FINANCIAL STAEMENT FRAUDS

<u>THESIS STATEMENT</u>

Role of the Audit Committee, under the Legal Framework of Pakistan, needs to be enhanced in Order to Effectively Overcome Financial Statement Frauds.

Submitted by
Riffat Mahmood Khan
179-FSL/LLMCL/F07
riffatkhanlaw@gmail.com

Supervised by
Mr. Muhammad Yousaf Amanat

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Final Approval

It is certified that we have read the dissertation submitted by Miss Riffat Mahmood Khan, titled "Role of the Audit Committee, under the Legal Framework of Pakistan, needs to be enhanced in Order to Effectively Overcome Financial Statement Frauds" as partial fulfillment of requirement of degree of LL.M (Corporate Law).

We have evaluated the dissertation with respect to its scope, quality and excellence and found it up to University requirement for award of degree of LL.M

Examination Committee

Supervisor

Mr. Muhammad Yousaf Amanat

Visiting Lecturer, IIUI

External Examiner

Mr. Misbah-ul-Mustafa

Visiting Lecturer, IIUI

Internal Examiner

Mr. Attaullah Khan Mahmood

Associate Professor, IIUI

بسم الله الرحمن الرحيم

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DEDICATION

I dedicate my this research work to my Parents

Mr. Muhammad Mahmood Khan

And

Mrs. Muhammad Mahmood Khan

Riffat Mahmood Khan

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I am gratefulness to Mr. Imran Ahsan Khan Nyazee for his guidance in formulating this research statement.

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Riffat Mahmood Khan

LIST OF ABBREVIATIONS

ACFA	Association of Certified Fraud Examiners
AICPA	American Institute of Certified Public Accountants
BSE	Bombay Stock Exchange
CCG	Code of Corporate Governance of Pakistan, 2002.
CEO	Chief Executive Officer
CFO	Chief Finance Officer
COSO	Committee of Sponsoring Organizations
CPA	Certified Public Accountants
DTR	Disclosure and Transparency Rules as issued by FSA
FSA	Financial Services Authority (UK)
IAS	International Accounting Standards
ISA	International Standards on Auditing
KSE	Karachi Stock Exchange
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
SAS	Statement on Auditing Standards of AICPA
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission (USA)
SECP	Securities and Exchange Commission OF Pakistan
SPE	Special Purpose Entity

LIST OF CASES

1. Enron Case (USA, 2002)

2. Hafizullah & Co., Chartered Accountants (2006 CLD 588)

3. Kamran & Co., Chartered Accountants (2006 CLD 1023)

4. Messrs Gardezi & Co. Chartered Accountants (2008 CLD 861)

5. Securities and Exchange Commission Vs. Ranko Ron Cucuz, William D. Shovers, Jesus Bonilla-Valdez, Ronal D. Kolakowski, and HLI Operating Company , Inc., April 2006.

ABSTRACT

This research is conducted to examine the financial statement frauds and their prevention and detection by the Audit Committee under the legal framework of Pakistan. In this age of corporatization it is of crucial importance to retain the confidence of the investors on fair functioning of the corporations. This depends principally on the transparency and credibility of financial reporting system of a company. The presence of an effective and efficient Audit Committee among the Board of Directors of the company ensures the veracity and credibility of the financial statements and corporate reports of a company. A vigilant oversight function by the Audit Committee significantly prevents the instances of the financial statement frauds in a company.

Under the legal framework of other countries the Audit Committee is working competently, in terms of its composition and responsibilities, in controlling financial statement frauds. Under the legal framework of Pakistan the Audit Committee is not functioning effectively due to the fact of lack of strict legislation in this regard. It is strongly recommended that the role of the Audit Committee should be enhanced in Pakistan by introducing new provisions in the Companies Ordinance, 1984 and Code of Corporate Governance so that the cases of financial statement frauds could be avoided.

PREFACE

FINANCIAL STAEMENT FRAUDS

Role of the Audit Committee, under the Legal Framework of Pakistan, needs to be enhanced in Order to Effectively Overcome Financial Statement Frauds.

Financial statement frauds, being a kind of corporate crimes, are unfortunate fact of commercial life distressing large and small business alike. Financial statement frauds are committed by the management and the accounting staff of the company. In some cases the auditors are also involved in such frauds. Such frauds are committed through manipulation of accounts in financial statements. Financial statements are misrepresented by addition or omission of digits in such frauds. Financial statement frauds cause a huge amount of loss to the companies in which these are committed.

Financial statement frauds are in fact cooking or doctoring of account books by concealment of factual financial position of a company. In most of the cases of such frauds top management is involved. Such frauds are committed by falsely inflating revenues or decreasing expenses, and also by improper deferral of expenses in financial statements in order to misrepresent the financial position of company.

Enron was the first largest financial scandal of the world, in USA, in year 2002, which left the whole world thinking about these financial frauds, and their prevention. Owing to this, and some other like financial scandals the confidence of the investors in credibility of financial statements and corporate reports was shaken, and the integrity and reliability of financial reports became a very important & sensitive matter. The Sarbanes Oxley Act, 2002(USA) was a response to these financial statement frauds. The Sarbanes Oxley Act, 2002 brought into limelight the importance of 'Audit Committee'[1], and attempted to strengthen its role.

Audit Committee oversights the financial reporting system of a company. It checks the effectiveness of the system of internal control in a company. A vigilant oversight function by the Audit Committee can substantially reduce the instances of financial statement frauds and significantly prevent and detect their occurrence.

Since financial statement frauds are easier to prevent than to detect, a vigilant and efficient Audit Committee is indispensable for the prevention of such frauds. A strong and independent Audit Committee has increasingly become vital part of an organization's governance.[2] The composition of an Audit Committee is very important in determining its efficiency. As the main responsibility of the Audit Committee is to oversee the financial

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[1] A committee, of Board of Directors, of a company that oversights the financial reporting system of a company

[2] See Steven A. Harrast and Lori Mason-Olsen , "Can Audit Committees Prevent Management Fraud?", *The CPA Journal Online (January 2007)* , http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20 , 2008).

reporting process of a company, the members of the Audit Committee are required to be financially literate so that they could perform their functions in a sound manner. In order to keep the Audit Committee out of influence of the management the members of the Audit Committee are required to be non-executive directors.

The stronger the Audit Committee of a country, the lesser are the chances of frauds in its companies. The Audit Committee of the developed states is much competent, strong and efficient, and effectively controls the financial statement frauds as compared to the same in Pakistan.

The intention of this thesis is to study the role of the Audit Committee in controlling financial statement frauds in Pakistan, in context of the role performed by Audit Committee under the legal framework of other jurisdictions. The first chapter has focused on financial statement frauds. In second chapter it is seen that how the Audit Committee plays its role in detection and prevention of financial statement frauds. The role of the Audit Committee under legal framework of some other jurisdictions like USA, UK and India is overviewed in the third chapter. The role of the Audit Committee under the legal frame work of Pakistan is examined and analysed, in the light of case law, in 4th chapter. The final chapter consists of two parts. In first part the conclusion of the dissertation is drawn. In the second part the recommendation, for enhancement of the role of Audit Committee, under the legal framework of Pakistan, are prescribed.

Chapter # 1

INTRODUCTION AND FUNDAMENTAL CONCEPTS

1.1 Introduction:

Financial statement frauds are among the kinds of 'corporate crime '[1]. These frauds are committed by the management of a corporation. Sometimes management alone is involved in these frauds, and sometimes auditors are also involved in them. These frauds cost companies a massive amount. According to US Department of Justice financial statement fraud is one of the three kinds of corporate frauds.[2] The number and size of these frauds is largely increasing.[3] There are numerous instances of such frauds in the recent years that undermine the quality, and reliability of financial reporting process.[4]

Enron was the first largest financial statement frauds of the world in US in year 2001, followed by some other like cases, that left the whole world thinking about these financial frauds and their prevention. Sarbanes Oxley Act 2002 was a response to these frauds.

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1 A crime, committed against a corporation or by a corporation, by its employees by way of deception.

2 See Keith Slotter, *Financial Fraud and the FBI* ,(paper presented at the LSU Fraud and Forensic Accounting Conference, America, 2007), www.bus.lsu.edu/academics/accounting/events/downloads/2007/SlotterPresentation (assessed July 19, 2008)

3 See W. Steve Albrecht, *Business Fraud (The Enron Problem)* (n. d.), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

4 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 1.

Due to the Enron disaster, and other financial scandals of the same nature, caused by fraudulent financial statements, many investors lost confidence in credibility of financial statements and corporate reports.[5] Consequently, the veracity and reliability of financial statements and reports became a very crucial & sensitive concern.[6]

1.1.1 Financial Statements:

Financial statements are formal records of financial activities of a business, or other entity. These provide an overview of financial condition of the business in both short and long term.[7] In the financial statements all the relevant financial information of a business is presented in a systematic manner and in a form easy to understand. Financial statements are used to analyse the fianancial position of a company by many users like investors, financial institutions (banks and other lending companies), creditors, owners, management, tax authorities, securities analysts and general public.

1.1.2 Kinds of Financial Statements:

Financial Statements are of four kinds which are as follow:

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5 See W. Steve Albrecht, *Business Fraud (The Enron Problem)* (n. d.), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

6 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 1.

7 See Wikipedia, The Free Encyclopedia, *Financial Statements*, http://en.wikipedia.org/wiki/Financial_statements (assessed Aug 16, 2009).

i. Balance Sheet:

A Balance Sheet shows at a specific Date the ***financial position*** of the company by indicating the resources that it owns, the debts that it owes, and the amount of owner's equity (investment) in the business.[8] It is called a 'balance' sheet because the amount of assets is equal to the sum of the liabilities and owner's equity.[9]

ii. Income Statement:

An Income Statement indicates the ***profitability*** of the business over the preceding year. or other time period.[10] It presents the results of the entity's operations during a period of time such as one year. Since the Income Statement reports on a business' profit and loss it can also be referred to as a Profit and Loss Statement.[11]

iii. Statement of Owner's Equity or Retained Earnings:

A **statement of owner's equity** explains certain changes in the amount of owner's equity in the business by highlighting the equity positions at the beginning and end of the reporting period.[12]

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[8] See Robert F. Meigs and Walter B. Meigs, *Accounting: The Basis for Business Decisions*.9th ed.1993 p. 7

[9] See Professor Cram, Financial Statements: Overview http://www.college-cram.com/study/accounting/accounting-cycle/financial-statements-overview

[10] See Robert F. Meigs and Walter B. Meigs, *Accounting: The Basis for Business Decisions*.9th ed.1993 p. 7

[11] See Professor Cram, *Financial Statements: Overview* http://www.college-cram.com/study/accounting/accounting-cycle/financial-statements-overview

[12] See Professor Cram, *Financial Statements: Overview* http://www.college-cram.com/study/accounting/accounting-cycle/financial-statements-overview

iv. Statement of Cash Flow:

A Statement of cash flows summarizes the cash receipts and cash payments of the business over the same time period covered by the income statement.[13] It shows how money has flowed into and out of the company, and generally demonstrates the short-term viability of the company's cash position.[14]

Owing to the high number of reports of corporate failures in the recent years, financial statement fraud has become the centre of public and regulatory interest.[15] Almost every corporation of the world is bothered by the financial statement frauds and is keen to know how to overcome them. The penalties for fraudulent financial reporting have significantly increased that clearly reflects the view of society on such frauds. For example, Bernard Ebbers, the former chairman of WorldCom was recently jailed for a period of 25 years for devising a $US11 billion financial statement fraud.[16]

For understanding financial statement fraud it is pertinent to point out what fraud actually is.

1.2 Fraud:

Black's Law Dictionary defines fraud as:

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13 See Robert F. Meigs and Walter B. Meigs, *Accounting: The Basis for Business Decisions* .9th Ed. p. 7

14 See Professor Cram, *Financial Statements: Overview* http://www.college-cram.com/study/accounting/accounting-cycle/financial-statements-overview

15 See Paul Coram, Colin Ferguson, Robyn Moroney, *The Value of Internal Audit in Fraud Detection* (May, 2006) , 9 , www.afaanz.org/research/AFAANZ%200642.pdf (assessed August 4, 2008).

16 Ibid.

"All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated".[17]

Fraud, in general, is defined in Webster's New World Dictionary as

"The intentional deception to cause a person to give up property or some lawful right."[18]

Fraud is a criminal act committed, by a person or persons, to deceive another or others, in any way. Fraud is a "Conduct based on deceit, forgery or corruption."[19] "Fraud is like an elephant, easier to recognize than to define."[20]

1.2.1 History of Fraud Offences:

Though stealing property or goods has been a crime at common law since the most primitive recorded times,[21] to gain property or advantage by way of deception is prohibited under the criminal law only as a result of legislation. In past, while the common law recognized crimes

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17 Henry Campbell Black, Black's Law Dictionary 5th ed. (West Publishing Co., St. Paul, Minnesota, 1979)

18 See Barbara R. Farrell and Joseph R. Franco, "The Role of the Auditor in the Prevention and Detection of Business Fraud: SAS No. 82," *Western Criminology Review 2/1* (1999), http://wcr.sonoma.edu/v2n1/farrell.html (assessed July 19, 2008).

19 See Gavin McFarlane, *The Layman's Dictionary of English Law* (London : Waterlow Publishers Limited , 1984) , 116.

20 Asad Ali Shah, *Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud , Pakistan's Experience,* http://www.oecd.org/dataoecd/5/13/39367990.pdf (assessed July 13, 2008).

21 Sir James Fitzjames Stephen, *A History of the Criminal Law of England* (1883) vol. 3, in Alex Steel, "Money for Nothing, Cheques for Free? The Meaning of 'Financial Advantage' in Fraud Offences," *Melbourne University Law Review,* vol. 31 (2007) , 202- 4 , http://works.bepress.com/cgi/viewcontent.cgi?article=1001&context=alex_steel pdf (assessed July 15, 2008.

1.3 Financial Fraud:

1.3.1 Definition:

"Financial fraud is any non-violent offense that is committed by or against an individual or corporation and results in a financial loss".[26]

Under 'ISA 240'[27] it is defined as,

"An intentional act, done by one or more individual among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage."

1.3.2 Meaning and Nature:

Financial frauds are one of the kinds of corporate frauds that result in monetary loss to the corporations. Being fraud against the corporation, owned by the shareholders, financial frauds are also termed as also shareholder frauds.[28] These frauds occur when the employees of a corporation deliberately mislead the company's shareholders by misrepresenting the information in the financial statements or other corporate reports. Financial frauds are most

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26 Lawyershop, *Financial crime*, http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/financial-crimes/ (assessed 16 July ,2008).

27 ISA stands for International Standards of Auditing. ISA 240 is one of these International Standards of Auditing titled *"The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements"* redrafted in December 2006. These statndards are issued as guideline for auditing professional by the International Auditing and Assurance Standard Board (IASSB), a standard setting board of the International Federation of Accountants (IFAC) which is the global organization for the accountancy profession having 157 member bodies and associates in 123 countries of the world.

