THE EXTERNAL AUDITOR’S RESPONSIBILITY IN DETECTING FRAUD

Ignoring material facts, an absence of internal controls, and a “one-man show” management style might all contribute to a successful fraud in financial statements. The external auditor’s role requires reviewing and reporting on financial statements with transparency and fairness while supporting management’s integrity. This session explores how to examine financial statements to detect potential issues, determine mistakes from intentional wrongdoing, and how to proceed once a fraud is uncovered.

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# THE EXTERNAL AUDITOR’S RESPONSIBILITY IN DETECTING FRAUD

## Introduction

### Speaker’s Opinion

Fraudulent Financial Statements (FFS) are currently a crucial issue. This is because no one can imagine that External Auditors (EA) would intentionally act against the principles or standards of the integrity and transparency that they must believe and follow in accordance with the performance of their duties and responsibilities. Unfortunately, this is because the rules of governance, professional ethics, and standards all recently became a sonorous logo that is not practically implemented in reality.

In absence of the supervision or control over EA’s work, we might expect corrupt outcomes. The reaction by the professional community regarding EA issues and their questionable involvements in doing business is a total mystery. Everyone knows the tremendous destructive effect of the issuance of a FFS, but no one even blinks. The reaction is always focused on the wrong act and detrimental consequences, but no one thinks or talks about the remedies or what can we can do to stop this devastating, intentional act of negligence.

Are they untouchable? Or what is happening? Are they inviolable like PEPs (Politically Exposed Persons)? I believe that now is the time to highlight EAs’ acts of negligence. How is it done? Why is it perpetrated? And what are the suggested remedies to stop such terrible acts?

## The Issue

- Many fraud offenses occur in huge amounts due to management defrauding its books and records. It manipulates them to show purposely something unexpressive of its real financial and income statements. This is done for many reasons, but the most
important one is that it is done for a personal illegitimate gain for the top management personnel.

- Another reason is to maintain growth of net income of the company to enable it to compete in the stock market and keep its price shares stable in the secured zone to avoid the unexpected fluctuations.
- Obviously, management manipulation is tailored in some instances professionally with assistance of the external auditors (EA). The common approach of doing this is through overstating the revenue.
- Defrauded Audited Financial Statements (DAFSs) are released after management alters its books and records and the EA signs off on the auditor’s report.
- DAFS means that FS amounts, balances, and/or disclosures are intentionally misstated (defrauded) for a purpose by management and the EA authenticated it.
- Approved and issued DAFS by the EA are assisting the fraud perpetrator (management of the client’s company) in communicating the manipulation and justifying it to the stakeholders. Then it seems that everything is right and correct.
- Many issued DAFS ignore intentionally an important disclosure that if disclosed, they will turn upside down the whole net income reported and/or threaten the ongoing concern of the company.
- Some DAFS show improper disclosure or ignore material qualification to satisfy its client’s management because expressing it would threaten the client’s business or reputation.
- Some other DAFS offenses are reporting an understatement of net income or even reporting a loss purposely for tax evasion.

Who Is Primarily Responsible? For What?

- The EA is primarily responsible for issuance of an approved DAFS that contains altered financial data and
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- Information. It becomes a fact because if these DAFS are not issued, then it couldn’t be published to the public; therefore, consequential damages wouldn’t happen. The company’s management is also responsible for reporting manipulated (forged) financial data or information.

- Collusion between the EA and the management of the company comes to light to satisfy management’s interest. The EA obeys management’s claims after debates and might fight for each concept. At the end of such debates, auditors acquiesce. Because the EA does not want to lose the client, he has to accept its requests to maintain his revenue; otherwise, refusing crucial demands of the client could cause him to lose the business gradually.

- Under many laws, the EA would be punished if his negligence was proven. Punishment ranges from suspension of doing business, fines, and closure to prison—which is virtually rare.

- In absence of supporting proof of intentional negligence, most EAs feel that is hard to prove their failure to disclose fraud intentionally, especially if they are not obliged to detect fraud based on any standards, regulations, or even principles or customariness.

- Therefore, absence of supervision over EAs’ activities encourage them to commit negligence intentionally if it would satisfy their clients without them being hurt. Because at the end of day, everyone calls it negligence. People believe that negligence is something fishy, debatable, clouded, and not clear, and that no one can accuse EAs not only on the basis of a law but rather to prove their responsibility in cooking the client’s books and records.

