

# Reporting irregularities in financial statements: case study



Nowadays, especially in Bulgaria, people are becoming more and more hungry for money, that is why the word fraud takes part more often in our speech. Fraud is part of criminal law, and it comes when we have personal gain by fraudulent way or damaging another individual. The most common purpose of frauds are connected with person or entities trying to assign and stole money or valuables. There are plenty of models, which are especially constructed to define and reveal frauds, most of them will be used in this paper to decide whether Asil Nadir should be sentenced or not. More about analysis and comparisons with other cases and examples of models can be found in appendix 1 and 2.

## **Proposed Fraud Investigation Plan for Polly Pack's Financial Statement Fraud**

Given below is the proposed investigation plan for Polly Pack's financial statement fraud:

### 1. Develop an understanding of the activities of Polly Pack

To understand the activities of microfinance institutions, the auditor should pay attention to: the main concerns of the leaders on the objectives and strategies of the institution, the institution's organizational structure, operation of its business, results of operations, ability to self-finance, operations and other major economic events may affect its financial statements, accounting issues and changes accounting policies, and funding sources.

To obtain this information, the auditor should meet with the leaders of the institution; visit at least one agency, and review reports and other documents.

1. 1 Interviews The auditor should meet the main leaders of Polly Pack, including CEO, the head of the financial service or financial director, credit responsibly and activities, and the head of information systems. This is also the time for the auditor to discuss the first time with the staff of the internal audit, the Board of Directors and major shareholders or lenders, if they have subjects of concern that should be subject to review missions on the basis of agreed or special audits procedures. During these interviews, the auditor should bear in mind the list of items of financial statements. After these initial meetings, the auditor should assess any breach of financial reporting requirements. Analysis of financial statement must be carried out prior to this interview since financial statements may present many significant anomalies.

If the first investigations reveal a level of unacceptable business practice or misleading presentation of financial, the auditor may seek further in-depth investigation into a particular area.

1. 2 Visits The auditor must visit several regional offices to acquire understanding of the institution's activities and responsibilities that were decentralized. Auditors should perform some initial visits at the stage of pre-commitment, and more visits during the planning phase.

1. 3 Review of financial reports and documents The auditor should also consider the reports and other documents for a better understanding of the institution. Unless they are not available, the following may be helpful:

- previously audited financial statements;
- budgets and strategic plans;
- the monthly activity reports, including tables of cash flows, the credit statistics and reports on outstanding;
- loan agreements and grants;
- assessments by donors;
- evaluation reports and correspondence from the authorities re-rules

A thorough reflection needs to be carried out on the appropriate reports for Polly Peck, according to its size and age.

1. 3 Understand the standards and accounting methods The accounting rules and methods of Polly Peck are not conventional, and therefore require special attention from the auditors

## **2. Evaluating Accounting Standards**

The external auditor shall determine the accounting standards used by the institution. Many microfinance institutions do not follow the national standards or international.

2. 2 The accounting policies During the pre-commitment, the external auditor should ask the management of the institution which accounting method it uses. Sometimes the service accounts of the institution are not able to answer this question. Many institutions have adopted accrual

accounting, sometimes in a modified form. This accounting method is consistent with the standards imposed by most accounting bodies. But some institutions continue to use cash. Auditors should know that it can be in the interests of Polly Peck to register their activities, especially the product credits, according to a cash basis, taking into account adjustment proposals made at the end of the year by the auditor. Since operations of Polly Peck were overseas in Turkey, it did not follow a uniform accounting from one account to another, which further complicates the work of the auditor.

2. 3 The legal structure of Polly Peck in Turkey in the Context of Company Law of the Region The auditor must look at how the institution considers as a publicly owned multinational. This vision often has implications for accounting. In foreign countries organizations usually produce financial reports that reflect less rigorously financial performance. Some do not even produce financial statements Annual. The majority uses the cash and excludes amortization, adjustments for inflation, provisions for risk changes, provisions for social security, and other similar items to gain from tax exemptions. As regulated financial institutions, Polly Peck must not only comply with generally accepted accounting principles, but also the specific regulations governing banks.