28 See Shareholder Fraud InfoCenter , *Shareholder Fraud Information*, http://www.shareholderfraudinfocenter.com/information.php (assessed July 16, 2008).

common form of white collar crimes[29] and are increasingly largely. The rate of increase in such frauds is alarming[30]. In the year 1998 more than 300,000 people were arrested in USA for financial fraud. In year 1999, roughly one-third of Americans fell victim of such frauds.[31] Financial frauds seem to grow more rapidly than international trade.[32] At present financial frauds are more complex and involve larger sums than ever before. The most common form of financial frauds is financial statement fraud.

1.4 Financial Statement Fraud:

1.4.1 Definition:

The definition of financial statement fraud is found in several authoritative reports and books. Financial statement fraud is defined by the Association of Certified Fraud Examiners (ACFE) as:

"The intentional, deliberate, misstatement or omission of material facts, or accounting data in the financial statements which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision".[33]

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29 See Lawyershop, *Financial crimes,* http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/financial-crimes/ (assessed 06 July ,2008)

30 See Finextra.com, *UK Financial Fraud Rising-CIFAS* (April 24, 2007) , http://www.finextra.com/fullpr.asp?id=14576 (assessed August 5, 2008).

31 Ibid.

32 See Richard M Leary, Wim Vandenberghe and John Zeleznikow , *Towards a Financial Fraud Ontology a Legal Modelling Approach* (paper presented at the ICAIL Workshop on Legal Ontologies & Web based legal information management, 2003), 8 , http://www.lri.jur.uva.nl/~winkels/LegOnt2003/Leary.pdf (assessed July 11 ,2008)

33 Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 2.

common form of white collar crimes[29] and are increasingly largely. The rate of increase in such frauds is alarming[30]. In the year 1998 more than 300,000 people were arrested in USA for financial fraud. In year 1999, roughly one-third of Americans fell victim of such frauds.[31] Financial frauds seem to grow more rapidly than international trade.[32] At present financial frauds are more complex and involve larger sums than ever before. The most common form of financial frauds is financial statement fraud.

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29 See Lawyershop, *Financial crimes*, http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/financial-crimes/ (assessed 06 July ,2008)

30 See Finextra.com, *UK Financial Fraud Rising-CIFAS* (April 24, 2007) , http://www.finextra.com/fullpr.asp?id=14576 (assessed August 5, 2008).

31 Ibid.

32 See Richard M Leary, Wim Vandenberghe and John Zeleznikow , *Towards a Financial Fraud Ontology a Legal Modelling Approach* (paper presented at the ICAIL Workshop on Legal Ontologies & Web based legal information management, 2003), 8 , http://www.lri.jur.uva.nl/~winkels/LegOnt2003/Leary.pdf (assessed July 11 ,2008)

33 Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 2.

The Treadway Commission report defined financial statement fraud as:

"Intentional or reckless conduct, whether act or omission, that results in material misleading financial statements."[34]

The American Institute of Certified Public Accountants (AICPA), in its Statement of Auditing Standards (SAS) No. 99, defined financial statement fraud in this way:

"An intentional act that results in a material misstatement in financial statements that are the subject of an audit."[35]

1.4.2 Meaning and Nature:

Financial statement fraud is a deliberate deception which results in loss, injury, or damage to the company. It is in fact cooking or doctoring of account books by concealment of accurate facts about the financial position of a company. It is committed through accounts manipulation in financial statements for misrepresenting the financial position of company. Financial statements are misrepresented by addition or omission of digits in these frauds.

The terms financial statement fraud and management fraud are same as management is responsible for preparing reliable and fair financial statements and the top management is almost always involved when this kind of fraud occurs. The cost of fraudulent financial

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34 Ibid.

35 See Public Company Accounting Oversight Board , Standing Advisory Group Meeting , *Financial Fraud* (September 8-9,2004), http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Fraud.pdf (assessed July 21, 2008)

reporting is greatly far above the ground than any other kind of fraud. [36]

In the ACFE's first survey, "Report to the Nation on Occupational Fraud and Abuse," published in 1996, it is stated that financial statement fraud is one of three principal illegal schemes committed against organizations.[37] The forms and faces of financial statement fraud are many, and often disastrous.[38]

1.5 Modes of Committing Financial Statement Frauds:

Financial statement frauds are committed by manipulation of accounts in financial statements. There are following modes of committing financial statement frauds.

1.5.1 Overstatement of Assets and Income

1.5.2 Understatement of Liabilities and understatement of Expenses

1.5.3 Understatement of Assets and Income

1.5.4 Overstatement of Liabilities and Expenses

1.5.5 Creating 'Special Purpose Entities'

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[36] See, e.g., Asad Ali Shah, *Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud, Pakistan's Experience,(n. d.),* http://www.oecd.org/dataoecd/5/13/39367990.pdf (assessed July 13, 2008).

[37] See Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Online Journal of Accountancy* (January 2002), http://www.aicpa.org/pubs/jofa/apr2002/wells.htm (assessed July 19, 2008).

[38] See Courtenay Thompson, *Exposing Financial Statement Fraud* (Dec,1999), 1, http://findarticles.com/p/articles/mi_m4153/is_6_56/ai_58451919 (assessed August 6, 2008).

1.5.1 Overstatement of Assets and Income:

i. Overstating Assets:

Assets of the company are falsely overstated in order to represent the financial position of the company much stronger than actual. Assets are usually overstated by overstatement of current assets such as marketable securities. Assets are also overstated in financial statements in cases of mergers and acquisitions.[39] . The 1997 COSO study indicated that deliberate overstatement of company assets occurred in 38% of cases of financial statement frauds.[40]

Example:

WorldCom case is an example of financial statement fraud committed by way of overstatement of assets.[41]

ii. Falsely Inflating/Overstating Revenues by Improper Revenue Recognition:

Falsely overstating revenue by improper revenue recognition is also a technique of committing financial statement fraud.[42] The first COSO study in 1987 identified

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39 See W. Steve Albrecht, *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

40 Kerry L. Francis and Albert Lilienfeld, *Why Understand Financial Accounting and Reporting Fraud,*(paper presented at ? 15th Annual International Conference, Orlando, Florida, November 12, 2002), http://plusweb.org/files/Events/D&O-Francis%20Handout.pdf (assessed August 10, 2009).

41 See W. Steve Albrecht, *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

42 See Keith Slotter, *Financial Fraud and the FBI* ,(paper presented at the LSU Fraud and Forensic Accounting Conference, America, 2007),

improper revenue recognition in 47% of the cases of financial statement frauds reviewed from 1981 to 1986 in USA. Improper revenue recognition technique was used in 50% of the financial statement fraud cases filed in USA from year 1987 to 1997 and in excess of 60% of the cases filed in year 2000.[43]

There are many ways of improper revenue recognition. Some are as follow.

a. Bill and Hold:

'Bill and Hold' is recognition of revenue from sale transactions that are billed, but not shipped. For example recognition of revenue when products or services are not delivered,[44] or the sale is not substantially completed and the risk of ownership or loss remains with the seller.[45]

b. Out of Period Sale:

Out of period sale is recognition of revenue prior to the completion of the sale transaction. The earning is not accomplished at the time revenue is recognized.[46] Thus, revenues are prematurely recognized in this case.

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www.bus.lsu.edu/academics/accounting/events/downloads/2007/SlotterPresentation (assessed July 19, 2008)

[43] Kerry L. Francis and Albert Lilienfeld, *Why Understand Financial Accounting and Reporting Fraud,*(paper presented at ? 15th Annual International Conference, Orlando, Florida, November 12, 2002), http://plusweb.org/files/Events/D&O-Francis%20Handout.pdf (assessed August 10, 2009).

[44] Deloitte, *Ten Things About Financial Statement Frauds: A Review of SEC Enforcement Releases, 2000-2006,* Deloitte Forensic Center, June 2007 http://www.prnewswire.com/mnr/deloitte/28699/docs/28699_Graphics_10_Things_on_Fraud_booklet_3.PDF (assessed June 20, 2009).

[45] Kerry L. Francis and Albert Lilienfeld, *Why Understand Financial Accounting and Reporting Fraud,*(paper presented at ? 15th Annual International Conference, Orlando, Florida, November 12, 2002), http://plusweb.org/files/Events/D&O-Francis%20Handout.pdf (assessed August 10, 2009)

[46] Deloitte, *Ten Things About Financial Statement Frauds: A Review of SEC Enforcement Releases, 2000-*

c. Roundtripping:

One way of revenue recognition that has received increased attention in recent times is "roundtripping.". In practice of roundtripping a company provides funds or its assets to customers so that the customers could purchase and pay for a product, with no sound probability that the customers would ever repay the same.[47]

Example:

Global Crossing, Quest and WorldCom used the technique of roundtripping for committing financial statement fraud where they exchanged rights of use on their fiber optic networks to other telecom companies and then recorded theses leases in their financial statements as revenue. [48]

1.5.2 Understatement of Liabilities and Expenses:

Liabilities and expenses are understated in financial statements via following ways:

i. Improperly Capitalizing Expenses:

This arises when expenses are improperly recoded as capital (rather than as expense) in the financial statements. In this way of committing financial statement fraud expenses

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2006, Deloitte Forensic Center , June 2007 http://www.prnewswire.com/mnr/deloitte/28699/docs/28699_Graphics_10_Things_on_Fraud_booklet_3.PDF (assessed June 20, 2009).

47 Kerry L. Francis and Albert Lilienfeld, Why Understand Financial Accounting and Reporting Fraud,(paper presented at ? 15th Annual International Conference, Orlando, Florida, November 12, 2002), http://plusweb.org/files/Events/D&O-Francis%20Handout.pdf (assessed August 10, 2009)

48 Ibid.

such as repair expenses, costs etc. are falsely characterized as capital in financial statements of the company.[49] The objective of improper capitalization of expenses is to show lower expenses and increase earnings or profit of the company.

Example:

This practice was used by the Fine Host Corporation, which was a provider of food and beverage concession, catering and other services in the United States, in the extensive financial statement fraud committed from the year 1992 to 1997. This fraud involved, as its key mechanism, improper capitalization of millions of dollars in Company expenses as assets. The method of committing fraud was that when a contract was signed, the costs attributed to it were then falsely transferred to a "contract rights" account and were treated as capitalized costs.[50] In this way Fine Host, routinely and improperly allocated a pool of general and administrative (G&A) expenses to the contract rights account without any documentary support for this practice, thus inappropriately recognised these costs as income.[51] In February of 1998, it was discovered that Fine Host had overstated its income by $28 million for fiscal years 1992 to 1996 and by $21 million in the first three quarters of year 1997.[52]

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[49] Bruce Dubinsky, Spotting the RED FLAGS in Financial Documents: Financial Statement Frauds, Knowing What to Look For, 2007.

[50] Frank E. Ryerson, "Improper Capitalization and the Management of Earnings", *Proceedings of ASBB,S Volume 16, Number 1*, http://asbbs.org/files/2009/PDF/R/RyersonF.pdf (assessed Aug 12, 2009).

[51] Ibid.

[52] Ibid.

ii. Decreasing Expenses:

In this mode of committing financial statement fraud, some of the expenses are not recoded in the financial statements in order to show fewer expenses. Cost of goods, labor and services etc. are not recorded in financial statements in this technique.[53]

Example:

Example of committing financial statement fraud by decreasing expenses is financial statement is Enron case in year 2002.[54]

iii. Improper Deferral of Expenses:

Improper deferral of expenses in financial statements, for the sake of improving financial results, is also a mode of committing financial statement frauds.[55] In this technique expenses applicable to the current fiscal period are recorded at some date in future. Basically, the recording of expenses in one period is reversed, and than the same are later re-recorded in the next period.[56] Typically, this scheme continues to perpetuate itself in future periods.[57]

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[53] See W. Steve Albrecht, *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

[54] Ibid.

[55] See A Ramaiya, *Guide to the Companies Act,* 16th ed., part 3., (Nagpur : Wadhwa and Company , 2006), 8615.

[56] Robert L. Golden, *Financial Statement Fraud: And the Sarbanes-Oxley Act of 2002,* March 25, 2003, http://www.gsbbcpa.com/news/archives/Financial%20Statement%20Fraud%20and%20the%20Sarbanes-Oxley.pdf (assessed Aug 17, 2009).

[57] See Keith Slotter, *Financial Fraud and the FBI* ,(paper presented at the LSU Fraud and Forensic Accounting Conference, America , 2007), www.bus.lsu.edu/academics/accounting/events/downloads/2007/SlotterPresentation (assessed July 19, 2008)

Example:

Example of improper deferral of expenses is case titled "Securities and Exchange Commission Vs. Ranko Ron Cucuz, William D. Shovers, Jesus Bonilla-Valdez, Ronal D. Kolakowski, and HLI Operating Company , Inc., formally known as Hayes Lemmerz International Inc", filed In the United States District Court, Eastern District of Michigan Date April 26, 2006.[58]

Though, accounting principles require expenses to be recorded in the same period in which they are incurred, during the relevant period to this case, in contravention of accounting principles, HLI Operating Company achieved targets by improperly deferring expenses to balance sheet accounts. With the consent of the company's management, operating expenses were removed from the income statement accounts and shifted to the balance sheet. By improperly deferring expenses to the balance sheet accounts, HLI Operating Company overstated its assets in some instances and understated its liabilities in other. From approximately May 2000 to July 2001 the management routinely ordered the employees to hit the internal targets even though the only way the targets could be reached was by making improper accounting entries that removed the expenses from the income statements.

iv. Decreasing the Liabilities:

Decreasing the liabilities in the financial statements is also a mode of committing financial statement fraud. Liabilities are decreased by means of not recording loans, accounts payable,

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58 http://www.sec.gov/litigation/complaints/2006/comp19668.pdf (assessed August 11, 2009).

accrued and contingent liabilities, warranty liabilities etc.[59]

Example:

Enron scandal is an example of committing financial statement fraud by decreasing liabilities in the financial statements.

1.5.3 Understatement of Assets and Income:

This is vice versa to overstatement of assts and income. Assets and income are understated by not recording accounts receivable in financial statements and by recoding property and equipment as expenses in financial statements etc.[60] Assets and income are commonly understated in order to avoid taxes or to deceit the creditors in case of insolvency. Bankruptcy financial statement frauds typically occur through this practice.[61]

Sometimes assts are also understated to make a related-party transaction i.e. to sell the assets to same related-party (director or management) at a lower price.

Example:

WorldCom is an example of understating assets and income for the purpose of making related party transaction.

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59 See W. Steve Albrecht , *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

60 Bruce Dubinsky, *Spotting the RED FLAGS in Financial Documents: Financial Statement Frauds, Knowing What to Look For,* 2007.

