

Agenda Item 3-C

Additional Root Cause Analysis of Fraud Cases

This Agenda Item sets out the additional work performed to respond to encouragement from respondents to the Discussion Paper (DP), [Fraud and Going Concern in an Audit of Financial Statements: Exploring the Differences Between Public Perceptions About the Role of the Auditor and the Auditor's Responsibilities in a Financial Statement Audit](#), to further analyze the root cause(s) of recent fraud cases.

A summary of this additional work has been included in **Agenda Item 3-B** (“Overall Analysis”), which together with the other information gathering activities, supports the proposed actions included within the draft project proposal in **Agenda Item 3-A**.

It is not intended that this Agenda Item is specifically discussed at the December 2021 IAASB meeting.

I. Background and Purpose

1. In September 2020, the IAASB published the DP. Responses were received by February 2021 and analyzed by the IAASB.
2. Several stakeholder responses to the DP encouraged the IAASB to perform further root cause analysis on recent frauds to better understand whether possible changes made to the auditing standard may address issues related to past frauds.
3. In addition to consulting with stakeholders through the DP on issues and challenges related to fraud, a range of other information-gathering activities were undertaken to inform the development of a project proposal, including:
 - (a) An **academic desktop review** by IAASB Staff of 102 research reports to identify relevant research on fraud in an audit of financial statements.
 - (b) A review of feedback submitted by various stakeholders on the topic of fraud through **other completed or ongoing IAASB projects**: [ISA 540 \(Revised\)](#),¹ new and revised Auditor Reporting Standards,² ISA Implementation Monitoring,³ [ISA 315 \(Revised 2019\)](#),⁴ [Audits of Less Complex Entities \(LCEs\)](#), and the [Strategy for 2020–2023 and Workplan for 2020–2021](#).
 - (c) A review of **initiatives and developments in different jurisdictions** covering the topic of fraud in an audit of financial statements (e.g., changes in Japan to their fraud standard, work

¹ International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

² The Auditor Reporting Standards comprise: ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*; ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*; ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*; ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*; ISA 570 (Revised), *Going Concern*; ISA 260 (Revised), *Communication with Those Charged with Governance*; and conforming amendments to other ISAs.

³ The IAASB's ISA Implementation Monitoring Project was completed in July 2013 and was undertaken to determine whether further changes were needed to the ISAs arising from the IAASB's Clarity project. Any [findings](#) as part of this review related to fraud have been included for consideration as part of the current initiatives on fraud.

⁴ ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

undertaken by Accountancy Europe, the [Brydon](#) and [Kingman](#) reviews in the UK and the [2019 Fraud Thematic Review](#) in Canada). IAASB Staff continue to monitor developments globally.

- (d) **Outreach meetings** with representatives from firms, national standard setters (NSS), regulators and audit oversight authorities, academics, corporate governance experts, public sector representatives, and other professional organizations.
 - (e) **Three roundtable discussions** with a wide range of stakeholders across the globe, each described below. For details of the key messages from those roundtables, refer to the document published by the IAASB Staff titled "[Summary of Key Take-aways: IAASB Fraud and Going Concern Roundtables](#)." The objective of the roundtables was to further explore specific elements of the nature and root cause of frauds and has informed the Fraud Working Group (WG) as it has considered the development of a project proposal on fraud.
 - (i) [Technology-Focused Fraud Roundtable](#) – On September 1, 2020, the IAASB hosted the 1st of the roundtable series on fraud and going concern, which was focused on the impact of technology advancements on fraud perpetration and detection. This event was moderated by Fiona Campbell, former IAASB Deputy Chair, and virtually attended by 52 participants, IAASB members, observers and staff. Participants included forensic auditors, financial statement auditors, fraud audit methodology experts, third party audit solution companies, regulators, academics, and public sector representatives.
 - (ii) [Expectation Gap and Auditor Reporting Roundtable](#) – On September 28, 2020, the IAASB hosted the 2nd of the roundtable series on fraud and going concern, which was focused on the "expectation gap," or differences between public perceptions and the auditor's responsibilities for fraud and going concern. This event was moderated by Fiona Campbell, former IAASB Deputy Chair, and virtually attended by 58 participants, IAASB members, observers and staff. Participants included investors, analysts, corporate governance experts, audit firms, academics, regulators, public sector representatives, and select others.
 - (iii) [Audit Procedures Related to Fraud in Audits of LCEs](#) – On October 7, 2020, the IAASB hosted the 3rd of the roundtable series on fraud and going concern, which was focused on audits of LCEs. This event was moderated by Kai Morten Hagen, IAASB Member and the LCE Task Force Chair, and virtually attended by 44 participants, IAASB members, observers and staff. Participants included auditors, audit methodology experts, and representatives of third-party audit solution companies and professional accountancy bodies.
4. All of the above activities helped the Fraud WG better understand the root causes of fraud to help identify the key issues that will be addressed by a project on fraud.
5. Notwithstanding the substantial information gathering activities undertaken, in response to the DP feedback, the Fraud WG undertook additional targeted information-gathering activities to determine whether anything more about the underlying cause of fraud that could be addressed in the auditing standards could be learned. These additional activities included:
- (a) Targeted outreach with stakeholders who have extensive knowledge and experience with fraud cases, including police and crime commission representatives, fraud investigators, regulators, and audit firms;

