Role of Internal Controls, Auditing and Accounting Standards in Prevention and Detection of Frauds

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1. Introduction

Frauds, manipulations and misappropriation of funds are the result of failures of administration and bad corporate governance. A great need has arisen for formation and mandatory compliance of the accounting and auditing standards prescribed by the Institute of Chartered Accountants of India (ICAI). To minimize frauds and embezzlements and to avoid recurrences of malpractices, there is need of good corporate governance, strong business ethics and mandatorily implementation of Auditing, Financial Reporting Standards and other compliances as prescribed by various regulatory bodies in the country. The companies which are registered with stock exchange/s must adhere to following up of security laws failing which these should be penalized with heavy fines and other strong punishments. There should be no loopholes in laws to avoid taking benefit by the unauthorized persons and statutory compliances are made in letter and spirits.

Fraud is a common phenomenon and has major impact in various economic sectors of all the countries. Frauds are result of human greed, shortcuts to achieve powers and earn easy money which encompasses deceiving, illicit and malpractices, hiding or misrepresentation of financial numbers for personal gains. This gives unauthorized benefit to the individual or third party on behalf of that individual. It is pertinent to note that the mistakes in presentation of financial statements do not constitutes fraud. This is a result of cheating, misrepresentation or deception and an intentional act to benefit unauthorized personnel or other persons for making money through short cuts and is done through unfair means. A survey by a reputed agency made in the past mentioned in their report that on an average five percent of the revenues is eaten through fraudulent activities which might amount to 3.5 trillion or more in total every year.

KPMG mentioned in their report on survey made through their 204 executives who studied the units having annual revenues of $250 million or more and found that around 65% of the respondents expressed that fraud was the highest risk in their organizations.

2100 professionals of Deloitte Forensic Centre team surveyed and found that around 46% of the frauds were done due to recession. As per survey done by "Annual Fraud Indicator 2012" the scale of frauds against all victims in the UK, is in the region of £73 billion per annum. In 2006, 2010 and 2011, it was £13, 30 and 38 billions, respectively.

2. Categories of Frauds

Reuber and Fischer (2010) stated that there are many news about revelations of organizations indulging in fraudulent activities. The people who might commit frauds or embezzlements can be divided into three categories. Top level executives like CEO or CFO, middle level managers or lower level employees like cashiers, riders etc.

The type of frauds may differ in all three categories. For example, CEO or CFO would indulge in fraudulent activities by manipulating data, giving false information for obtaining loans or misrepresentation and submission of financial statements to regulatory bodies and stock exchange for higher stock rates.

Similarly, the KPMG Fraud Survey (KPMG 1994, 1998, 2003) reported that around 10 percent of total frauds committed are significant. All the stakeholders are affected badly by the incorrect or manipulated financial reporting. It raises questions on creditability of the financial reporting systems or the accounting standards prevailing in that country. Foreign investors loose their confidence in stock market of that country. Not only this, it raises questions on the roles and integrity of regulators and statutory auditors. This has adverse effect on relationship with outsiders like sundry creditors, debenture holders, preference

