

# Detection of Creative Accounting Related Frauds in the Zimbabwean Cotton Industry-The Internal Auditor's Role: Evidence From One Large Cotton Company

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## Abstract

Prompted by behavioural manifestations of massive creative accounting and fraud perpetration in the Zimbabwean cotton industry, particularly in the pre-dollarisation era, the research identifies the need to assess the value of the internal audit function in detecting creative accounting related frauds in this busy industry which is characterized by seed cotton procurement as a key activity. The study employed the quantitative research design, studying one large cotton company in Zimbabwe. Data was collected from ten out of twelve depots in one region and sampling was random. The study defined creative accounting related fraud as rule bending, falsification or manipulation of accounting information, loophole seeking, and systematic misrepresentation of the income and assets of the company. Statistical tests for relatedness between the internal audit function and fraud detection were done. Empirical evidence suggests that the more internal audit visits the more the reported frauds.

**Keywords:** Internal audit; Creative accounting; Fraud detection

## 1. Introduction and Background

Several authorities have defined creative accounting in a number of ways, but most of them narrow down to the manipulation of accounting information by one or more people, who in turn get an unfair advantage as a result. Merchant and Rockness (1994) define creative accounting as any action on the part of management which affects reported income and which provides no true economic advantage to the organisation and may in fact, in the long term be detrimental. The Public Company Accounting Oversight Board (2002) concurs with Merchant and Rockness' definition and further elaborates on creative accountancy as follows: It involves the use of accounting standards and the flexibility provided by them and the omissions within them to make financial statements look somewhat different from what is intended. It consists of rule bending and loophole seeking. The term creative accounting as generally understood refers to the systematic misrepresentation of the income and assets of companies. Creative accounting also includes the process by which transactions are structured so as to produce the required accounting outcome rather than allowing accounting to report transactions in a neutral way.

Since creative accounting is meant to benefit certain individuals, this is obviously an act directly attributable to fraud perpetration. Fraud was defined by KPMG (2004) as: Any dishonest activity involving the extraction of value from a business, directly or indirectly, regardless of whether the perpetrator benefits personally from his or her actions. The PCAOB's definition for creative accounting is used in this study, to address the overall research problem that is, evaluating the role of the internal audit function in detecting creative accounting-related frauds.

The company's aggregated reports between 2005 and 2009 revealed that during the seed cotton procurement season, more frauds occur as compared to growing season. As the hyperinflationary situation worsened, cases of theft and volumes of losses increased progressively. The reports had figures of creative accountancy related frauds and employee thefts. Notably the numbers of reported cases of creative accountancy-related frauds in both the growing and buying seasons were relatively higher than employee thefts. This suggested that fraud perpetrators thrive more on creativity than simple misappropriations. The case by case aggregated losses resulting from creative accounting related frauds were on the rise as compared to the employee thefts. This prompted the research, to gather sufficient evidence which can be used either to support or denounce the need for internal audit visits.

## 2. Statement of the Problem

Behavioral manifestations of creative accounting and fraud perpetration among procurement officers, buyers and cashiers in the cotton industry served as evidence that such practices were rampant. This warrants the need for examining the audit risk by evaluating the value of the internal audit function in detecting creative accounting related frauds.

### **3. Objective of the study**

To determine if the act of internal auditing assists in the detection of creative accounting related frauds in the Zimbabwean cotton industry.

### **4. Research Questions**

- (1) Does the company have an operational internal audit function in place?
- (2) Is there a relationship between the act of internal auditing and the detection of creative accounting related frauds?

### **5. Literature Review**

#### **5.1 Theoretical Review**

According to the PCAOB (2002) internal audit is an important part of the corporate governance structure within an organization. Corporate governance includes those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process. Anderson et al (1993) identified three monitoring mechanisms that have been identified in the corporate governance literature. They are external auditing, internal auditing, and directorships. The Institute of Internal Auditors (1999) added the audit committee to this list as the fourth cornerstone of corporate governance. In recent years, major corporate collapses have focussed attention on corporate governance and also emphasised internal auditing as part of the governance process. The IIA considers the objective of internal auditing to be both supporting and strengthening the organisation's governance mechanisms and evaluating and improving the effectiveness of risk management and control.