- Responsibility of the EA occurs when he signs off on the auditors’ report along with his client’s financial statements (first statement of the Financial Position or
Balance Sheet)—which include one or more of the offences explained above—without expressing any qualified opinion or disclosure footnote to the DAFS.

- However, the definition of offence is known to many. But, there is no one who can say it. How difficult and unfair it is when you feel that the one who should defend and protect you is the same one who deceives you.

How Is a DAFS Issued?
- Issued DAFS contains fictitious Auditors Report (AR) which unexpressed a real fact existed or expressed a fake information that it shouldn’t be declared (Sometimes Ignore material disclosure/closed eyes).
- The very famous statement in the auditor’s report, “fairly represented,” is a joke and a routine form that must be filled out as a normal course of doing business, and no one considers what it means or how it can be important and affect many stakeholders.
- The clean (unqualified) AR is usually issued regardless of the consequences, except an issue that the EA feels could compromise auditors’ integrity. Only then, auditors in this case work carefully in their favor to ensure they are not affected (untouchable) or accused of negligence because of an omission of a disclosure, improper disclosure, or hiding material qualifications. They have to be sure regarding meeting their client requests safely without being questioned. Material auditors’ findings that affect their opinion to release qualified/disclaim reports are negotiated with management before such findings are disclosed.
- However, management always wins the debates because they are using rationalizations to convince auditors that the management’s and company’s reputations will be at risk if their requests are refused. Obviously, auditors would accept transferring
management’s risk to themselves because they know the risk of hiding or ignoring material issues by them would not have the same impact on them personally if the risk is disclosed. The auditors always go with what benefits the client. The EA works to satisfy their client’s needs but without incurring losses.

- Sometimes audit fees carry overvalued prices. Why is that? Because auditors here are doing additional, special hidden services besides their normal business. (Some suspicious overvalued audit and consultation fees, contracts, and investigations exposed a corrupted collusion between the audit firm and the client to share the illegitimate personal gain from the difference between the overvalued price and the normal price of the contract.)

- Audit fees currently do not fit the cost incurred to cover all of the auditor’s visits. Mostly because of the high cost of qualified auditors’ resources and increased cost of living standards. However, the small and medium audit firms (even big, in the meantime) reduce their audit fees to compete, as well as to gain more clients to cover fixed costs. This obviously would affect the audit quality. The audit coverage percentage of external audit assignments, if performed properly and professionally, would be minimal. This is not an excuse to participate in wrong acts to overcome the issue, but rather an explanation for poor audit outcomes.

- Interviews with auditors revealed that the reason they did not disclose material facts in their auditor’s report due to many unrealistic excuses, which most of them related to the following statements: “It is not our responsibility to detect fraud,” “This is not our business,” “We didn’t know that there was a fraud,” “We give our opinion only and we are not obligated to detect fraud,” and so many other excuses.
Unfortunately, there is nothing clear and specific in any law or regulation—civil, criminal, or commercial, even auditors’ profession law—to put the burden of proof of the wrongful act (fraud) on the EA, but alternatively, it is a prosecutor’s and FE’s (investigative parties) responsibility. Therefore, to prove that the auditor intentionally participated in a wrongful act is almost a challenge.

That is why EAs are untouchable; not because they have any power or authority that prevents them from being accused, but because there is no adequate rule that may impose supervision and control over their business activities or exercise real punishment other than punitive damages over the convicted when failed. Most of the cases that involve EAs are settled out of court by the prosecution (not transferred to court) if the EA agrees to pay the determined damages plus a fine equal to the cost of the damages they caused.

The EA accepts his client’s requests to retain him because nothing would prove that fraud existed while doing the audit, and he knows it.

The EA knows that there is nothing in any law that might accuse him of not informing the respective authorities of a fraud that could be perpetrated.

Eight Key Accounting Principles with an Emphasis on Fraud: Materiality

According to the generally accepted accounting principles, *materiality* is a user-oriented concept. “If there is a misstatement so significant that reasonable, prudent users of the financial statements would make a different decision than they would if they had been given correct information, then the misstatement is material and requires correction.”
Matching
The matching concept requires that the books and records and the resultant financial statements match revenue and expenses in the proper accounting period. Fraud can occur when purposeful attempts are made to manipulate the matching concept.

