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Considerations of Private Companies in Regard to External Auditing Including the Detection and Prevention of Fraud

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CONSIDERATIONS OF PRIVATE COMPANIES IN REGARD TO EXTERNAL AUDITING INCLUDING THE DETECTION AND PREVENTION OF FRAUD

By

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Abstract:

Fraudulent activities occur in all types of companies. Recently, external auditors have become increasingly important in detecting and preventing these frauds. With their independence, auditors can provide external comfort with their opinion as to the fairness of their client's financial statements. The goal of this thesis is to express the importance of fraud prevention in private companies, especially smaller private companies, and illustrate how external audits can have an impact in fraud prevention. After conducting interviews with private companies, many reasons were found as to why private companies either conduct or do not conduct an external audit. This research bridges the information gap that exists between public and private companies regarding how they view preventing fraud with external audits.

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Introduction:

Fraud has been around since the inception of commerce, and companies still struggle with fraud throughout their organizations today. Corporate fraud scandals were especially prevalent in the early 2000s, with accounting scandals such as Enron and WorldCom. These scandals involved large sums of money, and, as a result, the American Institute of Certified Public Accountants was created to oversee the accounting standards and practices that take place within U.S. companies in order to prevent any further scandals with such levels of destruction.

One main type of accounting fraud that occurs in companies is financial statement fraud. Financial statement fraud hurts the external users and decision makers of a company's financial statements because they could change investment or bank loan decisions for those users. As a result of external users being hurt, the overall economy suffers as well because people will be less willing to invest in companies after fraudulent activities are uncovered.

Fraud in companies has multiple costs that go along with it. Not only does fraud have a direct cost of one million dollars on average, but also there are indirect costs and opportunity costs to fraud (Brown, n.d). Companies generally experience these costs every two to three years on average (Brown, n.d.). However, both indirect and opportunity costs make it difficult to quantify the total cost of fraud.

Fraudulent activities still exist in organizations today. It is especially prevalent in companies that trust their employees too much. If given the right circumstances, employees can betray that trust by committing fraud within an organization. This trust often exists in smaller, private companies with employees who have worked at the company for an extended period of time. These employees at smaller, private companies have knowledge of where they can gain access to the financial statements in order to cover up fraudulent activities.

A company's financial statements have an essential role in communicating a company's financial health to decision makers, such as investors and creditors. As a result, it is important that this information does not contain material misstatements, so decisions can be made with maximum knowledge. However, company management has more information about the financial health of the company than do the external users. This creates information asymmetry because one party has more information than the other. This information asymmetry is when external auditing becomes relevant.

An external audit provides reasonable assurance that the financial statements of their client are not materially misstated, so decision makers have relevant information. External audits work to minimize the level of information asymmetry so decision makers can make decisions with the information in the company's financial statements.

However, not all companies are required to have external audits. The government does not require private companies to conduct external audits because private companies do not issue their financial statements to the public. Nonetheless, information asymmetry continues to exist in private companies, and therefore, auditing still has vital importance.

Fraud prevention remains important in all companies, and one such way management can prevent fraud is through hiring a CPA firm to conduct an external audit of the company. Although yearly external audits are expensive, they remain less costly than fraud. Management in smaller private companies also has two other options for which they can reap some of the benefits of an external audit without the high cost. These are audit reviews and a specific accounts external audit.

To research how private company management views external auditing as a means of fraud prevention, I interviewed nine companies headquartered in Columbia, South Carolina. My interviews included questions about the length of time the companies have been audited, what factors drove them to conduct an external audit, how the companies chose an accounting firm to conduct the external audit, what benefits they hope to obtain from an external audit, and whether or not resource misappropriation was a factor in choosing to conduct an external audit. Through these questions, I discovered the number of private companies interviewed that conduct external audits, along with valuable insight into why each private company chose to conduct an annual external audit. The companies that do not conduct external audits also provided valuable insights into their decision to forgo such an audit.

