Ethics, Fraud, and Internal Control

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Objectives

• Broad issues pertaining to business ethics
• Ethics in accounting information systems
• Ethical issues in information technology
• Management fraud and employee fraud
• Common fraud techniques in manual and computer-based systems
• Implications of computer technology on the internal control structure
Business Ethics

Why should we be concerned about ethics in the business world?

- Ethics are needed when conflicts arise--the need to choose
- In business, conflicts may arise between:
  - employees
  - management
  - stakeholders
- Litigation
### Four Main Areas of Business Ethics

**Ethical Issues in Business**

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<thead>
<tr>
<th>Equity</th>
<th>Executive Salaries</th>
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<td>Comparable Worth</td>
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<td>Product Pricing</td>
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<td>Rights</td>
<td>Corporate Due Process</td>
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<td>Employee Health Screening</td>
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<td>Employee Privacy</td>
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<td>Sexual Harassment</td>
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<td>Diversity</td>
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<td>Equal Employment Opportunity</td>
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<td>Whistle-Blowing</td>
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<td>Honesty</td>
<td>Employee and Management Conflicts of Interest</td>
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<td>Security of Organization Data and Records</td>
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<td>Misleading Advertising</td>
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<td>Questionable Business Practices in Foreign Countries</td>
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<td>Accurate Reporting of Shareholder Interests</td>
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<td>Exercise of Corporate Power</td>
<td>Political Action Committees</td>
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<td>Workplace Safety</td>
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<td>Product Safety</td>
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<td>Environmental Issues</td>
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<td>Divestment of Interests</td>
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<td>Corporate Political Contributions</td>
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<td>Downsizing and Plant Closures</td>
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Behavioral Stage Theory of Moral Development

Stage of Moral Evolution

- Stage 1
  - Punishment Orientation
  - Obey rules to avoid punishment.

- Stage 2
  - Reward Orientation
  - Obey rules to obtain reward.

- Stage 3
  - Good Boy/Girl Orientation
  - Conform to acceptable behavior standards to receive the approval of others.

- Stage 4
  - Authority Orientation
  - Obey rules to avoid censure by authority for not "doing one's duty."

- Stage 5
  - Social Contract Orientation
  - Obey rules to obtain respect of peers and maintain self-respect.

- Stage 6
  - Ethical Principle Orientation
  - Guided by self-selected ethical principles that promote self-esteem.
Computer Ethics…

Concerns the social impact of computer technology (hardware, software, and telecommunications).

**What are the main computer ethics issues?**

- Privacy
- Security and accuracy
- Ownership of property
- Environmental issues
- Equity in access
- Artificial intelligence
- Unemployment and displacement
- Computer misuse
- Internal control integrity
What is Fraud?

Five Conditions of Fraud

- **False representation** - false statement or disclosure
- **Material fact** - a fact must be substantial in inducing someone to act
- **Intent to deceive** must exist
- The misrepresentation must have resulted in **justifiable reliance** upon information, which caused someone to act
- The misrepresentation must have caused **injury or loss**
2002 CFE Study of Fraud

- Loss due to fraud equal to 6% of revenues—approximately $600 billion
- Loss by position within the company:

<table>
<thead>
<tr>
<th>Position</th>
<th>Percent of Frauds</th>
<th>Loss</th>
</tr>
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<tbody>
<tr>
<td>Manager and employee</td>
<td>6</td>
<td>$500,000</td>
</tr>
<tr>
<td>Manager alone</td>
<td>36</td>
<td>250,000</td>
</tr>
<tr>
<td>Employees alone</td>
<td>58</td>
<td>60,000</td>
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</table>
Enron, WorldCom, Adelphia
The Underlying Problems

- **Lack of Auditor Independence**: auditing firms also engaged by their clients to perform nonaccounting activities such as actuarial services, internal audit outsourcing services, and consulting.

- **Lack of Director Independence**: directors who have a personal relationship by serving on the boards of other companies, have a business trading relationship as key customers or suppliers, have a financial relationship as primary stockholders or have received personal loans, or have an operational relationship as employees.

- **Questionable Executive Compensation Schemes**: short-term stock options as compensation scheme result in short-term strategies aimed at driving up stock prices at the expense of the firm’s long-term health.