Conservatism
An example of conservatism in accounting is the use of lower-of-cost-or-market rule as it relates to inventory valuation. If the market value of inventory falls below its original cost to the company that is currently on the books (e.g., technology that has become obsolete), the inventory must be written down to its market value, thus lowering the asset valuation of the company. If a company’s financial statements intentionally violate the conservatism constraint, they could be fraudulently misstated.

Going Concern
Concept assumes the business will go on indefinitely in the future. If there is serious doubt about whether a business can continue, the management of the company must disclose this information as a footnote in the financial statements. For example, assume a company is in the computer parts manufacturing business. Last year the company earned $200,000 after taxes. This year management is aware that new technology will make the business totally obsolete, and by next year, the business will likely close. Financial statements could be defrauded if a going concern issue was ignored from a footnote in the financial statements.

Cost
GAAP require that most assets be carried on the financial statements by the exchange transaction, as this
is generally the most conservative method. This figure is referred to as *historical* or *acquisition cost*. However, there are some exceptions to the historical cost principle. If the assets are worth less than what they cost, this lower value is to be carried on the financial statements.

**Objective Evidence**
Another GAAP that is often impacted by fraud deals with the subject of objective evidence. Accounting records are designed to be kept on objective, rather than subjective, evidence. That is to say, almost everyone can agree on what the asset costs historically versus what it might be worth at the present time. In valuing assets on the financial statements, the accountant looks for objective evidences of the asset’s cost—an invoice, a canceled check, a contract. Built into this assumption of objective evidence, but not specifically stated, is that such evidence can be presented fraudulently; a document can be forged or faked. So the evidence used by the accountant to value assets at their cost does not have to be absolute, only reasonable.

**Consistency**
In order for financial information to be presented fairly over a period of time, the method of presentation must be consistent, even if it is not the most accurate measure from year to year. For example, one easy way for the value of assets and income to be inflated is through the depreciation methods companies use on their books. By switching depreciation methods from one year to the next, and if these changes have a material impact on the financial statements, the company must disclose the changes in the footnote to the financials. Fraud often occurs when consistency is intentionally avoided to show false profit.
**Full Disclosure**

The principle behind full disclosure, as in the consistency example, is that any material deviation from GAAP must be explained to the reader of the financial information. In addition, any known event that could have a material impact on the future earnings must be explained or disclosed. Many major financial statement frauds have been caused by the purposeful omission of footnote disclosure to the statements. For example, if the company is being sued and is in danger of a material monetary judgement, that must be disclosed in the financial. However, avoiding such disclosure represents a fraud.
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FFS Types

Financial Statement Fraud

- Assets/Revenue Overstatements
  - Timing Difference
  - Fictitious Revenue
  - Concealed Liabilities & Expenses
  - Improper Disclosure
  - Improper Asset Valuation

- Assets/Revenue Understatements
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<tr>
<th>How to Detect FFS (Documents Review)</th>
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<tr>
<td>❑ Read the auditor’s report (AR) carefully.</td>
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<tr>
<td>❑ Scan if there is any qualification, disclaimer, or adverse opinion.</td>
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<tr>
<td>❑ If there is a qualification, read it thoroughly and try to analyze the wording into figures that matches with the related notes to the financial statements if available or to the statements figures itself.</td>
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<td>❑ In case of a disclaimer/adverse opinion, suspicion is too high; therefore, a full analytical review should be performed to discover why the EA disclaimed/adversed his opinion (very rare).</td>
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<td>❑ Compare the qualification to the related IFRS or GAAP topic to ensure that proper disclosure by both the management and EA has been fulfilled.</td>
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<td>❑ Check the correctness, completeness, and accuracy of the disclosure to ensure that it does not omit any material paragraph that must be expressed.</td>
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<tr>
<td>❑ Check and assess the materiality of the qualification by assessing its related value to the net income (profit), assets, liabilities, and equity to determine the nature of its effect on the stakeholders.</td>
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<td>❑ Perform an analytical review to the FFS balances in view of the value of qualification to uncover any omission or avoidance of other facts that must be expressed but were ignored for a reason.</td>
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<td>❑ Be careful of tricks, as sometimes an incomplete qualification is being disclosed to satisfy some FS readers, but not all of them.</td>
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<tr>
<td>❑ If the auditors’ report was clean (no qualifications), read the financial statements carefully and perform the analytical review over the statements with its comparatives, scan for unjustified fluctuations or overstatements/understatements, unexpected fall or rise in the expenses, revenue, etc.</td>
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- Once a difference, mistake, departure from GAAP or IFRS, or any offence is detected, immediately take a note in details to identify the offence, its nature, its value, its effect, and related damages in value if possible.
- Determine the name of the perpetrator (if the criminal act involves a group of persons, section, or department, then the name of each employee/person of the group, or section, or department must be identified separately because under the criminal law, an accusation cannot be assigned to an entity), his title in the company if he is an employee, or his relation to the company if he was outsider, and whether there is any correlation or collusion with an insider.
- Collect the direct and supporting evidence, if available, and get copies, but bear in mind that these copies must show signatures, names, titles, and level of the authorized signatory. However, it’s important to get a copy of the company’s authority matrix and CR for reference.