2. 3 Examine accounting statements for any financial irregularities Auditors must engage in the following activities

The external auditor should investigate books of account and internal control of the institution through:

- discussions with managers and staff at various levels;
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- review of documents such as procedure manuals, descriptions
- positions and organizational charts;
- consideration of the reports produced by the accounting department;
- compliance with the institution's activities, including IT operations and loan processing at headquarters and agencies

### **3. Reporting Irregularities in Financial Statements**

Accounting operations of Polly Peck were generally de-centralized because of the operations of the organization taking place in Turkey. In such companies, the activity of an agency is often recognized at the regional level, then transmitted periodically (usually monthly) to the head office. This is usually responsible for the production of consolidated financial statements. In some institutions, all the accounting is performed at headquarters.

**3. 1 Reporting irregularities of internal control systems** Multinational businesses need a strong system of internal control to ensure the success of its operation. However, Polly Peck was significantly weaknesses at this level, and the auditor should therefore pay particular attention to the evaluation system organization of internal control. Since, the board of Polly Peck was largely passive, and the governance structure tends to be lax. This is why the system of internal control organization of the institution depends largely on the level of commitment and competence of its management.

**3. 2 Take into account the audit risk** As with any audit, the auditor must explicitly assess the audit risk, that is to say, the opportunity to express an opinion on incorrect the accuracy of the financial statements of the institution, both in terms of financial statements at the level of account

balances. Audit risk has three components: inherent risk, the risk control, and the risk of non-detection. At the financial statement level, the main determine risks are inherent risk and control risk. Regardless of the system of internal control, some risks come from the nature of the business activities and its industry.

At Polly Peck a significant number of account staff did not fully understand the credit procedures as they have been trained to work in the social field rather than in the field financial. Accounting was carried out by staff with little experience of double entry accounting, international accounting standards, etc. In addition, the organization's activities were decentralized and geographically dispersed often in remote areas without adequate infrastructure.

3. 3 Identify breaches of risk control policies faulty procedures may cause a significant risk control through audits of microfinance institutions. Yet internal controls are crucial for microfinance institutions. When the internal control has too significant weaknesses, the audit of the institution may become impossible. If control risk is high, the auditor must evaluate whether we can to use extensive substantive tests, and if this approach is economically feasible for the institution. In addition to a thorough evaluation of internal controls, the external auditor must test the controls made at the account balances but prior to these tests, the external auditors should explain their understanding and evaluation systems, using checklists of descriptions and charts.

3. 4 Identify risk of non-detection The risk of non-detection, that is to say the risk of material misstatement not be detected by the auditor shall be determined for each balance account, this risk depends on the assessment of inherent risk and risk control.

3. 5 Defining the level of significance The definition of significance levels is crucial in determining the nature, e- tense, and timing of audit procedures. A significance level is limit beyond which the potential errors are considered problematic. If the sum of uncorrected misstatements identified during the audit de- passes the threshold of significance, the auditor may not be able to issue an unqualified opinion. The significance level is inversely related to audit risk. more the audit risk, that is to say the combination of inherent risk, risk control and the risk of non-detection is evaluated as important, the higher the threshold significance is low. In other words, only a low level of defects not corrected is acceptable. The significance depends on the determinants identified during the mission planning. An important determinant of financial statements is a factor that users of financial statements are most likely to focus their attention, given the nature of the institution. Identification of factors determinants is a matter of professional judgment. Determinants, which can be used to determine the significance level are e. g. net income, total assets, revenues, and funds own. Significance levels may vary between 2 and 10% of factor. In the United States, some use external auditors, as basis of materiality for a commercial bank, 2% of total assets. For an institution whose weak internal controls, the auditor may reduce significant at 1% of total assets acceptable rate

abnormalities. There is no general rules to define the thresholds of significance, hence the auditor should use his/her judgment.

The evaluation by the auditor of materiality and audit risk at planning the audit, may change after evaluating the results of audit procedures. This may be due to a change in circumstances, or a development of knowledge of the listener, following the audit. For example, if the audit is scheduled before the end of the year, the auditor will anticipate the results of and financial position. If actual results to differ materially from this estimate, the assessment of materiality and audit risk may be changed.