- (b) A review of targeted additional academic papers focused on specific fraud cases; and
 - (c) Other additional review of fraud cases based on publicly available information.
6. The purpose of this Agenda Item is to summarize information obtained through the *additional* information-gathering activities performed that were targeted to better understand the nature of recent fraud cases.
7. The Fraud WG will continue to monitor and consider the root causes of current fraud cases over the course of the project through its continued outreach and continued monitoring of publicly available information of new fraud cases that may arise.

II. Targeted Outreach

8. As described above, to better understand the root causes of recent fraud cases, IAASB Staff performed outreach with targeted stakeholders who have extensive knowledge of the nature of specific fraud cases. Fifteen stakeholders (deemed to have additional insights on fraud in their field of expertise), who represented a broad range of stakeholder groups, were contacted, which culminated in meetings with eight of these stakeholders.
9. The stakeholders interviewed represented a wide range of global and regional stakeholder views that included police forces/crime commissions, global accounting firms,⁵ regulators and audit oversight authorities. In addition to global representatives, the individuals interviewed included representatives from the broader Asia Pacific region.
10. Discussions were undertaken anonymously such that the public dissemination of the information would not be attributed to any particular stakeholder.
11. The discussions were focused on the following topics:
- (a) How frauds are being executed and concealed;
 - (b) Who is involved in the frauds;
 - (c) Whether frauds involved related parties;
 - (d) What financial accounts were impacted;
 - (e) How the frauds were eventually detected, and by who;
 - (f) Whether and to what extent technology was involved;
 - (g) Whether material frauds started small but grew over time (and if so, what length of time), or whether the frauds were material from the start; and
 - (h) Any other details to help better understand the nature of the frauds and the root causes of the issues as to why they were not prevented or detected earlier.
12. The following table summarizes the key messages and trends heard during these targeted outreach meetings. A summary of what was heard has also been included in the “Matters Identified from the Additional Root Cause Analysis of Fraud Cases” column in the Overall Analysis (see **Agenda Item 3-B**), which is intended to map the “key points” from this additional work to the issues and challenges

⁵ Meetings with firm representatives included individuals in a global role, with those individuals having an extensive knowledge of the underlying causes of frauds on a global basis.

that have already been identified by the other information gathering and research activities, and the proposed actions in the draft project proposal on fraud (i.e., as set out in the scope of the draft project proposal). The table below does not describe every comment heard during the discussions, but summarizes the key points taken away as a whole.

Topic	Summary of Key Points from Outreach
What Auditors Can Do Better⁶	<p>Participants in the outreach meetings gave their perspectives on what auditors can do better to improve fraud detection in future. They noted the following:</p> <ul style="list-style-type: none"> • Auditors need to exercise professional skepticism more robustly and perform a thorough risk assessment. Participants were not of the view that a suspicious mindset is necessary for auditors. • Auditors need to have a good understanding of the business model, corporate culture, and management’s motivations (including compensation / bonus structure) so they are more sensitized to potential indications of fraud. • Auditing areas susceptible to fraud (e.g., revenue, cash, goodwill, etc.) should involve people on the engagement team that have the right level of experience and expertise, including specialists where they are necessary. • It is important for auditors to obtain a thorough understanding of internal controls, including the design and operating effectiveness of the controls, as well as how management is involved. • The engagement team discussion, including the discussion on fraud, should be more than a perfunctory exercise and should not be perceived as a single event (rather it should be a continuous consideration whether more is necessary throughout the audit). • The importance of auditor independence should be emphasized. • External confirmations and inventory observations are important in carrying out fraud-related procedures, but no specific issues with the auditing standards were noted.
Nature of Fraud	<ul style="list-style-type: none"> • The basic underlying nature and types of frauds have not changed significantly from what ISA 240⁷ describes (i.e., ISA 240 describes that the two types of intentional misstatements relevant to the audit are misstatements resulting from fraudulent financial reporting or misappropriation of assets). • The specific nature of each fraud varies considerably case by case, and may often result from a number of reasons, many of which involve complex

⁶ The Fraud WG notes that the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (“IESBA Code”) sets out the fundamental principles of ethics that establish the standards of behavior expected of a professional accountant and establishes the International Independence Standards.

