Skip Scholar

James Smith

English Composition II

April 26, 2023

The Role of Auditors in Audit Fraud: Red Flags, Responsibilities, and Real-life Examples

Introduction

Auditors are people who review the financial situation of public companies; public companies are companies that have stock available on the market and report their findings to the public so that the public can have a clear understanding of a company's financial state.

An audit is an inspection of a corporation's or individual's accounts to make sure that they are in accordance with the laws. There are two types of audits; an external audit and an internal audit. An external audit is normally performed by someone with little to no connection to the company they are auditing. While an internal audit is done by accountants that the company has hired to make sure they are following the laws. Any company that has shares of itself in the stock market needs to have annual audits (Nachbaur 1).

Audit fraud occurs when a company or auditor illegally alters financial statements to manipulate the audit that will be released to the public so that the financial situation seems better or worse than it is. Audit fraud is an important matter as the manipulation of financial records by a sizable company with numerous investors can potentially result in a significant number of people being left financially destitute. The investors are left without money due to the false

information given to them by the company and when it is found out that the company has lied the stock price will go down meaning that their shares will be worthless.

Thesis Statement

When considering audit fraud one of the questions people may ask is "What party is responsible for presenting false financial information." In many cases, the auditor and the company work together to hide the information but sometimes the company tries to deceive an auditor to hide their information (Thomas 1). Whose fault would it be if the company is able to trick the auditor and get away with their crime? <u>The responsibility of failing to find false information while performing an audit lies solely on the auditor. Additionally, they are somewhat at fault for all the damage the company causes with the inaccurate report.</u>

Qualities of An Auditor

In order to know why an auditor is at fault when they produce a false audit, it is important to discuss the qualities that a good auditor must have and talk about some of the red flags of auditing. Knowing the qualities of a good auditor is crucial to understand because it makes finding out why an auditor failed easier because people can look into what qualities they were missing, and allow for themselves to learn from the past mistakes that others have made.

According to a study by Edward, Sitepu, and Ginting an auditor's performance is linked to their expertise, knowledge, attitude, emotional intelligence, a healthy sense of professional skepticism, and sincerity while performing their work. A good auditor will remain unfazed by other people's attitudes or demands and will conduct an honest and accurate financial review (80-82).

By knowing the qualities that an auditor must have to be successful in providing high-quality audits, looking into why bad auditors fail can become simpler. Arthur Andersen, the accountant at Enron, was lacking sincerity and emotional intelligence while performing his job, which led him to favor money instead of the law (Thomas 1). When looking into real-life examples of audit fraud keeping in mind these qualities will help in finding out what went wrong.

Many new auditors may struggle to discover financial fraud when auditing a company that is actively trying to hide its records (Souza et al 1). But many of the common red flags that auditors should look out for when auditing are well known and can be found with some inspection. These red flags can include the rapid growth or decrease of revenue without an event that would explain it, the dominance of a single person in the company, clear understatements of expenses, and excessive involvement of non-financial executives in financial matters and many more (Radu et al 3-4).

Knowing that auditors can educate themselves on red flags for their profession means that many of the errors made by newer auditors when dealing with fraud could be avoided if they tried to become better auditors before that point. This implies that auditors are at fault for their mistakes or ignorance during an audit, because they could have taken the time to improve themselves before the audit.

Counterargument

One possible counterargument could be that despite the availability of resources to learn about red flags, some companies may be very skilled at disguising their fraudulent activities in

ways that are difficult for even experienced auditors to detect. Sometimes the majority of the company's own auditors are not aware of the fraud. Additionally, auditors may face time and resource constraints that limit their ability to conduct a comprehensive investigation of all potential red flags.

Even if auditors are able to identify red flags, they may face resistance or pushback from company executives who may be trying to hide fraudulent activities. All of these problems may make the auditor's job hard or impossible and they should not have to invest that much time and money into potentially finding fraud.

Rebuttal

While some fraudulent activities can be difficult to detect, auditors are trained professionals with the expertise to identify red flags and uncover potential fraud. Time and resource constraints along with pushback from company executives may pose challenges, but adhering to auditing standards, exercising professional judgment and skepticism, and taking appropriate steps can help auditors fulfill their responsibilities effectively.

Auditors play a critical role in protecting the financial integrity of companies and ensuring that accurate financial information is provided to stakeholders. While auditors face challenges in detecting fraudulent activities, they have access to a wide range of tools and techniques to help them identify red flags and uncover potential fraud.