3. 6 Evaluation of the internal audit and relations with auditors internal The external auditor should consider the work of internal auditors during the phase planning the audit. Internal auditors evaluate and monitor systems accounting and internal control. Internal audit is an essential element to ensure a sound internal control system, and also an important tool reduction, detection and investigation of fraud.

3. 7 Obtain an approved status laws or regulations may impose establishment of an internal audit service. When there is an internal audit function, the auditor must evaluate its objectivity, its scope, technical skills and rigor. This assessment must include a review of the service organization, its staff, its purpose, its reports and programs. Potential conflicts must be evaluated. For example, if the audit service Internal reports on its work in the service that he is auditing, the question of the objectivity of the findings of the internal audit service arises. such situation can significantly reduce the value placed on the work of the internal auditor by the external auditor.

Ideally, the internal audit department must account of his work directly to the board or committee audit, if one exists. If the external auditor believes, following a screening assessment, the internal audit service is reliable, it must test the work performed by the service to confirm this assessment. This is usually done by performing a new test on a sample of the work performed by the auditor.

## Conclusion

The paper laid down a methodical approach to investigate fraud in financial statements of Polly Peck to identify whether the CEO or the top management of the company was involved in deliberate falsification of financial statements to raise share price of the company and to fraud shareholders of the company. The key consideration in this plan was triangulation of the elements of the investigation to find out whether all elements of the financial reporting match. Triangulation is all the more important for investigation of Polly Peck's finances since the operations of the company were overseas and centralized reporting was not carried out of company's finances.

## Appendix 1

In this Appendix will be reviewed a part of Polly Peck`s frauds and most of the unclear moves and actions of Asil Nadir, also will be made a consideration and comparison with Enron case.

Polly Peck was a great company with a superb vision on the market and it won't be a lie if it is said that is was a " shareholder dream" for every investor in the world. It has many close points of fraud to Enron case.

The first fraudulent coincidence is that in both cases the most important papers and documents disappear. Enron shredded tons of paper, while in Polly Peck's case they just disappear and Nadir told that there are no available and existing documents in their original.

The second conjunction with Enron case is that Polly Peck built a hotel in Turkey, which costs around 70 million and the debt of the company did not increase. In Enron the debts were " transferred and funded" to other small companies. The main idea here is the head company to looks attractive, valuable and without debts.

The third coincidences between both companies is that they deal with complementary goods, which can't be substitute. As well Enron, in Polly Peck case we have huge problems with accounting. In the first case we have fault accounting, here also emerge some misleadings in this sector/department.

## **Appendix 2**

In this appendix will take a look at the meanings of the methods and approaches, which are part of fraud investigation and help us to reveal a fraud. Firstly, it should be known that such investigation is quite expensive and it should be started if there are really serious reasons that fraud occur.

Testimonial evidence: This type of evidence is collected from people, who are interviewed and persuade to fill in honestly test, to realize whether we can believe in them. In Polly Peck's case should be used this model, to take an interrogation with the people worked for this company and eventually may know something important.

Documentary evidence: This type of evidence is collected from computers, documents, servers, data mining, public records, searches and so on. In addition, in such situations the databases are great source of information, no matter the information is deleted, it can be restored. This type of evidence can be used as well in this case, because most of the fraudulent information is saved on computers and if restored can answer us the basic question, is there a fraud or not.

Physical evidence: This type of evidence is concerned with taking fingerprints, id numbers, weapons, stolen property and so on, which can be linked to a fraudulent act.

Personal observation: This type of evidence is also named “sense” evidence, because it is very close to the information, which is “heard, seen, felt, etc.”.

A second method of investigating a scheme is to focus on the fraud triangles. It should be investigated all variants, elements of the following triangles.

Theft act: try to seize the perpetrator to wrench a data or information.

Concealment: In this part should be taken under consideration and used documents, computer hard disks, etc.

Conversion: is to define whether the defendant used money or property fraudulently for personal benefit. A great example of this type is the case: [Brandt v. State, 1944]