⁷ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial statements*

Topic	Summary of Key Points from Outreach
	<p>transactions. Often, the nature of the fraud depends on the type of the entity involved and the motivations of the fraudster.</p> <ul style="list-style-type: none"> ○ As an example, in large publicly listed entities, management may be motivated to make it look like the company is performing well to increase share price (which could be driven by compensation arrangements tied to share price). Smaller, non-listed entities may be motivated to look profitable to obtain financing from a lender.
How Frauds Are Executed and Concealed	<ul style="list-style-type: none"> • Participants in the outreach meetings provided some examples of how frauds are executed and concealed, while acknowledging this varies considerably case by case. Some of the examples discussed were: <ul style="list-style-type: none"> ○ Booking fictitious journal entries through accrual accounts, reserve accounts, or certain asset accounts (such as construction-in-progress) to overstate revenue or understate expenses, or to smooth earnings or losses over time. ○ Structuring transactions with third parties who are involved in the fraud. ○ Inflating the amount of goodwill booked in a business combination that was not performed at arms-length. ○ Roundtrip transactions, such as selling a certain amount of goods to a third party while at the same time agreeing to buy back the same amount of goods, with the intention of overinflating revenue.
Who Is Involved⁸	<ul style="list-style-type: none"> • In most large, material financial reporting fraud cases, executives or company management are the key players. More junior staff may also be involved if they are doing what they are told as directed by company management. • Frauds committed by lower-level employees tend to be less material and the nature is more often misappropriation of assets. • In some of the jurisdictions interviewed, it is common for third parties to be involved. However, this was not noted by others interviewed. • System and Organization Control (SOC) 1 reports are not common in all jurisdictions internationally, which contributes to lack of controls oversight related to third parties.

⁸ The Fraud WG notes that paragraphs A2 through A5 in the application material of ISA 240 discuss financial reporting fraud and misappropriation of assets as well as the levels within the organization who are typically involved. These paragraphs remain consistent with what was heard during the outreach meetings.

Topic	Summary of Key Points from Outreach
Whether Frauds Involve Related Parties	<ul style="list-style-type: none"> • Involvement of related parties is more common in certain jurisdictions than others. • Some participants in the outreach meetings noted they often see more related-party involvement in private entities rather than publicly listed entities.
Financial Accounts Impacted	<ul style="list-style-type: none"> • Participants in the outreach meetings agreed that revenue is still the most prominent area where fraud is committed. • In addition, the following areas were noted as being vulnerable to fraud: <ul style="list-style-type: none"> ○ Reserves and accrual accounts. ○ Certain asset accounts, like construction-in-progress. ○ Goodwill. ○ Cash. ○ Receivables and invoice factoring. ○ Research and development expenses. ○ Inventory. ○ Cash flows from operating activities on the statement of cash flows.
How Frauds Are Detected, and By Who	<ul style="list-style-type: none"> • Often, the company self-identifies fraud through whistleblower programs or other company controls. • In some jurisdictions, it is common that regulators or authorities identify frauds. • Internal audit is also a source of fraud detection. • Typically, frauds are identified less by the external auditors than other sources.
Impact of Technology	<ul style="list-style-type: none"> • Participants in outreach meetings noted that while technology may add a layer of sophistication or complexity to how frauds are committed, the nature of the fraudulent acts being performed have not changed drastically over the past decades. • Face-to-face conversations are still very important when performing fraud-related procedures, and technology will never fully replace the human element of auditing. • Technology is increasingly used by auditors to perform fraud-related procedures. For example, data analytics is helping to identify anomalies, or to identify situations when management has not provided all requested data.

Topic	Summary of Key Points from Outreach
Materiality Over Time⁹	<ul style="list-style-type: none"> • Frauds almost always start small and grow over time. • Participants noted one reason for this is that fraudsters test what they can get away with. If they do not get caught right away, they gain confidence and continue committing fraud in larger amounts over time.