### Interviewing External Auditors

If you could not obtain direct evidence of the offence detected during your documents review, then you might get such evidence by interviewing the EA.

- Do not forget that we are not a jurisdiction authority to judge the EA; on the contrary, a polite and respectable interview should be maintained.
- By doing this we will be able to get the EA’s whole story.

Always respect anyone who is interviewed. Try to understand his point of view, and show him that you have the ability to realize his motives. Here, there is no admission to be obtained, but rather a cause of action to know why the EA issued a fraudulent financial statement.
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There is always a strong link between the EA and the company’s management. The agreement between them was made in a private meeting. Such meetings take place between the EA’s partner in charge of the company and the CEO of the company. But execution of what they agreed on are represented and performed by the company’s FM and auditor in charge of the assignment. In most FFS cases in small- or medium-size companies, to overstate revenue, a journal voucher (JV) is passed in the company books and records by the FM, and the EA approves it to affect their AFS draft for discussion before finalizing the AFS. In many cases, the JV is signed only by the accounts manager and not approved by FM to keep himself out of responsibility (just a wrong belief). But as per law, failing to sign any document by anyone does not exempt him from being accused if his responsibility and duties require doing so.

However, if you find such a JV during your interviewing process, obtain a copy of it immediately, and ensure that it has been approved by anyone from the FD, posted accordingly to the company ledger, and included in the audited financial statement that has been approved and issued by both the CEO and the EA’s partner. Then you’ve got direct evidence if was not obtained from the document review.

If interviewing the EA didn’t reveal supporting evidence of the wrongdoing, interviewing the client’s personnel might expose particular information that would lead to the supporting evidence.

### Identify the Perpetrator (Accused)

The primary accused is the one who signed off on the auditor’s report of the AFS and the first statement (partner in charge), and the secondary person responsible and
accused is the one who signed off on the first statement of the DAFS (Balance Sheet), who could be a CEO or chairman, depending on the company’s organizational chart and structure. The reason the audit partner is the primary accused is that without his approval of the FFS (DAFS), it would have not been issued and published to the public or stakeholders. The CEO’s or chairman’s accusation is because he participated in the wrongdoing and facilitated the production of the FFS by the EA’s partner. The perpetrator should be identified by name, occupation, or title, and a copy of his ID and cell phone number must be obtained for easy reference and summons.

Writing a Report
The report should be presented to the prosecutor in charge for the notification under examination by the CFE or (expert, consultant, etc.). It must be written in conclusive straight forward language, and short statements are preferable to get to the point. Long statements, telling stories, nonconstructive words are not favored. The report should contain the answers to the main information requested by the prosecution who drafted the commission letter issued, and delivered it to the CFE. The information is as follows:

- Define the nature of the offence and its value.
- Define the name and occupation of the perpetrator.
- Obtain the evidence/proof of the offence.
- Attach all supporting documents to the report.

Felony Versus Misdemeanor
Felony involves criminal law only. Fraud cases, bribery, and embezzlement that involved public funds, entities, or officers are classified as a felony in the penal code (for most Arabic countries). Imprisonment for felony fraud charges is from three to ten years.
A civil action, as opposed to criminal action, is an action for wrongdoing that does not result in a criminal fine or incarceration. Civil actions involve disputes that are not of significant public concern.