and other shareholders. The damages creates bad image of that country in the outer world. Many persons lose their jobs in consequence.
Therefore, there is need of effective measures and proper mechanism to safeguard the goodwill and losing of assets due to fraudulent activities made by unauthorized personnel. The auditors' responsibilities need be revised and should be more specific and punishments for non compliance and for their professional misconduct should be heavy.
Pricewaterhouse conducted survey of Biennial Global Economic Crime in (2007) of more than 3,000 corporate in 34 countries and found that the increase in misrepresentation was increased by 140% (from 10% to 24%) which is a very serious concern though more strict controls had been implemented by the regulatory authorities and SOX after 2002. The major negative impact of such frauds is that the investors loose their confidence in stocks resulting adverse effect on the shareholdings and price of shares of that corporate. In most of cases, frauds are done by the directors and officers of corporate by misrepresenting the financial statements or presenting rosy pictures which in reality are not in existence in actual.
There are so many directors and officers of the corporate who are under scrutiny in regard to unethical or illegal practices. The need of the hour is of qualified and skilled professionals who could investigate in depth the weakness in internal controls, quality of corporate governance and the fairness of financial disclosures and statements the non existence of which had lead to frauds and misappropriations by the corporate (Bhasin 2008).
After a big scandal of Enron, following the legislative and regulatory reforms of corporate America, Sarbanes-Oxley Act of 2002 was introduced to alleviate such happenings in future. Cynthia Cooper and Sherron Watkins played the major role in exposing both scandals i.e. Worldcom and Enron. Basically, SOX Act played a big role in minimizing the frauds due to fixing responsibility of officials and close monitoring of the financial transactions.
The SOX Act, 2002 specifically fixed the responsibilities of the Auditors, Management, C.F.Os, C.E.Os and middle level managers to avoid frauds.
The biggest fraud of the century in corporate done by Mr. Ramalinga Raju, Chairman of Satyam Computer Services (Satyam) which was labeled as Indian Enron in India. This organization was having operations in 66 countries and he kept manipulating financial numbers to mislead the stock market. Moreover, there was question on the integrity of the audit company, a big four firm named as Price Water House whose licence was put under cancellation for some time after this scandal. Satyam Computer used to be fourth largest number software service provider company in India.

PWC in 2007 in its Bennial Global Economic Crime Survey of 152 organizations found that around 35 of the organizations had experienced fraud in previous to years and around 54 % reported they were suffering from economic related crimes.

3. Review of Literature

Jeffords (1992) examined 910 cases for assessing the risk factors mentioned in Treadway Commission Report. He opined that approximately 63 % of the risk cases are due to weak internal control systems.
Calderon and Green (1994) analyzed 114 actual cases of corporate fraud published in the "Internal Auditor" during 1986 to 1990. He noticed that around 60% of frauds were due to not proper segregation of duties, production of manipulated financial numbers and lack of internal control system. He further observed that in around 45% of the cases, persons at managerial level and professionals were involved.
Smith (1995) defined embezzlers are the persons who take benefit of the weaknesses of internal control systems and take advantage of the situation. He advised strict implementation of internal controls and selection of employees after thorough investigation of their background before employment.
Bologna and Lindquist (1996) examined that the basic reason of embezzlement is environmental.
Ziegenfuss (1996) studied the frauds happening in state and local authorities and opined that the category of frauds in most of the cases were misappropriation of funds, manipulated representation of financial statements and theft and fake invoicing.
Haugen and Selin (1999) mentioned in their research that the integrity of the Management is the major factor for frauds apart from poor internal controls and the advanced computer technology.
Brahma (2000) have found in their study that not checking and non compliance of the laid down systems, policies and procedures by the supervisory staff is the main reason of committing frauds by unauthorized officials.

Adeniji (2004:354) and ICAN (2006:206), *T*he fraud is a willful act of one individual or the group of persons to conceal, misrepresent or omission of truth which includes misappropriation, embezzlement or use the assets of the organization without authorization for the purpose of cheatin to one individual, the organization or the public at large.

Harris and William (2004), studied and drawn conclusion that in Banks the frauds were committed due to high turnover of employees and shifting of directors, appointment of persons who are not qualified for audit or accountants posts.

4. Role of Sound Internal Control System to detect frauds-

As per auditing standards of ICAI, the duty of implementation of strong internal control is duty of the Management. The root cause of all types of frauds, embezzlements and misappropriations is lack of internal controls in the organizations i.e. either the same are not in existence or are weak or there are many loopholes.