61 Ibid.

1.5.4 Overstatement of Liabilities and Expenses:

This is vice versa to understatement of liabilities and expenses. Liabilities and expenses are also commonly overstated in order to avoid taxes, or to deceit the creditors in case of insolvency. Bankruptcy financial statement frauds typically occur through this practice as well.[62]

1.5.5 Creating Special Purpose Entity:

Financial statement frauds are seldom masked by creating an organizational structure that makes it easy to hide fraud.[63] This is done by creating a Special Purpose Entity (SPE), also referred to as special purpose vehicle (SPV). SPE's are legal entities, such as limited companies, trusts, or limited partnerships, established for, specific and limited objectives.[64] Like every company SPE's have promoters or sponsors. Mostly, a company sponsors its formation. SPE is a joint venture between the sponsoring company and a group of outside investors.[65] Once a SPE's is created it acts wholly as an sovereign entity including appointment of its directors, paying off its expenses etc and the assets are transferred to it are

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62 Ibid.

63 See American Institute of Certified Public Accountants, *A Framework for detecting Financial Statement Fraud,* http://www.aicpa.org/download/antifraud/055.pdf (assessed July 15, 2008)

64 See Wikipedia, The Free Encyclopedia, *Special purpose entity,* http://en.wikipedia.org/wiki/Special_purpose_entity (assessed Aug 12, 2009).

65 See W. Steve Albrecht, *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

"legally isolated" and consequently are no longer available to the sponsoring company.[66]

Risk manmagement is the most common objective of forming a SPE. The SPE's are used to isolate the company from financial risk.[67] SPE helps a company to finance large projects, thereby achieving its goals, without putting the entire company at risk.[68] Since the SPE's are subject to fewer risks, they provide greater ease to the lenders.[69] In fact companies use SPE's to legally isolate a high risk project/asset from the parent company by allowing other investors to take a share of the risk.[70]. SPE's are also used by the sponsoring companies to raise debt while at the same time making it almost impracticable for investors to find out the actual amount of debt exposure.[71]

Though the SPE's are business entities formed for the purpose of conducting a well specified activity, but due to their complex nature, they can be used to manipulate a corporation's financial results.[72]

66 The Bond Market Association, International Swaps and Derivatives Association, Security Industry Association, *Special Purpose Entities and the Securitization Markets,* (Feb 1, 2002), http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf (assessed Aug 10, 2009).

67 See Wikipedia , The Free Encyclopedia, *Special purpose entity,* http://en.wikipedia.org/wiki/Special_purpose_entity (assessed Aug 12, 2009).

68 See W. Steve Albrecht , *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

69 See Wikipedia , The Free Encyclopedia , *Special purpose entity,* http://en.wikipedia.org/wiki/Special_purpose_entity (assessed Aug 12, 2009).

70 Ibid.

71 See AcaDemon, Term Papers and Essays, Enron and Special Purpose Entities, (2002), Essays http://www.academon.com/lib/paper/16900.html (assessed Aug 11, 2009).

72 Neal F. Newman, "Enron and the Special Purpose Entity: Use or Abuse? The Real Problem - The Real Focus", *Bepress Legal Series. Working Paper 1165. School,* (March 20, 2006), http://law.bepress.com/expresso/eps/1165 (assessed Aug 11, 2009).

Example:

Enron's scandal of 2001 is an example of use of SPE for the purpose of committing financial statement fraud. In fact, Enron had perpetrated a very sophisticated form of accounting fraud through its repeated use of SPE's.[73] Basically, Enron used the tool of SPE's in order to hide losses and fabricate earnings.[74] Since Enron's primary motive was to curtail financial statement losses, accelerate profits , and avoid adding debts to its balance sheet which could have hurt its reliability in the energy trading business, it abused the SPE's for doing so.[75] The name of one Enron's SPE was Joint Energy Development Investments Limited (JEDI) which was created in 1993 in form of a 50/50% partnership between Enron and the California Public Employees Retirement System (CalPERS).[76]

1.6 Perpetrators of Financial Statement Frauds:

Financial statement fraud is something which cannot be committed by the financial statements themselves, it is rather perpetrated by the management or other top officers or directors or by the employees. Top management is approximately always involved when financial statement fraud occurs.[77]

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73 Ibid.

74 See Wikipedia, The Free Encyclopedia, *Special purpose entity*, http://en.wikipedia.org/wiki/Special_purpose_entity (assessed Aug 12, 2009).

75 Steven L Schwarcz, "Enron and the Use and Abuse of the Special Purpose Entities in Corporate Structures", *University of Cincinnati Law Review*, [Vol 70: 2006], *http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID918222_code485747.pdf* (assessed Aug 11, 2009).

76 See W. Steve Albrecht , *Business Fraud (The Enron Problem))* (New York: American Institute of Certified Public Accountants, ©2003-2005), http://www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt (assessed July 22, 2008).

77 American Institute of Certified Public Accountants , *A Framework for detecting Financial Statement*

Auditors are also involved in most of the cases of financial statement frauds. In fact the auditors are the ones who guide and assist the management in committing such frauds. In some cases of such frauds only internal auditors are involved and in others both the internal as well as external auditors are involved. For example in Enron's case the external auditor Arthur Andersen was also involved.

The majority of frauds, almost 64%, are committed by employees. Nevertheless, frauds committed by managers or executives are three-and-a-half times more costly than those committed by employees.[78] The management referred here means the senior management and executive, and the employees means the accounting employees who are appointed by and work under the supervision of the management. The longer an employee has worked in a company, the higher the losses caused by him.[79]

1.7 Victims of Financial Statement Frauds:

The direct victims of financial statement frauds are corporations but the ultimate victims are the owners of the company in which such type of fraud is committed as was the case with Enron where the public, who had bought shares of Enron, suffered the loss. The rate of these

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Fraud (n.d.), http://www.aicpa.org/download/antifraud/055.pdf (assessed July 15, 2008). See also Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 10.

78 See Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Online Journal of Accountancy* (January 2002), http://www.aicpa.org/pubs/jofa/apr2002/wells.htm (assessed July 19, 2008).

79 See Keith Slotter, *Financial Fraud and the FBI* ,(paper presented at the LSU Fraud and Forensic Accounting Conference, America, 2007), www.bus.lsu.edu/academics/accounting/events/downloads/2007/SlotterPresentation (assessed July 19, 2008)

frauds fluctuates with the size of the company.

The major median losses occurred in public companies, and the smallest took place in non profit organisations and governmental agencies.[80] The smallest companies were over a hundred times more exposed to fraud than their largest ones.[81]

1.8 Motives of Committing Financial Statement Frauds:

Financial statement frauds are committed for a wide variety of reasons. Some of which are following.

1. A very universal reason of committing financial statement fraud by the management is to cover up assets misappropriation for personal use.[82]
2. Moral decay in society is also an important factor which becomes a cause of committing financial statement fraud by both, the Management as well as the employees.[83]
3. Lack of responsible corporate governance is one of the most prominent reasons of committing financial statement fraud.[84]

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80 Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Online Journal of Accountancy* (January 2002),

http://www.aicpa.org/pubs/jofa/apr2002/wells.htm (assessed July 19, 2008).

81 Ibid.

82 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 57.

83 See Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Online Journal of Accountancy* (January 2002),

http://www.aicpa.org/pubs/jofa/apr2002/wells.htm (assessed July 19, 2008).

84 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley

4. Another reason of committing financial statement fraud is that the top management does not care or reward appropriate performance.[85]

5. Low salaries and poor training and promotion opportunities of the employees also become cause of committing financial statement fraud.[86]

6. A very important reason is the lack if 'Internal Control Mechanism'.

7. Poor communication practices or methods also become cause of committing financial statement fraud.[87]

1.9 Purposes of Committing Financial Statement Frauds:

Financial statement frauds may serve the following purposes.

1. To Obtain Personal Gains:

Obtaining personal gain is a purpose of committing financial statement frauds which is found in majority of cases.

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and Sons, 2002), 45

[85] See Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Online Journal of Accountancy* (January 2002), http://www.aicpa.org/pubs/jofa/apr2002/wells.htm (assessed July 19, 2008).

[86] Ibid.

[87] See Asad Ali Shah, *Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud, Pakistan's Experience,(n. d.),* http://www.oecd.org/dataoecd/5/13/39367990.pdf (assessed July 13, 2008).

2. To Obtain Credit or Long term Financing etc:

Obtaining credit, long term financing, or additional capital investment based on misleading financial statements may be a purpose of committing financial statement fraud by the management.[88] It was the purpose of committing financial statement fraud in Enron's case.

3. To Obtain Performance-Related Bonus:

To obtain performance-related bonuses may also be a purpose of committing financial statement fraud by the management of a company.[89]

4. To Conceal Deficiencies in Performance of Management:

To concealing deficiencies in performance of management from public may be a purpose of committing financial statement fraud by the management of a company.[90]

5. To Resolve Temporary Financial Difficulties of the Company:

Resolving for the short term financial difficulty faced by the company may be a

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88 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 58.

89 Bruce Dubinsky, *Spotting the RED FLAGS in Financial Documents: Financial Statement Frauds, Knowing What to Look For, 2007.*

90 See Asad Ali Shah, *Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud, Pakistan's Experience, (n. d.),*
http://www.oecd.org/dataoecd/5/13/39367990.pdf (assessed July 13, 2008).

purpose of committing financial statement fraud by the management.[91]

6. To meet company goals and objectives:

To meet company goals and objectives, such as receiving higher purchase price for acquisition, is also a purpose of committing financial statement fraud.[92]

7. To Obtain Listing Status of National Stock Exchange:

Another purpose of committing financial statement fraud by the management of a company is to obtain national stock exchange listing status, or to meet minimum listing requirements in order to prevent from being de-listed.[93]

8. To Meet Security Analysts' Expectations:

To meet or exceed security analysts' expectations of earning or growth is also a purpose of committing financial statement fraud by the management of a company.[94]

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[91] See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 58.

[92] See Keith Slotter , *Financial Fraud and the FBI* ,(paper presented at the LSU Fraud and Forensic Accounting Conference, America , 2007) , www.bus.lsu.edu/academics/accounting/events/downloads/2007/SlotterPresentation (assessed July 19, 2008)

[93] See Asad Ali Shah, *Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud , Pakistan's Experience,(n. d.),* http://www.oecd.org/dataoecd/5/13/39367990.pdf (assessed July 13, 2008).

[94] See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 58.

1.10 Detection and Prevention of Financial Statement Frauds:

It is estimated that the EU loses numerous millions euro per year due to financial fraud. Therefore, the prevention and early detection of fraudulent financial reporting is highly important.[95]

Financial statement frauds are detected in a company through audit of financial statements and books of accounts. Fraudulent financial statements are detected by focusing on the changes in reported assets, liabilities, revenues, and expenses from period to period.[96] Nevertheless, the detection of such frauds is much hard, and even after audit most of such frauds remain undetected. The involvement of auditors may be one of the reasons of it. It is well known universally that financial statement frauds are something which is easier to prevent than to detect.[97]

In order to effectively prevent financial statement fraud all parties in the financial reporting process should act with integrity and follow the goal of preventing and detecting fraud.[98]

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95 See Richard M Leary, Wim Vandenberghe and John Zeleznikow , *Towards a Financial Fraud Ontology a Legal Modelling Approach* (paper presented at the ICAIL Workshop on Legal Ontologies & Web based legal information management, 2003), 5 , http://www.lri.jur.uva.nl/~winkels/LegOnt2003/Leary.pdf (assessed July 11, 2008).

96 American Institute of Certified Public Accountants , *A Framework for detecting Financial Statement Fraud* (n.d.) , http://www.aicpa.org/download/antifraud/055.pdf (assessed July 15, 2008).

97 See Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Online Journal of Accountancy* (January 2002) , http://www.aicpa.org/pubs/jofa/apr2002/wells.htm (assessed July 19, 2008).

98 See Public Company Accounting Oversight Board , Standing Advisory Group Meeting , *Financial Fraud* (September 8-9,2004), http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-

The key responsibility for preventing fraud rests with senior management and the board of directors. The tone set by senior management, i.e. the corporate culture; within which financial reporting takes place is the most important factor in maintaining the integrity and veracity of the financial reporting process. Responsible corporate governance that sets the "tone at the top" by demanding high quality financial reporting and not tolerating misstated financial statements is the most important practical monitoring mechanism for preventing and detecting financial statement fraud.[99]

To combat the problem of fraud, another vital element is strict internal control mechanism, isolation of duties, and separation of functions.[100] The Audit Committee must ensure that internal controls are adequate and effective in preventing, detecting, and correcting financial statement fraud and leave no room for management to make the control activities ineffective.[101]

A third component to deterring fraud is creating a business environment that reduces the perceived necessity of a pressured employee to commit fraud. This environment includes creating open and consistent communications for hiring, evaluating employee performance,

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08/Fraud.pdf (assessed July 21, 2008)

99 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 12.

100 See Barbara R. Farrell and Joseph R. Franco , "The Role of the Auditor in the Prevention and Detection of Business Fraud: SAS No. 82," *Western Criminology Review 2/1* (1999), http://wcr.sonoma.edu/v2n1/farrell.html (assessed July 28, 2008).

101 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 12.

and appraising employees for the sake of promotion.[102]

Financial frauds often start with manipulation of quarterly accounts and financial statements. A public company's financial reporting process includes the preparation and presentation of quarterly financial information. In order to reduce the instances of financial statement frauds quarterly prepared financial statements must be audited very carefully under the supervision of the Audit Committee as the Audit committee is responsible to stockholders for overseeing the financial reporting process. Hence a vigilant and diligent oversight function by the Audit Committee can substantially reduce the instances of financial statement frauds and significantly prevent and detect their occurrences.

1.11 Summary:

Today financial statement fraud is a universal problem. The cost to business and the public can only be estimated, as many such frauds remain unreported. Management, directors and employees of the company are the Preparators of such frauds. Such frauds are committed either for gaining personal financial gain or for the purpose of misleading and deceiving the shareholders or security analysts etc.

The development of computers into businesses may make corporations more exposed to

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102 See Barbara R. Farrell and Joseph R. Franco , "The Role of the Auditor in the Prevention and Detection of Business Fraud: SAS No. 82," *Western Criminology Review 2/1* (1999), http://wcr.sonoma.edu/v2n1/farrell.html (assessed July 28, 2008).

fraud and abuse.[103] Everyone must comprehend that fraud is not a victimless crime. The cost of financial statement fraud is shared by all by means of higher costs, and lower corporate profits.

Financial statement frauds are easier to prevent than to detect. Financial statement frauds are detected through audit of financial statements. The audit of financial statements and books of accounts in a company is conducted under the supervision of Audit Committee. Thus the Audit Committee assumes the most crucial role in detecting and preventing financial statement frauds.

In order to combat financial statement frauds, a concrete effort should be made by the Audit Committee. A vigilant oversight function by the Audit Committee can substantially reduce the instances of financial statement frauds, and considerably prevent and detect their occurrences. Through a vigilant and efficient Audit Committee, adequate internal controls by management, and codes of ethics for employees financial statement frauds can, effectively, be controlled.