III. Academic Review and Other Research

Targeted Additional Academic Reports and Other Publicly Available Information on Recent Public Fraud Cases

13. In addition to the targeted outreach meetings held and summarized above, IAASB Staff also reviewed targeted additional academic reports (in addition to the general desktop academic review performed as mentioned in paragraph 3) that covered studies of fraud cases. A summary of this information is shown in **Appendix 1** to this paper.
14. IAASB Staff also reviewed other publicly available information to better understand the facts and circumstances surrounding specific 'recent' public fraud cases to determine whether there are any other areas that have not been identified that need to be addressed in the project proposal. A summary of this information is shown in **Appendix 2** to this paper.
15. The review of these academic reports and recent public fraud cases described in **Appendix 1** and **Appendix 2**, respectively, demonstrate the variety of the types of fraud perpetrated. However, there were common issues or themes identified, including:
 - The collapse or absence of oversight by those charged with governance;
 - Involvement by executives or company management;
 - Impairment of board independence;
 - Collusion with third parties (e.g., structuring complex transactions with third parties);
 - Weak corporate culture;
 - Inappropriate fraudulent financial reporting (including those arising from significant risk areas other than revenue recognition);
 - Use of fictitious journal entries;
 - Weak exercise of professional skepticism by auditors;
 - Impairment of or threats to auditor independence;
 - Failure to consider external fraud red flags (e.g., short seller reports); and
 - Failed external confirmation process.

⁹ The Fraud WG notes that paragraph A2 of ISA 240 described that earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management and that pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting.

16. The Fraud WG considered these common issues or themes identified when developing the scope of a proposed project on fraud. However, the Fraud WG notes that the common issues and themes identified through this additional work have already been broadly captured in the key issues identified that will be addressed by a project on fraud as set out in the draft project proposal in **Agenda Item 3-A**.
17. In addition, some of the commonality from the lessons learned on these fraud cases considered will need to be addressed through the combined efforts of auditors and other participants in the financial reporting ecosystem.¹⁰ While standard setters have a role to play, it will take efforts from all parties in the financial reporting ecosystem to substantially improve the issues related to fraud prevention and detection. For example, in many of the cases considered, strengthened governance board oversight and independence may have contributed to earlier prevention or detection of those frauds.
18. To emphasize the importance of all stakeholders in the financial reporting ecosystem in addressing issues raised on fraud, the Fraud WG has proposed other actions (i.e., activities of an educational nature and engagement with others) in the draft project proposal.

Association of Certified Fraud Examiners (ACFE) 2020 Report to the Nations

19. In addition to the specific cases above, IAASB Staff reviewed the [2020 Report to the Nations](#) published by the ACFE. This report presents findings of a study of 2,504 occupational fraud cases investigated between 2018 and 2019 in 125 countries. It was compiled based on questionnaire responses submitted from Certified Fraud Examiners (CFEs), in which they provided information about current fraud cases they investigated. These CFEs provided information on the method of fraud employed, the loss, the victim organization, the perpetrator, the means of detection, and the response by the victim organization after the fraud had been detected.
20. The following are some of the notable key points and insights derived from the study that may be relevant to the considerations about the fraud project proposal:
 - (a) Financial reporting fraud schemes are less common than misappropriation of assets, but also more costly. They made up 10% of cases with a median loss of \$954,000. Asset misappropriation made up 86% of cases, with a \$100,000 median loss.
 - (b) 43% of fraud schemes were detected by whistleblower tips, and half of those came from employees. Telephone hotline and email were each used by whistleblowers in 33% of cases.
 - (c) A lack of internal controls contributed to nearly one-third of frauds. The presence of anti-fraud controls is associated with lower fraud losses and quicker detection.
 - (d) Between employees, managers, and owners/executives, owners/executives committed only 20% of the studied fraud schemes but caused the largest losses with an average of \$600,000.
 - (e) Certain fraud risks were more likely in small businesses than in large organizations, such as billing fraud, payroll fraud, and check / payment tampering.

¹⁰ The 'financial reporting ecosystem' includes those involved in the preparation, approval, audit, analysis and use of financial reports, for example, the entity and its management (i.e., preparers), Boards and audit committees, external auditors, governments, regulators, professional bodies, standard-setters, investors, analysts, lenders, and other financial statement users). Each participant of this ecosystem plays a unique and essential role that contributes towards high quality financial reporting.