This thesis will focus on how private companies view external auditing in small, private companies. After researching fraud in U.S. businesses, I discovered a lack of research into how private companies view fraud and what they are doing to prevent fraud. As a result, this thesis will focus on the reasons for which private companies either conduct or do not conduct external audits because the government does not mandate private companies to conduct yearly external audits. The goal of this thesis, aside from encouraging private companies to consider an external audit, is to help private company management find the option that provides the most benefit at the lowest cost in order to prevent fraud.

Fraud Introduction:

Imagine owning a company with a great work environment and seemingly trustworthy employees, and then discovering those employees cannot be trusted because thousands of dollars have disappeared from the financial statements. To have all of the hard work and long hours that were put into the building of the company be eradicated by fraud would be disconcerting. If given the choice, would it not be ideal to minimize the risk of that discerning feeling from occurring? This is a situation in which no founder or CEO wishes to find themselves. That is because in this situation, fraud has occurred within the company. The Association of Certified Fraud Examiners defines fraud as "any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means" (Association of Certified Fraud Examiners, 2014). Fraud is not just a modern occurrence; in fact, the earliest recorded attempt at committing fraud was in 300 B.C when a Greek sea merchant, Hegestratos, attempted to sink his ship in order to collect insurance on it (Hammond, 2015). This is a clear example of insurance fraud. However, there are many additional types of fraud, such as asset misappropriation, embezzlement, financial statement fraud, and consumer fraud ("Four Types of Fraud," 2016*)*.

This thesis will focus specifically on financial statement fraud, which is the most common type of fraud that external auditors catch ("Report to the Nations on Occupational Fraud and Abuse," 2014). One category within financial statement fraud is misappropriation of a company's assets to the point that the financial statements are materially misstated, which will be discussed later in this section. Fraudulent financial reporting spans a wide array of illegal acts.

These illegal acts include management or employee manipulation of documents (such as trial balances, the general ledger, journal entries, depreciation and amortization schedules to name a few) to be relied upon when preparing financial statements of the company. It can also include intentionally changing or omitting any events, transactions, or significant information from the financial statements. Lastly, it also includes intentionally misapplying any generally accepted accounting principles (GAAP) in determining account amounts or certain disclosures (Messier, 2017). The purpose of financial statement fraud is to mislead the users of the financial statements and inflate the strength of the company (Bradford, n.d.)

Recent regulations have been put in place in order to mitigate prior financial statement frauds, such as the Enron scandal, from occurring again. These regulations have helped prioritize an external auditor's role in detecting frauds before they appear in the financial statements. Auditors have increasingly been able to detect financial statement frauds and the misappropriation of assets when the misappropriation is material to the financial statements. Although only one type of fraud, financial statement frauds materialize in numerous ways.

Types of Fraud:

The ways financial statement frauds materialize include revenue overstatement, expense alteration, improper disclosures, asset overstatement, and manipulation of revenues or expenses. Revenue overstatement is the most common of these, which involves recording sales before sales are actually made or before the customer makes a payment. Employees can overstate revenues in a few different ways including: recording sales when shipping to company-owned facilities, re-invoicing past due accounts to decrease the age of receivables, billing for future sales before is normal, and replicating previous billings (Bradford, n.d.).

A company can also alter its expenses in order to make income numbers higher. In the WorldCom scandal, there were numerous operating expenses that were capitalized (that is, recorded as an asset rather than an expense) on the balance sheet instead of immediately expensing them. WorldCom employees did this to delay recognition of these normal expenses and inflate income for that period.

Financial statement frauds through improper disclosures in the financial statements is another way management can conceal fraud. Improper disclosures come about by making incorrect statements in annual reports or other SEC filings. This is where external auditors become relevant. If an external auditor is confused or does not understand the ambiguous statements in the disclosures, then the external users, such as investors and creditors, will not likely be able to interpret the meaning, and therefore management can conceal fraud from the public. It is important that management provides these financial statement users with accurate information and ensures that there is little to no information asymmetry, which exists when one party does not possess the same quantity of information as the other side.