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[103] See Barbara R. Farrell and Joseph R. Franco , "The Role of the Auditor in the Prevention and Detection of Business Fraud: SAS No. 82," *Western Criminology Review 2/1* (1999), http://wcr.sonoma.edu/v2n1/farrell.html (assessed July 28, 2008).

Chapter # 2

ROLE OF THE AUDIT COMMITTEE IN CONTROLLING FINANCIAL STATEMENT FRAUDS

2.1 Introduction:

Audit Committee is an operating committee of the Board of Directors that is charged with oversight of financial reporting process in a company.[104] The Committee members are taken from amongst the members of the Company's board of directors, and a Chairperson is selected from amongst the members.[105] Audit Committee is at the core of the financial reporting process of a company.[106] It is now the gatekeeper of financial information which the shareholders and the investing public rely upon in order to make up to date investment decisions.[107] The stronger, the Audit Committee of a country, the lesser are the chances of frauds in its companies. Though the Audit Committee is performing its functions for the last four decades, but after the Sarbanes Oxley Act of 2002 (USA), it has been assigned new duties in the financial reporting system.[108]

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[104] See Wikipedia, The Free Encyclopedia, *Audit Committee*, http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

[105] Ibid.

[106] See A Ramaiya , *Guide to the Companies Act,* 16th ed., part 3., (Nagpur : Wadhwa and Company , 2006), 8615.

[107] See Stuart D. Buchalter and Kristin L. Yokomoto , "The Audit Committee's New Job Description", The CPA Journal Online (2002) , http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm (assessed Sep 8, 2009).

[108] See Steven A. Harrast and Lori Mason-Olsen , "Can Audit Committees Prevent Management Fraud?", The CPA Journal Online (January 2007) , http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20 , 2009)

2.2 History of Audit Committee:

In 1939 the New York Stock Exchange (NYSE) introduced the concept of Audit Committee for the first time.[109] In 1972 the U.S. Securities and Exchange Commission (SEC) recommended public companies, for the first time, to establish an Audit Committees composed of independent directors, and by 1974, the SEC began to require public disclosure of whether Audit Committee members were, in fact, independent or not.[110] In 1977 NYSE adopted a listing requirement that Audit Committees be composed entirely of independent directors.[111] In 1998, SEC Chairman Levitt emphasized the importance of greater controls by the Audit Committee to guard against fraudulent financial reporting.[112]

In February 1999, a committee comprising individuals from the NYSE, NASDAQ, public companies, and CPA firms issued the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.*[113] This report recognized that the Audit Committee has a crucial role in ensuring high-quality financial

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109 See Stuart D. Buchalter and Kristin L. Yokomoto, "The Audit Committee's New Job Description", *The CPA Journal Online (2002)*, http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm (assessed Sep 8, 2009).

110 See Steven A. Harrast and Lori Mason-Olsen, "Can Audit Committees Prevent Management Fraud?", *The CPA Journal Online (January 2007)*, http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20, 2009).

111 See Wikipedia, The Free Encyclopedia, *Audit Committee*, http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

112 See Steven A. Harrast and Lori Mason-Olsen, "Can Audit Committees Prevent Management Fraud?", *The CPA Journal Online (January 2007)*, http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20, 2009).

113 See Stuart D. Buchalter and Kristin L. Yokomoto, "The Audit Committee's New Job Description", *The CPA Journal Online (2002)*, http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm (assessed Sep 8, 2009).

reporting.[114] Shortly after this report, the stock regulators issued some new rules and regulations imposing certain requirements and responsibilities on Audit Committee members. Today, a massive amount of practices and regulations deals with the composition, roles, and responsibilities of Audit Committee.

In year 2002, during greatest awareness of financial statement frauds, the US Congress passed the Sarbanes Oxley Act, 2002 that greatly enhanced the powers and role of Audit Committee and made it much stronger than ever before.[115]

2.3 Composition of Audit Committee:

The composition of Audit Committee depends entirely on the prevailing securities laws, and the rules and regulations of Stock Exchanges, in a country. The members of the Audit Committee are selected from amongst the board of directors. The number of members of Audit Committee depends upon prevailing laws, and the size and business of the company. Mostly it is around three to six.[116]

In most of the developed countries the members of Audit Committee are required to be independent directors. Independence of the members of Audit Committee means that they

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114 Ibid.

115 See Steven A. Harrast and Lori Mason-Olsen , "Can Audit Committees Prevent Management Fraud?", *The CPA Journal Online (January 2007)* , http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20 , 2009).

116 See e.g., The Institute of Internal Auditors USA , *Sample Audit Committee Charter* http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed July 15, 2008).

cannot accept any fees from the company other than for serving as a director, and cannot be affiliated person of the company or any of its subsidiaries.[117] To be independent, a director should not have any relationship with the company that obstructs the performance of his duties and responsibilities. In the developed countries all members of the Audit Committee are required to be *'financially literate,'*[118] including one financial expert.[119] To be an "Audit Committee financial expert," the Audit Committee member ought to have an experience of accounting and auditing profession so that he may have a greater understanding of economic and accounting principles, grasp how accounting policies and principles are applied in the company's financial statements.

2.4 Importance of the Composition of Audit Committee:

Since the Audit Committee is at the apex of financial reporting process; its composition is of crucial importance. The competence of an Audit Committee can be judged by examining its composition[120]. In fact the efficiency of the Audit Committee depends greatly upon its composition.

Independence of the members of Audit Committee and their financial literacy are the two

117 See Stuart D. Buchalter and Kristin L. Yokomoto, "The Audit Committee's New Job Description", The CPA Journal Online (2002), http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm (assessed Sep 8, 2009).

118 They should have ability to read and understand financial statements of a company.

119 See The Institute of Internal Auditors USA, *Sample Audit Committee Charter* http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed July 15, 2008).

120 Ebrahim Sidat, "Conference on Bank's Corporate Governance: The Role of Audit Committee in Good Corporate Governance" (paper presented at Karachi, May 29, 2006).

core features which make the audit committee stronger and efficient.

To be effective, an Audit Committee needs to be highly independent and have the necessary expertise and know-how of the financial reporting process.[121] Actually, its members are required to be independent so that they might not have any relationship with the company that get in the way of the exercise of independent judgment.

Financial literacy is a vital competency that the members of the Audit Committee must encompass.[122] In fact, the main function of the Audit Committee, i.e. to oversight the financial reporting process of a company, is not likely to be performed if its members are not financially literate. Without being financially literate the members of the Audit Committee would not be in a position to discover any accounting error or fraud, which in turn will defeat the ultimate essence of the Audit Committee. The accounting and auditing knowledge of the members of Audit Committee helps in resolving the problems aroused from ambiguous accounting issues.[123]

In most of the developed states like USA and UK the Audit Committee is composed of independent directors, all financial literate including one financial expert who have a

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121 See Mak Yuen Teen, "Improving the Implementation of Corporate Governance Practices in Singapore", (Singapore, June 26, 2007), http://www.mas.gov.sg/resource/news_room/press_releases/2007/CG_Study%20_Executive_Summary_260607.pdf (assessed July 20 , 2008).

122 See A Ramaiya , *Guide to the Companies Act,* 16th ed., part 3., (Nagpur : Wadhwa and Company , 2006), 8616.

123 See Jeffrey Cohen et al ., The Corporate Governance Mosaic and Financial Reporting Quality , *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

background of accounting and auditing profession.

In fact, the Audit Committees comprised solely of independent directors, and with at least one member having an accounting or finance background are more efficient in prevention, and detection of financial statement frauds.[124] In a survey conducted by the Audit Committee Institute of Ireland 72% of the population questioned, and 77% of the members of audit committees questioned, replied that the composition of the Audit Committee should include at least one financial expert.[125]

Another view regarding the requirement of financial expert is that in presence of a financial expert the rest of the members of the Audit Committee will become relaxed and will greatly depend on him which could defeat the ultimate purpose of Audit Committee and there is also a possibility that the financial expert might himself get involved in the fraud, hence detecting fraud will become impossible in such a scenario.

Nevertheless, the requirement of one expert is made for the reason that accounting is a complex knowledge and some of its principles are so complicated that the manipulation of a single digit or misinterpretation of a rule can veil a huge fraud, and only an expert could

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[124] See K. Raghunandan et al ., "Audit Committee Composition, "Gray Directors" and Interaction with Internal Auditing ," *Questia Journal Article Excerpt,* vol. 15 (2001) , http://www.questia.com/googleScholar.qst;jsessionid=L8MHGPk485GWkL9T2QnCbJ8L9mMBTykckfxn7YpLK39VNGsTFjJj!-707025669?docId=5002413072 (assessed July 16 , 2008).

[125] See Audit Committee Institute Ireland , *Corporate Governance and Audit Committees : A Survey of Current Attitudes* , 7th October 2003 at http://www.auditcommitteeinstitute.ie/docs/Survey_Results.pdf (assessed July 19, 2008).

understand the same. The presence of a financial expert in Audit Committee ensures that if some complex accounting principle has been employed by the management, which the common Audit Committee members are unable to understand, the expert would understand that, and ask about the same by the management and auditors, and which in turn will save a company from major loss.

So far as the involvement of the financial expert himself in a fraud is concerned, its chances are very few any as the members of the Audit Committee are independent and non-executive; they do not have much interaction with the management and the auditors. Whenever the Audit Committee, for the performance of its function, has a meeting with the CEO, CFO or the auditors, all of its members are present there; hence there is no likelihood that the financial expert of the Audit Committee could get involved with the management and the auditors in a fraud.

In fact, getting more knowledgeable Audit Committee members leads to greater cooperation between auditors and the Audit Committee members and highly reduces the chances of financial statement frauds.[126]

2.5 Responsibilities of the Audit Committee:

Audit Committees always have had legal responsibilities under the regulations of Securities

[126] See Jeffrey Cohen et al ., "The Corporate Governance Mosaic and Financial Reporting Quality", *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

Regulatory Authorities, and the rules of Stock Exchanges, nevertheless, after the recent corporate scandals like Enron, Audit Committees have been assigned significantly increased responsibilities.[127]

Following are the major responsibilities of the Audit Committee:

2.5.1 Oversight of Financial Reporting Process:

First and foremost responsibility of the Audit Committee in a company is to review financial reports quarterly and annually. Audit Committee reviews the interim and annual financial statements, and considers whether they are complete, consistent with information provided by the management, and reflect appropriate accounting principles.[128] In addition the members of the Audit Committee discuss and oversight the complex accounting estimate and judgments made by management and the implementation of new accounting principles.[129]

For the purpose of oversight of financial statements the Audit committee interacts regularly with senior financial management such as the Chief Finance Officer (CFO). In fact the Audit Committee must develop good relationships with the CEO, CFO, and the internal and

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127 See Stuart D. Buchalter and Kristin L. Yokomoto, "The Audit Committee's New Job Description", *The CPA Journal Online (2002)*, http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm (assessed Sep 8, 2009).

128 See The Institute of Internal Auditors USA, *Sample Audit Committee Charter*, http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

129 See Wikipedia, The Free Encyclopedia, *Audit Committee*, http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

external auditors, so that it can easily access information about all significant issues in financial reporting for resolving any matter requiring action.[130]

2.5.2 Oversight of the External Auditing:

Responsibilities of the Audit Committee includes oversight of the external auditing function. External auditors are required to report the Audit Committee on such matters as their views on management's selection of accounting principles, any disagreement or difficulties encountered in working with management, and any identified fraud or illegal act.[131] The Audit Committee reviews the effectiveness of the external audits.[132] The selection of the external auditor requires the approval of the Audit committees.[133] Under the Sarbanes-Oxley Act, the Audit Committee is directly responsible for the appointment, compensation, and oversight of the outside auditor.

The Audit Committee, on a regular basis, meets separately with the external auditors to discuss such matters that the committee or auditors believe should be discussed privately.[134] Audit Committee ensures that the external auditor is independent, and there exists no

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130 See Steven A. Harrast and Lori Mason-Olsen, "Can Audit Committees Prevent Management Fraud?", The CPA Journal Online (January 2007), http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20, 2009).

131 See Wikipedia, The Free Encyclopedia, *Audit Committee*, http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

132 See Jeffrey Cohen et al., "The Corporate Governance Mosaic and Financial Reporting Quality", *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

133 See Wikipedia, The Free Encyclopedia, *Audit Committee*, http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

134 See The Institute of Internal Auditors USA, *Sample Audit Committee Charter*, http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

conflicts of interest that might interfere with the auditor's ability to issue its opinion on the financial statements.[135]

2.5.3. Oversighht of the Internal Auditing:

The Audit Committee oversights the process of internal auditing in a company. The Audit Committee approves the annual audit plan of the company and reviews with the management the activities, staffing, and organizational structure of the internal audit function.[136] The Audit Committee reviews the effectiveness of the internal audit function.[137] The Audit Committee on a regular basis, meet separately with the chief audit executive (the head of internal audit in a company), to discuss such matters that the committee believes should be discussed privately.[138]

2.5.4. Oversight of Regulatory Compliance:

Oversight of the regulatoty compliance of code of conduct in a corporation is also a

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[135] See Wikipedia, The Free Encyclopedia, *Audit Committee*, http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

[136] See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

[137] See Jeffrey Cohen et al ., "The Corporate Governance Mosaic and Financial Reporting Quality" , *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

[138] See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

responsibilitty of the Audit Committee.[139] The Audit Committee reviews the effectiveness of the system for monitoring compliance with laws and regulations, and the findings of any examinations by regulatory agencies.[140] Audit Committees discuss litigation or regulatory compliance risks with management. The Audit Committee also obtains regular updates from management and the legal counsel of the company regarding compliance matters.[141]

2.5.5. Monitoring the Internal Control Process:

Another responsibility of the Audit Committee is to monitor the internal control mechanism of a company. To fulfill its responsibilities, the Audit Committee creates an environment of openness and accountability, and ensures that adequate controls are in place, or needs to be strengthen in the company.[142] Internal control includes the policies and practices used to monitor the operations, accounting, and regulatory compliance of the company.[143] Internal control mechanism is very important for a company as it is crucial in controling corporate frauds. The Audit Committee considers the effectiveness of the company's internal control

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139 See Wikipedia , The Free Encyclopedia , *Audit Committee* , http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

140 See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

141 See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

142 See Audit Committee Leadership Network in North America, Viewpoints, *Preventing , detecting , investigating fraud: The audit committee's role* (March 24, 2005). www2.eycom.ch-publications-items-viewpoints-us-200503-en.pdf (assessed Sep 25, 2009).

143 See Wikipedia , The Free Encyclopedia , *Audit Committee* , http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

system.[144] The Audit Committee should be in a position to identify risks of management override of internal controls and it must work closely with the internal and external auditors to identify warning signs of lapses in management behaviour.[145] Management and both the internal and external auditors reports the Audit Committee regarding the effectiveness and efficiency of internal control.[146] The Audit Committee considers these reports.[147] The Audit Committee should meet regularly and as needed with the company's CFO, internal auditor, and other persons responsible for the company's financial reporting process and internal controls.

