THE FRAUD TREE AND ITS INVESTIGATION IN AUDIT

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Abstract. *The purpose of the present research paper is to introduce a new structure of the Fraud Tree and to suggest certain audit procedures possibly employed in examining its branches. For the purpose of the present paper the authors thereof have referred to the analysis of related research literature, also applied the information comparison and generalization methods. Fraud is being committed in every part of the world, and in every sphere of human activities. Often fraud leads to financial nightmare and collapse of major international corporations which cause spill-off after-effects not only upon corporations and their employees, but also upon other related businesses and organizations, governments and societies. In view of globalization of economy, increasingly dynamic and competitive business fraud has changed in character though has not downscaled in its scope. Today fraudsters elaborate their attempts making use of the most state-of-the-art science achievements and innovative technologies. This largely facilitates the growth of the "Fraud Tree" with its new branches ever springing up. The present article represents an attempt to investigate individual fraud cases and the groups of persons committing this kind of crime. A new concept of "Fraud Tree" has been introduced with the following basic branches: i) material misstatements in financial statements; ii) asset misappropriation; iii) corruption; iv) tax evasion; and v) others. Every branch on the Fraud Tree has several sub-branches, and significant efforts should be devoted in the course of audit to examine the scope, formation conditions of each such sub-branch. The present paper includes guidelines for the principal actions and procedures to be followed by an auditor in view of the risks related to misstatements in financial statements, asset misappropriation, corruption and tax evasion.*

Key words: *fraud, Fraud Tree, fraud detection, investigation.*

Introduction

Fraud has always been present since the times reached by human memory extending up to our days and is highly likely to continue to be committed in the future. Anybody can be exposed to fraud – internal (corporate managers, shareholders, employees) and external (banks, tax institutions, suppliers, purchasers, investors, governmental institutions, financial experts, auditors and even the society at large) users of information. Fraud produces detrimental effect not only upon the financial status and performance of companies, it may ruin the company's image and damage its competitiveness. Fraud specifically creates obstacles to the development of foreign investment.

From time to time the erupting fraud disclosures result in huge financial scandals and bankruptcies of largest international corporations. On 2 December 2001, the energy company Enron was declared bankrupt making the lines as the largest ever collapse in the history of the USA. With a view to concealing its actual financial situation, for four years the management of the company was deliberately misleading information users by not including its partners' liabilities into corporate accounts and thus recklessly overstating its corporate earnings by USD 586 m or 20 % (*Skandalingas „Enron“...* 2002, p. 121). The Enron's scandal was shortly followed by the collapse of the telecommunications giant WorldCom. The corporation with 85,000 in staff operating in 65 countries world-wide was manipulating accounting entries by reporting its stationary costs (pens, pencils, paper, etc.) as its revenues. The Company share price was immediately dumped from USD 60 to just 20 cents (*Girdzijauskas*, 2007, p. 20). Fraudulent accounting has brought about absolutely detrimental losses to such global operators as Xerox, Kmart, GlobalCrossing, Adelphia Communications and a number of others.

Despite its ultimate importance to economy globally and to each individual company fraud as a phenomenon has not been thoroughly investigated. Lately though, fraud has become a focus for the Association of Certified Fraud Examiners (ACFE) that has developed a fraud classifier, the so-called 'Fraud Tree'. Some genuine of the Fraud Tree has been conducted by M. Mosquera and A. Scifo (2004). A range of issues related to fraud and forensic investigation has been covered by R. Turpen (1997), R. Vanasco (1998), J.Well (2002) and other authors. The most common fraud cases in Lithuania were examined by R. Bičiulaitis (2001), J. Mackevičius (2001), J. Mackevičius and R. Bartaška (2003), J. Kabašinskas and I. Toliatienė (1998), as well as by the private company *Pačiolis* (Jagminas, 1998). However, with fraud attempts becoming even more sophisticated and employing increasingly hardly detectable tools and methods, further fraud research and investigation have become absolutely necessary.