These tools may include data analysis software, forensic accounting techniques, and interviews with company personnel (Harris 1). Auditors now have more access to useful tools

than ever before and if they fail to do their job even with the advantages they now have it can be seen as a sign of negligence.

Despite the challenges that auditors face, their work is essential in maintaining the trust of stakeholders in financial reporting and in promoting the long-term success of companies, and failure to do so can result in a large number of people being left without enough money to support themselves.

Case Studies

After discussing the traits necessary for effective auditors, the focus will now shift to real-life examples of audit fraud. The first case study involves Enron, where the auditor had knowledge of the crime but failed to report it. The second case study concerns Luckin Coffee, where both internal and external auditors were unaware of the fraud and unable to detect it. These case studies will allow for further discussion into who is at fault in regard to audit fraud.

Enron

Enron was a trading company that was founded during the largest bull market the U.S. has ever had. This led to its meteoric rise in capital and renown. The problem was that the workplace environment produced a large incentive for the employees to not work together and possibly even take bad deals in order to line their pockets (Thomas 1).

The top management of Enron was making around $5,000,000 a year and that is significantly more than they should have been making for their positions (Teather 1). According to a study by Yiling Zhang and Lang Wei that fact and the financial fraud happening in the company are heavily related. “Using 5246 audits in the Chinese market between 2010 and 2012,

we find that the level of ethical culture in audit firms is significantly negatively associated with the magnitude of earnings management and the frequencies of financial restatements of their client firms (22)."

This quote suggests that there is a connection between executive compensation and the financial misconduct of a company. When top management is paid more money than could be considered reasonable, it can create a culture of greed and incentivize unethical behavior. The findings highlight the importance of implementing effective measures to maintain ethical behavior in companies and promote transparency in financial reporting.

In "The Rise and Fall of Enron" C. William Thomas discusses the Enron scandal and how 4,500 employees were left without jobs and a large number of investors were left without money due to the actions of Enron and Arthur Andersen. The auditor of Enron, Arthur Andersen had plenty of time to blow the whistle on Enron and he certainly had enough knowledge to know what they were doing was illegal, but he chose to chase monetary gains rather than follow the law. It was only due to a lack of finances needed to operate that they were eventually found out(1).

After Enron's lies were found out there was an outpouring of protests from the public both against Enron and the Government of The United States. This resulted in a large amount of new laws and legislations being made to make it harder to fake financial records and increased the punishments for doing so.

Luckin Coffee

Luckin Coffee was a new company that was founded in 2017 and was on the rise in the stock market. It was looking to be a firm competitor of Starbucks in China and many people had purchased their stocks. But Luckin Coffee was recently found out to be inflating their earning reports.

There were many parties involved in the company's fraud, but the important thing is that the external auditors failed to notice the discrepancies while auditing them. This failure would have let Lucking Coffee continue to trick investors, but there was an anonymous investigator who spent a large amount of time tracking the number of people who entered the stores and figured out the estimated earnings that they would have from that many customers and reported the discrepancy. An action such as this from the official auditors would have allowed for the truth to have been found out sooner.

The external auditors lacked professional skepticism and did not notice/report any red flags and the internal auditors failed to detect the traces of fraud within their company showing a lack of technical knowledge, (Chung 1).

Both of these cases demonstrate the failures of the auditor throughout the process due to a lack of the previously mentions traits. Arthur could have improved his emotional intelligence and drastically improved the lives of hundreds of thousands of people by reporting the crimes that Enron was committing earlier.

The auditors responsible for Luckin Coffee's audit could have improved their knowledge of red flags and allowed people to make better financial decisions, but in both cases, the auditors responsible failed in doing their jobs.

Counterargument

Another point of view may be that the companies are at fault for their fraud and that the auditors are only human and cannot catch all instances of fraud while performing an audit.

Companies have the primary responsibility for ensuring the accuracy and reliability of their financial statements. They are required to maintain adequate systems of internal control to prevent and detect fraud. They are required to provide auditors with complete and accurate financial records and disclosures. Companies are also supposed to be transparent in their financial reporting and should be giving a full disclosure for any of the material facts or circumstances that may affect the financial statements. The companies are the ones to blame when the information they provide is false.

