

AN ANALYSIS OF SMALL COMPANY FRAUDS AND IMPLICATONS FOR AUDITORS IN DETECTING FRAUDS

Michael Ulinski
Pace University
mulinski@pace.edu

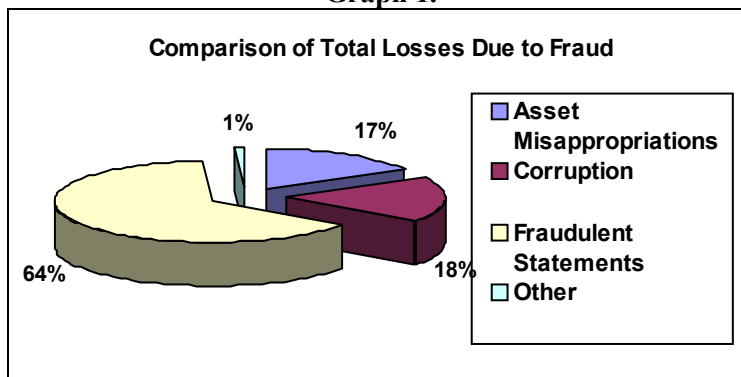
***ABSTRACT:** While much has been written about large company corporate frauds such as Enron, WorldCom, Computer Associates, and most recently REFCO, the risk of financial statement fraud and other frauds is not any less prevalent at small public companies. The researcher sets out to determine how these frauds compare to those committed by large companies. The researcher examined SEC Enforcement Releases and other data to determine if small company frauds are as common an occurrence as in large public companies and how they may be similar or different. Common types of frauds and their implications on small firm's auditors are suggested along with prevention and detection techniques. A risk approach as to how a small company might identify areas of vulnerability is applied. Special auditor attention is given to high-risk areas and audit procedures are suggested that could help identify possible misstatements caused by fraud. An audit risk approach suggested by professional standards and techniques from other fraud literature is used to refine findings. Cost/benefit analysis is recommended for small companies to consider when fighting fraud. Certain elements of Sarbanes-Oxley laws could also apply to these companies and help integrity of management. Particular application of ethics and codes of conduct might provide for internal prevention of some frauds. The guidance of corporate codes of conduct from large companies could be applied to smaller companies. Conclusions are drawn and recommendations for further research are made.*

INTRODUCTION

The growth in the US economy may well be in small company creation and start up company growth. The need for CPA firms with the capacity to service these emerging companies is becoming apparent. A major concern for investors and other users of financial statements is whether those statements are free of fraud or other material misstatements. The related literature seems to indicate that small company frauds are as common as large company frauds and may have special characteristics because of the lack of internal control in smaller companies. The researcher investigates the types of management fraud that is most common in small companies and suggests how the outside auditor might rely on recent guideline from COSO's smaller public companies internal control framework and applicable sections of the Sarbanes-Oxley Act (SOX).

Generally, frauds fall into one of three major categories: asset misappropriation, corruption or fraudulent statements. Fraudulent financial statement reporting is the type of fraud creating the greatest total losses, as indicated by the adapted graph below. (**Graph 1.**) In a study by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), an analysis of U.S. public companies was done to examine fraudulent financial reporting for the time period of 1987-1997. The data was collected from "instances of alleged fraudulent financial reporting by registrants of the U.S. Securities and Exchange Commission first described by the SEC in an Accounting and Auditing Enforcement Release (AAER) issues during the period 1987-1997." The study focused on "alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 18(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial statement reporting." The search identified almost 300 companies accused of fraudulent financial reporting during the 11 year period, from which a final sample of 200 companies was taken.

Graph 1.