- **Inappropriate Accounting Practices**: a characteristic common to many financial statement fraud schemes.
  - Enron made elaborate use of special purpose entities to hide liabilities through off-balance-sheet accounting.
  - WorldCom transferred transmission line costs from current expense accounts to capital accounts, allowing them to defer some operating expenses and report higher earnings.
Sarbanes-Oxley Act

- Signed into law July 2002
- Its principal reforms pertain to:
  - The creation of the Public Company Accounting Oversight Board (PCAOB)
  - Auditor independence—more separation between a firm’s attestation and non-auditing activities
  - Corporate governance and responsibility—audit committee members must be independent and the audit committee must oversee the external auditors
  - Disclosure requirements—increase issuer and management disclosure, including off-the-balance items
  - New federal crimes for the destruction of or tampering with documents, securities fraud, and actions against whistleblowers
Why Fraud Occurs

Fire needs...

Oxygen  Fuel  Spark
Why Fraud Occurs- Fraud Triangle

Situational Pressures e.g.
an employee is experiencing financial difficulties

Available Opportunities e.g. poor internal controls

Rationalisation personal morals of individual employees
Employee Fraud

- Committed by **non-management personnel**
- Usually consists of: an employee taking cash or other assets for personal gain by circumventing a company’s system of internal controls
Management Fraud

- It is perpetrated at levels of management above the one to which internal control structure relates.
- It frequently involves using the financial statements to create an illusion that an entity is more healthy and prosperous than it actually is.
- If it involves misappropriation of assets, it frequently is shrouded in a maze of complex business transactions.
Fraud Schemes

• Three categories of fraud schemes according to the Association of Certified Fraud Examiners:
  A. fraudulent statements
  B. corruption
  C. asset misappropriation
A. Fraudulent Statements

- Misstating the financial statements to make the copy appear better than it is
- Usually occurs as management fraud
- May be tied to focus on short-term financial measures for success
- May also be related to management bonus packages being tied to financial statements
B. Corruption

- Examples:
  - bribery
  - illegal gratuities
  - conflicts of interest
  - economic extortion
C. Asset Misappropriation

- Most common type of fraud and often occurs as employee fraud.
- Examples:
  - making charges to expense accounts to cover theft of asset (especially cash)
  - lapping: using customer’s check from one account to cover theft from a different account
  - transaction fraud: deleting, altering, or adding false transactions to steal assets
Computer Fraud

- Theft, misuse, or misappropriation of assets by altering computer data
- Theft, misuse, or misappropriation of assets by altering software programming
- Theft or illegal use of computer data/information
- Theft, corruption, illegal copying or destruction of software or hardware
- Theft, misuse, or misappropriation of computer hardware
Using the general IS model, explain how fraud can occur at the different stages of information processing?
Input Manipulation

• This phase of the system is **most vulnerable** because it is very easy to change data as it is being entered into the system.

• Often referred to as “Data Diddling”

• Requires low level of computer expertise.

• Also, GIGO (garbage in, garbage out) reminds us that if the input data is inaccurate, processing will result in inaccurate output.
Program Manipulation

Program Frauds
- Altering programs to allow illegal access to and/or manipulation of data files
- Destroying programs with a virus e.g. Trojan Horse
- Requires perpetrators to have program-specific knowledge.

Operations Frauds
- misuse of company computer resources, such as using the computer for personal business
Output Manipulation

- Effected by targeting the output of the computer system.
- Achieved by falsifying instructions to the computer at the input stage.
- E.g.
  - Encoding falsified information on the back of bank cards & credit cards.
  - Salami Technique
Information Generation Fraud

Stealing, misdirecting, or misusing computer output

Scavenging

• searching through the trash cans on the computer center for discarded output (the output should be shredded, but frequently is not)
Internal Control Objectives According to SAS No. 78

1. **Safeguard assets** of the firm
2. **Ensure accuracy and reliability** of accounting records and information
3. **Promote efficiency** of the firm’s operations
4. **Measure compliance** with management’s prescribed policies and procedures
Modifying Assumptions to the Internal Control

Objectives

• **Management Responsibility**
  The establishment and maintenance of a system of internal control is the responsibility of management.

• **Reasonable Assurance**
  The cost of achieving the objectives of internal control should not outweigh its benefits.