In the context of auditing, management has more information about the fairness of the company's financial statements and whether or not the financial statements contain material misstatements than the company's investors and creditors. Management is on the inside of the company, so they can easily access this information, and they often have the knowledge of fraudulent activities, if any. Investors and creditors, on the other hand, largely rely on the financial information management presents. This is why it is necessary for auditors to verify that the financial statements do not contain material misstatements to diminish the level of information asymmetry and provide reasonable assurance that both sides have similar information.

Another method of fraudulent behavior is when a company overstates its assets, such as the company's accounts receivables or inventory. This gives the illusion that the company has more assets than they actually do.

Less commonly, companies can also *understate* revenue or *increase* expenses. Companies may do this in order to avoid paying a high amount of corporate taxes. However, doing this may also negatively impact other aspects of the company such as earnings per share ratios and bank loans.

Auditors have also caught misappropriation of assets when the misappropriation causes material misstatements within the financial statements, which is a category within financial statement fraud because of its relevance to the financial statements. Misappropriation of assets is the theft of any type of the company's assets to the point that it causes the financial statements to be misstated (Messier 2017). Misappropriation of the company's assets can materialize in a few different ways. This could be stealing of a company's assets, such as inventory, especially if the company has valuable inventory that can be resold. Another way to misappropriate assets is paying for goods and services that the company never received. Lastly, an employee could embezzle the money customers or clients are paying for the company's goods and/or services, and therefore, the company never receives these payments.

As previously illustrated, fraud perpetrators can commit fraud in a multitude of ways. Frauds within a company can be detrimental to both a company's bottom line and its reputation. This detrimental effect of fraud can further emphasize the importance of fraud prevention, which is where external auditing becomes relevant in private companies.

Fraud perpetrators can have many reasons for committing fraud, which include: having too great of financial debt to overcome due to a personal situation, such as a divorce or the desire to have great wealth, or due to an employee's vices, such as gambling or a drug addiction. Other reasons could be to pay for a family member's medical care or pay for his or her child's college tuition. Oftentimes, fraudsters believe they will pay the company back once get the money. Although fraud perpetrators initially thought that, in the end, it is not the case. As such, fraud has a direct financial cost and a major impact on the company.

Fraud Statistics and the Impact of Fraud

Some private companies are required to file their financial statements with the SEC to satisfy certain classes of shareholders, lenders, and insurance companies (Shaftoe, n.d.). However, the majority of private companies do not need to file their financial statements as public companies do. Although not required, yearly external and/or internal audits have been shown to decrease the fraud losses in a company. Research from the AICPA has found that companies that conduct yearly audits had median fraud losses that were thirty-five percent less than those with no internal or external audit (Ochs, 2007). The fraud losses in companies who do not conduct external audits tend to be much higher.

Further to this point, the ACFE identified that family-owned private companies accounted for the greatest number of fraud cases in 2002 at thirty-one point nine percent of fraud cases ("Report to the Nations on Occupational Fraud and Abuse," 2002). This high fraud rate in family-owned private companies could be because management believes external audits are unnecessary since they are a family run business and typically smaller. Companies often opt out of financial statement audits because of the great expense but opting out can be even more financially detrimental to the company over the long term.

Most major companies report a fraud incident every two to three years, and fraud costs a private company an average of one million dollars per incident (Brown, n.d.). The Association of Certified Fraud Examiners has discovered that the typical company can lose up to five percent of its annual revenues to misappropriation ("Report to the Nations on Occupational Fraud and Abuse," 2014). In one study, it was determined that in seventy-five percent of cases, the fraud-related losses can be more than three percent of total company expenditures. In seventeen years, the average fraud losses were greater than five percent. Furthermore, the average losses of fraud have risen in the previous two years by almost eighteen percent (Gee & Button, 2015).

For companies not taking the proper fraud prevention steps, one million dollars (on average) every two to three years can end up being a frequent and costly expense. Management may think that fraud will not happen in their companies because they have such a close-knit community. However, that often is the environment in which a fraudster can take advantage of the trust within the company.