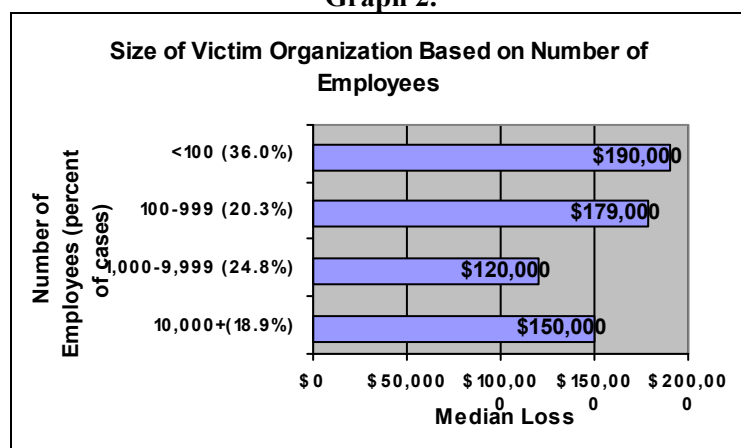
*Represents size of misstatement rather than actual cash loss

**Adapted from *Occupational Fraud and Abuse* by Joseph T. Wells CFE, CPA

The study found that most of the companies committing financial statement frauds were small companies and “the typical size of most of the sample companies ranged well below \$100 million in total assets in the year preceding the fraud period.” Most of these companies, 78%, were not even a listed on the New York or American Stock Exchanges. (COSO p. 5) Fraud amounts in total were large in relation to the small sizes of the companies involved in the fraudulent financial reporting schemes. The average fraud was “\$25 million and the median was \$4.1 million.” The average company’s total assets were \$533 million and the median company had assets totaling at only \$16 million.

According to the most recent Report to the Nation on Occupational Fraud and Abuse by the Association of Certified Fraud Examiners (ACFE), small businesses, those with fewer than 100 employees, tend to suffer disproportionately large fraud losses as indicated by the graph below. (Graph 2.) The median loss for fraud cases attacking small organizations was \$190,000, which exceeded the median loss for cases in any other group. Small organizations were also the most heavily represented group, making up 36% of all frauds in the study.

Graph 2.



*Adapted from the 2006 Report to the Nation on Occupational Fraud and Abuse by the Association of Certified Fraud Examiners (ACFE)

According to the Federal Bureau of Investigation, as reported by the AICPA Corporate Finance Insider Staff from a recent AICPA/FBI Webcast, corporate fraud has yielded the following statistics since the implementation of SOX in 2002:

Table 1.

Corporate Fraud Since Sarbanes Oxley (2002)* **
Over 400 cases of corporate fraud are pending
Restitution totaling over \$1 million
561 indictments to date (320 C-class executives)
379 convictions to date
3 to 6 new cases opening per month

**Adapted from "Small Company Financial Fraud" by AICPA Corporate Finance Insider Staff*

***Statistics as of January 5, 2006*

The April 2005 edition of the Institute of Management & Administration’s (IOMA) Report on Financial Analysis, Planning & Reporting also states that small companies are the target of majority of the SEC’s financial fraud cases. Only 20% of the cases brought forth by the SEC are high profile financial reporting fraud cases. The IOMA continues to report that the vast majority of frauds involving smaller companies never make it to the press or general public. According to Susan G. Markel, SEC chief accountant in 2004, only 37 of 179 financial fraud actions were Fortune 500 firms.

One of the authors of the COSO fraud report, Joseph Carcello, a University of Tennessee professor, states that about 75% of companies subject to fraud allegations described in SEC enforcement releases from 1998 to 2003 had market capitalizations of less than \$700 million, and 40% had market capitalizations less than \$100 million. (Rapoport 2005)

COMMON TYPES OF FRAUD

Examining the common types of financial statement frauds, the most typical frauds were the overstatement of revenue and assets as shown in the adaptation of a table reported in the COSO study below. (**Table 2.**) Over half of the frauds accounted for fictitious or prematurely recorded revenues. “About half the frauds also involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant, and equipment and other intangible assets, and recoding assets that did not exist.” (COSO p. 6)

Table 2.