#### **5.2 Empirical Review**

A landmark study by Coram et al (2006) sought to assess whether organisations with an internal audit function are more likely to detect fraud than those without. In this study, the researchers used a unique self-reported measure of fraud primarily relating to misappropriation of assets for the first time. The fraud data were from the 2004 KPMG Fraud Survey. The internal audit data were from a separate mail survey sent to the respondents of the KPMG Fraud Survey. The research established that organisations with an internal audit function are more likely than those without such a function to detect fraud within their organisations.

Carcello et al (2005) in their US study examined the size of internal audit budgets and found that they were positively related to company size; leverage; financial, service, or utility industries; inventory; operating flows; and audit committee review of the internal audit budget. They also found that internal audit budgets were negatively related to the percentage of internal auditing that was outsourced. These researchers concluded that companies facing higher risk will increase their organizational monitoring through internal audit, providing evidence of the value of the internal audit function.

### **6. Research Methodology**

#### **6.1 Research Design**

The study employed the quantitative research design as done by Coram et al (2006) who researched on the value of the internal audit function in fraud detection in Australia. The design makes use of statistical tests which provide more sensible conclusions on the research objective.

#### **6.2 Population and sample**

Data for the study was collected from a sample of ten depots out of the twelve depots in one of the two regions. Sampling was random. Buyers from all the ten depots were selected. The head of internal audit department was purposively selected to respond.

#### **6.3 Data collection approaches**

Fraud and internal audit data from the 2012 Fraud and Internal Audit Survey across ten depots within one region of the company was used. All the nine buying points in a chosen depot were considered. An interview was conducted with the head of internal audit department of the company for triangulation purposes. A pilot test was done in one of the two regions where the company operates. This region was not considered for the final responses. The research used questionnaires mailed to respondents at selected depots and buying points in the region where pilot testing was not done.

#### **6.4 Research instruments**

Questionnaires and an interview were used to collect data. The questionnaire was sent to depot managers and buyers. An interview was used for triangulation purposes.

#### **6.5 Data analysis procedures**

Tables and Chi Square Tests were used to analyse the data.

## 7. Discussion of Findings

The questionnaire response rate was ninety six percent. The research noted that sixty two out of ninety six (sixty four percent) locations were visited by the internal auditors. Out of the fifty three locations that did not report any fraud during 2011, twenty six of them had no internal audit during that year. On the other hand, out of the 43 locations that reported frauds, 35 had an internal audit visit, while 8 had no such a visit by the internal auditors. This is suggestive that the internal audit function is of essence if frauds are to be reported within organisations and business units.

The same research findings were taken for a Chi-Square test to test for relatedness between having an internal audit visit and the likelihood of reporting fraud in business units. The following parameters applied for the test: (1) the sample consisted of 96 replies to the internal audit survey; (2) the test was for relatedness or between whether the depots and buying points had an internal audit visit and the likelihood of them reporting fraud.

Since the calculated F (F Cal) was smaller than the Chi squared test (F tabulated) there was evidence for the relatedness between whether the depots and buying points had an internal audit visit and the likelihood of them reporting fraud. Hence, the internal audit function has a role which cannot be over-emphasised. In a nutshell, this research found that business units with an internal audit function are more likely than those without such a function to detect and report fraud.

## 8. Conclusions and Recommendations

Findings of this study promptly suggest that the internal audit function is of essence if frauds are to be reported within organisations and business units. This provides evidence that internal audit adds value to the control and monitoring environment within business units such as buying points and depots to detect fraud. Evidence is also provided of the clear relationship between having the internal audit function and being able to report fraud within organisations and their business units. The Chi-Square test produced evidence for the relatedness between having an internal audit visit and the likelihood of reporting fraud. Hence, the internal audit function has a role which cannot be over-emphasised. From the issues explored in this study, we note that there are many other areas which should lure future researchers. The effectiveness and value of internal audit within organizations should be examined further in different industries and in different ways.

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