This "it won't happen to me" mentality is so common in all aspects of life that it even has a name- the optimism bias. This bias is when individuals believe they will experience more positive outcomes than negative outcomes because positive outcomes are more likely. Humans have this belief that they are not susceptible to bad outcomes (Osbaldiston, 2016).

Company executives, especially those in smaller, private companies and/or family-owned businesses, believe their companies to have less fraud than the average. However, fraud harms smaller, private companies more because the fraud losses are a larger percentage of the revenues of the smaller private companies. In the business world, the optimism bias can cause private company executives of smaller companies to not have a public accounting firm conduct an external audit because they do not believe fraudulent activities will happen within their small communities. Fraud can have a negative impact on multiple areas within a company, such as the financial situation, employee morale, and even the hiring process, therefore, management needs to overcome the optimism bias.

Although fraud is costly for all companies, small private companies are much less likely than larger companies to conduct external audits. “Just 56% of organizations with fewer than 100 employees represented in the survey underwent external audits of their financial statements, compared with 91% of businesses with 100 or more employees" (Tysiac, 2012). Fraud not only increases company expense by one million dollars, on average, but it can hurt the company in more ways, including a decrease in employee morale and the number of potential new hires, along with harming the company’s reputation. All of which can potentially lead to the downfall of a company and make the cost of an external audit suddenly worth the expense.

One such indirect cost is a decrease in employee morale. Employees can become distraught because a fraudster invalidated their hard work. They can become frustrated that an employee or employees unfairly destroyed the company when they put in long hours only to have it disappear with fraud. This frustration can cause some employees to leave the company. Without preventive measures to work to mitigate fraudulent activities, employee turnover could become costly for the human resources department.

This decrease in employee morale would require companies to exert a significant amount of effort into the finding and hiring of new employees to replace those that left. If potential new hires found out about those disgruntled employees, then it could be difficult to attract top recruits and keep employee turnover at a relatively low rate. All of which only increases costs for companies.

This is only a glimpse into the full cost of fraudulent activities for a company because the total cost of fraud is difficult to quantify. This true cost includes the one million average direct cost of fraud, but it also includes indirect costs of fraud, such as when the company has to rebuild its reputation. Fraud comes with a high financial cost and reputational damage to a company. Further to this point, both Nevada University and Friedrich-Alexander University determined that companies facing fraud within their senior management team could see a thirty percent erosion to their share price above and beyond the initial loss (Pan & Skeels, 2016). Therefore, it is imperative that companies understand the benefits of preventing such activities from occurring.

Fraud can also lead to lost economic opportunities, along with the direct and indirect costs of fraud. Some of these missed opportunities are less investments in the company, increased company debts, the inability to make investment income, and late payment fees (Funk, 2015). Although opportunity cost is difficult to quantify, it is an important and usually high price tag. Therefore, the opportunity cost of fraud requires considerable attention when looking at the cost-benefit analysis of an external audit in small, private companies.

Not only is fraud costly for the company itself, but it also damages the economy as a whole. Many times, the public can become distrusting of corporations after a fraud occurs (Funk, 2015). This is harmful because not only does the public lose trust in corporations, but it also becomes skeptical of the stock market as a whole.

This lack of trust can then prompt people investing in the stock market to withdraw their funds because they are less willing to take risks when fraud has occurred, especially when they may not have all the necessary information to make smart investment decisions. When people do not invest in the stock market, corporations are unable to conduct the necessary research because of a lack of funds. This, in turn, hurts overall economic progress. Fraud permeates into many different areas of the business world. It hurts retirement accounts, demolishes company reputations, and wreaks havoc on companies involved. Companies, business owners, and investors can lose billions from asset misappropriation that devalues companies and causes them to miss out on economic opportunities (Funk, 2015).