However, the CFE or investigator in fraud cases must determine the act first. In public prosecution, all cases are considered criminal acts (felonies). If investigation of a case determine that the offences involved were not criminal, then the prosecutor would retain the case and no more actions or investigations are to take place. The plaintiff may take the case to court if he wants a solution, remedies, or compensation for the damages incurred.

Examination of fraud cases in public prosecution in Arabic countries involve public funds frauds, embezzlement, and bribes, all of which are considered felonies and punishable according to penal code articles.

**Current Situation (Circumstances)**
Everyone knows from the social media networks that financial statements frauds become very dangerous on many parties and have a tremendous negative effects over not only stakeholders but rather than the whole economy of a country.

PWC faces three major trials that threaten its business for alleged negligent audits. An unfavorable verdict in the trial currently playing out in a Florida state court could inflict a significant monetary wound. That, combined with a possible unfavorable judgment in another trial scheduled for federal court in Alabama in February of 2017, and the third in a Manhattan federal court within the next year, might be fatal. *The trial has the potential to influence public perception of auditors, as well as strategies used by*
the plaintiff’s lawyers that try cases against them, regardless of the eventual verdict.

Because of that and the history of actual cases, I believe we need a change in everything that relates to external auditors. Their role MUST be restructured toward protecting businesses and the economy from collapse and not be limited to expressing an opinion on the fairness of the financial statements of a business or company.

We believe that a major reengineering process should be made to the audit standards, ethics, and regulations that regulate the whole profession in light of fraud detection responsibilities by external auditors.

**Suggested Remedies**

- External auditors’ work MUST be supervised by upper authority or a committee that has the power to do so.
- Audit report text format MUST be restructured to reflect more specific responsibility towards detecting fraud that can be measured by the prudent person.
- Identify what *fraud detection* means to the EAs specifically to limit the exposure of their responsibility to certain defined red flags that if uncovered must be declared by them and reflected accordingly if they are material in their auditor’s report.
- Failure to do so MUST be met by prompt, strict action by legal authorities that have a power for judgement to take proper and quick action against any failure made by the EA.
- Finally, the audit standards MUST be redesigned to contain specifically the following:
  - Fraud detection definition for EAs
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- Fraud detection responsibilities of EAs
- A mandatory special paragraph in the auditor’s report concerning fraud detection stating that if there is any fraud cases reported or not during the audit, if uncovered, a full disclosure of the nature, materiality, and effect of the fraud on the company’s results/financial position
- Such paragraph is to be disclosed to put the fraud’s burden of proof over the EA in the event of any fraud uncovered after signing off on the FS.
- EA ethics should be modified to include articles regarding fraud detection by the auditors and punishments in the event of failure to report fraud.

- The audit standards should be more efficient in relation to a fraud detection process. EAs’ scope of work should be modified to include a fraud detection process that states that the EA’s responsibility in detecting fraud is not a target, but if uncovered during the audit, it will be his responsibility to disclose it with its effect over the whole financial statements in a special paragraph as explained.
Case Study
Misleading Concept

Ben is a chief accountant who takes care of day-to-day accounting transactions, recording, and bookkeeping functions in a real estate company. Ben reports directly to the financial manager who is reporting in turn to the CEO and chairman of the company and the group. The real estate company is a subsidiary of a group of companies that consists of two more subsidiaries, a brokerage company, and an IT company. The chairman/CEO of the group has concerns about the net profit of the holding company, which is declared every quarter of the year, whereas the three subsidiaries and the holding company are listed on the stock market. Ben’s main objective was to maintain the growth of the net profit every quarter to ensure that the listed share price did not go down. This objective, in fact, is normal and legitimate, but the way it was done was not.

At the end of the third quarter of 2010, the net profit of the holding company was less than the second quarter by about $3M. This was because of a decrease in revenue of the real estate company due to a shrink in demand for land plots as a result of price increases. This resulted in a decline of the net income (profit) of the holding company during this quarter. The CEO wanted to increase the third quarter net income by $5M to achieve a net growth of $2M over the second quarter. To do this, the CEO called Ben and informed him to pass a journal voucher in the real estate company’s books and records at the end of September 2010 to record $34M in land plot sales that were contracted for with some customers on September 30, 2010. Ben told him that such a JV would not be accepted by the auditors, but the CEO insisted. The CEO told Ben that he would convince the auditors later.