- (f) Small companies are more likely to lack internal controls, while large companies are more likely to have controls overridden.
 - (g) Poor tone at the top was the primary risk factor in 22% of all financial statement frauds.
 - (h) 85% of all fraudsters displayed at least one behavioral red flag while committing their crimes. The top three red flags are individuals who live beyond their means, are experiencing financial difficulties or have an unusually close association with a vendor or customer.
21. The Fraud WG has proposed certain actions as part of a project on fraud that are supported by the findings above (see **Agenda Item 3-A**), including enhancements to requirements and application material related to the auditor's understanding of internal controls and corporate culture, updates to the fraud risk factors currently included in the Appendix to ISA 240 (and consideration of relocation to the application material) and development of application material to illustrate scalability of requirements relevant to LCEs.

IV. Conclusion on the Additional Work Performed

22. The feedback obtained through the additional targeted outreach and research (as described in **Sections II and III** of this paper), together with the extensive feedback from all other information-gathering activities performed (as described in **Section I** of this paper), forms the basis of the Fraud WG's proposals for a project on fraud (see Overall Analysis in **Agenda Item 3-B**, which summarizes the findings all together).
23. The following summarizes the key takeaways for the Fraud WG from the additional work performed:
- (a) Each fraud is unique and often results from a number of contributing factors.
 - (b) The issues related to fraud will need to be addressed through combined efforts in standard-setting by the IAASB (i.e., through a project to revise ISA 240), as well as action from all participants in the financial reporting ecosystem. The focus of the IAASB's activities in a project will be on standard-setting because this is the IAASB's mandate but the ability to use the IAASB's global voice to encourage action from others is also recognized. The IAASB will need to further consider how this can be done.
 - (c) Corporate culture and internal controls (particularly strong governance) are a key aspect of fraud prevention and detection. There are elements of these topics that cannot be addressed through audit standard setting without corresponding requirements for management. The focus of the IAASB will be on enhancements that can be made through actions within its remit.
 - (d) The exercise of professional skepticism in identifying and investigating "red flags" is a critical component of the financial statement audit as it relates to the risks of material misstatement due to fraud.
 - (e) Non-material fraud and third-party fraud are issues that deserve further consideration and it is proposed they are included in the IAASB project.
24. In the view of the Fraud WG, the results of this additional work performed illustrates that the significant areas where there are challenges and issues on fraud have already been broadly identified as key issues in the draft project proposal, and also reinforces the proposed actions included in the scope of the project proposal (see **Agenda Item 3-A**).

25. As noted previously, the Fraud WG will continue to monitor current fraud cases and consider possible implications for the IAASB's standards over the course of the project.

Targeted Additional Academic Reports

#	Title of Academic Report	Brief Description of Relevant Information from Academic Report
1	"Assessing the Risk of Fraud at Olympus and Identifying an Effective Audit Plan" (Fukukawa, Mock and Srivastava) (2014)	<p>This study introduces an approach to the assessment of financial statement fraud risk and audit program planning and illustrates its application by simulating its use in the 1999 audit of Olympus. However, the relevant information for purposes of this root cause analysis is the background of the Olympus fraud which the paper details, as summarized below:</p> <p><u>Timeline:</u></p> <ul style="list-style-type: none"> • The Olympus fraud was exposed in July 2011 in an article published by a journal called Facta. • In September 2011, the Chief Operating Officer (COO), sent a questionnaire letter about the issue to the Chief Executive Officer (CEO) and other directors and staff, but did not receive a satisfactory response. • The COO was appointed CEO in October and asked PwC UK to investigate the issue. However, on October 14, he was dismissed as CEO by the board of directors. He then asked the Serious Fraud Office (SFO) in the UK to investigate the issue. • In November 2011, the company issues a press release admitting to fraud. <p><u>Nature of the Fraud:</u></p> <ul style="list-style-type: none"> • Olympus had two main lines of business: cameras and medical instruments. In the 1980s, the camera business experienced a substantial downturn. As a strategy to compensate for declined performance, management pursued a strategy of increasing non-operating income through short-term investments. From 1985 to 1999, short-term investments constituted more than 20% of total assets. • The short-term investment portfolio suffered losses in the 1990's, but the company did not need to report the accrued losses due to accounting standards at the time, which allowed financial instruments to continue to be valued at historical cost until they were sold or matured.

