Why don't auditors detect fraud?

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(Submitted 3/7/2006 for publication in Strategic Finance)

The Fraud

Bill Carter was a dangerous person for a company – an angry, terminated ex-employee. For 22 years, Carter had worked for Cardinal Wholesalers, a Fortune 500 company that manages a nationwide chain of grocery stores, and had reached the level of purchasing department supervisor.[*] But Carter was fired for looking at inappropriate Web sites on his company computer. Out of work, in need of money, and mad at his former employer, Carter persuaded Mike Smith, Carter's replacement, to jointly perpetrate a fictitious vendor scheme against Cardinal. (The purpose of a fictitious vendor scheme is to trick the victim company into paying vendor invoices for which it receives nothing in return.)

Five years into the scheme, Carter and Smith had each pocketed $900,000. Then Carter drank to excess one night at a local bar and bragged about the scheme to a total stranger sitting next to him. Carter explained in detail how he and Smith had stolen $1.8 million from Cardinal and even divulged the name of the fictitious vendor, 'Tri-State Trucking.' The next morning the stranger called Cardinal and offered to sell the incriminating information for $250,000 to Debbie Roberts, Cardinal's chief loss prevention specialist. Roberts refused the stranger's offer and hired Fraud*wise*, a forensic accounting firm.

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[*]This case is based on an actual investigation conducted by the lead author. The names of the victim company and the various players have been changed to protect their privacy.

After two days, the forensic accountants identified Tri-State Trucking as a very suspicious vendor and questioned Smith, who was the only person to approve payment on the suspicious invoices. Smith admitted that Tri-State was a "bogus vendor" and that "the whole thing was Bill Carter's idea." The forensic accountants turned over their investigative report and documentary evidence to the FBI. The FBI successfully charged and convicted Smith and Carter for mail fraud, which is the fraud statute most commonly used to prosecute fraud cases. Carter was sentenced to 54 months in prison and was ordered to relinquish his $300,000 401K plan to Cardinal as restitution. In return for his guilty plea and testimony against Carter, Smith received 48 months in prison.

Questions

The fictitious vendor scheme perpetrated against Cardinal for five years was not discovered by its independent auditor, a Big Four accounting firm, during the annual audits of Cardinal's financial statements. The auditor's failure to detect the fraud understandably raises the following questions:

1. Why didn't the auditors discover the fraud?
2. Should the auditors have discovered the fraud?
3. Who is/should be responsible for detecting fraud?

To answer these questions we must first: (1) define two types of fraud, (2) understand the purpose of a financial statement audit, and (3) understand the objectives of a fraud audit.

Asset-theft vs. financial statement fraud

The Association of Certified Fraud Examiners offers the following definitions of two types of fraud. *Asset-theft fraud* is "the use of one's occupation for personal gain through the deliberate misuse or theft of the employing organization's resources or assets." Asset-theft fraud typically involves dishonest employees who have figured out a way to divert some of their employer's cash flow into their own pockets. The Cardinal Wholesaler case is a perfect example of asset-theft fraud. *Financial statement fraud* is "the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or

omission of amounts or disclosures in the financial statements in order to deceive financial statement users." This type of fraud, commonly referred to as "cooking the books," typically involves the overstatement of assets or revenues and the understatement of liabilities or expenses. Financial statement fraud is typically perpetrated by corporate executives whose compensation is closely tied to their employer's financial performance. The WorldCom fraud perfectly exemplifies financial statement fraud. Under the direction of Bernie Ebbers (CEO) and Scott Sullivan (CFO), WorldCom's accountants improperly recorded billion of dollars in expenditures as assets instead of expenses. Such improper accounting made WorldCom's financial position look much better than it really was and influenced investors and creditors to make economic decisions that ultimately resulted in billions of dollars in losses.

Financial statement audits

The primary purpose of a financial statement audit is to determine if a company's financial statements "present fairly" its financial position at a certain point in time. Investors, creditors, governments, and other stakeholders rely on financial statements for making economic decisions about a company. Since management is responsible for preparing the financial statements, someone independent of the company's management needs to vouch for the statements as being truthful and accurate. Such is the responsibility of the independent auditors, who provide assurance that the financial statements: (1) conform with generally accepted accounting principles, and (2) present fairly, in all material respects, the company's financial position. If properly planned and conducted, a financial statement audit should uncover financial statement fraud. If the auditors issue an opinion that the financial statements present fairly, when in fact they do not, they can be held civilly liable for any losses incurred by those who relied upon the misrepresented financial statements. Such liability was the downfall of Arthur Andersen, the independent auditor for Enron, WorldCom, Sunbeam and Waste Management—all of which were involved in financial statement frauds that resulted in billions of dollars in stakeholder losses.

Fraud audits

The primary objectives of a fraud audit include: (1) examine the system of internal controls in place for safeguarding assets, (2) identify any weaknesses in those controls, and (3) determine if anyone within the company has exploited the control weaknesses and misappropriated assets for personal gain. If properly planned and conducted, a fraud audit should uncover asset-theft fraud. However, it is highly unlikely that a financial statement audit will uncover asset-theft fraud. Why? Let's revisit the fictitious vendor scheme, an asset-theft fraud, perpetrated against Cardinal Wholesalers. The fraudulent payments made to Tri-State Trucking were recorded by reducing the cash account by $1.8 million and expensing the same amount on the income statement. Accordingly, the financial statements presented fairly Cardinal's financial position since both cash and net income had been reduced by the amount of the fraud. The independent auditors correctly concluded that Cardinal's financial statements presented fairly its financial condition.

Summary

In answer to the three questions posed earlier: The independent auditors didn't discover the fraud because the fairness of the financial statements was not impaired by the fraud. The independent auditors should not have discovered the fraud since detecting asset-theft fraud falls outside the scope of a traditional financial statement audit, which is designed to uncover financial statement fraud. A fraud audit, which is designed to uncover asset-theft fraud, is a separate engagement from a financial statement audit and requires auditing professionals with specific anti-fraud training and experience. The ideal fraud auditor should be both a Certified Public Accountant (CPA) and a Certified Fraud Examiner (CFE). Unfortunately, many companies who engage independent auditors to conduct a financial statement audit mistakenly assume they are buying a fraud audit. If a company's motivation for engaging auditors is because of concerns or suspicions involving asset-theft fraud, it should specifically request a fraud audit instead of, or in addition to, a financial statement audit.