ABSTRACT
Financial statements that represent the financial and operational results of a business are the main sources when taking an investment, credit or another decision about that business. If the financial statements do not reflect the real scene, any decisions taken by anyone will be ineffective and factors will be allocated inefficiently. It is needless to say that right decisions depend on relevant, understandable and reliable financial statements. But the high profile accounting and auditing scandals experienced particularly in the 2000s cost a great deal of money and broke the reliability of financial information. This scene addresses countries to make new regulations and/or develop existing ones including International Accounting and Financial Reporting Standards (IAS/IFRS), International Standards on Auditing (ISA), and International Standard on Review Engagements (ISRE) in order to increase the reliability. The aim of this study is to clarify fraud concept and compare the regulations on fraud audit in publicly-held companies in the Turkish and US Capital Markets.

Key words: Fraud audit, fraudulent financial reporting, regulations on fraud audit, publicly-held companies

INTRODUCTION
The objective of financial statements is to provide information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions (Mirza et al., 2006: 7). But sometimes users may be provided with disinformation. This may results from an intentional act or somebody’s carelessness. If it is intentionally, it is called fraudulent financial reporting. Financial fraud is a serious problem worldwide. In the past decade, fraud has received considerable attention from the public, press, investors, the financial community, and regulators because of high profile reported fraud at large companies such as Lucent, Xerox, Rite Aid, Cendant, Sunbeam, Waste Management, Enron Corporation, Global Crossing, WorldCom, Adelphia, and Tyco (Rezaee, 2005: 278). Such accounting and auditing scandals experienced cost a great deal of money and broke the reliability of financial information. This scene addresses countries to make new regulations and/or develop existing ones including International Accounting and Financial Reporting Standards (IAS/IFRS), International Standards on Auditing (ISA), and International Standard on Review Engagements (ISRE) in order to increase the reliability. The aim of this study is to clarify fraud concept and compare the regulations on fraud audit in publicly-held companies in the Turkish and US Capital Markets.

I. FRAUD CONCEPT
A complete understanding of the nature, significance, and consequences of fraudulent financial reporting activities requires a proper definition of financial statement fraud.
Fraud is defined in Webster’s New World Dictionary as “the intentional deception to cause a person to give up property or some lawful right” (Rezaee & Riley, 2010: 4). Also fraud can be defined as “an act that involves the use of deception to obtain an illegal advantage” (Krambia-Kapardis, 2002: 266). Fraud is neither new nor easy to characterise. Ethical, legal, institutional and economic aspects are interrelated from the outset. Fraud usually implies deceit or bad faith, as opposed to good faith, integrity and honesty (Blanque, 2003: 61). In each country, the definition of fraud will be slightly different; however, in essence, it involves breaking the law and/or violating the regulatory framework. Fraud can be committed by individuals or management. For individuals, accounting fraud would generally involve theft of, for example, inventory or cash. For management, there is also the crime of preparing false financial statements intended to deceive users (Jones, 2011: 8).

The five basic elements of fraud are identified as (Rezaee & Riley, 2010: 7):

- A false representation of a material nature
- Knowledge that the representation is false or reckless disregard for the truth
- Reliance on the false representation by the victim
- Financial damages are incurred (to the benefit of the perpetrator)
- An act that was intentional

### 1.1. Types and Cost of Fraud

Association of Certified Fraud Examiners (ACFE) which is the world’s largest anti-fraud organization and premier provider of anti-fraud training and education categorize fraud as corruption, asset misappropriation and fraudulent statements. These categories are identified like the following (ACFE, 2010: 10):

**Asset misappropriations** are those schemes in which the perpetrator steals or misuses an organization’s resources. These frauds include schemes such as skimming cash receipts, falsifying expense reports and forging company checks.

**Corruption** schemes involve the employee’s use of his or her influence in business transactions in a way that violates his or her duty to the employer for the purpose of obtaining a benefit for him/herself or someone else. Examples of corruption schemes include bribery, extortion and a conflict of interest.

**Financial statement fraud** schemes are those involving the intentional misstatement or omission of material information in the organization’s financial reports. Common methods of fraudulent financial statement manipulation include recording fictitious revenues, concealing liabilities or expenses and artificially inflating reported assets.

According to ACFE’s 2010 Report to the Nations on Occupational Fraud and Abuse*, asset misappropriation schemes were the most common form of fraud in the study by a wide margin, representing 90% of cases — though they were also the least costly, causing a median loss of $135,000. Financial statement fraud schemes were on the opposite end of the spectrum in both regards: These cases made up less than 5% of the frauds, but caused a median loss of more than $4 million — by far the most costly category. Corruption schemes fell in the middle, comprising just under one-third of cases and causing a median loss of $250,000. In addition to observing the frequency and median losses caused by the three categories of fraud, the proportion of the total losses suffered based on scheme category is analyzed. The cases in ACFE’s study represented a combined total loss of more than $18 billion.