#	Title of Academic Report	Brief Description of Relevant Information from Academic Report
		<ul style="list-style-type: none"> • A new accounting standard was issued that would require the investments to be recorded at fair value in 2001. Rather than book the accrued losses, Olympus committed fraud. • The fraud was committed using two schemes: <ul style="list-style-type: none"> ○ The first scheme called “Tobashi” resulted in transferring losses in investments to other entities outside the company. Olympus established dummy companies which purchased the short-term investments at historical cost (which was significantly higher than fair value at the time of purchase). ○ The purpose of the second scheme was to dispose of the losses in the dummy companies which were transferred to them. In acquiring some companies, Olympus first had the investment funds purchase stock of the target companies, and then purchased those stocks from the investment funds at much higher prices than the original costs or the market value of the target companies. In addition, Olympus paid unreasonably high advisory fees to a financial advisor that had colluded with the company. The ‘profits’ of the investment funds and most of the advisory fees were then used to offset the transferred losses. As the result of these fraudulent transactions, the losses in the short-term investments had changed their form to goodwill incurred in the acquisitions and Olympus had planned on amortizing the goodwill in the future, thus postponing the recognition of the losses. • The frauds committed were complex and involved collusion with third parties.
2	"Steinhoff collapse: a failure of corporate governance" (Rossouw and Styan)	<p>This report provides a summary of the circumstances surrounding the Steinhoff fraud in South Africa, as well as some lessons learned.</p> <ul style="list-style-type: none"> • Steinhoff was at one point the world's second largest furniture retailer and had a presence in 33 countries. • Steinhoff operates with a two-tier Board structure. It remains a single board but consists of two separate tiers. The first tier is the Supervisory Board which, at the time of the fraud, included several non-executive directors including Bruno Steinhoff. The second tier is the Management Board that consisted of three individuals, all members of executive management (the CEO, COO, and chief financial officer (CFO)).

#	Title of Academic Report	Brief Description of Relevant Information from Academic Report
		<ul style="list-style-type: none"> • In the months running up to December 2017, rumors about the financial health of Steinhoff surfaced. A confidential report was leaked to five entities in September 2017 that highlighted several major, potentially fraudulent issues, at Steinhoff. • In September 2017, Deloitte (the company’s auditors) approached the Auditing Committee of Steinhoff with a request for certain audit evidence. • The CEO failed to provide the requested audit evidence and resigned. The Audit Committee advised the Supervisory Board against the publication of the unaudited financial statements, and this led to significant decline in share price. Deloitte requested a forensic investigation. • Steinhoff later announced that its financial statements for 2015 and 2016 had to be restated and could no longer be relied upon. <p><u>Lessons Learned</u></p> <p>The academic report provides judgments about what went wrong in the case of Steinhoff.</p> <ul style="list-style-type: none"> • The authors note that Steinhoff’s Supervisory Board failed in its duty to discharge its corporate governance, at least in relation to exercising due oversight over the Management Board’s activities. • Moreover, the Board issued financial statements that did not accurately reflect the Company’s financial position, as evidenced by the need for prior year restatement of financial statements. • The authors also note that the role of external auditors and relying on work done by others may also require further introspection. • The authors noted there are challenges when it comes to investigating allegations of fraud due to lack of transparency of financial transactions across borders. • Lastly, the authors question the ability of South African authorities to investigate and prosecute white collar crime.
3	"Using Altman Z-score and Beneish M-score Models to Detect Financial Fraud and Corporate Failure: A Case Study of Enron	The purpose of this academic paper is to determine whether Altman Z-score and Beneish M-model could detect the financial fraud and corporate failure of Enron Corporation. However, for purposes of this root cause analysis, the relevant information obtained about the nature of the Enron case, is detailed below:

#	Title of Academic Report	Brief Description of Relevant Information from Academic Report
	Corporation" (Maccarthy)	<ul style="list-style-type: none">• There were three major violations under generally accepted accounting principles (GAAP) that led to the failure of Enron: (1) off-balance sheet arrangements, (2) mark-to-market impacts, and (3) the manipulation of derivatives.• Enron kept large amounts of debt off its financial statements and admitted that earnings had been overstated because the company failed to follow the rules of qualifying for Special Purpose Entities (SPE).• There were also many activities between Enron and their auditors, Arthur Anderson, that threatened independence.

Appendix 2

Recent Public Fraud Cases – Other Publicly Available Information

The summaries within this table are from publicly available information and have been used to help inform the Fraud WG in developing the scope of the project proposal to address fraud in an audit of financial statements. Actual facts and circumstances, which are not public, may be different.

