% of their experiences had been for personal gain, with 15% in order to alay cash flow problems, and 14% to suppress profits. Other motivations for fraud noted were in order to retain crucial staff and to reduce tax liability on sub-contractors.

We wanted to clarify which parties were responsible for the majority of fraud cases within smaller companies. In keeping with the findings of the APB, 75% of respondents assigned responsibility to owner managers, with only 20% of cases involving employees only (shown in Table 5). The majority of fraud cases reported in response to our survey were ones where the perpetrator had acted alone. 2% of frauds were by owner-managers in collusion with their employees, 1% involved employees colluding with third parties, with none involving owner-managers with third parties only, or owner managers, employees and third parties in collusion. Other individuals noted as being responsible for committing fraud included a Treasurer acting as sole perpetrator. 211 cases of fraud were noted in total.

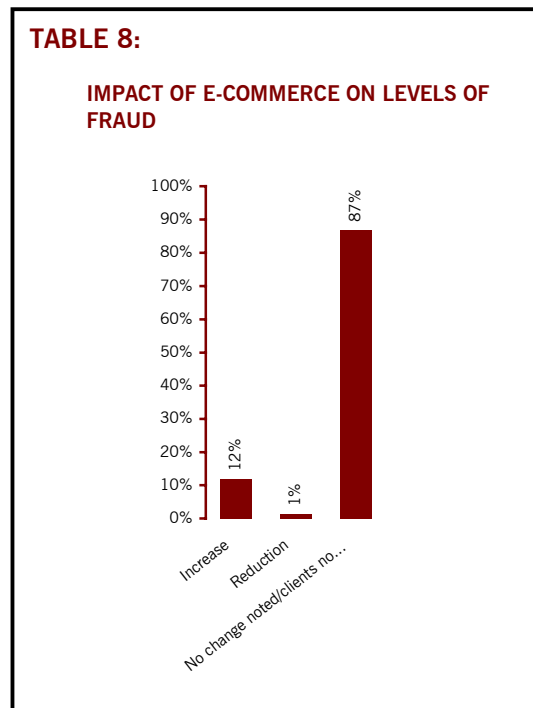
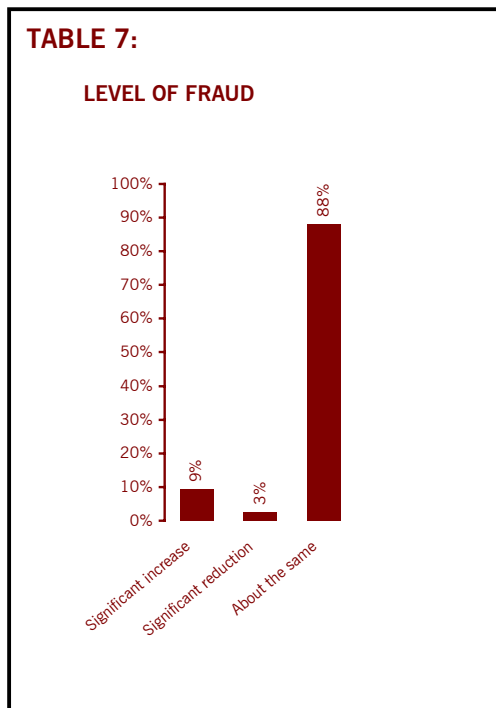


We wanted to establish how much money was involved in these cases. 75% of cases involved less than 5% of turnover, with 16% between 6-10%, 7% between 11-20%, and fewer than 2% greater than 21% of the turnover (see Table 6A).

The statistics were similar as a percentage of capital employed, shown in Table 6B, with 76% involving less than 5% of capital, 15% involving 6-10%, and 5% between 11-20% of capital. However, 3% were between 21-50% of capital employed and 2% were greater than 50%.



We asked respondents, regardless of whether they had encountered or suspected the existence of fraud over the last five years, what their general perception was of the level of fraud affecting small entities. As shown in Table 7, 88% of respondents felt that the level was unchanged, with 9% noting a significant increase and 3% noting a significant reduction.