Fraud: essence and impact

In its most general sense fraud means actions, behaviors and/or oral expressions deliberately aimed at deception and / or misinformation (*Dabartinės lietuvių kalbos žodynas* (The Dictionary of Contemporary Lithuanian), 1993, p. 21). Fraud may also be referred to an intentional error conceived in advance. Such errors are often accompanied by certain actions designed to conceal their presence (Mackevičius, 2001, p. 288). Fraud was defined as: any dishonest activity involving the extraction of value from business, directly or indirectly, regardless of whether the perpetrator benefits personally from his or her actions. (Coram, Ferguson, Moroney, 2006). So, the concept of fraud is quite extensive. Therefore, most often it is defined by reference to specific objects and goals of a particular fraud. Namely, fraud is usually defined as a sequence of activities perpetrated to obtain money, property or services, to avoid payment or loss of services, or to secure personal or business advantages. These acts are not dependant upon the application of threat of violence or of physical force. (International Standards for Professional Practice of Internal Auditing, 2002, p. 26).

An act of fraud may be also defined as a crime in the economic sphere manifested by a theft of somebody else's property or title to such property by abusing trust (Auditorskij slovar 2003, p. 81). Some authors classify fraud into active and passive fraud. The key feature of active fraud is a supply of false information. Passive fraud involves concealment of certain circumstances which otherwise had to be notified (Osnovy audita, 2000, p. 147).

Frauds are committed in all spheres of human activities, not merely in business, but also in public and financial sectors (Ratlift, 1996, p. 864). Under current dynamic and competitive business conditions fraud has also evolved now employing most modern science achievements and innovative technologies. With the introduction of computers and other computation techniques to perform a series of management functions, fraud has declined in scale although it has become increasingly sophisticated.

Instances of fraud produce a tremendous effect upon corporate and financial performance, its corporate image and business continuity. Fraud ruins the reliability of financial statements and the value thereof as a principal source of information. Therefore the disclosure of frauds, examination of the underlying motives, tools employed and other related issues has lately acquired a special significance. And auditors in the fulfillment of this task are assigned a very special role.

Auditors' focus is aimed at acts of fraud that cause material misstatements in corporate financial statements. From the audit view point "fraud" is defined as an "intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage" (Handbook on International Auditing, Assurance and Ethics Pronouncements, 2008 p. 230). This definition of fraud emphasizes three important things:

1) One or several corporate managers, employees and third parties may be engaged in commitment of fraud;
2) Fraud is a series of deliberate acts, usually prepared in advance;
3) Fraud is aimed at obtaining unjust or illegal benefit.

The audit objectivity principle requires from an auditor to express his/ her opinion on any presence of fraud in financial statements and the impact of such fraud on reliability of information. The International Standard on Auditing 240 emphasizes an auditor's obligation to examine any misstatements of information occurring due to: (i) fraudulent financial reporting (misstated, omitted or undisclosed amounts, intentional overriding of accounting principles, altering of accounting records), (ii) misappropriation of assets (theft of an entity's tangible and intangible assets, embezzling receipts, causing an entity to pay for goods and services not received, etc.)

