Current Affairs Noticeboard

Fraud in small and medium enterprises

Rob Dalton (2004a), an Ernst and Young partner specialising in emerging and fast-growth companies outlines a typical scenario involving fraud in small and emerging businesses. Dalton notes several warning signs associated with this fraud. Dalton (2004a) argues that much publicity is given to fraud involving large companies, but the devastating impact of fraud on smaller organisations is not publicised. These enterprises may have a lean corporate structure and do not have sufficient staff to appropriately segregate duties or introduce control processes (p.49).

The first indicator of the fraud is the general ledger mess that camouflages fraud. Dalton (2004a) notes that a messy general ledger is “designed to confuse and frustrate anyone who stumbles across any anomalies in the results of the business” (p.49). A messy general ledger can occur where the finance manager has total control in finance matters and the finance department is understaffed and staff are inexperienced or underskilled. There also may be little involvement in finance matters by the Chief Executive Officer or owner of the business. One advantage of the general ledger mess to fraudsters is that it is extremely difficult to follow the transaction trail and thus anybody who has queries about a transaction are generally frustrated by the mess. The mess not only occurs in the general ledger but also in the documentation that supports ledger entries. Inadequate or underskilled staff act as an “accomplice” to the fraudster as their failings make the mess worse and they cannot help the persons who have queries.

Aligned to the above problem the next warning signal of the fraud is that monthly financial reports are prepared on spreadsheets and bear no resemblance to the general ledger. These financial statements “show what the audience expects to see, and therefore few, if any, questions are asked” (p.49). Dalton (2004a) states that:

> In situations where his type of fraud arises, the company auditors often undertake substantive audit procedures around information supplied by the finance manager. Often no information system work is undertaken as the finance manager insists the system is corrupt and continues to produce errant journal entries (p.49).

It could be argued that no auditor should accept the above and any auditor accepting this situation would be regarded as negligent. At a minimum the auditor should notify the relevant level of management about the state of the ledger. This is a control weakness. This gives management the opportunity to rectify the situation and possibly discover and/or prevent the fraud from occurring in the future. The AWA case stated auditors should evaluate the internal control system. If internal control weaknesses were identified they should be reported to management. If management does nothing about the weaknesses, the AWA case further held that the weaknesses should be reported to the board of directors (Godsell, 1993, p.118).

Section 286 of the Corporations Act states that companies must keep proper records. The existence of a proper functioning general ledger would be regarded as a very basic control. The non-existence of this type of ledger should immediately raise the suspicions of the auditor. A properly updated general ledger summarises the recording of transaction data and integrates the recording of transactions in the subsidiary ledgers such as debtors and stock ledgers to the general ledger. The non-existence of a properly maintained ledger is evidence that this recording process has broken down and a warning of the company's incompetence in record keeping. Alternative sources of information provided by the finance manager should be treated with great suspicion.

Further factors in this fraud as described by Dalton (2004a) are

- that there is a "complicated web of unusual journal entries in either asset, liability or suspense accounts to provide the perfect platform to write cheques for his or her benefit" (p.49).
- cheques are written to finance manager, fictitious vendors or related parties
- one person has total autonomy over finance function and has authorisation to manipulate controls and processes (p.49).
- no supervision of bank reconciliations and general ledger reconciliations

Dalton (2004a) gives several suggestions to detect or prevent this type of fraud. He states the following should occur.

- Key functions such as the bank reconciliation and general ledger reconciliations should be randomly verified;
- Random verification of the complete audit trail for cheques issued
- Discussion with the auditors to understand the scope of the audit and the quality of the information produced by the system
- Ensure that "one person should never have total, unsupervised autonomy over any function" (p.49).

Question

Do you believe an auditor should base their audit on data obtained from spreadsheets? Explain your answer.

References

Dalton Rob, 2004a, “Solo supervision raises risk of fraud”, *The Australian Financial Review*, 24 August, p.49

Godsell David, 1993, *Auditors’ Legal Duties and Liabilities in Australia,* Longman Professional, Melbourne