*This Report is based on data compiled from a study of 1,843 cases of occupational fraud that occurred worldwide between January 2008 and December 2009. All information was provided by the Certified Fraud Examiners (CFEs) who investigated those cases. The fraud cases in this study came from 106 nations — with more than 40% of cases occurring in countries outside the United States — providing a truly global view into the plague of occupational fraud.

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Chart 1. Percent of Total Losses Suffered Based on Fraud Categories

(Source: ACFE, 2010: 13)

<table>
<thead>
<tr>
<th>Fraud Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Misappropriation</td>
<td>20.80%</td>
</tr>
<tr>
<td>Corruption</td>
<td>11.30%</td>
</tr>
<tr>
<td>Financial Statement Fraud</td>
<td>68.00%</td>
</tr>
</tbody>
</table>
As indicated in the Chart 1., of the total reported losses that were attributable to a specific scheme type, approximately 21% were caused by asset misappropriation schemes, 11% by corruption and 68% by fraudulent financial statements. In Turkey, there is no statistic like that, unfortunately. In addition to the financial cost incurred by the victims, the cost of fraud includes the financial costs arising out of litigation, against auditors who fail to detect fraud, as well as damage to the accounting profession’s credibility (Krambia-Kapardis, 2002: 266). Another classification scheme divides fraud according to victims. These are summarized in Table 1.

Table 1. Types of Fraud

<table>
<thead>
<tr>
<th>Type of Fraud</th>
<th>Perpetrator</th>
<th>Victim</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee embezzlement</td>
<td>Employees of an organization</td>
<td>The employer</td>
</tr>
<tr>
<td>Vendor fraud</td>
<td>Vendors of an organization</td>
<td>The organization to which the vendors sell goods or services</td>
</tr>
<tr>
<td>Customer fraud</td>
<td>Customers of an organization</td>
<td>The organization which sells to the customers</td>
</tr>
<tr>
<td>Management fraud (Financial Statement Fraud)</td>
<td>Management of a company</td>
<td>Shareholders and/or debt-holders and regulators (taxing authorities, etc.)</td>
</tr>
<tr>
<td>Investment scams and other consumer frauds</td>
<td>Fraud perpetrators-all kinds</td>
<td>Unwary investors</td>
</tr>
<tr>
<td>Other (Miscellaneous) types of fraud</td>
<td>All kinds-depends on the situation</td>
<td>All kinds-depends on the situation</td>
</tr>
</tbody>
</table>

(Source: Albrecht et al., 2009: 11)

**Employee Embezzlement:** Employees use their positions to take or divert assets belonging to their employer. This is the most common type of fraud.

**Vendor Fraud:** Vendors either overbill or provide lower quality or fewer goods than agreed.

**Customer Fraud:** Customers don’t pay, pay too little, or get too much from the organization.

**Management Fraud (Financial Statement Fraud):** Management manipulates the financial statements to make the company look better than it is. This is the most expensive type of fraud.

**Investment Scams and Other Consumer Frauds:** These types of frauds are committed on the Internet and in person and obtain the confidence of individuals to get them to invest money in worthless schemes.

**Other (Miscellaneous) Types of Fraud:** Any time anyone takes advantage of the confidence of another person to deceive him or her.

### 1.2. Fraud Triangle

A well-known criminologist, Donald R. Cressey, created a model that has been used often in the years since he first proposed it. Cressey created the Fraud Triangle in which each leg of the triangle represents a different component of what causes a fraudulent act (Kardell, 2007: 17). One leg of the fraud triangle represents a perceived non-shareable financial need (i.e., perceived pressure). The second leg represents perceived opportunity, and the final leg stands for rationalization (Chen & Elder, 2007: 4).

![Fraud Triangle](source: Ramos, 2003)

The three sides of the triangle mean that the following (Ramos, 2003):

**Incentive/Pressure:** Management or other employees may have an incentive or be under pressure, which provides a motivation to commit fraud.

**Rationalization/Attitude:** Those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess an attitude, character or set of ethical values that allows them to knowingly and intentionally commit a dishonest act.
Opportunity: Circumstances exist - for example, the absence of controls, ineffective controls, or the ability of management to override controls - that provide an opportunity for fraud to be perpetrated. According to the fraud triangle, fraud will occur only if there is (1) a perceived opportunity to commit the fraud and not get caught, prosecuted and convicted; (2) a perceived pressure to commit the fraud (e.g., financial pressures, work-related pressures, egotistical pressures) and (3) an ability to rationalize the wrong-doing. If any of these three elements is eliminated, then fraud is not likely to occur (LaSalle, 2007: 77). According to AICPA (American Institute of Certified Public Accountants), although the risk of material misstatement due to fraud may be greatest when all three fraud conditions (e.g., attitude, opportunity, and incentives) are observed or evident, the auditor cannot assume that the inability to observe one or two of these conditions means there is no risk of material misstatement due to fraud (SAS No:99; Wilks & Zimbelman, 2002: 2).