• **Methods of Data Processing**
  The techniques of achieving the objectives will vary with different types of technology.
Limitations of Internal Controls

- Possibility of honest errors
- Circumvention via collusion
- Management override
- Changing conditions—especially in companies with high growth
Exposures of Weak Internal Controls (Risk)

- **Destruction** of an asset
- **Theft** of an asset
- **Corruption** of information
- **Disruption** of the information system
The Internal Controls Shield

Undesirable Events
- Access
- Fraud
- Errors
- Mischief

Exposure

INTERNAL CONTROL

Assets
Preventive, Detective, and Corrective Controls

Undesirable Events

Levels of Control

Preventive

Detective

Corrective

Preventive

Detective

Corrective

Preventive

Detective

Corrective

Preventive

Detective

Corrective

Preventive

Detective

Corrective

Preventive

Detective

Corrective
Auditing Standards

- Auditors are guided by **GAAS** (*Generally Accepted Auditing Standards*)
- 3 classes of standards
  - general qualification standards
  - field work standards
  - reporting standards
- For specific guidance, auditors use the AICPA’s **SASs** (*Statements on Auditing Standards*)
SAS No. 78

Describes the relationship between the firm’s...

- internal control structure,
- auditor’s assessment of risk, and
- the planning of audit procedures

How do these three interrelate?

The weaker the internal control structure, the higher the assessed level of risk; the higher the risk, the more auditor procedures applied in the audit. AIS is particularly concerned with the internal control structure.
Five Internal Control Components: SAS No. 78

1. Control environment
2. Risk assessment
3. Information and communication
4. Monitoring
5. Control activities
1. The Control Environment

- Integrity and ethics of management
- Organizational structure
- Role of the board of directors and the audit committee
- Management’s policies and philosophy
- Delegation of responsibility and authority
- Performance evaluation measures
- External influences--regulatory agencies
- Policies and practices managing human resources
2. Risk Assessment

- Identify, analyze and manage risks relevant to financial reporting:
  - changes in external environment
  - risky foreign markets
  - significant and rapid growth that strain internal controls
  - new product lines
  - restructuring, downsizing
  - changes in accounting policies
The AIS should produce high quality information which:
- identifies and records all *valid* transactions
- provides *timely* information in appropriate detail to permit proper classification and financial reporting
- *accurately* measures the financial value of transactions, and
- accurately records transactions *in the time period in which they occurred*
Auditors must obtain sufficient knowledge of the IS to understand:

- the classes of transactions that are material
  - how these transactions are initiated [input]
  - the associated accounting records and accounts used in processing [input]
- the transaction processing steps involved from the initiation of a transaction to its inclusion in the financial statements [process]
- the financial reporting process used to compile financial statements, disclosures, and estimates [output]
The process for assessing the quality of internal control design and operation

[This is feedback in the general AIS model.]

- Separate procedures--test of controls by internal auditors
- Ongoing monitoring:
  - Computer modules integrated into routine operations
  - Management reports which highlight trends and exceptions from normal performance
5: Control Activities

- Policies and procedures to ensure that the appropriate actions are taken in response to identified risks
  - performance reviews--results vs. forecasts
  - information processing
    - general controls
    - applications controls
  - segregation of duties
  - physical controls
Segregation of Duties

- In manual system, separation between:
  - authorizing and processing a transaction
  - custody and recordkeeping of the asset
  - subtasks

- In computerized system, segregation should exist between:
  - program coding
  - program processing
  - program maintenance
Nested Control Objectives for Transactions

Control Objective 1
- Authorization
- Processing

Control Objective 2
- Authorization
- Custody
- Recording

Control Objective 3
- Authorization
- Task 1
- Task 2
- Custody
- Task 1
- Task 2
- Recording
Physical Controls

Authorization

- used to ensure that employees are carrying out only authorized transactions
- *general* (everyday procedures) or *specific* (non-routine transactions) authorizations

Supervision

- a compensation for lack of segregation; some may be built into computer systems
Physical Controls

**Accounting Records**
- provide an audit trail

**Access Controls**
- help to safeguard assets by restricting physical access to them

**Independent Verification**
- reviewing batch totals or reconciling subsidiary accounts with control accounts
Internal Controls in CBISs

Transaction Authorization

- The rules are often embedded within computer programs.
  - EDI/JIT: automated re-ordering of inventory without human intervention
Segregation of Duties

- A computer program may perform many tasks that are deemed incompatible.
- Thus the crucial need to separate program development, program operations, and program maintenance.
Internal Controls in CBISs

Supervision

• The ability to assess competent employees becomes more challenging due to the greater technical knowledge required.
Internal Controls in CBISs

Accounting Records

- ledger accounts and sometimes source documents are kept magnetically
  - no audit trail is readily apparent
Access Control

- Data consolidation exposes the organization to computer fraud and excessive losses from disaster.
Internal Controls in CBISs

Independent Verification

- When tasks are performed by the computer rather than manually, the need for an independent check is not necessary.
- However, the programs themselves are checked.