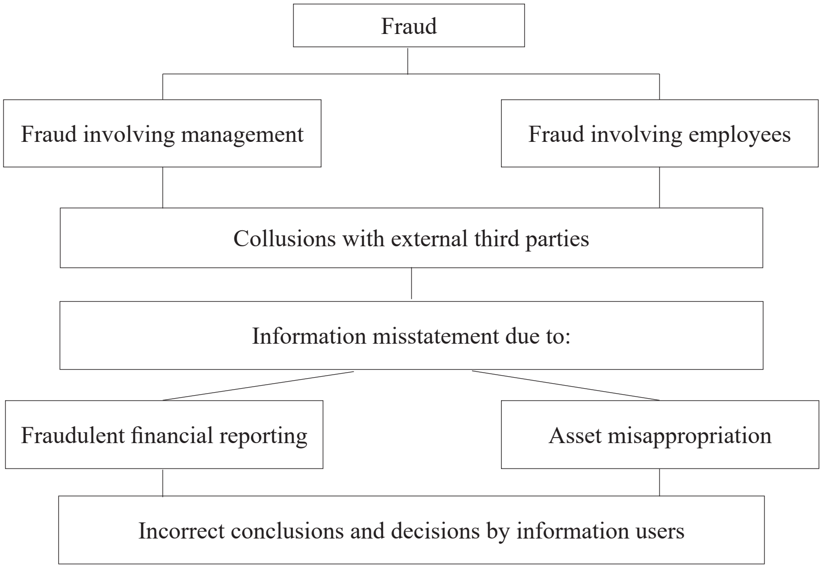

Fig. 1: ***Impact of fraud upon decisions of information users***

Source: compiled by the authors

(Handbook on International Auditing, Assurance and Ethics Pronouncements, 2008 p.231). Such misrepresentations of information may cause the users of such information to arrive at incorrect conclusions and/or pass wrong decisions (see Fig. 1).

Companies and organizations that are hit with employee fraud, including embezzlement, asset misappropriation, and financial statement manipulation are often surprised that the incident occurred. Even more surprising to executives and boards of directors is the fact that their auditors did not find the fraud sooner, or did not find it at all. After all, isn't that what auditors are supposed to do? (Coenen, 2006)

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error, because fraud may involve sophisticated and carefully organized schemes designed to conceal it. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Intents of fraud are specifically difficult for an auditor to detect where they are related to management decisions concerning accounting estimates and application of accounting principles.

For auditors fraud involving management is more difficult to detect than fraud involving employees. Certain levels of management may have an unlimited influence in the entity, they may be in a position to override control procedures, or direct their subordinates to perform certain transactions, conceal facts, or come into agreement with third parties, etc. Auditors tend to trust the information, although knowingly misleading, supplied by corporate manager.

Fraud Tree and Relevance of Research thereof

Fraud cases tend to take a great variety of forms. They depend on a number of factors, such as corporate governance structure, internal control schemes, activities performed (production, commercial, financial, investment, etc.), the expedience of persons committing fraud and others. Literature available on audit (Mackevičius, Bartaška, 2003, p. 39; Atestuoto auditoriaus darbo vadovas, 2003; Handbook on International Auditing, Assurance and Ethics Pronouncements 2008, p. 231; Well,, 2002, p. 25–26; Vanasco, 1998, p. 17–19) specifies the following fraud cases as the most common:

1) Falsification of primary and consolidated records;
2) Falsification, intentional manipulation or altering of accounting entries used to prepare financial statements;
3) Concealment of transactions, failure to record such transactions in primary documents and failure to enter such transactions in accounting records and financial statements (intentional omission);
4) Unauthorized recording of transactions in primary documents and entry into accounting records and financial statements (entry of transactions that have not been actually performed);
5) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure;
6) Deliberately incorrectly developed accounting policy;
7) Intentional supply of incorrect information on transactions and/or corporate operational status;
8) Deliberately inaccurate forecasts and estimates of financial indicators;
9) Asset misappropriation (theft) and embezzlement;
10) Other cases.

It is always a challenge for the auditor to foresee any occurrence of any of the above or any other types of fraud in an entity. Therefore the Association of Certified Fraud Examiners has offered a unified professional fraud classifier, also known as "the Fraud Tree" for investigation of frauds. The Association defines three key branches of the Fraud Tree: (i) asset misappropriation; (ii) corruption, and (iii) fraudulent reporting.

The International Standard on Auditing 240 specifies the importance for an auditor to examine two types of information misstatement, namely: (i) fraudulent financial reporting, and (ii) asset misappropriation. In terms of the "Fraud Tree" theory, IAS 240 refers to only two branches of the Fraud Tree. But in reality fraud is becoming increasingly sophisticated, elaborate, employing scientifically based methods and technologies, and evolving into a growing number of new forms. Tax evasion is becoming one of fast growing crimes and certain illegal acts aimed at VAT avoidance in particular. Thus new branches appear on the Fraud Tree (see Fig. 2).