2.5.6. Oversight of Risk Management:

The Audit Committee oversights the function of risk management in a company. Every corporation has a variety of functions that perform activities to understand and address risks that could threaten the achievement of the organization's objectives.[148] The Audit Committee discusses and reviews the policies and practices used by the organisation to

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144 See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

145 See Audit Committee Leadership Network in North America, Viewpoints, *Preventing* , *Detecting ,Investigating fraud: The Audit Committee'sRrole* (March 24, 2005). www2.eycom.ch-publications-items-viewpoints-us-200503-en.pdf (assessed Sep 25, 2009).

146 See Wikipedia , The Free Encyclopedia , *Audit Committee* , http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

147 See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

148 See Wikipedia , The Free Encyclopedia , *Audit Committee* , http://en.wikipedia.org/wiki/Audit_committee (assessed Aug 15, 2009).

identify and respond the risks.[149]

2.5.7. Reporting Responsibilities:

The Audit Committee regularly reports the board of directors about its activities, issues, and related recommendations.[150] It also reports annually to the shareholders, describing its composition, responsibilities and how they were discharged.[151]

2.5.8. Other Responsibilities:

The Audit Committee institutes and oversees special investigations as needed.[152] The Audit Committee also evaluates, on a regular basis, the performance of the committee and each of its individual member.[153]

2.6 Duties of the Audit Committee:

Audit committee members owe fiduciary duties to the company and its shareholders, which include the duty of care, the duty of loyalty, and the duty to make informed judgments.

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149 Ibid.

150 See The Institute of Internal Auditors USA , *Sample Audit Committee Charter* , http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/ (assessed Sep 10, 2008).

151 Ibid.

152 Ibid.

153 Ibid.

2.7 Role of the Audit Committee in Prevention, and Detection of Financial Statement Frauds:

There is a linkage between the characteristics of the Audit Committee and the rate of financial statement frauds.[154] Audit Committee plays a very important role in detection, and prevention of financial statement frauds by performing its function of monitoring the financial reporting system.[155] Audit Committee acts as watchdog over the financial reporting process.[156] In fact the Audit Committee plays a central role in ensuring the credibility of financial reporting process and reduces the possibility of fraud.[157]

Since the occurrence of significant frauds can frequently be attributed to an override of internal controls, the Audit Committee plays an important role to ensure that internal controls are proper, and effective.[158] Basically, the Audit Committee maintains a line of defense against management fraud by monitoring the internal controls of an organization.[159]

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[154] See Jeffrey Cohen et al ., "The Corporate Governance Mosaic and Financial Reporting Quality", *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

[155] See American Institute of Certified Public Accountants , Audit Committee Toolkit, *Fraud and the Responsibilities of the Audit Committee,* at p 1. http://www4.globalcompliance.com/pdf/fraud-and-responsibilities-of-audit-committee.pdf

[156] See John Morrissey , "Corporate Responsibility and the Audit Committee" , (speech delivered at the General Audit Management Conference, New Orleans, Louisiana , March 21, 2000), http://www.sec.gov/news/speech/spch357.htm (assessed August 3, 2008).

[157] See Smith & Keens, *Company Law for Students,* 10th ed., (London : Pitman Publishing , 1996), 407.

[158] Jeffery Lucy AM, "*Neighbourhood Watch : Current and Future Expectstions of Regulators and Market Supervisors*" (speech delivered at National Conference of Australian Coprporate Lawyers Association, Melbourne, November 10, 2005).

[159] See Steven A. Harrast and Lori Mason-Olsen , "Can Audit Committees Prevent Management Fraud?", *The CPA Journal Online* (January 2007) , http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20 , 2009).

Hence the Audit Committee leaves no room for the management to override control activities.[160]

The Audit Committee plays an active role in the prevention and deterrence of fraud by ensuring that the company has appropriate antifraud programs to identify potential fraud, and the investigations are undertaken if fraud is detected.[161] Hence the Audit Committee adds the credibility of financial statements of a company and reduces the chances of fraud in them.[162]

In order to prevent financial statement frauds the Audit Committee creates an environment of openness and accountability, gains exposure to the management team and demands the fraudsters to leave the company.[163] Hence a vigilant oversight function by the Audit Committee can substantially reduce the instances of financial statement frauds and considerably prevent and detect their occurrences.[164]

In a survey, conducted by KPMG Audit Committee Institute, of about 500 Audit Committee members in 2004, from various industries, 70.5% of them said that the losses incurred in some of the high-profile financial reporting scandals of the last few years could have been

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160 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 12.

161 See John Morrissey , "Corporate Responsibility and the Audit Committee" , (speech delivered at the General Audit Management Conference, New Orleans, Louisiana , March 21, 2000), http://www.sec.gov/news/speech/spch357.htm (assessed August 3, 2008).

162 See Smith & Keens, *Company Law for Students,* 10th ed., (London : Pitman Publishing , 1996), 407.

163 See Audit Committee Leadership Network in North America, Viewpoints, *Preventing , Detecting ,Iinvestigating fraud: The Audit Committee's Role* (March 24, 2005). www2.eycom.ch-publications-items-viewpoints-us-200503-en.pdf (assessed Sep 25, 2009).

164 See Zabihollah Rezaee, *Financial Statement Fraud: Prevention and Detection* (New York : John Wiley and Sons, 2002), 10.

avoided or reduced if the financial reporting and audit processes of the company had been overseen by an independent Audit Committee of today's standards.[165]

Since financial statement frauds are easier to prevent than to detect, a vigilant and efficient Audit Committee is essential for their prevention. Antifraud programmes and internal control system flow more smoothly if the Audit Committee is strong and efficient. Hence a strong Audit Committee is crucial for avoiding financial statement frauds.[166]

2.8 Summary:

An Audit Committee plays an active role in the prevention and deterrence of fraud by ensuring that the company has appropriate antifraud programs, and controls in place to identify potential fraud. Audit Committee adds the credibility of financial statements of a company by minimizing the chances of frauds in them.

A strong Audit Committee is necessary for avoiding financial statement frauds.[167]In fact a strong and independent Audit Committee has increasingly become an indispensable part of an organization's governance.[168] Getting more knowledgeable Audit Committee members

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165 See Steven A. Harrast and Lori Mason-Olsen , "Can Audit Committees Prevent Management Fraud?", *The CPA Journal Online (January 2007)* , http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20 , 2009).

166 Jeffery Lucy AM, "*Neighbourhood Watch : Current and Future Expectstions of Regulators and Market Supervisors*" (speech delivered at National Conference of Australian Coprporate Lawyers Association, Melbourne, November 10, 2005).

167 Jeffery Lucy AM, "*Neighbourhood Watch : Current and Future Expectstions of Regulators and Market Supervisors*" (speech delivered at National Conference of Australian Coprporate Lawyers Association, Melbourne, November 10, 2005).

168 See *Steven* A. Harrast and Lori Mason-Olsen, "Can Audit Committees Prevent Management Fraud?",

leads to greater cooperation between auditors and the Audit Committee members which in turn reduces the chances of frauds.[169] Antifraud programmes and controls flow more smoothly when the Audit Committees is active in fulfilling its responsibilities.

The CPA Journal Online (January 2007), http://www.nysscpa.org/cpajournal/2007/107/essentials/p24.htm (assessed July 20, 2009).

169 See Jeffrey Cohen et al., "The Corporate Governance Mosaic and Financial Reporting Quality", *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

CHAPTER # 3

LEGISLATIVE FRAMEWORK OF THE AUDIT COMMITTEE IN OTHER JURISDICTIONS

3.1 Introduction:

The Audit Committee is functioning effectively in controlling financial statement frauds under the legal framework of other jurisdictions as weighed against the same in Pakistan. The legislative framework, for the Audit Committee, of three other jurisdictions i.e. USA, UK and India is examined in this context. The Audit Committee of USA is studied for the reason that the capital market of the USA is very much strong. One of the main reasons of their strong capital market is their effective investor protection laws and rules. The legal framework of Audit Committee in UK is studied for two reasons. Firstly, being a common law country, Pakistani legal system is based on English legal system. Secondly, the corporate sector of the UK is regarded as very strong with respect to its laws and rules regarding protection of investors. The legal framework of the Audit Committee in India is studied for the reasons that India is a developing country like Pakistan, and it came into being with Pakistan.

3.2 Legislative Framework of the Audit Committee in USA:

Earlier, in USA the Audit Committee was regulated by the listing standards of the National Stock Exchanges and securities associations and the rules of SEC, but owing to high profile of corporate frauds it was regulated through statute in the year 2002. The Sarbanes Oxley Act, 2002 was passed in this regard which regulated the composition and the responsibilities of the Audit Committee. This Act greatly enhanced the importance of the Audit Committee, and most of the other States of the world also updated their existing security laws and regulations regarding Audit Committee.

At present in USA the Audit Committee is being dealt by the Sarbanes Oxley Act, the rules promulgated under the Securities and Exchange Act, 1934 and the listing standards of the Stock Exchanges and securities associations. Rule 10A-3 of the Securities and Exchange Act, 1934 deals with the Audit Committee of the listed companies. The rules of the national securities exchanges and national securities associations that meet the requirement of the rule 10A-3 of the Securities and Exchange Act, 1934 are operative and the listed companies are required to comply with these rules.[170] Its provisions are same as that of the Sarbanes Oxley Act, 2002.

Section 3(a) 58 of the Securities Exchange Act, 1934 defines the Audit Committee. Section

[170] See Rule 10A-3 of the Securities and Exchange Act, 1934.

205(A) 58 of the Sarbanes Oxley Act, 2002 also gives the same definition of the Audit Committee. This definition is as follow:

"The term Audit Committee means a committee (or equivalent body) establish by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer, and if no such committee exists with respect to an issuer, the entire board of directors of the issuer."[171]

3.2.1 Composition of the Audit Committee in USA:

Statutory Requirements:

Section 301 of the Sarbanes Oxley Act, 2002 and Rule 10A-3 of the Securities and Exchange Act, 1934 describes the composition of the Audit Committee. The requirements under both of these are exactly same and are as follow:

1. Each member of the Audit Committee shall be a member of the board of directors of the issuer[172].
2. Each member of the Audit Committee is required to be an independent director.[173] Under the Act and the rule, in order to be considered as independent a member of the Audit Committee may not, other than in his capacity as a member of the audit

[171] Section 3(a) 58 of the Securities Exchange Act, 1934, See also Section 205(A) 58, the Sarbanes Oxley Act, 2002.
[172] See Section 301, the Sarbanes Oxley Act, 2002. See also Rule 10A-3 of the Securities and Exchange Act, 1934.
[173] Ibid.

committee, a member of the board of directors, or a member of any other board committee, accept any consulting, advisory, or other compensatory fee from the issuer.[174] It is further required that in order to be considered as independent a member of the Audit Committee may not be an affiliated person of the issuer or of any subsidiary of the issuer.[175]

Requirements under the Listing Standards of New York Stock Exchange:

According to the listing standards of the New York stock exchange every listed company must have an Audit Committee as required by Rule 10A-3 of the Securities and Exchange Act, 1934.[176] The listing standards of the New York stock exchange also specified certain additional requirements for the Audit Committee. Following are the salient features of the composition of the Audit Committee under these listing standards.

1. The audit committee must have a minimum of three members.[177]
2. All members of audit committee must be independent.[178] According to the listing standards of New York Stock Exchange a director is not independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company and the basis of such determination are

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174 Ibid

175 Ibid.

176 See Rule 303A.06, Listing Standards of the New York Stock Exchange as approved on November 25, 2009.

177 See Rule 303A.07, Listing Standards of the New York Stock Exchange as approved on November 25, 2009.

178 Ibid.

disclosed in the listed company's annual proxy statement or, in the company's annual report filed with the SEC.[179]

Further, a director is not independent if:

(i) The director is, or has been an employee of the listed company within the last three years.[180]

(ii) An immediate family member (i.e. a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law) of a director is, or has been an executive officer of the listed company within the last three years.[181]

(iii) The director or an immediate family member of a director has received, during any one year period within the last three years, more than $120,000 in direct compensation from the listed company, other than as director and committee fees and pension.[182]

(iv) a director or an immediate family member of a director is, or was within the last three years a current partner or employee of a firm that is the company's internal or external auditor.[183]

3. Each member of the audit committee must be financially literate[184]

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179 See Rule 303A.02, Listing Standards of the New York Stock Exchange as approved on November 25, 2009.
180 Ibid.
181 Ibid.
182 Ibid.
183 Ibid.
184 See Rule 303A.07, Listing Standards of the New York Stock Exchange as approved on November 25, 2009.

4. At least one member of the audit committee must be financial expert i.e. he must have accounting or related financial management expertise.[185]

5. The standards also require that if any member of the audit committee is simultaneously serving as a member of the Audit Committees of more than three public companies, the board of directors must determine that such simultaneous service would not impair the ability of such member's effective service on the listed company's audit committee and such determination must be disclosed in the listed company's annual proxy statement or, annual report filed with the SEC.[186]

3.2.2 Responsibilities of Audit Committee in USA

Statutory Responsibilities:

The responsibilities of the Audit Committee under the Sarbanes Oxley Act, 2002 and Rule 10A-3 of the Securities and Exchange Act, 1934 are exactly same. These responsibilities are as follow:

1. The Audit Committee of each issuer is responsible for the appointment and compensation of a registered public accounting firm as an outside auditor of the

[185] Ibid.
[186] Ibid.

company for the purpose of preparing or issuing an audit report or related work.[187]

2. The Audit Committee of each issuer is also responsible for oversight of the work of the outside auditor (registered public accounting firm) and the outside auditor (registered public accounting firm) shall report directly to the Audit Committee.[188]
3. Audit Committee is responsible to establish procedure for redressing the complaints received by the issuer regarding accounting, internal controls, or auditing matters and the questionable accounting or auditing matters.[189]
4. Audit Committee is authorized to engage independent counsels and independent advisors as it determines necessary to carry out its duties and the company is bound to provide for appropriate funding for the payment of compensation to the outside auditor and any counsel or advisor appointed by the Audit Committee.[190]

Responsibilities under the Listing Standards of New York Stock Exchange:

Charter:

Under the listing standards of New York stock exchange and all stock exchanges of USA the Audit Committee must have a written charter that state the purpose, duties and responsibilities of the Audit Committee.[191]

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187 See Section 301, the Sarbanes Oxley Act, 2002. See also Rule 10A-3 of the Securities and Exchange Act, 1934.

188 Ibid.

189 Ibid.

190 Ibid.

191 See Rule 303A.07, Listing Standards of the New York Stock Exchange as approved on November 25,

The duties and responsibilities of the Audit Committee under the listing standards of New York stock exchange are following.