When the real estate company’s external auditors began the current audit review for the third quarter, they noticed that there was a revenue of $34M supported by contracts of land plot sales on September 30. The cost of these plots amounted to $29M. The auditors’ concern was not in the supporting documents but the early recognition of revenue. However, the revenue should not have been recorded in that quarter. Their objection was for premature revenue recognition. Obviously, they knew the reason for passing such a JV in the books and records of the real estate company. After a meeting with the CEO, the JV was accepted by the auditors.

The audited financial statement (AFS) was approved and issued by the auditors after this meeting. What happened in the meeting? Nobody knows, but the AFS was issued. That is the fact.
The problem here is not that the auditors accepted the issue of a $5M increase in the net profit, but the issuance of a clean auditor’s report without a qualification or a disclosure of the $35M overstatement in the revenue to the footnote in the AFS. This highlighted the premature revenue recognition, which was against IFRS and/or GAAP standards, and its effect on the company’s resulting net income of $5M. The auditors cannot change or push company management to change anything in the books and records. The books and records of any company are its own property. But the EA’s duty is to qualify and disclose if there is a dispute and explain such an issue to the stakeholders in the auditor’s report. How did this issue become known? It is simple. It was a tip. Someone was trading in the securities market on the brokerage company’s shares and detected that the shares of the brokerage company (related party of the group) had been suspiciously traded in one day with a high volume of shares by one investor only.

During the investigation by the authorities in charge, the commissioning letter was issued to the fraud examiner to begin investigating the case. The information file, along with all of its documents, was delivered to the fraud examiner for examination and reporting purposes. During the review of the documents, and after interviewing the parties concerned, the examiner detected that the person who traded shares in the brokerage company suspiciously in one day was the CEO/chairman of the holding company. The fraud examiner discovered that the CEO was trying to increase demand on the brokerage company’s shares, allegedly to increase the share price and allow him to sell his shares for personal, illegitimate gain. On the other hand, and to be more conservative, to allow him to falsify the growth of the holding company’s net profit. He manipulated the real estate company’s books and records throughout the JV explained above to increase the net income of another company, but the brokerage company led to the correlation between both events and objectives. Now the situation became clearer to the fraud examiner. The hidden link between the real estate company and the brokerage company revealed the first offence (unrelated to the auditors’ issue), which was detected in the brokerage company—the CEO illegally traded the brokerage company’s shares for personal gain. And the second offence detected (auditors’ issue) was the premature revenue recognition that resulted in overstating the net profit of the real estate company and holding company by $5M.

The offences were identified, along with the names and occupations of the perpetrators in the fraud examiner’s report to the prosecutor. The supporting evidence documents were as follows: (1) sale/purchase of shares contracts made in the name of the CEO of the holding company, (2) the JV recording the revenue of $34M and the cost of $29M in the sale of plots of land, and (3) AFS that supports the offence of a clean audit report and highlighted the misstatement of the net income of $5M and the auditors’ omission of material disclosure in the auditors’ report that resulted in
falsely overstating the net income of the holding company. The perpetrators were (as per penal code): The CEO/chairman (main accused), the finance manager (accused participant), and the external auditors (accused participants).

After the fraud examiner’s report was delivered to the prosecutor, the investigation led to charges against the CEO/chairman of the holding company, who admitted to the offences. Reconciliation was made between the CEO and the legal authorities, which resulted in the CEO’s repayment of the funds he defrauded from illegal dealings in the stock market, as well as a fine equal to the funds defrauded.

The main accused of the fraud (CEO), who appropriated (stole) public funds, entered into a reconciliation with the legal authorities as shown above. The accused participant (financial manager) was released with a record showing his involvement in a felony but without conviction. His involvement would prevent him from getting any public post in the future. Case is closed. Nothing happened to the external auditors. In absence of deterrence, don’t blame them. No blame, no claim. Anyone can do it—not only auditors, but many professionals can do it in the absence of deterrence.