Every branch on Fraud Tree has several sub-branches (see Table 1).

The size of every branch and sub-branch on the Fraud Tree is influenced by different conditions and circumstances, goals and motives of persons involved in

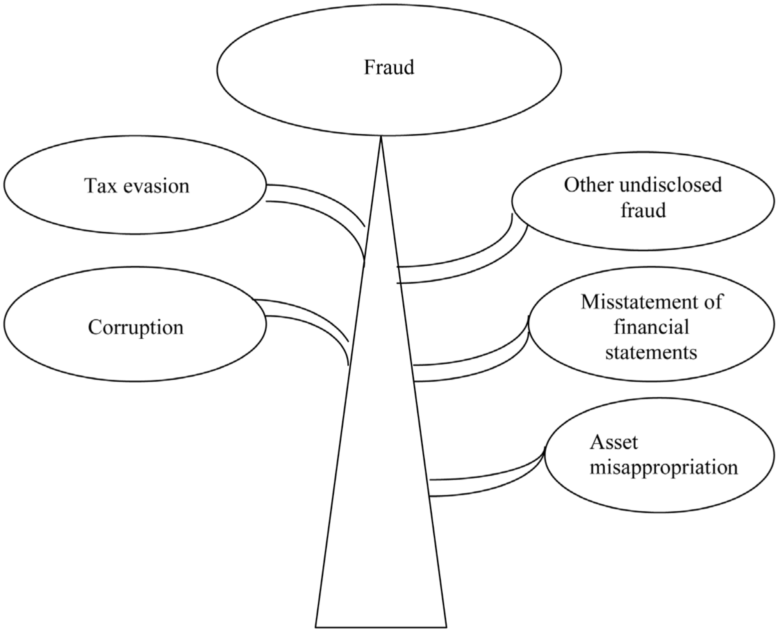

Fig. 2: ***Fraud Tree***

Source: compiled by authors

Table 1. ***Sub-branches of the Key Branches on the Fraud Tree***

Key Branches	Sub-branches
1. Asset misappropriation	1. Cash thefts 2. Manipulations in securities 3. Theft of tangible and intangible property 4. Deliberately inappropriate use of tangible and intangible property 5. Concealment of income related to receipt of cash
2. Corruption	1. Bribery 2. Extortion 3. Conflicts of interests 4. Illegal gratuities
3. Misstatement of financial statements	1. Falsification of documents and accounting records and the illegal use thereof 2. Failure to enter the actually performed transactions into accounting records 3. Entrance of actually unperformed transactions into accounting records 4. Illegal overstatement or understatement of assets and/or revenues 5. Illegal overstatement or understatement of expenses and/or liabilities
4. Tax evasion	1. Concealment of revenues 2. Failure to submit VAT returns 3. Falsification of export records 4. Incorporation of shell companies
5. Other frauds	Other different frauds, undisclosed and non-described in relevant literature, although committed in practice.

Source: compiled by authors

the designing of the crimes. Three basic circumstances/ preconditions may be distinguished however, upon the presence of which a fraud may be committed:

1) Management and/or other employees in a company are induced or forced to commit fraud;
2) Opportunities (e.g. weak internal controls) conducive to commitment of fraud;
3) Persons intending to commit fraud have relevant unethical attitude and features of character.

But in reality the presence of all three above preconditions is not indispensable for commitment of an act of fraud. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them. The more intense is the pressure or encouragement, the higher is the probability that the person will commit fraud. Most commonly, frauds are driven by a strive to gain benefit (Mackevičius, 2001, p. 299), other motives being jealousy, anger, revenge, greed, blind belief in something, hatred, pride, mistrust, laziness, mockery, acknowledgement of being a loser, lack of knowledge, sickness, pain, fear of loss, uncertainty, etc. (Kabašinskas, Toliatienė, 1997, p. 169). An auditor must take any and all measures and perform all possible procedures in order to disclose and investigate frauds properly.