1. To oversight the financial reporting process of a company.[192]
2. To meet with management and the independent auditor for reviewing and discussing the listed company's annual audited financial statements and quarterly financial statements.[193]
3. To oversight the performance of internal and independent auditors.[194]
4. To oversight the qualification and independence of the independent auditors.[195]
5. To oversight the regulatory compliance of the rules by the company.[196]
6. To prepare an audit committee report as required by the SEC.[197]
7. To make annual performance evaluation of the audit committee.[198]
8. To report to the board of directors regularly.[199]
9. To discuss policies with respect to risk assessment and risk management.[200]
10. To meet separately and periodically with management, internal auditors and independent auditors.[201]
11. To review with the independent auditor any audit problems or difficulties and management's response.[202]

2009.

192 Ibid.

193 Ibid.

194 Ibid.

195 Ibid.

196 Ibid.

197 Ibid.

198 Ibid.

199 Ibid.

200 Ibid.

201 Ibid.

3.3 Legislative Framework of the Audit Committee in UK:

In UK the audit committee is being dealt by the code of corporate governance called the Combined Code on Corporate Governance and the rules of the Financial Services Authority (FSA). The Combined Code of the UK was issued in 1998 for the first time.[203] Thereafter, it has been updated at regular intervals. It is last updated in June 2008. It is being issued by Financial Reporting Council of the UK. The Financial Reporting Council is an independent regulator in the UK whose main object is to promote confidence in corporate reporting and governance in UK.[204] It is responsible for the development of Code of Corporate Governance in UK. The UK Companies Act of 2006 is the latest law dealing with the companies in UK. It deals with the financial reporting process and the audits of the financial statements but it is silent with respect to the audit committee.

Since the Combined Code on Corporate Governance, 2008 did not impose a mandatory requirement on companies to have an audit committee; the application of the code was on a "comply or explain" basis up till June 2008. Nevertheless, having

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202 Ibid.

203 Financial Reporting Council, *The Combined Code and associated guidance*, *http://www.frc.org.uk/corporate/combinedcode.cfm* (assessed Dec 26, 2009).
204 See Wikipedia, The Free Encyclopedia, *Financial Reporting Council*, http://en.wikipedia.org/wiki/Financial_Reporting_Council (assessed Dec 27, 2009).

an audit committee was the accepted "norm" among the listed companies.[205] In June 2008, the Financial Services Authority (FSA) implemented the European Union Statutory Audit Directive and amended its rules to include a new Disclosure and Transparency Rule (DTR 7.1) for companies whose securities are traded on market. This Disclosure and Transparency Rule mandated the companies to establish an audit committee. Thus the 'comply or explain' basis referred above was replaced by 'comply or face' FSA's sanctions.[206] According to DTR 7.8, the compliance with the provisions A.1.2, C.3.1, C.3.2 and C.3.3 of the combined code will result in compliance with the DTR 7.1.[207] Under the Listing Rule 9.8.6 of the UK Listing Authority as amended on October, 2009 a listed company is required to include in its annual financial report a statement as to the compliance of Section 1 of the Combined Code and if any provision of the Combined Code is not complied with the reason of such non-compliance.[208]

Since the Combined Code on Corporate Governance and the rules of the Financial Services Authority regulates the audit committee in UK; the rules regarding the audit committee are further clarified by the Guidance on the audit committee issued by the Financial Reporting Council in Oct, 2008. This guidance is also called Smith Guidance.

205 See Deloitte, *Catch the 2009 Current: the Audit Committee Knowledge*, p.5
206 Ibid.
207 DTR 7.8 Disclosure and Transparency Rule of the Financial Services Authority as amended on 29th June, 2008.
208 LR 9.8.6, Listing Rule of the UK Listing Authority as amended on October, 2009.

3.3.1 Composition of the Audit Committee:

The composition of the audit committee is described in the provision C.3.1 of the Combined Code on Corporate Governance and DTR 7.1.1 of the FSA. The salient features of composition of the audit committee are as follow:

1. The audit committee should be composed of at least three or in case of smaller companies two directors.[209]
2. All members of the audit committee should be independent/non-executive directors.[210]
3. All members of the audit committee should be financially literate.[211]
4. At least one member should have recent and relevant financial experience.[212]

3.3.2 Meetings of the Audit Committee:

There should be at least three meetings of the audit committee in a financial year.[213]

3.3.3 Responsibilities of the Audit Committee:

The responsibilities of the audit committee are stated in the Combined Code on

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209 The Combined Code on Corporate Governance, June 2008, C.3.1, http://www.ecgi.org/codes/documents/combined_code_june2008_en.pdf (assessed Dec 24, 2009).

210 Ibid.

211 Ibid.

212 Ibid. See also DTR 7.1.1 Disclosure and Transparency Rule of the Financial Services Authority as amended on 29th June, 2008.

213 Financial Reporting Council, *Guidance on Audit Committees*, October 2008, p.6. http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf (assessed Jan 15, 2009).

Corporate Governance as well as in the Disclosure and Transparency Rules of the FSA. Smith guidance on Audit Committee is issued by the Financial Reporting Council to supplement the Combined Code on Corporate Governance.

Written Term of Reference:

According to the Combined Code on Corporate Governance the role and responsibilities of the audit committee are required be stated in a document called the written term of reference of the audit committee. Basically, in UK term of reference serves the same purpose as is served by the charter of the audit committee in the USA. The role and responsibilities of the audit committee include the following:

The role and responsibilities of the audit committee include the following:

1. To supervise the financial reporting process of a company for ensuring reliability of the financial statements of the company.[214]
2. To review company's internal financial control and risk management process.[215]
3. To make recommendations to the company's board regarding hiring/firing, remuneration and terms of engagement of the external auditor.[216]
4. To oversight and review the independence and effectiveness of the external auditor.[217]

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[214] The Combined Code on Corporate Governance, June 2008, C.3.2, See also DTR 7.1.3 Disclosure and Transparency Rule of the Financial Services Authority as amended on 29th June, 2008.

[215] Ibid.

[216] The Combined Code on Corporate Governance, June 2008, C.3.6 http://www.ecgi.org/codes/documents/combined_code_june2008_en.pdf (assessed Dec 24, 2009).

[217] The Combined Code on Corporate Governance, June 2008, C.3.2, See also DTR 7.1.3 Disclosure and Transparency Rule of the Financial Services Authority as amended on 29th June, 2008.

5. To make and implement policy regarding engagement of the external auditor to provide non-audit services and to make recommendations to the board in this regard.[218]

6. To make sure that proper arrangements are there for investigation and follow-up action in case any fraud is found in the financial statement of the company.[219]

7. To evaluate the efficiency of company's internal audit function and in case of companies where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and accordingly should make a recommendation to the board.[220]

8. The audit committee should ensure that the internal auditor has direct access to the audit committee and is accountable to the audit committee.[221]

9. The audit committee should approve the appointment of the head of internal audit.[222]

10. To report the board of directors where the audit committee is not satisfied with any aspect of financial reporting of the company.[223]

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[218] Ibid.

[219] The Combined Code on Corporate Governance, June 2008, C.3.4 http://www.ecgi.org/codes/documents/combined_code_june2008_en.pdf (assessed Dec 24, 2009).

[220] The Combined Code on Corporate Governance, June 2008, C.3.5 http://www.ecgi.org/codes/documents/combined_code_june2008_en.pdf (assessed Dec 24, 2009).

[221] Financial Reporting Council, *Guidance on Audit Committees,* October 2008, p.11. http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf (assessed Jan 15, 2009).

[222] Financial Reporting Council, *Guidance on Audit Committees,* October 2008, p. 11 http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf (assessed Jan 15, 2009).

[223] Financial Reporting Council, *Guidance on Audit Committees,* October 2008, p.9. http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf (assessed Jan 15, 2009).

11. To review the significant financial reporting issues aroused in connection with the financial statements and corporate reports.[224]

3.4 Legislative Framework of the Audit Committee in India:

In India the statute which deals with the audit committee is the Companies Act, 1956. Initially, the Companies Act, 1956 of India was silent about the audit committee. In the year 2000 section 292-A was inserted which deals with the audit committee.

In India a company that wants to get itself listed on a stock exchange has to enter into an agreement, for listing of shares, with the Stock Exchanges. The listing agreement for the Indian stock exchanges is prescribed by the Securities and Exchange Board of India (SEBI) and its compliance is mandatory. Clause 49 (ii) of the listing agreement deals with the audit committee. This clause was last revised by the Securities and Exchange Board of India (SEBI) on October 29, 2004[225] and the date for its compliance by the stock exchanges was 1st January, 2006.

The listing regulations of the stock exchanges also deal with the audit committee.

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224 Financial Reporting Council, *Guidance on Audit Committees,* October 2008, p.9. http://www.frc.org.uk/documents/pagemanager/frc/Smith_Guidance/Guidance%20on%20Audit%20Committees%20October%202008.pdf (assessed Jan 15, 2009).

225 See Circular of Securities and Exchange Board of India, SEBI/CFD/DIL/CG/1/2004/12/10 dated October 29, 2004.

3.4.1 Composition of the Audit Committee:

(i) Requirements under the Companies Act, 1956:

Following are the requirements of the composition of the audit committee under section 292-A of the Companies Act, 1956 of India.[226]

1. Every public company which has a paid-up capital of five crore rupees or more is required to form an audit committee.
2. The audit committee is required to be composed of a minimum of three directors.
3. Two-third of the members of the audit committee are required to be non- executive directors.
4. The chairman of the audit committee is elected by the members from amongst themselves.
5. The composition of the audit committee is required to be disclosed in the annual report of the company.

(ii) Requirements under the Listing Agreement and the Listing Regulations of the Bombay Stock Exchange:

The requirements for the audit committee under clause 49 (ii) of the listing agreement of

226 See Section 292-A, The Companies Act, 1956.

India and listing regulations of the Bombay Stock Exchange, which is the first stock exchange in India and the oldest stock exchange in Asia, are same. These requirements are as follow:[227]

The requirement of minimum number of members of the audit committee is same as that in the Companies Act, 1956 i.e. three, and likewise two-third of the members of the audit committee are required to be independent director.

1. All members of the audit committee are required to be financially literate.[228] This requirement is in addition to the requirements under the companies Act.
2. One of the members of the audit committee is required to be a financial expert.[229] This requirement is also in addition to the requirements under the companies Act.
3. The chairman of the audit committee is required to be an independent director.

3.4.2 Responsibilities of the Audit Committee:

(i) Responsibilities of the Audit Committee under the Companies Act, 1956:

Following are the responsibilities of the audit committee under the Companies Act, 1956 of

227 See Clause 24(ii) A, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006. See also Clause 49(ii), Listing Agreement issued by the Securities and Exchange Board of India.
228 Ibid.
229 Ibid.

India.[230]

1. **Terms of Reference:**

   In India like UK written terms of reference of the audit committee are specified by the Board of directors of the company. The audit committee is required to act in accordance with terms of reference.[231]

2. **Discussion with the Auditors:**

   The audit committee is required to make discussions with the auditors regarding internal control system, the scope of audit and the observations of the auditors.

3. **Review of Financial Statements:**

   The audit committee is required to review the half-yearly and annual financial statements before submission to the Board.

4. **Compliance of the Internal Control System:**

   The audit committee is required to ensure the compliance of the internal control systems of the company.

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230 See Section 292-A, The Companies Act, 1956.

231 Ibid.

5. Power to conduct Investigation:

The Audit Committee is authorized to investigate into any matter in relation to financial statements and shall have full access to information contained in the records of the company.

6. Professional Advice:

The Audit Committee is authorized to take external professional advice, where necessary in order to carry out its functions.

7. Recommendations:

The audit committee is required to make recommendations to the Board of directors on any matter relating to financial management, including the audit report. The recommendations of the Audit Committee on such matters are binding on the Board and in case the Board does not accept these recommendations, it shall be bound to explain record the reasons to the shareholders.[232]

8. Chairman to attend the Annual General Meeting:

The chairman of the audit committee is required to attend the annual general meetings of the company to clarify the queries of the shareholders.[233]

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232 Ibid.
233 Ibid.

(ii) Responsibilities under the Listing Agreement and the Listing Regulations of the Bombay Stock Exchange:

Following are the powers and responsibilities of the audit committee under clause 49 (ii) of the listing agreement of India and the Listing Regulations of the Bombay Stock Exchange:[234]

1. To oversight financial reporting process of the company.[235] This requirement is also present in the Companies Act, 1956.
2. To review the annual and quarterly financial statements before submission to the board for approval.[236] This obligation is also present in the Companies Act, 1956.
3. To make recommendations to the board regarding appointment, removal etc. of the external auditors and fixation of their compensation.[237] However, this responsibility of the audit committee is not specified in the Companies Act, 1956.
4. To review the performance of outside directors.[238] This obligation is also present in the Companies Act, 1956.
5. To review the adequacy of internal control system.[239] Again, this obligation is also mentioned in the Companies Act, 1956.

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234 See Clause 24 C, D and E, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006. See also Clause 49(ii), Listing Agreement issued by the Securities and Exchange Board of India.

235 See Clause 24 D, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006. See also Clause 49(ii), Listing Agreement issued by the Securities and Exchange Board of India.

236 Ibid.

237 Ibid.

238 Ibid.

239 Ibid.

6. To review periodically the function of risk management.[240] However, this function is not specified in the Companies Act, 1956.

7. To review the adequacy and efficiency of internal audit department with respect to its structure and functioning.[241] Nevertheless, this obligation is not specified in the Companies Act, 1956.

8. To make discussion with internal auditors on any significant findings and follow up there on.[242] This requirement is also specified in the Companies Act, 1956.

9. To review the findings of any internal investigations by the internal auditors regarding matters where there is suspected fraud or irregularity and to report the matter to the board.[243] This requirement is also present in the Companies Act, 1956.

10. To review the internal control weaknesses as mentioned in the internal audit report and letters issued by the outside auditors.[244] This requirement is also stated in the Companies Act, 1956.

11. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.[245] This function is also mentioned in the Companies Act, 1956.

12. To examine the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders or creditors.[246] This requirement is in addition to the

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240 Ibid.
241 Ibid.
242 Ibid.
243 Ibid.
244 See Clause 24 E, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006.
245 See Clause 24 D, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006.

responsibilities under the Companies Act, 1956 and it attempts to enhance the role of the audit committee to a greater extent.

13. To review the managements discussion and analysis of the financial condition of the company.[247] This requirement is also absent in the Companies Act, 1956.
14. The audit committee is empowered to obtain outside legal or other professional advice.[248] This requirement is present in the Companies Act, 1956.
15. To review the statement of management regarding significant Related Party Transactions.[249] This requirement is also absent in the Companies Act, 1956.
16. To review the appointment, removal and compensation etc. of the Chief Internal Auditor.[250] This requirement is also absent in the Companies Act, 1956.
17. The audit committee of the listed holding company is required to review the financial statements of the unlisted subsidiary company.[251] This requirement is also absent in the Companies Act, 1956.
18. The audit committee is required to carry out any other function mentioned in its terms of reference.[252] This requirement is also present in the Companies Act, 1956.