The three legs of the Fraud Triangle also represent three approaches an organization could use to prevent fraud. Two legs, rationalization and social pressures, are difficult for organizations to manage. These two legs of the fraud triangle are derived from individual attitudes and circumstances which are generally beyond the control of the organization. The last leg, perceived opportunities, can be managed by the organization quite effectively (Kardell, 2007: 17). Therefore understanding the fraud triangle is essential to evaluating financial fraud. When someone is able to grasp the basic concept of the fraud triangle, they are able to better understand financial frauds, how they occur, why they occur, and what to do to stop them (Ravisankar et al., 2011: 492).

1.3. Victim Organizations

More than 40% of victim organizations in ACFE’s study were privately owned businesses, and nearly one-third were publicly traded companies, meaning that almost three-quarters of the victims represented in that study came from for-profit enterprises. 16% of the frauds reported to ACFE occurred at government agencies. Not-for-profit organizations were the least represented category, with less than 10% of frauds taking place at these entities (ACFE, 2010: 27).

Graph 1. Organization Type of Victim - Median Loss

![Graph](source:ACFE, 2010: 28)

In addition to experiencing the most frauds, private and public companies were also victim to the costliest schemes in ACFE’s study as indicated in Graph 1. The median loss for the cases at these businesses was $231,000 and $200,000 respectively. In contrast, the losses experienced by government agencies and not-for-profits were about half as much. Government agencies had a median loss of $100,000 while not-for-profits lost a median of $90,000 (ACFE, 2010: 27). Most experts agree that preventing fraud is much easier and less expensive than actually detecting the fraudulent activities. Companies may be unaware of how expensive fraud can be until they become victims of fraud. There are two types of expenses incurred: the direct costs of the fraud itself and the indirect costs of the follow-up investigation and legal representation. The direct monetary loss associated with fraud is the cost of the fraudulent activity itself, including the money taken, inventory stolen, or other asset loss due to the fraud. Calculating this expense can be a daunting task if the fraudster decides not to cooperate and identify the full extent of the fraudulent activity. Furthermore, recovery of the loss is rare. The indirect costs include the legal representation for the company against the perpetrator in civil actions. Companies can incur further legal expenses if the fraud becomes a criminal matter. Companies themselves may also become the subject of a civil or criminal action, and incur further expenses, if the fraud resulted in the loss of money to an outside entity or another individual such as another employee (Kardell, 2007: 16-17).

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3. Regulations on Fraud Audit: Turkish and US Capital Markets Case

In 2001, the financial fraud being perpetrated at Enron become public, partly due to whistleblower Sherron Watkins. The fraud was the largest in history at that point. In the preceding decade, several other significant financial frauds had occurred such as Waste Management, Sunbeam, and Phar-Mor. As we know, the Enron fraud caused a significant number of activities in Congress and the profession. On July 30, 2002, Congress passed the Sarbanes-Oxley Act of 2002 (SOX). In December 2002, the AICPA adopted SAS no.99 Consideration of Fraud in a Financial Statement Audit, which superseded SAS no.82. The most significant differences between SAS no.99 and its predecessor are the process itself and the auditor’s responsibility for immaterial frauds (Singleton & Singleton, 2010: 302). Sarbanes-Oxley Act of 2002, which may be the most important legislation affecting the public accounting profession in our lifetime focused on five critical improvements related to auditing and auditing and the financial statements (Rittenberg et al., 2010: 13):

1. Improved corporate governance  
2. Required reporting on internal controls  
3. Audit standard setting moved to a new quasi-public organization  
4. Improved independence of the external audit function  
5. Acknowledgment of greater public expectations of auditors.

SOX aims to restore investor confidence in US capital markets by improving corporate governance, the quality of audits, and the strength of internal controls in part by increasing the consequences management can encounter if they are caught committing financial statement fraud (Ugrin & Odom, 2010: 440).