Methods Used to Misstate Financial Statements	% of the 204 Sample Companies Using a Fraud Method
Improper Revenue Recognition Recording fictitious revenue- 26% Recording revenues prematurely 24% No description/ “overstated” 16%	50%
Overstatement of Assets (excluding A/R account due to revenue fraud) Overstating existing assets – 37% Recording fictitious assets - 12% Capitalizing items that should be expensed – 6%	50%
Understatement of Expenses/Liabilities	18%
Misappropriation of Assets	12%
Other Misc. Techniques	20%

**Table adapted from Fraudulent Financial Reporting 1987-1997 An Analysis of U.S. Public Companies by COSO*

**Based on sample selected by COSO researchers*

**Subcategories such as premature revenues or fictitious revenues and assets do not sum to the category totals due to multiple types of fraud employed at a single company*

Markel is quoted in the IOMA’s report of “Small Companies Target of Majority of SEC Financial Fraud Cases” as stating a number of common financial fraud schemes that have been uncovered by the SEC. These schemes include premature revenue recognition, excess reserves to smooth earnings, improper accounting for vendor rebates, improper capitalized costs, related party transactions, and undisclosed compensation among others.

The 2006 Report to the Nation on Occupational Fraud and Abuse by the Association of Certified Fraud Examiners (ACFE) also identified the most common types of financial statement fraud schemes as shown in the adaptation of a table reported in the ACFE study below. **(Table 3.)** According to the study, financial statements are manipulated through one of the following five methods: “(1) reporting fictitious or overstated revenues; (2) concealing or understating liabilities or expenses; (3) timing differences – recording revenues or expenses in the wrong period; (4) improperly valuing assets; or (5) failing to disclose significant information such as contingent liabilities or related-party transactions.” (ACFE p. 16)

Table 3.

Financial Statement Fraud Schemes		
Category	Description	% of FSF Cases
Concealed Liabilities	Schemes in which financial statements are misstated by improperly recording liabilities and/or expenses.	45.0%
Fictitious Revenues	Schemes in which financial statements are inflated by recording sales of goods or services that never occurred, or by inflating actual sales.	43.3%
Improper Asset Valuations	Schemes in which the value of an organization’s assets is fraudulently misstated in the organization’s financial statements.	40.0%
Improper Disclosures	Schemes in which management fails to disclose material information in its financial statements in an attempt to mislead users of the financial statements.	37.5%
Timing Differences	Schemes in which financial statements are intentionally misstated by recording revenues in a different accounting period than their corresponding expenses.	28.3%

** Table adapted from the 2006 Report to the Nation on Occupational Fraud and Abuse by ACFE*

** The sum of percentages exceeds 100% because a number of cases involved more than one method of falsifying financial statements*

IMPLICATIONS FOR THE COMPANIES INVOLVED

The COSO’s fraud report discusses the implications of fraud for the companies involved. Since these companies are mostly small, there seems to be an unwillingness or incapability to implement internal controls in a cost-effective manner, which leads to the opportunity for financial statement fraud. Just to name one possibility of weak internal controls in small companies that is infamous: the overriding of controls, which is easier here than in larger companies. The study speculates that companies may not be hiring senior executives with sufficient knowledge and experience in financial reporting. A benchmark for internal controls needs to be set and contributions need to be made by audit committees, boards, management, and auditors together.

Regulators and stock exchanges should evaluate, says the COSO study, the tradeoff benefit of designing policies that will exempt small companies. Regulators need to focus on the smaller type of companies, where the frauds are actually occurring more frequently.

Discovering fraud committed by a company or within a company can mean the demise of the entity. The table below illustrates the status of companies after fraud was disclosed. (Table 4.) The table is adapted from the COSO Fraud report and based on the sample they took between 1987 and 1997. 36% of the fraudulent companies examined went bankrupt or defunct. About 21% delisted from the national stock exchange, while others were merged into other companies, sold off pieces of their business, or ended up changing ownership in the form of stockholders. (COSO p. 38)

Table 4.

Status of Companies After Fraud Disclosed		
<u>Company Status Subsequent to the Fraud</u>	<u># of Sample Companies Affected</u>	<u>% of Sample Companies Affected</u>
Bankrupt, defunct	73	36%
Changed ownership		
-Sold large portion of assets	6	3%
- Merged with another company	15	7%
- Experienced change in controlling shareholders	10	5%
Total	31	15%
Delisted from the national stock exchange	42	21%

**Table adapted from Fraudulent Financial Reporting 1987-1997 An Analysis of U.S. Public Companies by COSO*

IMPLICATIONS FOR THE CONTROL ENVIRONMENT

According to the COSO Guidance on Internal Controls, “the control environment component (of the internal control framework) is the foundation upon which all other components of the internal control are based. A strong control environment, particularly in a smaller company setting, can partially compensate for internal control deficiencies in other areas and often is viewed synonymously with the ‘tone at the top’.”