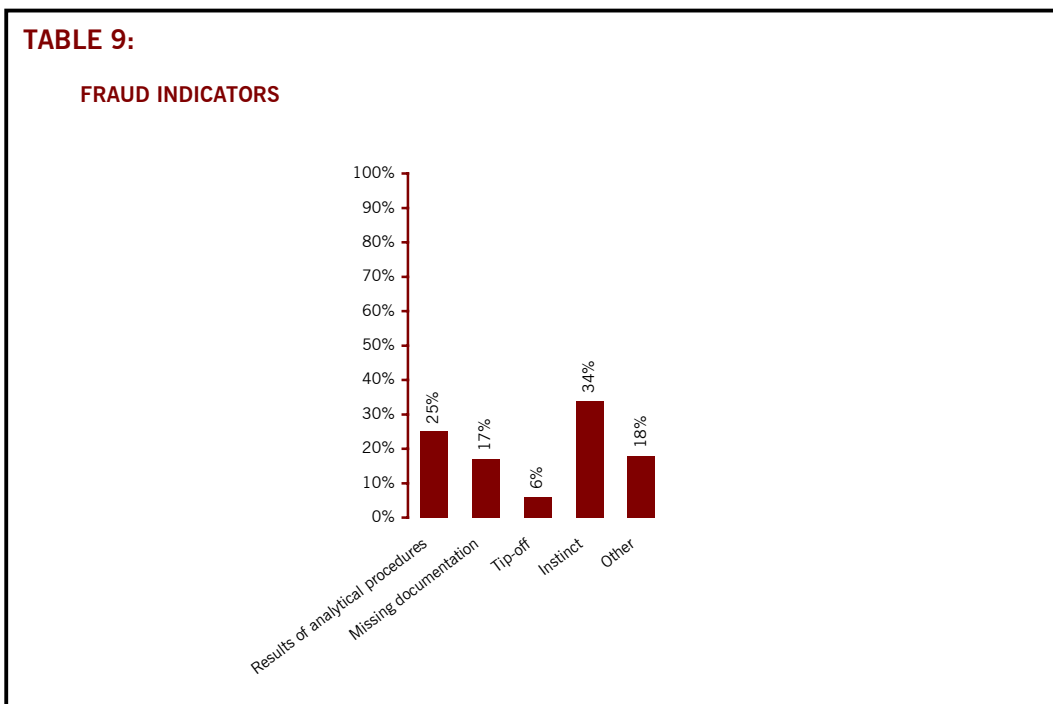


We also wanted to establish whether members felt that the introduction of electronic commerce had in any way affected the level of fraud committed. Results showed that a slightly higher amount felt there was an increase (12%) with fewer feeling that there was a reduction (only 1%) but the majority (87%) had not noted any changes in the level of fraud or felt that their clients were unaffected by e-commerce.

Objective 2: To develop a list of fraud indicators

We wanted to discover what the main indicators for fraud were. We therefore asked our members what had lead them to suspect that their clients were affected by fraud.

34% of respondents attributed the discovery of fraud to instinct, with 25% having been lead to suspect fraud as a result of unexplained fluctuations in gross profit margins or as a result of other analytical procedures (see Table 9). 17% became suspicious due to missing documentation and 6% were ‘tipped-off’ about the existence of fraud.



18% of respondents noted that there were other reasons for the discovery of fraud. A great many noted that the fraud had been uncovered as a result of Inland Revenue investigations, many noted inconsistencies between company accounts and bank accounts. Some noted that their concerns had been raised by apparently fabricated invoices or other false documentation while others had been asked by their clients to investigate whether any fraud had taken place.

Results clearly show that the majority of cases where fraud was detected for reasons other than 'instinct', had been discovered as a result of the scrutiny of company accounts, whether this be by the auditor/accountant or by an outside body such as the Inland Revenue. This would indicate that, should a company feel threatened by fraud, an easy way to detect, and possibly subsequently deter, the existence of fraud would be to ensure the regular audit of its accounts.

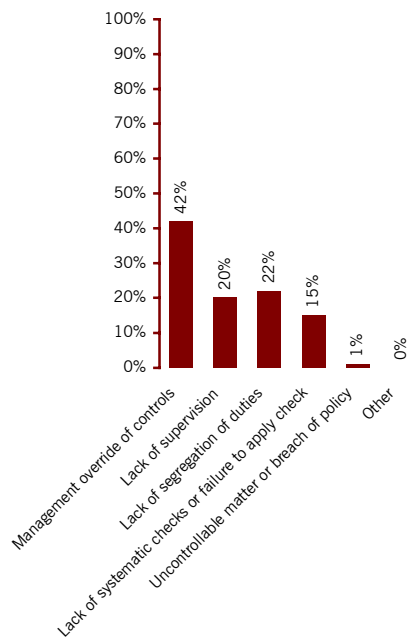
Objective 3: To establish how often there is a link between control weaknesses and the occurrence of fraud

For a smaller company, however, the cost of a regular audit may seem inappropriate in relation to its annual turnover or the scope available for fraud. For such companies, it might prove helpful to be aware of any weaknesses within the company’s control structure which could facilitate the committing of fraud.