Auditor's actions in investigating the "Fraud Tree": detection of a risk of fraud

An auditor's possibilities to detect an act of fraud depends on his/her professional competence, practical skills and experience, incidence rate and scope of fraud cases, scale of collusions involved and many other factors. Audits and reviews are procedures performed on financial statements of a company, for the purpose of determining whether financial statements include any material misstatements. Misstatements are essentially wrong numbers due to numerical errors, fraud, or errors in interpreting accounting rules. Misstatements are material, if they are large enough to make a difference to a user of financial statements such as bank or investor. So how does fraud fit into idea of material misstatements? Misstatements can be caused by either error or fraud. Auditors have some responsibility for detection of both errors and frauds that are material, but this responsibility is not absolute. (Coenen, 2006).

Fraud by it's nature is something that can be extremely difficult to detect to. Users of financial statement can sometimes be mistaken when they think that unqualified opinion issued by the auditor on financial statements always means that these statements are one hundred percent accurate and their systems are totally robust – this is not necessarily the case. Auditors should therefore ensure that their letters of engagement emphasise that the nature of the audit is such that a material misstatement may not be revealed during the audit. However, this is not designed as a 'get out of jail' card for not doing appropriate audit testing in terms of fraud. Auditors must ensure that their audit work supports the opinion they give on financial statements and an efficient audit would normally detect a material misstatement whether caused by fraud or error.

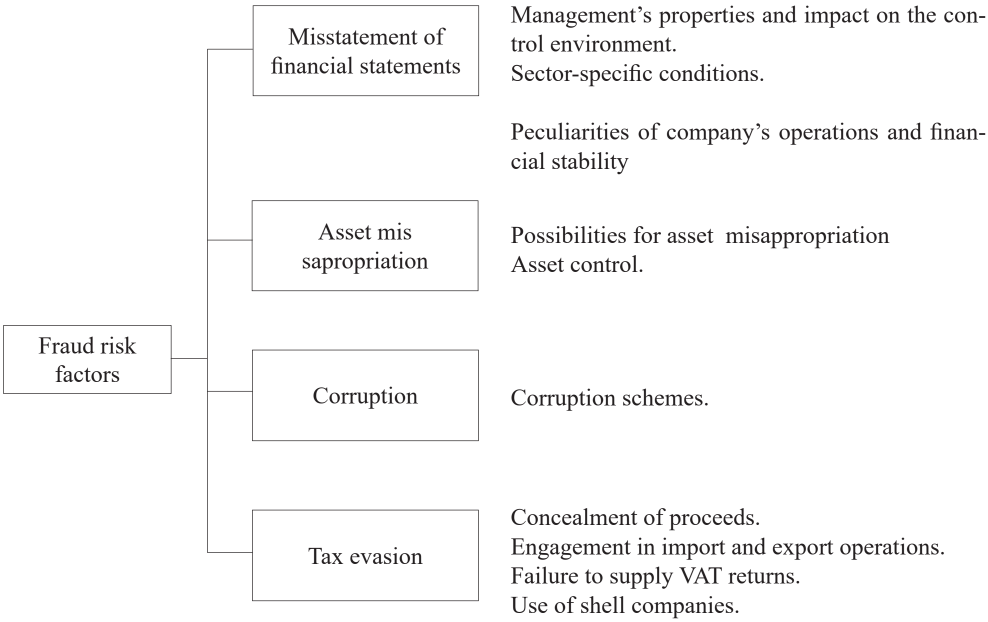

Fig. 3. ***Examination and evaluation of fraud risk factors.***

Source: compiled by authors

The auditor must seek for as much as possible scrutinized examination of circumstances and events creating conditions favourable for the commitment of fraud, fraud detection of methods and motives, as well as tools, through which such fraud has been committed, i.e. as many as possible risk factors involved. Fraud-related risk factors are overly numerous, therefore it is expedient to classify them into certain categories (See Fig. 3) and consider them properly and consistently.