#	Case	Brief Description of Publicly Available Information	Some Lessons Learned	Sources
1	Olympus	<p><u>Company:</u> Olympus is a major Japanese manufacturer of optical imaging, laboratory, and medical equipment.</p> <p><u>Main players:</u> Executives.</p> <p><u>How they did it:</u> Olympus executed a “tobashi” scheme by selling devalued investments to an ‘unrelated’ entity under common control at historical costs. In this way, no loss was recorded by Olympus on the sale of the investment. The losses were recorded eventually as impairment of goodwill. To do this, Olympus would buy the ‘unrelated’ entity that held the investments, with the price set at the lower market value and then add in significant goodwill to the acquisition such that the new subsidiary would be bought for an amount equivalent to the historical cost of the devalued investments. Olympus would then gradually write-down goodwill from the acquisition of the previously ‘unrelated’ entity as a permanent impairment. At the end of the scheme, the devalued investment would be restored to Olympus’ balance</p>	<ul style="list-style-type: none"> • There were concerns over the corporate governance for Olympus. Outside directors should be truly independent and not connected to management. In addition, the Board needs to exercise appropriate oversight and challenge management. • It is important that those in oversight or auditing roles understand the corporate culture of an entity. 	<p>“Deep Roots of Fraud at Olympus,” <i>New York Times</i></p> <p>“Olympus Fraud Renews Focus on Corporate Governance.” <i>Compliance Week</i></p> <p>“Inside Olympus,” <i>ACFE</i></p>

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#	Case	Brief Description of Publicly Available Information	Some Lessons Learned	Sources
		<p>sheet at the lower market value, and the losses would be recorded through the income statement but not as investment income but rather as impairment of goodwill.</p> <p><u>How they got caught:</u> Significant asset impairment was exposed in a Japanese financial magazine, which caused the new CEO to ask questions.</p>		
2	Steinhoff	<p><u>Company:</u> Steinhoff is a furniture and household goods company headquartered in South Africa.</p> <p><u>Main players:</u> Executives and individuals outside the company purporting to be independent third parties.</p> <p><u>How they did it:</u> Steinhoff recorded fictitious or irregular transactions over a period covering 2009-2017 to inflate income and hide losses at the company's operating units.</p> <p><u>How they got caught:</u> In September 2017, information was leaked about potentially fraudulent behavior. In December 2017, the CEO suddenly resigned, resulting in huge decrease in share price. A forensic investigation was launched.</p>	<ul style="list-style-type: none"> Steinhoff's two-tiered governance structure made up of a Supervisory Board and a Management Board had too much power on the management board. The Supervisory Board failed in its duty to exercise oversight over the management board's activities and independence of the board. Auditors need to perform sufficient procedures when relying on the work of other auditors to satisfy themselves that the work is reliable. 	<p>"PwC investigation finds \$7.4 billion accounting fraud at Steinhoff, company says." Reuters</p>

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#	Case	Brief Description of Publicly Available Information	Some Lessons Learned	Sources
			<ul style="list-style-type: none"> • Auditor independence must be maintained. • The ability of the authorities to investigate and prosecute white collar crime plays a role in deterring and resolving fraud issues. 	
3	Enron	<p><u>Company:</u> Enron was a Houston-based commodities, energy, and service corporation.</p> <p><u>Main players:</u> Company executives and external auditor.</p> <p><u>How they did it:</u> Among other actions, Enron used special purpose vehicles (SPVs) or special purpose entities (SPEs) to hide large amounts of debt from investors and creditors. They also manipulated earnings through derivatives and mark-to-market accounting.</p> <p><u>How they got caught:</u> Internal whistleblower.</p>	<ul style="list-style-type: none"> • It is important that those in oversight or auditing roles understand the corporate culture and internal controls at an entity. • Effective Board oversight and independence is critically important to fraud prevention and detection. • Auditor independence must be maintained. 	<p>“Enron Fast Facts,” CNN</p> <p>“The Role of the Board of Directors in Enron’s Collapse.” Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs United States Senate</p>
4	Luckin Coffee	<p><u>Company:</u> Luckin Coffee is a Chinese coffee company and coffeehouse chain.</p> <p><u>Main players:</u> Company executives.</p> <p><u>How they did it:</u> Luckin Coffee sold vouchers redeemable for tens of millions of cups of coffee to companies that had ties to the chairman and controlling shareholder. These</p>	<ul style="list-style-type: none"> • Investors must perform sufficient due diligence and investigate red flags such as suspicious exponential growth. • Potential red flags warrant immediate scrutiny. 	<p>“Behind the Fall of China’s Luckin Coffee: a Network of Fake Buyers and a Fictitious Employee.”</p> <p><i>The Wall Street Journal</i></p>