We asked our members what factors they felt had enabled the fraud to be perpetrated (see Table 10). 42% of respondents felt that the fraud had been enabled as a result of management, either the owner or a director, being able to operate without any reporting requirements and with total control over all aspects of transactions. 20% noted that a lack of supervision had enabled the fraud to take place and 22% noted that a lack of segregation of duties had facilitated the committing of fraud. 15% put it down to a lack of systematic checks, or failure to apply a check, and only 1% of respondents felt that the fraud had been uncontrollable.

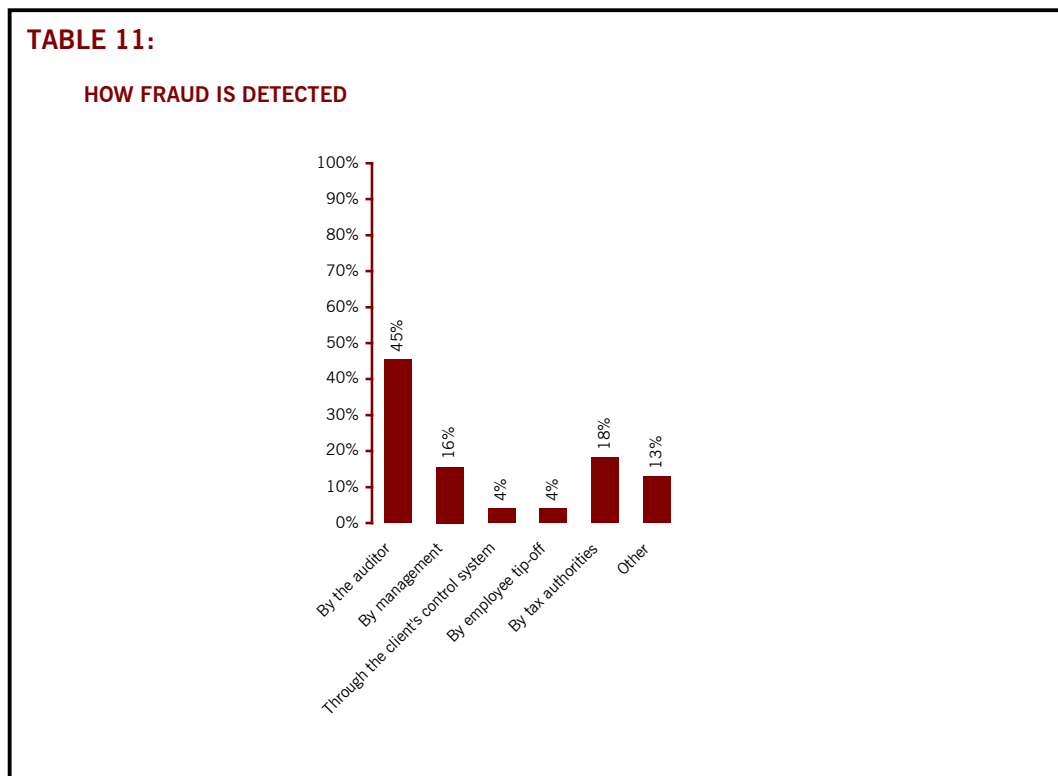
TABLE 10:

FACTORS ENABLING FRAUD



Objective 4: To find out how fraud is detected

We wanted to find out how the fraud was detected, and by whom. Results are illustrated by Table 11.



The majority of respondents (45%) noted that the fraud was uncovered by the auditor. The reasons given for the auditor noticing the existence of fraud included: the detection of false invoices, delays in bankings, discrepancies between cash sheets and bankings, discrepancies noticed when seeking to reconcile the accounting records, or during petty cash, P11D or similar checks, suspicions caused by the lifestyles of the company directors, by the business in question not doing as well as would be expected or as well as similar businesses, and through the investigation of unlikely gross profit.

18% of respondents noted that fraud had been uncovered by the tax authorities (either VAT or Inland Revenue), with 16% noting that management had discovered the fraud. 4% of respondents commented that the fraud had been detected through the client's own control system, and a further 4% through an employee 'tip-off'.

13% noted 'other' reasons for the fraud's discovery. These included a change in personnel, external accountants preparing a quarterly VAT return and the management accounts, the Housing Benefit office discovering the fraud where the claim had not been declared to the accountant, by the accountant carrying out a non-audit assignment, or, in one case, following a grant application to the European Union.