Investigating the risks of material misstatements in financial statements, an auditor must focus on analysis of management characteristics and their effect upon the control environment within an entity. The auditor must find out such circumstances as management inclination to inappropriately understate declarable revenues overstate corporate share value, management's commitment to fulfill apparently unrealistic or history of negligent attitude towards internal controls, or ignoring any requirements set by external regulatory institutions, etc. The auditor must notice the efficiency of the corporate organizational structure, rotation of managers, board or council members, any claims against the entity or its management for fraud or other incompliance, etc.

The auditor must examine also the key sector-specific fraud risk factors (e.g., fierce competition within the sector, declining industry, numerous bankruptcies, rapid changes in industry, rapidly developing technologies, etc.).

A special attention must be paid to fraud risk factors related to corporate operations features and financial stability. Firstly, the auditor has to evaluate company's ability to generate its cash flows, perform the analysis of key relevant financial indicators (solvency, profitability, asset turnover, cost level and others), find out whether or not the company has been engaged in unusual or overly complex transactions, whether or not it is engaged in unduly aggressive sales promotion or profit enhancement programs, etc.

In investigating asset misappropriation risk factors the auditor must make every effort to detect possibilities for such asset misappropriation to take place. He/she must pay attention to the following factors: whether the company keeps high amounts of cash, or a number of fine, but especially marketable and valuable things and easily exchangeable items in the entity. Thoroughly assess the features of the property concerned, property types and possibilities for stealing. The auditor shall be specifically thorough in assessing asset security control system.

Corruption cases always pose a greatest challenge to the auditor. Corruption is an attempt to gain some unjust benefit by abusing one's official position, or bribery of an official or a public figure (Dabartinės lietuvių kalbos žodynas), 1993, p. 327). Corruption schemes may take a huge variety of forms, as a rule involving third parties. Most common types of corruption in Lithuania are bribery and conflict of interests. In an act of bribery, a person is engaged in offering, giving or taking, or intermediates in offering, giving or taking something valuable, so that certain laws, resolutions or business decisions would be replaced without any knowledge of certain related persons.

In schemes of conflicts of interests, managers or employees of companies have certain personal financial or economic interests through economic operations that have most immediate effect upon the performance of the company. As a rule, the aforementioned and some other corruption schemes (extortion, illegal gratuities, etc.) are related to other fraud schemes (e.g. stealing of property, concealing of sales revenues, etc.). Therefore corruption schemes during audit may be detected only after identifying and examining other fraud schemes.

There are many ways of fraud seeking to seize VAT, and they happen to be very inventive. Among most popular types of fraud are revenue concealment, performance of export and import operations, failure to supply VAT returns and incorporation of shell companies. When seeking to conceal revenues goods or raw materials obtained are written-off as consumed, but actually they are sold where the proceeds are not required to be entered into a cash-register, or where no accounting documents are issued, e.g. in the street market. Ordinarily this is the way to market some highly demanded consumer goods.

In performance of export operations, an export operation is actually performed, but incorrect data on the value, quantities and/or purchasers of goods are entered in relevant documents, export documents are forged, and goods are not actually exported. In performance of import operations, such imports of goods are not declared (smuggling), some other goods are defined in relevant documentation, or goods are actually imported, but incorrect data on their value, quantities or consignors are declared in relevant documentation.

Investigating cases of failure to supply VAT returns, an auditor must pay an appropriate attention to the fact that this may be the way of seeking to:

1) Conceal performed activities and avoid tax payment;
2) Avoid payment of VAT to the budget by implementing any of illegal activity models, where such unpaid VAT is included into the VAT returns and/or recovered from the budget by other companies participating in such criminal activities.

To avoid VAT payment to the state budget, corporate managers sometimes use shell companies. The term 'fictitious/ shell companies' is usually applied to the companies, which are used not for economic activities, but rather seeking selfish interests or as a cover in performance of any other activities than provided in incorporation documents of such companies. As a rule, such companies are incorporated with the use of forged documents and/or on behalf of a dummy (usually, some socially excluded person), who is not actually participating in activities of such incorporated company and sometimes even unaware of such company. Shell companies may be also invented companies, in the name of which sales documents of goods/ provided services may be issued (name and legal details of such invented company, or name of legally existing company, but invented legal details, or legal details by some other company may be provided in the documents).