Monitoring the pressures faced by senior management, such as market expectation, compensations plans, etc, is crucial to the nature of the control environment. Knowledgeable executives can be a good and bad; good because they can help to educate other executives about financial reporting issues and can avoid aggressive reporting, and bad because such knowledge can be used to construct a fraud.

Audit Committees are crucial, even in smaller companies. There is a concentration of fraud of companies with less than \$50 million in revenues who have weak audit committees, pointing out the importance of strong audit committees in smaller companies. The number of committee meetings and expertise in the financial field should come under the microscope.

As a result of frauds mostly resulting in misstated revenues and assets, more attention needs to be made to interim reviews. More audit procedures related to transaction cutoff and asset valuation maybe considered. According to the COSO Fraud report, “based on the assessed risk related to internal control, the auditor should evaluate the need for substantive testing procedures to reduce audit risk to an acceptable level and design tests in light of this consideration.”

IMPLICATIONS FOR AUDITORS

SAS 99 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.” Professional skepticism is needed for auditors to look beyond just the financial statements and understanding more about the business and its risks unique to the industry, possible motivations of top management (including compensation plan structure), and internal controls of the company. In cases where the control environment is weak with a weak board and audit committee, audit risk should be increased accordingly before going forth with the audit.

According to COSO, the types of audit reports issued by the auditors on the last fraud financial statements were inconsistent. The results can be seen in the table below. (Table 5.) 55% of the audit reports issued on the fraudulent companies were unqualified opinions, meaning that auditors were not picking up on fraud which was revealed not too long after the release of the audit report. Only 3% of the sample had a disclaimer of opinion. The implementation of SAS 99 needs to be emphasized and applied correctly to audits of public companies for the sole reason that auditors need to be aware of fraud implications to the company and how it is reflected in the financial statements. (COSO p. 36)

Table 5.

<u>Types of Auditor Reports on Last Fraud Financial Statements</u>		
<u>Type of Auditor Report</u>	<u>Number of Reports by Type</u>	<u>Percentage of Audit Reports by Type</u>
Unqualified Opinions	78	55%
Modified or Qualified Reports	59	42%
Going Concern- 19 reports		
Litigation uncertainties- 9 reports		
Other uncertainties- 9 reports		
Change in accounting principle- 15 reports		
Change in auditor across Comparative Reporting periods- 20 reports		
GAAP Departures- 4 reports		
Disclaimer of Opinion	4	3%
Number of Auditor Reports Available for Review	141	100%
*Above do not sum to equal the 59 modified or qualified reports because some of the reports addressed more than one modification / qualification issue		

**Adapted from COSO Report on Fraud*

FRAUD PREVENTION THROUGH CODE OF CONDUCT

In the article “Small Business – Where Fraud Can and Does Occur,” the West Virginia Society of Certified Public Accountants talks about the importance of implementing company-wide written code of conduct that “is clearly and concisely communicated to all personnel.” Allen DeLeon, founder of the Maryland firm DeLeon & Stang, states that “Typically fraud is prevented by controls, but just as important is creating a leadership style and culture in which fraud absolutely unacceptable ... We find that the combination of the two is most effective.” SAS 99 provides an exhibit that details how to create a code of

conduct, develop a company culture with zero tolerance for fraud, and design systems that reduce the risk of fraud. (WVCPA)

CONCLUSIONS AND RECOMMENDATIONS

While knowledge gained from surveys of fraud categories and SEC enforcement releases on small companies, the auditor needs guidance from the professional organizations and regulating bodies to properly plan and possibly detect fraud in financial statements. Small companies may become the economic engine in the coming years. Auditors may need to be well trained and equipped to provide the public with transparent, useful financial statements free of fraud or other material misstatements. While COSO for small companies and applicable SOX provisions may help the auditors during their examinations, a code of conduct and self policing by small companies may well be the best way to assure the public of good governance and quality financial statements. A continued emphasis on internal controls for small companies is recommended as well as due diligence by the accounting profession.

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