CASE STUDY
FRAUD INVESTIGATION

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Presentation of the case study

- **Group X (non public)**
  - An industrial group which went bankrupt.
  - Total 2015 sales amount to 1 billion dollars.
  - Management cooked the books for years.

- **Audit firm**
  - Big international network
  - The Group X engagement was never inspected by H3C.
  - A complaint against the firm lodged with H3C by the professional body

- **H3C Investigation**
  - Opening in 2017 and still ongoing
  - Collection and examination of audit files of the group and its affiliates for the last 4 years
  - Hearings of audit team as well as the firm CEO
  - Completion of draft report

- **For the purpose of the PCAOB Institute, H3C will illustrate a fraud case with the example of an affiliate of Group X for FY 2012.**
  - This affiliate, Company A, is an industrial company specializing in the manufacture of meat products. Total sales amount to about 100 M$. 

Overview of the fraudulent schemes

- By examining the audit files, H3C identified the following fraudulent schemes implemented by Company A

  ➢ Revenue and receivables were fraudulently increased by recording:
    - forged financial advances to meat suppliers (about 14 M$),
    - a new price listing without customers approvals (about 10 M$),
    - revenue before goods deliveries (amount non-determined),
    - accrued revenue on litigations with suppliers (about 2 M$).

  ➢ Equity investments in Company B fraudulently non-impaired by increasing their fair value (impact of 14 M$):
    - Revalued net asset method was preferred to a less favorable method (multiple of EBITDA).
    - Company B fixed assets were arbitrarily revalued upwards.
    - Company B debts were decreased.

- Total fraud amounted at least to 40 M$ representing about 40% of Company A sales.
Performance of audit work

- The audit team is well-staffed and competent.

- The audit file is thick and in appearance well-documented.
  - All firm audit questionnaires were completed and no issues were identified.

- In particular, concerning fraud:
  - All fraud questionnaires were addressed and it was concluded that ISA 240 was correctly applied.
  - Interviews with management on fraud were carried out and it was concluded that management was aware of the risk of fraud and that no fraud was identified.
  - Tests on accounting journal entries were carried out.
  - A management representation letter with paragraphs on fraud was obtained.

- Concerning the audit of revenue and receivables
  - Numerous tests were implemented: analytical review, reconciliation between different ledgers, third-party confirmation, cut-off tests,…

- Concerning the audit of equity investments
  - Entity calculations were checked.
Description of audit failures

- **Lack of professional skepticism**
  - Very high confidence in management
  - Several audit procedures were based on management statements.
  - No critical analysis was carried out on management estimates.

- **Lack of supervision by the signing partner**
  - Significant misstatements were identified by the audit team, but not by the partner who considered a low engagement risk and consequently only did a high level review.

- **Only substantive audit approach**
  - An approach based on internal control (including IT) would have allowed the audit team to identify deficiencies in sales process and segregation of duties.
  - In a context of retail sales, substantive approach covered only a small part of revenue and receivables and did not consequently enable the auditor to identify fraudulent schemes.

- **Insufficient extent of substantive procedures**
  - Incoherent variance of receivables should have triggered supplementary audit procedures.
  - No response to third-party confirmation and insufficient alternative procedures.
  - No consequences were drawn from cut-off misstatements because of the audit team consideration that they were non-significant, whereas an extrapolation would have demonstrated their significance and the need to extend the test sample.
Preliminary findings from H3C investigation

- Audit failures played a major part to the non-detection of fraud.
- However other factors could possibly play a role in the fraud magnitude.
- The ongoing H3C investigation is working towards a possible collusion between the auditor and Group X management

Thus, the H3C:
- requested the firm to communicate all emails between the signing partner and Group X management,
- solicited the public prosecutor's office for assistance to investigate some prohibited links between the signing partner and Group X management.

- In addition, the H3C is also working towards identifying possible failures in the firm internal procedures by:
  - analysing the firm internal procedures,
  - interviewing the firm top management.
QUESTIONS?

More information: www.h3c.org

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