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246 Ibid.

247 See Clause 24 E, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006.

248 See Clause 24 C, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006.

249 See Clause 24 E, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006.

250 Ibid.

251 See Clause 24 (iii), Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006. See also Clause 49(ii), Listing Agreement issued by the Securities and Exchange Board of India.

252 See Clause 24 C, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006. See also Clause 49(ii), Listing Agreement issued by the Securities and Exchange Board of India.

CHAPTER # 4

ROLE OF THE AUDIT COMMITTEE IN CONTROLLING FINANCIAL STATEMENT FRAUDS IN PAKISTAN

Before discussing the role of the Audit Committee in controlling financial statement frauds in of Pakistan it is crucial to take a glance of the financial reporting process in Pakistan.

4.1 An Overview of Financial Reporting Process in Pakistan:

Under the legal framework of Pakistan financial statements are prepared annually and quarterly. It is the responsibility of every company to keep proper books of accounts relating to its earnings, expenses, assets and liabilities at its registered office.[253] The books of accounts of the company are open to inspection by the directors and members during business hours.[254]

The directors of a company approve the balance sheet and profit and loss accounts of the company and are responsible to place balance sheet and profit and loss accounts of the company along with the auditor's report and director's report before the annual general meeting of the company. Copy of these documents are sent to every member at least twenty

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[253] See Section 230, Companies Ordinance, 1984.
[254] See Section 231, Companies Ordinance, 1984.

one days before meeting.[255] After the balance sheet and profit and loss accounts are laid before the annual general meeting of the company their copies are filed with the registrar within thirty days of such meeting.[256]. Copies of quarterly accounts are sent by the company to the members, registrar and stock exchange within one month of close of quarter.[257]
The auditors of the company are appointed by the company in its annual general meeting and hold office till the conclusion of next annual general meeting.[258]

4.2 Legislative Framework of the Audit Committee in Pakistan:

In Pakistan the Audit Committee is being dealt by the Code of Corporate Governance issued by the Securities and Exchange Commission of Pakistan on March 28, 2002. Prior to the Code of Corporate Governance, 2002 (CCG) there was no concept of Audit Committee in Pakistan. The CCG mandated the establishment of an Audit Committee in the listed companies. The compliance of the CCG is obligatory for listed companies.[259] The CCG is a part of Listing Regulations of all the three Stock Exchanges of Pakistan i.e. Karachi Stock Exchange, Islamabad Stock Exchange and Lahore Stock Exchange. Unlike USA and India there is no statutory provision dealing with the Audit Committee

255 See Section 233, Companies Ordinance, 1984.
256 See Section 242, Companies Ordinance, 1984.
257 See Section 244, Companies Ordinance, 1984.
258 See Section 252, Companies Ordinance, 1984.
259 See Zahid Zaheer ," Enhancing Corporate Governance Standards in Commonwealth member countries in Asia:Country Paper Pakistan" (paper presented at Workshop by the Commonwealth Secretariat & Global Corporate Governance Forum, Washington , June 17th- 18th 2006, Maldives).

in the Companies Ordinance of Pakistan. Similarly, unlike UK there is no rule of SECP in Pakistan that mandate the presence of the Audit Committee in registered companies. In Pakistan the only document dealing with the Audit Committee is the CCG which is incorporated as it is in the Listing Regulations of the stock exchanges.

4.2.1 Composition of the Audit Committee:

Following are the salient features of the composition of the Audit Committee under the Code of Corporate Governance, 2002 and listing regulations of all the three stock exchanges of Pakistan.[260]

1. Minimum Number of Members:

The minimum number of members of the Audit Committee is required to be three.[261]

This requirement is same as that under the legal framework of USA, UK and India.

2. Non-Executive Directors:

Under the Code of Corporate Governance the majority of members of the Audit Committee are required to be non-executive directors.[262]

This requirement is weaker as compared to the same under legal framework of USA and

[260] See e.g., Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007

[261] See Clause xxx, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002.

[262] Ibid.

UK. The audit committee of USA and UK is required to be composed exclusively of independent directors.[263] Nevertheless, in India the two-third of members of the Audit Committee are required to be independent[264]. In fact, the members of the Audit Committee are required to be independent directors so that they might not have any relationship with the company which could hinder the exercise of independent judgment. The independent members of the Audit Committee can exercise independent judgment, while performing their functions, without facing any influence from the management of the company. Thus, the independence of the members of the Audit Committee increases its competence and efficiency.[265]

3. Chairman of the Audit Committee:

The chairman of the Audit Committee is preferably required to be a non-executive director.[266]

This requirement is weaker as compared to the same under other jurisdictions as it is only a recommendation that is clear by the word 'preferably', not a mandatory requirement, whereas in other jurisdictions it is mandatory.

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263 See Section 301, the Sarbanes Oxley Act, 2002. See also Rule 10A-3 of the Securities and Exchange Act, 1934.

264 See Section 292-A, The Companies Act, 1956.

265 See Mak Yuen Teen, "Improving the Implementation of Corporate Governance Practices in Singapore", (Singapore, June 26, 2007), http://www.mas.gov.sg/resource/news_room/press_releases/2007/CG_Study%20_Executive_Summary_260607.pdf (assessed July 20 , 2008).

266 See Clause xxx, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002.

The composition of the Audit Committee is very much important with respect to its crucial objective of controlling financial statement frauds in a company. The effectiveness of an Audit Committee can be judged by looking at its composition.[267] There are two main weaknesses in the composition of the Audit Committee under the CCG. These are as follow:

1. Under the legal framework of other jurisdictions all the members of the Audit Committee are required to be financially literate whereas this fundamental requirement is missing in the CCG. Financial literacy is in fact the basic competency which must be mandatory for the members of the Audit Committee.[268] Since, the main function of the Audit Committee is to oversight the financial reporting process of a company, the same could not be performed if its members are not financially literate. Without being financially literate it is impossible for a member of the Audit Committee to identify any accounting error or fraud, which in turn will defeat the ultimate object of existence of the Audit Committee. Basically, it is the accounting and auditing knowledge of the members of the Audit Committee that helps it in solving problems aroused from ambiguous accounting issues.[269]

2. Another very important requirement which is missing in the composition of the Audit

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[267] Ebrahim Sidat, "Conference on Bank's Corporate Governance : The Role of Audit Committee in Good Corporate Governance" (paper presented at Karachi, May 29, 2006).

[268] See A Ramaiya, *Guide to the Companies Act,* 16th ed., part 3., (Nagpur : Wadhwa and Company, 2006), 8616.

[269] See Jeffrey Cohen et al ., The Corporate Governance Mosaic and Financial Reporting Quality, *Journal of Accounting Literature* (2004, 87-152), http://www2.bc.edu/~cohen/Research/Research4.pdf (assessed August 6, 2008).

Committee under CCG is the presence of a financial expert in the Audit Committee. Under the legal framework of USA, UK and India the Audit Committee is essentially required to include a financial expert in its composition who has experience of accounting and auditing profession. Actually, a financial expert is required to be present in the Audit Committee for the reason that accounting is a complex knowledge and some of its principles are so complicated that only an expert could understand that. The presence of a financial expert in Audit Committee ensures that if some complex accounting principle has been applied by the management, which the common Audit Committee members are unable to understand, the expert would understand the same.

4.2.2 Meetings of the Audit Committee:

The Audit Committee is required to hold at least one meeting in every quarter of financial year.[270] These meetings are required to be held prior to the approval of interim financial results of the listed company by its Board of Directors. This requirement is same in other jurisdictions.

4.2.3 Responsibilities of the Audit Committee:

Following are the responsibilities of the Audit Committee under the CCG and the listing regulations of Stock Exchanges of Pakistan.

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270 See Clause xxxi, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002.

1. Terms of Reference:

In Pakistan like UK and India written terms of reference of the Audit Committee are determined by the Board of directors of the listed company.[271] The Audit Committee acts in accordance of its terms of reference.

2. Recommendations regarding External Auditors:

The Audit Committee is responsible for making recommendations to the board of directors regarding appointment, resignation or removal of external auditors and audit fees.[272]

This responsibility is same under the legal framework of UK and India whereas under the legal framework of USA i.e. the Sarbanes-Oxley Act, 2002 the Audit Committee is exclusively responsible for the appointment of outside auditor.[273]

3. Recommendations regarding Non-Audit Services:

The Audit Committee is also responsible for making recommendations to the board of directors with respect to the engagement of the external auditors to provide non-audit

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[271] See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002. See also, Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

[272] See Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007

[273] See Section 301, the Sarbanes Oxley Act, 2002. See also Rule 10A-3 of the Securities and Exchange Act, 1934.

services.[274] The Board of Directors is required to act in accordance with the recommendations of the Audit Committee in except if there are strong grounds to proceed otherwise.

The Audit Committee has the same responsibility under legal framework of the other jurisdictions.[275]

4. Review of the Financial Statements:

The Audit Committee is responsible to review the interim and annual financial statements of the listed company before their approval by the Board of Directors with special focus on any changes in accounting policies and practices, and compliance with the applicable accounting standards, listing regulations and other statutory and regulatory requirements.[276] The Audit Committee ascertains that the accounting system and reporting structure of the company are adequate, and effective.[277]

This is of course the fundamental responsibility and is present under the legal framework of USA, UK and India.[278]

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[274] See Clause xl, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002.

[275] See e.g., C.3.2, The Combined Code on Corporate Governance, June 2008. See also DTR 7.1.3 Disclosure and Transparency Rule of the Financial Services Authority as amended on 29th June, 2008.

[276] See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002. See also, Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

[277] See Asad Ali Shah, *Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud, Pakistan's Experience, (n. d.),*
http://www.oecd.org/dataoecd/5/13/39367990.pdf (assessed July 13, 2008).

[278] See e.g., C.3.2, The Combined Code on Corporate Governance, June 2008. See also Section 292-A, The Companies Act, 1956.

5. Responsibilities with respect to External Auditors:

The Audit Committee is responsible to facilitate the external auditors in performance of their duties.[279] The duties of the external auditors are stated in the Companies Ordinance, 1984.[280] The external auditors conduct the audit of books of accounts and financial statements of the company and prepare audit report in accordance with the requirements of the Companies Ordinance, 1984. The Audit Committee discusses with external auditors major observations arising from interim and final audits and any matter that the auditors may wish to highlight. These discussions may take place in absence of the management if necessary.

This responsibility of the Audit Committee is also prescribed under the legal framework of USA, UK and India.

6. Coordination between Internal and External Auditors:

The Audit Committee is responsible to ensure coordination between the internal and external auditors of the listed company.[281]

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279 See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002. .See also, Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

280 See Section 255, Companies Ordinance, 1984.

281 See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002. .See also, Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

The responsibility of the Audit Committee to ensuring coordination between the internal and external auditors of the company is present under the legal framework of USA, UK and India as well.[282]

7. Review of Management Letter:

The responsibilities of the Audit Committee include review of management letter issued by external auditors and the response of the management on these letters.[283]

The Audit Committee under the legal framework of USA, UK and India almost owe the same responsibility.[284]

8. Responsibilities with respect to Internal Audit Function:

The Audit Committee is responsible to review the scope and extent of internal audit and to ensure that the internal audit function has adequate resources and is appropriately placed within the listed company.[285]

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282 Ibid.

283 Ibid.

284 See e.g., Clause 24 E, Regulations of the Bombay Stock Exchange Limited, as amended upto 31st December, 2006. See also Rule 303A.07, Listing Standards of the New York Stock Exchange as approved on November 25, 2009.

285 See Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

Under the legal framework of USA and India the Audit Committee is responsible to oversight the performance of internal auditors. In UK under the Combined Code on Corporate Governance the Audit Committee is responsible to evaluate the efficiency of company's internal audit function and if there is no internal audit function in the company, the Audit Committee should consider annually whether there is a need for an internal audit function and accordingly should make a recommendation to the board.[286]

9. Internal Investigations:

The Audit Committee is responsible to consider major findings of internal investigations and the response of management in this regard.[287] Considering the key findings of internal investigations is an important responsibility of the Audit Committee with respect to its function of controlling financial statement frauds.[288]

The responsibility to review findings of any internal investigations by the internal auditors regarding matters where there is suspected fraud or irregularity is also present in India. Whereas under the legal framework of UK the Audit Committee is also responsible to ensure that proper arrangements are there for internal investigations and follow-up action in case any fraud is found in the financial statements of the company.[289]

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286 C.3.5, the Combined Code on Corporate Governance, June 2008. http://www.ecgi.org/codes/documents/combined_code_june2008_en.pdf (assessed Dec 24, 2009).

287 See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002. .See also, Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

288 See Nazir Ahmad Shaheen, *Practicle Approach to the Companies Ordinance 1984* (Rawalpindi : Federal Law House , 2004) , 256.

289 C.3.4 , The Combined Code on Corporate Governance, June 2008.

10. Internal Control Systems:

The Audit Committee is responsible to determine that internal control systems of the listed company are adequate and effective.[290] Review of the statement on internal control systems prior to endorsement by the Board of Directors is a significant responsibility of the Audit Committee.[291]

This responsibility of the Audit Committee is present under the legal framework of USA, UK and India as well.[292]

11. Determination of Compliance with the Statutory provisions:

The Audit Committee is responsible for determination of compliance with relevant statutory requirements and corporate governance.[293] The Audit Committee is also responsible to identify significant violations of the statutory requirements and corporate governance.

This responsibility of the Audit Committee is also present under the legal framework of USA.

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http://www.ecgi.org/codes/documents/combined_code_june2008_en.pdf (assessed Dec 24, 2009).

290 See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002. .See also, Clause 37, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

291 Ebrahim Sidat, "Conference on Bank's Corporate Governance : The Role of Audit Committee in Good Corporate Governance" (paper presented at Karachi, May 29, 2006).

292 See e.g., C.3.2, The Combined Code on Corporate Governance, June 2008. See also DTR 7.1.3 Disclosure and Transparency Rule of the Financial Services Authority as amended on 29th June, 2008. See also Section 292-A, The Companies Act, 1956

293 See Clause xxxiii, Code of Corporate Governance, 2002 issued by the SECP on March 28, 2002.

12. Other Responsibilities assigned by the Board of Directors:

The Audit Committee is also responsible to perform any other function as may be assigned by the Board of Directors in the terms of reference of the Audit Committee.[294]

This general responsibility of the Audit Committee is present under the legal frame work of India and UK with respect to the terms of reference of the Audit Committee, and in USA with respect to the charter of the Audit Committee.

4.3 An overview of Financial Statement Frauds in Pakistan and the Role of the Audit Committee in this Regard:

Since the CCG exists under legal framework of Pakistan which regulates Audit Committee, and is a part of the listing regulations of all the three Stock Exchanges of Pakistan; the role of the Audit Committee is much weaker in controlling financial statement frauds. It is rather ineffective in the listed companies who are required to have an Audit Committee under the CCG and listing regulations.