SAS 99 established standards and provided guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). SAS 99 did not change the auditor’s responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. However, it did establish standards and provide guidance to auditors in fulfilling their responsibility, as it relates to fraud (Albrect et al., 2008: 6). SAS 99 reflects the public’s expectation that the auditor will use a proactive approach to fraud detection. That approach must start with planning the engagement with a proper consideration of the likelihood that fraud exists within the company (Rittenberg et al., 2010: 420). SAS 99 defines fraud as an intentional act that results in a material misstatement in financial statements. There are two types of fraud considered: misstatements arising from fraudulent financial reporting (e.g., falsification of accounting records) and misstatements arising from misappropriation of assets (e.g., theft of assets or fraudulent expenditures). The standard describes the fraud triangle. Generally, the three ‘fraud triangle’ conditions are present when fraud occurs (http://en.wikipedia.org).

The audit should be designed to provide reasonable assurance that material fraud will be detected. Further, the standard reemphasizes the need for professional skepticism on every audit engagement - even those in which the auditor has great familiarity and trust in the client and its management. SAS 99 recognizes that management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and overriding established controls that otherwise appear to be operating effectively (Rittenberg et al., 2010: 419-420). In Turkey, Capital Markets Board (CMB of Turkey) issued the first guide about independent external auditing in 1987. Also the first communication Series:X No:16 was issued in 1996. Series:X No:22 “Communication on Independent Auditing Standards in Capital Markets” issued by CMB of Turkey in 2006 is used at independent auditing of publicly-held companies. This communication was prepared by following ISA and ISRE.

The sixth part of the communication is about fraud and abuse. Fraud and abuse is defined as “an act including deception to obtain an illegal advantage by business managers or people responsible for business management, employees or third parties. The probability of identifying fraud and abuse acted by business management is lower than the acted by employees. According to the communication, there are two types of fraud: asset misappropriation and fraudulent financial statements. Asset misappropriation includes stealing or misusing the business’ assets. Generally, it is acted by employees in a relatively unimportant amount. Fraudulent financial statement is misleading for financial statement users through intentional misstatement or omission of information in financial reports of the business. Also the Series:X No:22 identifies pressures, incentives and opportunities as “fraud risk factors”. Fraud risk factors do not always mean that a fraud exists. Therefore, independent auditor should evaluate these factors and fraud possibility by using professional opinion. Due to the nature of auditing and its inherent limitations (i.e. using sampling method, time pressure on auditors), auditor may not have absolute assurance. Therefore, independent auditing is based on reasonable assurance. Reasonable assurance means that collecting enough and proper auditing argument and deciding financial statements as a whole do not include an important misstatement in terms of quality and quantity.
Independent auditor takes a professional skeptical look at the auditing arguments. All these similarities or differences discussed are summarized in Table 2.

Table 2. Comparisons on SAS 99 and Series:X No:22

<table>
<thead>
<tr>
<th>Types of Fraud</th>
<th>SAS 99</th>
<th>Series:X No:22</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provide (based on)</td>
<td>Fraud Triangle</td>
<td>Fraud Risk Factors</td>
</tr>
<tr>
<td>Emphasize</td>
<td>Professional Skepticism</td>
<td>Professional Skepticism</td>
</tr>
<tr>
<td>Responsibility</td>
<td>Management</td>
<td>Management</td>
</tr>
</tbody>
</table>

Both of the regulations classify fraud in two categories as fraudulent financial reporting and asset misappropriation. Although SAS 99 calls fraud conditions as “fraud triangle”, Series:X No:22 calls them as “fraud risk factor”. According to these two regulations, auditing is based on reasonable assurance. Absolute assurance is already impossible because of auditing limits. In addition, each regulation emphasizes professional skepticism and management responsibility.

CONCLUSIONS

Efficiency, liquidity, safety, and robustness of financial markets are vital to the nation’s economic prosperity and growth, as millions of people directly or indirectly invest in the capital markets. Investors participate in capital markets as long as they have confidence in the quality, reliability, and transparency of public financial information disseminated to the markets (Rezaee&Riley, 2010: 4). If the market does not receive reliable data, investors lose confidence in the system, make poor decisions, and may lose a great deal of money; ultimately, the system may fail (Rittenberg et al., 2010: 2). At the present day, fraud in the accounting environment is on the increase, causing enormous losses to firms, individuals, and society and creating a morale problem in the workplace (Belkaoui and Picur, 2000: 33). Nobody can calculate costs of fraud because of its domino effect which begin from decision maker and move to shareholders, nation’s economy and even other nation’s economy as a result of globalization. Many countries note the cost of fraud by the accounting and auditing scandals experienced and have made regulations in order to decrease losses that fraud caused. In this study, regulations on fraud audit in publicly held companies operating in US and Turkish capital markets were compared. As a result of this comparison, similarities between SAS 99 and Series:X No:22 were striking. Both of these regulations regulate auditing in publicly held companies. Such regulations not only facilitate auditing but also decrease auditing costs. Further, the more the regulations are robust, the more reliable and healthy the financial statements occur.

REFERENCES