The following internal control measures would help considerably for prevention and detection of frauds-

1. Defining organization structure based on the philosophy of the Management and their modus operandi, i.e. authorities and responsibilities of the employees at all levels should be clearly defined and documented.
2. Maintain integrity, dignity, commitment for competence and ethical values
3. Clear Human Resource policies and procedures
4. Thorough investigation of employees before final selection
5. Defining of organizational objectives at each process level
6. Implementation of Enterprise Resource Solution (ERP) program
7. Financial transactions through digital modes only
8. Clear definition and implementation of accounting policies and procedures
9. Effective internal audit system
10. Identification of risk and its nature and suitable and early measures to control
11. Effective and strong data backup, security system (application network), data security and access by authorized personnel only.
12. Ongoing and effective monitoring system, reporting deficiencies and immediate action
13. Generation of quality information through ERP system
14. Effective communication channels amongst insiders and outsiders
15. Formation of Audit Committee having members who are key functionaries

5. Role of Standard Auditing Practices in detection of frauds

A controversial issue is whether the Auditors should be held responsible to detect and reporting of frauds and other illegal actions of the entities of which they are appointed in the capacity of Statutory Auditors. This issue of auditors responsibilities has more importance after the increasing trend of frauds at global level. In each country, the scope of work is defined by their respective Institutes of Accountants of that country. For example, in India the regulatory body is The Institute of Chartered Accountant of India (ICAI). In India the responsibility to detect frauds by auditors are in concurrence with the scope of work of statutory auditors and auditing standards defined by the Institutes.

In actual sense, the role of auditors with respect to detection of frauds has not been clearly defined and it is argued that primary objective of the auditors is to verify the accounts and financial statements and mention in their report whether these represent true and fair view of the financial transactions made by the organization during the year of audit. One more school has opined that the primary responsibility if prevention of frauds is of the Management and their responsibility is to ensure that the internal controls have been sufficiently in vogue and strictly followed.

If we go back to year 1920, the basic objective of the audit during those time was to detect frauds only, however, with the passage of time say in year 1930, the number of transactions increased and it was not possible by statutory auditors to check each and every financial transaction and the focus remained in

presentation of true and fair view of the financial statements only. They started claiming that the responsibility of prevention and detection of frauds rested with the management who would ensure that the internal controls have been sufficiently implemented in the organization.
At later years say in 1960, the auditors were under so much of criticism by shareholders, media and the public at large when the scandals in big organizations were brought to their notice and the auditors claimed that the detection of frauds was not their duty.
In 2005, after the fall of Enron, the duties of auditors were revamped in almost all over the world and in India presently, the auditors are bound to review and evaluate the effectiveness of risk management and mention in their report whether they have been sufficiently employed in the organization.
Considering the factors mentioned above, it is concluded that in case frauds, misappropriation of funds, embezzlements, manipulation and misrepresentations of financial statements, the auditors' scope of duties and responsibilities need be reviewed and revamped. In my opinion, it should be mandatory on their part to check and verify the documents and physical assets in details and clearly mention the weaknesses in internal control systems if persists so that precautionary measures are taken in advance by the Management to avoid financial losses. In case, the frauds comes in notice after the auditors have not qualified their report, the license of the Auditor should be cancelled apart from initiation of legal proceedings on the audit firm on account of professional misconduct.

6. Role of Accounting Standards in prevention and detection of frauds

Generally speaking, the lack of internal controls and weak system of accounting without having expert knowledge by the accountants has lead to the people to take advantages by committing frauds and and misappropriate or embezzle funds . Therefore, a systematic way of accounting following country's GAAP and accounting standards prescribed by the respective Institutes would give lesser chances to the persons to commit fraud by the individuals/groups.
In my opinion, the correct and uniform accounting would not only lead to proper comparison amongst other similar units but also give true and fair view of financial statements of the state of affairs. This will result to minimizing risk of frauds and embezzlement in the organizations.
As far as the accounting standards for education institutions are concerned, no standard is mandatorily applicable on them. However, ICAI has recommended that all the accounting standards from 1 to 32 except Accounting for Construction Contracts, Earning Per Share, Consolidated Financial Statements, Accounting for Taxes on Income, Accounting for Investment, Discontinuing Operations, Interim Financial Reporting and Reporting of Joint Venture should not be applicable on the Educational Institutions as the financial transactions of the Institutes are not related to for which the standards are prepared.
The ICAI has given its recommendation for education institutions mentioned as under-

1. Education Institutions to follow accrual basis of accounting
2. The accounting standards be made mandatory on them
3. Fund based method of accounting be applicable for designated types of funds
4. HRD Ministry to make program for training accountants on maintenance of accounts as per accounting standards

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