Additional Root Cause Analysis of Fraud Cases
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#	Case	Brief Description of Publicly Available Information	Some Lessons Learned	Sources
		<p>purchases helped the company record higher revenue than its coffee shops produced. They also processed payments to fictitious suppliers.</p> <p><u>How they got caught:</u> A US short seller circulated a report on Luckin Coffee showing that much of the company's revenue must be fabricated. Two months later, Luckin Coffee disclosed that as much as 2.2 billion yuan of its 2019 revenue had been fabricated.</p>		
5	Wirecard	<p><u>Company:</u> Wirecard is a German payments processing company.</p> <p><u>Main players:</u> Company executives.</p> <p><u>How they did it:</u> Wirecard revealed that \$2 billion supposedly held at Philippine banks was not there at all. Investigations are ongoing to determine exactly what happened.</p> <p><u>How they got caught:</u> Repeated allegations from whistleblowers, journalists, and speculators that its revenue and profits had been pumped up through fake transactions with obscure partners.</p>	<ul style="list-style-type: none"> • There were breakdowns in corporate governance that highlight the importance of board independence and oversight. • Potential red flags warrant immediate scrutiny. • External confirmations are an important auditor procedure to independently verify cash accounts. 	<p>“Three Early Lessons from the Wirecard Scandal,” <i>Forbes</i></p> <p>“How Wirecard Went from Tech Star to Bankrupt,” <i>The Wall Street Journal</i></p>
6	Parmalat	<p><u>Company:</u> Parmalat is an Italian food conglomerate.</p> <p><u>Main players:</u> Executives, management and third parties.</p> <p><u>How they did it:</u> Parmalat committed a variety of</p>	<ul style="list-style-type: none"> • External confirmations are an important auditor procedure to independently 	<p>“Financial Scandals, Scoundrels, and Crises - Parmalat,” <i>CFA Institute</i></p>

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		<p>fraudulent activities. They inflated revenues by creating fake transactions through a double-billing scheme. They used receivables from these fake sales as collateral to borrow more money from banks. They created fake assets thereby inflating reported assets. In some cases, they took on legitimate debt that they hid from investors. They also worked with investment bankers to engage in financial engineering which moved debt off balance sheet or disguised it as equity on the balance sheet. They colluded with third-party auditors and bankers. They forged documents to verify bank accounts for the external auditor.</p> <p><u>How they got caught:</u> In December 2003, despite having reported 4 billion euros in cash and short-term assets on the balance sheet, Parmalat defaulted on a 150 million Eurobond payment. This was the event that led to a series of other events: Parmalat's bond rating was downgraded to junk by S&P, the stock price fell 40%, and the CEO stepped down. An investigation into Parmalat's finances was launched.</p>	<p>verify cash accounts.</p> <ul style="list-style-type: none"> • Potential red flags warrant immediate scrutiny. • As many as 300 employees were aware of the fraudulent activity, which demonstrates the power of management/ people in authority in coercing others to participate. • The scope and magnitude of a fraud tends to escalate over time. 	
7	Allied Technologies	<p><u>Company:</u> Allied Technologies is a Singaporean manufacturer of precision stamped metal parts that also provides</p>	<ul style="list-style-type: none"> • Effective Board oversight is critically important 	<p>"Corporate Governance Case Studies, Volume 9" <i>Prof. Mak Yuen</i></p>

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#	Case	Brief Description of Publicly Available Information	Some Lessons Learned	Sources
		<p>vertically integrated precision manufacturing services.</p> <p><u>Main players:</u> Executives and third party.</p> <p><u>How they did it:</u> \$33 million of the company's funds that was purportedly held in an escrow account had been unaccounted for. The lawyer managing the account disappeared and is charged with misappropriation of funds, however, he alleges that the executive director and investor were responsible. An investigation is still pending. Further abnormalities were flagged by the company's auditors in relation to two newly acquired subsidiaries that were written down shortly after their acquisition.</p> <p>In this case, the auditor raised multiple concerns about the audit, including that the escrow account served no clear business purpose.</p> <p><u>How they got caught:</u> The Financial Times and two short sellers published reports exposing issues with the company.</p>	<p>to fraud prevention and detection.</p>	<p><i>Teen, PhD, FCPA and CPA Australia Ltd</i></p> <p>"Allied Tech board conducts special audit in response to latest allegations."</p> <p><i>The Business Times</i></p>