4.3.1 Case law:

There are a number of cases of financial statement frauds in Pakistan that show the inefficient role of the Audit Committee in controlling these frauds. Some of the cases are as follow:

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294 Ibid.

Messrs Gardezi & Co. Chartered Accountants:[295]

In the matter of Show-Cause Notice No. CLD/EMD/FIU/32/2006, dated 3rd March, 2008, decided on 3rd April, 2008.

Brief Facts:

In this case Messrs Gardezi & Co. Chartered Accountants (Auditors) audited the accounts and books of accounts of the Messrs United Sugar Mills Limited (the Listed Company) for the years 2003, 2004, 2005 and 2006 and prepared the audit reports that were 'materially misstated'. The auditors certified in the audit reports of the respective years that the balance sheet, profit and loss accounts and other financial statements of the company conform with the applicable accounting standards and requirements of the Companies Ordinance, 1984, and present a true and fair view of the state of affairs of the company. Whereas, the accounts were materially misstated that resulted in understatement of profit for the respective years. In fact, the company was in profit for all these years, but loss was stated in the audit report and audited financial statement and accounts. The profit was concealed and loss was stated in the financial statements by falsely understating the revenues which is a mode of committing financial statement frauds.

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[295] 2008 CLD 861

Finding:

The auditors in this case failed to design an effective audit plan and placed excessive reliance on the management's representation, thus failed to perform their professional duties with reasonable care and skill.

It was held that the auditors prepared the audit report otherwise than in conformity of requirements of the Companies Ordinance, 1984, thus committed default in terms of section 260 of the Companies Ordinance, 1986.

Analysis:

In this case financial statement fraud was committed by the management of the company through false understatement of revenues and improper capitalization of expenses, and the auditors failed to find out the same in the course of auditing the books of accounts thus prepared misstated audit reports.

The analysis of this case depicts a very important fact. Since it is case of a listed company and under the CCG and the listing regulations of all the three Stock Exchanges of Pakistan every listed company is required to establish an Audit Committee, the Audit Committee is nowhere discussed in this case which simply means that the Audit Committee was not existing in the board of directors of the company. Rather, more astonishing is the fact that through out the proceeding of the case neither of the parties talked about the non-existence of the Audit Committee in the company which shows that it is a routine matter for the listed companies to relinquish the requirement of the Audit Committee. This clearly portrays the weakest position of the compliance of the provisions of the CCG regarding the Audit Committee under the legal framework of Pakistan.

The Audit Committee is responsible to oversight the audit plans, and the efficiency and effectiveness of the auditors. It supervises the functioning of the auditors. If there were Audit Committee in this company, this fraud would not have happened.

Kamran & Co., Chartered Accountants[296]

In the matter of Show-Cause Notice No. EMD/233/541/2003-6575 dated December 21, 2005, decided on 2nd May, 2006.

Brief Facts:

In this case Messrs Kamran & Co., Chartered Accountants (Auditors) audited the accounts and books of accounts of the Messrs Morafco Industries Limited, a listed company, for the year ended June, 2005 and made the audit report which was misleading. The company was not a going concern and the fact was also stated by the management itself. But, the accounts of the company were prepared on a going concern basis and there was no justification of using the going concern assumption in the books

[296] 2006 CLD 1023.

of accounts. The auditors also failed to determine this fact and gave a clean report on the accounts and books of accounts of the company by certifying that the Balance Sheet, Profit and Loss Accounts and other Financial Statements of the company are in conformity with the applicable accounting standards and the requirements of the Companies Ordinance, 1984 and give a true view of the state of affairs of the company. However, the audit report of the previous year also stated the fact that the company is not a going concern, and the Financial Statements and books of accounts of the company are not in conformity with the applicable accounting standards and the requirements of the Companies Ordinance, 1984 and do not give accurate view of the state of affairs of the company.

Finding:

The auditors failed to perform their statutory obligations and professional duties with reasonable degree of care and skill. The auditors were held liable to punishment under the Companies Ordinance, 1984 and fine was imposed on them.

Analysis:

In this case of financial statement fraud the auditors audited the books of accounts negligently and recklessly and gave no consideration to the fact that the company is not a going concern whereas its books of accounts are being made on a going concern basis. Again, it is evident that the Audit Committee is not present in the board of directors of the company though the company is a listed one.

Hafizullah & Co., Chartered Accountants[297]

In the matter of Show-Cause Notice No. EMD/233/294/2002-11411-13 dated June 18, 2005, decided on 2nd March, 2006.

Brief Facts:

In this case Messrs Hafizullah & Co., Chartered Accountants (the Auditors) audited the books of accounts of Messrs Fateh Sports Wear Limited, a listed company, for the year ended June 30, 2004. The auditors prepared a misleading audit report by not giving the fullest information to the members of the company. The manufacturing activity of the Company was closed since the year 2003, and the company had laid off all its employees whereas the management prepared the books of accounts on a going concern assumption. The auditors failed to report this matter to the shareholders through their audit report and prepared a clean audit report.

Findings:

The auditors were held liable for not performing their statutory obligations. The auditors did not perform their professional duties with reasonable degree of care and skill. The

[297] 2006 CLD 588.

auditors were held liable to punishment under the Companies Ordinance, 1984 and fine was imposed on them.

Analysis:

In this case of financial statement fraud the auditors audited the books of accounts in a careless and irresponsible manner and ignored the fact that the company is not a going concern whereas its books of accounts are being made on a going concern basis. Once more, it is evident from this case that the Audit Committee is not present in the board of directors of the company though the company is a listed one. Indeed, if the Audit Committee would have been present in the board of directors of the company this fraud would not have happened.

All these cases depict the weakest position of the Audit Committee under the legal framework of Pakistan. In fact, the Audit Committee exists only in the provisions of the Code of Corporate Governance, 2002, not in practice. The main reason is that the CCG has no binding force. Practically its compliance is not mandatory. Though, the listing regulations of all the three stock exchanges of Pakistan mandate the requirement of the Audit Committee and it is mentioned in the clause 2 of listing regulation #5 of Karachi Stock Exchange (KSE) and Islamabad Stock Exchange (ISE) that the company which committed a default of requirements of the listing regulations may be de-listed.[298]

[298] See Clause 5, Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007.

Likewise, it is mentioned in regulation # 36 of the listing regulations of Islamabad Stock Exchange that whoever failed to comply with the listing regulations of Islamabad Stock Exchange shall be liable to fine.[299] But it is obvious from the case law that these provisions exist only to the extent of papers, not practically. Since there is no compliance of theses regulations these are totally ineffective.

In USA significant financial statement frauds were committed in case of Enron, WorldCom and some other cases in year 2002, and soon after that they made legislation to overcome this kind of fraud i.e. the Sarbanes Oxley Act, 2002. Whereas, in Pakistan the CCG was issued in 2002, but even in year 2010 the position of its compliance is so weak that financial statement frauds occur frequently.

Basically, the Audit Committee is working well under legal framework of other jurisdictions for the reason that it is being dealt by the statutes in addition to the listing standards and regulations, e.g. in USA the Audit Committee is mandatorily required under the Sarbanes Oxley Act, 2002 and likewise in India the Audit Committee is mandatorily required for the public companies under the Companies Act, 1956 and a punishment of upto one year imprisonment is given in case of its non-compliance. Though, in UK the Audit Committee is not mandatorily required under any statute, but it is mandatorily required under the Disclosure and Transparency Rules (DTR's) of the Financial Services Authority (FSA) and if a company breach these rules i.e. DTR's it has

299 See Clause36, Listing Regulations of Islamabad Stock Exchange.

to face the sanctions of the FSA. But in Pakistan the Audit Committee is regulated only through CCG which a part of listing regulations of the stock exchanges. There is no provision in the Companies Ordinance, 1984 that regulate the Audit Committee. Similarly, no rule of the Securities and Exchange Commission of Pakistan regulates the Audit Committee.

CHAPTER # 5

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion:

Financial statement frauds, being a kind of corporate frauds, are of significant importance in the present time. These frauds are committed by the management and accountants of the company through manipulation of accounts in the financial statements. The auditors of the company may or may not be involved in such frauds. The management conceals the true financial position of the company through the financial statement frauds. Top management of the company is involved in majority of cases of financial statement frauds. There are many modes of committing financial statement frauds (that have been discussed at length in the first chapter of this thesis). The reasons of committing Financial statement frauds are many e.g. to gain financial advantage, to conceal the deficiencies in the performance of the management etc.

The Enron case was the world's largest financial statement fraud in the year 2002, which made the whole world shocking about such frauds. Consequently, the investors began to lose their confidence on the reliability and credibility of the financial statements. As a response to the Enron's financial statement fraud the Sarbanes Oxley Act, 2002 was passed in USA that brought into limelight the importance of the Audit Committee.

The Audit Committee is a committee of the Board of Directors that is responsible to oversight the financial reporting process in a company. The Audit Committee is at the apex of the fnancial reporting process of a company. It is being regarded as a watchdog over the financial reporting system of a company. The members of the Audit Committee are required to be non-executive directors so that they can perform their duties without any influence from the managment of the company. The members of the Audit Committee are also required to be financially literate in most of the countries as the major responsibility of the Audit Committee i.e. to oversee the financial reporting process of a company could not be performed if its members are not financially literate. Audit Committee plays an active role in the prevention of financial statement frauds fraud by ensuring that the financial reporting system of the company is functioning appropriately and company has appropriate internal control system in place to identify potential fraud, and the investigations are undertaken if fraud is detected.

A strong and efficient Audit Committee is indispensable for avoiding financial statement frauds. The transparency of financial reporting system of a company depends, to a large extent, upon the efficiency of the Audit Committee. The strong and effective Audit Committee minimizes the instances of financial statement frauds in a company.

The Audit Committee under the legal framework of other jurisdictions like USA, UK and

India is much efficient and active in controlling the financial statement frauds.

Under the legal framework of USA a company is required to establish an Audit Committee under the statute i.e. the Sarbanes Oxley Act, 2002 and every listed company is required to establish an Audit Committee under the listing standards of the stock exchanges and the securities associations.

Under the legal framework of India every public company having a paid up capital of five crore is required to establish an Audit Committee under the Companies Act, 1956. Further, every listed company is required to establish an Audit Committee under the listing regulations of the respective stock exchange.

Under the legal framework of UK every company is required to establish an Audit Committee under the Disclosure and Transparency Rules (DTR) of the Financial Services Authority (FSA). Every listed company is required to establish an Audit Committee under the Combined Code of Corporate Governance as well.

Under the legal framework of Pakistan every listed company is required to establish an Audit Committee under the CCG and listing regulations of the stock exchanges.

The Audit Committee under the legal framework of other jurisdictions like USA, UK and India is much efficient and active in controlling the financial statement frauds as compared to the same in Pakistan. The major reasons of the weak role of the Audit Committeein Pakistan, in controlling financial statement frauds as compared to same under other jurisdictions are as follow:

1. The most important reason of weak and inactive role the Audit Committee in Pakistan is that its establishment is neither mandatory under any statute nor under ay rule of the SECP. It is only required, under CCG and the listing regulations, for the listed companies that even do not completely follow these regulations as its compliance is not strictly mandatory under the listing regulations. Whereas in some other jurisdictions like USA and India the Audit Committee is mandatorily required to be established under the statute, Likewise, in a few jurisdiction the Audit Committee is required to be established under the rules of the regulatory authority like in UK it is required to be established under the rules of the FSA.

2. Another very important reason of the weak role of Audit Committee ac in Pakistan is that there is no sentence or penalty prescribed in case of non-compliance of the listing regulations regarding the establishment of Audit Committee in the board of directors of the listed companies. Though, under the listing regulations of the stock exchanges the companies that do not comply with the listing regulations are required to be de-listed and it is mentioned in the listing regulations of Islamabad Stock Exchange that whoever failed to comply with the regulations shall be fined but no company has ever been fined or de-listed in Pakistan due to the reason of non-

compliance of the listing regulations regarding the Audit Committee. Whereas, in other jurisdictions like India an imprisonment of one year is prescribed under the Companies Act, 1956 for the companies not complying with the provisions regarding Audit Committee. Likewise in some countries like UK the companies not complying with the regulations and rules regarding the requirement of the Audit Committee have to face the sanctions of the regulatory authority i.e. FSA.

3. Under the listing regulations of Pakistan only a simple majority of the members of Audit Committee are required to be non-executive directors whereas in other jurisdictions like USA and UK all the members of the Audit Committee are required to be non-executive directors. Actually, the members are required to be non executive directors so that they might not have any relationship with the company that interferes with the exercise of independent judgment and they should be able to exercise independent judgment, while performing their function, without any influence of management of the company.

4. Under the listing regulations of Pakistan the members of the Audit Committee are not required to be financially literate whereas under the legal framework of other jurisdictions all the members of the Audit Committee are required to be financially literate.

5. Under the legal framework of Pakistan one financial expert is not required to be present in the Audit Committee, whereas the same is required under the legal framework of other jurisdictions.

6. Under the legal framework of Pakistan the Chairman of the Audit Committee is not mandatorily required to be a non-executive director, whereas in other jurisdictions like USA and UK the same is required to be a non-executive director.

5.2 Recommendations:

The role of the Audit Committee is much inefficient and dejected in Pakistan in controlling the financial statement frauds as compare to the same in other jurisdictions. Much legislative reforms are required in this area. Some significant recommendations, which if be incorporated under legal framework can change the scenario, are as follow:

5.2.1 Recommendations Regarding Strict Compliance of the Listing Regulations:

A punishment of at least one year should be prescribed in the listing regulations for the companies which do not comply with the listing regulations regarding the Audit Committee. Further, heavy fines should be prescribed and the companies should practically be de-listed in case of non compliance of the listing regulations.

5.2.2 Recommendations Regarding Rules of the SECP:

The Securities and Exchange Commission of Pakistan should make rules regarding the establishment of the Audit Committee in all public companies having a minimum paid up capital of e.g. 2 crore (as the SECP may deem appropriate), and strict penalties should be prescribed for the companies which do not comply with the rule.

5.2.3 Recommendations Regarding Amendment in the Companies Ordinance, 1984:

The Companies Ordinance, 1984 should be amended to include a provision for establishing the Audit Committee in all public companies having a minimum paid up capital of e.g. 4 crore (as the legislature may deem appropriate), and a punishment of upto two years should be prescribed in case of non-compliance of the provision.

5.2.4 Recommendations Regarding Composition of the Audit Committee:

i. Under the listing regulations all the members of the Audit Committee should be required to be financially literate.

ii. At least two-third majority of the members of the Audit Committee should be required to be non-executive directors under the listing regulations.

iii. The listing regulations should require that at least one member of the Audit Committee be a financial expert.

iv. The chairman of the Audit Committee should mandatorily be a non-executive director under the requirements of the listing regulations.

5.2.5 Recommendations Regarding the Powers of the Audit Committee:

Under the listing regulations the Audit Committee should be given the power to appoint independent counsel and other advisors in the course of performance of its duties as it deem necessary.

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