Some respondents commented that the frauds they had encountered had not been particularly sophisticated or well-covered and suggested that any check of the company accounts would have resulted in their discovery.

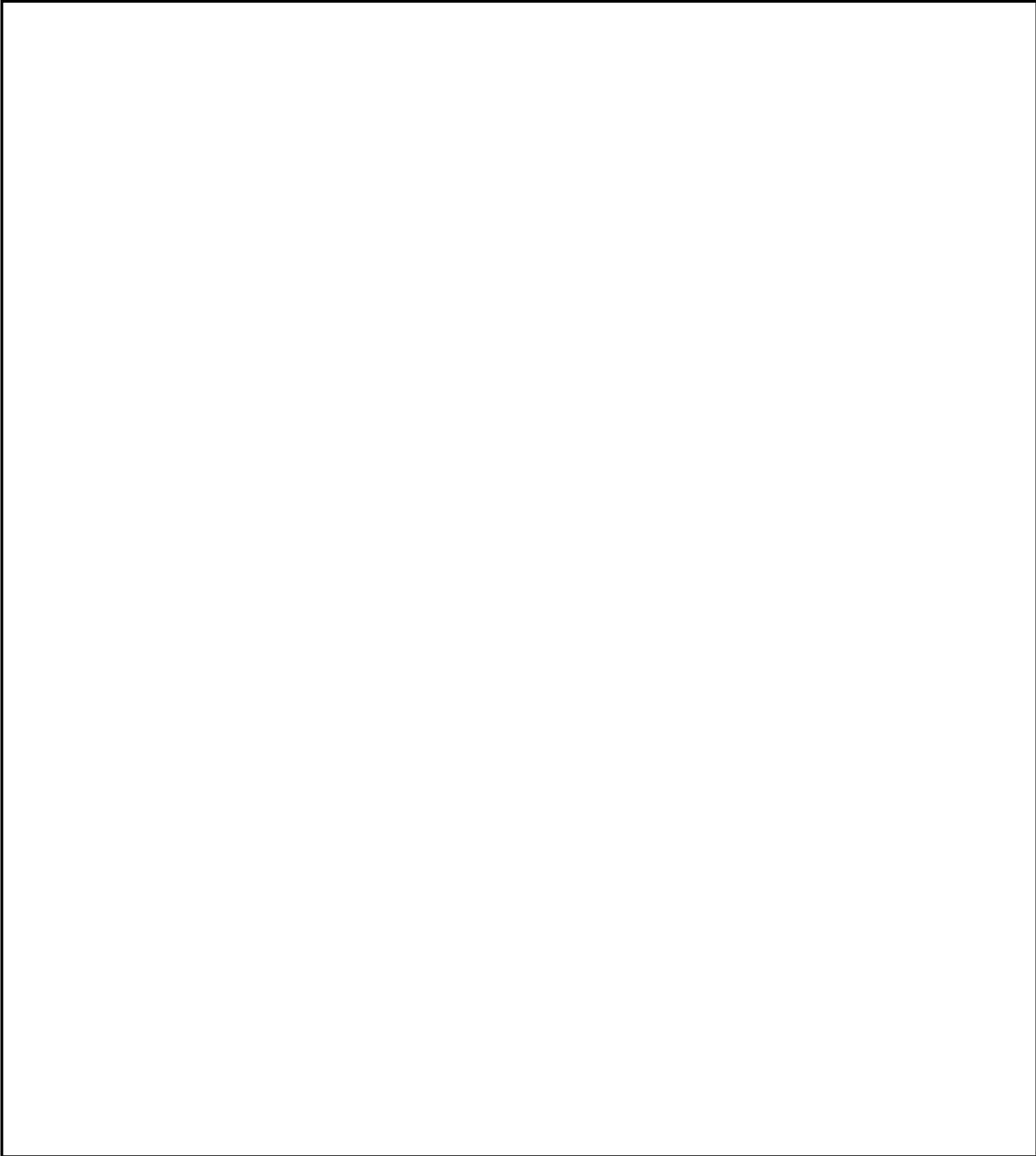
Bearing in mind that 75% of the cases experienced by our respondents involved owner-managers only, what is reflected here differs significantly from the APB's conclusion that management fraud is unlikely to be detected as part of the statutory audit of financial statements.

The Association of Chartered Certified Accountants

29 Lincoln's Inn Fields London WC2A 3EE United Kingdom

tel: +44 (0)20 7396 7000 fax: +44 (0)20 7396 7070 www.accaglobal.com





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Company: January 2001