Shell companies engaged in sales of goods or provision of services transactions fail to pay VAT to the State budget, whereas other companies taking part in such transactions declare VAT on their VAT returns and recover VAT from the State budget.

As soon as an auditor notices certain fraud risk factors, he / she, taking proper consideration of their character and significance, must decide whether the planned audit procedures are sufficient in this particular case, or their character, time and scope have to be changed with a possible application of additional, more elaborated procedures.

After qualified evaluation of the fraud risk factors, an auditor may identify the situations where a case of fraud may be present. Besides, the audit performance itself may prevent the management and/or employees of the company, as well as third parties engaged in certain illegal agreement from commitment of fraud. It should be stressed out, however, that the auditor is not responsible for the performance of fraud prevention.

As soon as an auditor detects significant information distortions due to fraud, he/she must notify this to the corporate management and senior managers, and in some cases even to the law enforcement and prosecution officials. It is extremely important to notify on due time for the management to undertake appropriate measures. It is important to notify even if the act of fraud is insignificant, e.g. a small amount of cash appropriated by a lower rank official in the company. Sometimes, auditors face the question which rank of the management he/she has to notify of his/her obtained evidence of possible or actual fraud. This depends on possibility of existing of any illegal agreement, or the management's involvement in the case of fraud. As a rule, auditors should notify the managers of a rank higher than that of the persons allegedly involved in the fraud.

Managers has the responsibility for the maintenance of adequate accounting records and internal controls, prevention and detection of fraud and errors, safeguarding of assets, selection and application of suitable accounting policies and appropriate disclosure of financial information in financial statements. Prevention and detection of fraud is a big challenge. In order to reduce its incidence, company management, boards of directors, regulators and auditors all must share responsibility. (Watson, 2002). In most cases internal audit is dedicated to determining what improvements would be needed to fraud management processes and how to make those changes quickly and efficiently.

Conclusions

A fraud is deliberate actions by one or several managers and/or employees in a company, or third parties, committed with an aim to benefit unduly and illegally. Frauds often induce huge financial scandals and collapses of largest international corporations. They cause lots of negative after-effects not only to companies and their staff, but also to other related corporations and organizations, governments and societies. Frauds are detrimental to the reliability of financial statements and may lead information users to arriving at incorrect conclusions or passing wrong business decisions.

As a rule, frauds encompass complex and carefully prepared schemes for concealment thereof. It is especially difficult to detect frauds in cases of collusions with external third parties. Auditors face a real challenge in detecting frauds committed by management that is much higher than in case of fraud involving employees, as managers are in a position to exercise significant influence in the company, have better possibilities to conceal certain facts, enter into agreements with third parties, etc.

As cases of frauds may be numerous and versatile, auditors are suggested to use the 'Fraud Tree' theory in order to facilitate detection of such frauds. According to the theory, all frauds are classified into certain categories. The authors of the present article suggest to apply the new structure of the Fraud Tree by distinguishing five key branches: (i) asset misappropriation; (ii) material misstatements of financial statements; (iii) corruption; (iv) tax evasion; (v) other undetected frauds. Every main branch on the Fraud Tree has several sub-branches. The size of each branch and sub-branch on the fraud tree is determined by different circumstances, goals and motives of the persons committing the fraud.

Auditors should take every effort in as scrutinized as possible examination of circumstances and events creating conditions conducive to the commitment of fraud, identifying the ways, tools and motives of such commitment. To facilitate disclosure and evaluation of fraud risk factors, we suggest the classification according to the main branches on the fraud tree with distinguishing most important risk factors related to each of them. For investigation of such risk factors, we suggest using audit procedures, changing the character, timing and scope of audit procedures.

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