Rebuttal

But, while some argue that it is the company's fault for wanting to deceive the public and that the auditor is not to blame for a crime that the company committed, the auditor's job is to provide an accurate financial report (Natt et al 1). If a company is committing crimes, the auditor should find out about it in the process of gathering the information needed to make an accurate report. Once aware of the information the auditor must report it to the authorities. Therefore, if they fail to uncover the crimes or fail to report any crimes they have uncovered they are partially at fault for any damage done by the company due to the financial fraud.

Auditors are obligated to perform their duties with integrity and objectivity, and they have a professional and ethical responsibility to exercise due care in their work. This includes not only ensuring that the financial statements are free from material misstatements but also identifying and reporting any irregularities or fraudulent activities that may be occurring within the organization. Failure to detect and report such activities can have serious consequences, both for the auditor and for the public.

Conclusion

In conclusion, audit fraud is a serious issue that can have far-reaching consequences for investors and the public. While some fraudulent activities can be difficult to detect, auditors are responsible for exercising professional judgment and skepticism while adhering to auditing standards. They must also possess the necessary qualities such as expertise, knowledge, attitude, emotional intelligence, and sincerity to effectively carry out their duties. Red flags are often present in cases of fraud, and auditors must be vigilant in detecting them.

Real-life examples such as Enron and Luckin Coffee illustrate the importance of auditors carrying out their responsibilities diligently and with integrity. Ultimately, it is the responsibility of auditors to produce accurate and honest financial reviews, and any failure to do so can have serious consequences. It is essential that auditors remain vigilant and committed to their duties to prevent and detect fraud in the financial sector. Auditors are the first people that are able to stop financial fraud for the companies they audit and when they fail to do so they are somewhat complicit in their crime because it is their job to stop it.

Works Cited

Legal Information Institute. (n.d.). Auditor. Legal Information Institute. Retrieved April 26, 2023, from https://www.law.cornell.edu/wex/auditor#:~:text=An%20auditor%20is%20one%2 0who,with%20a%20set%20of%20standards.

Kara. (2021, August 27). Case study: Luckin Coffee Accounting Fraud. Seven Pillars Institute. Retrieved April 26, 2023, from https://sevenpillarsinstitute.org/case-study-luckin-coffee-accounting-fraud/

Susanto, S., Ronny Edward, Y., Sitepu, W. R., & Ginting, R. R. (2022). The the effect of professional skepticism and auditing independency on audit performance with emotional quotient as moderating variable at pt. Bina Usaha mandiri sejahtera Medan. International Journal of Social Science Research and Review, 5(10), 80–92. https://doi.org/10.47814/ijssrr.v5i10.532

Encyclopædia Britannica, inc. (2023, March 29). Enron scandal. Encyclopædia Britannica. Retrieved May 1, 2023, from https://www.britannica.com/event/Enron-scandal

Guardian News and Media. (2002, June 18). Enron paid out $681M to top executives. The Guardian. Retrieved May 1, 2023, from https://www.theguardian.com/business/2002/jun/18/corporatefraud.enron

Herron, T. L., & Gilbertson, D. L. (2004). Ethical principles vs. ethical rules: The moderating effect of Moral Development on audit independence judgments. Business Ethics Quarterly, 14(3), 499–523. https://doi.org/10.5840/beq200414320

Souza, J. L., et al. “The Impossible Interview: A Two-Stage Interview Case for Auditing Students.” Journal of Multidisciplinary Research (1947-2900), vol. 13, no. 2, Fall 2021, pp. 75–108. EBSCOhost, search.ebscohost.com/login.aspx?direct=true&db=asn&AN=154473012&site=ehost-live.

RADU, loan, et al. “Mapping Fraud Risk in Financial Audit - Sales Operations.” SEA: Practical Application of Science, vol. 1, no. 2, July 2013, pp. 272–81. EBSCOhost, search.ebscohost.com/login.aspx?direct=true&db=asn&AN=101102938&site=ehost-live.

Zhang, Y., & Wei, L. (2022). Philanthropy, Audit Firms Culture and Auditor Independence. *PLOSONE*, *17*(11). https://doi.org/10.1371/journal.pone.0277567

Thomas, C. W. (2002, April 1). The rise and fall of Enron. Journal of Accountancy. Retrieved April 26, 2023, from https://www.journalofaccountancy.com/issues/2002/apr/theriseandfallofenron.html

What is an audit? everything about the 3 types of audits. Ageras. (n.d.). Retrieved May 1, 2023, from https://www.ageras.com/blog/what-is-an-audit#:~:text=How%20often%20are%20external%20audits,Securities%20Exchange%20Act%20of%201934.