Fraud has been around since the beginning of commerce, and therefore, it is not completely avoidable. However, companies can take steps to help prevent fraud. The first of which involves understanding how frauds can occur in businesses.

How Frauds Occur:

An important element in understanding how fraudulent activities can occur in companies is knowing that anyone can commit fraud. The majority of fraud perpetrators may not seem like criminals. This is because society's perception of criminals does not generally apply to those that commit fraud within a company. Even if employees have been honest for a long time, they still have the potential to commit fraud when severe financial pressures occur or employees perceive them as existing.

The Fraud Triangle:

The fraud triangle developed by the fraud criminologist, Dr. Donald Cressey, illustrates how frauds occur (Pavlo, 2011). The Association of Certified Fraud Examiners defines the three aspects of the fraud triangle as: perceived financial need, perceived opportunities, and rationalization. A financial need usually exists when an employee is in insurmountable debt due to a personal situation, such as a divorce or the desire to live a lavish lifestyle. It can even be related to that employee's vices, which can be anything from gambling to drug addiction. All of these situations put an individual in a stressful financial situation, where that individual does not feel he or she can share it with someone close to him or her.

To put it a little more simply: for fraud to occur, incentives or pressures must exist, opportunities to commit fraud must exist, and the perpetrator must have a certain attitude or rationalization to justify his or her fraudulent behavior.

The first part of the fraud triangle are incentives and pressures. Incentives and pressures that exist within the company start with senior management, which is paramount in any and every company. Another phrase for this is "tone at the top." If management cuts corners or does not place much emphasis on following ethical codes, then the employees are not likely to either. This can easily prompt the potential for employees to commit fraud.

Another incentive is that the employee at the company has a gambling addiction, desires a lavish lifestyle, wants to accelerate to the top of the company faster than normal, is going through a divorce or some other incentive. When employees become too greedy and constantly desire more wealth, an incentive to commit fraud can materialize. This fraud incentive could materialize because employees desire more wealth now, and they do not wish to wait to receive money or material possessions. These employees also may not want to work hard to accumulate wealth because of the length of time it would take to receive a promotion to a position with the desired higher salary.

Pressures can also exist when management's bonus payments are difficult to reach and/or excessively generous (Frost, 2012). This can be a way in which those employees with financial performance-based incentives can view fraud as a means to receive their generous bonus or meet management's too high of performance expectations. This can become even more prevalent when the performance measures seem impossible for any employee to reach. For example, they could attempt to achieve a significantly higher number sales this year relative to the previous year, making that bonus seem too challenging to achieve. Companies can avoid this fraud incentive by not tying bonuses to only financial performance, but also nonfinancial data, especially in harder economic times when employees have less control over their performance.

Although incentives have a large impact on fraud, it is not just incentives alone that drive employees to commit fraud.

The second part of the fraud triangle is opportunity. The opportunity to commit fraud must be present in order for the fraud to occur. For example, a company employee may discover that no one double checks the vendors in the accounting information system of which the employee has full control in managing; the employee is solely in charge of the addition and/or deletion of vendors. This presents an opportunity for the employee to create a fictitious vendor to which the company makes payments. From there, that employee can direct all checks from the fictitious vendor to him or herself. Instead of the company paying this fictitious vendor, it actually unknowingly pays the employee because there is no management supervision of this employee's responsibilities.

Other examples that can provide opportunities for employees to commit fraud is a complex organizational structure or a lack of transparency within the accounting system (Frost, 2012). An organizational structure that is too complex can be an issue because the company has no clear hierarchy. This is also related to a company's lack of internal controls because companies generally work to properly authorize transactions. If management delegates this authorization to various employees, a clear hierarchy may not exist, making it difficult to have a defined company structure.

A complex organizational structure attempts to hide a company's revenue streams and confuses third parties, such as the Internal Revenue Service (IRS). An example of this is the Enron scandal in 2002. Management kept many transactions off the balance sheet to hide revenue streams (Frost, 2012). This example follows the fraud triangle because it gives employees the opportunity to commit fraud; it illustrates the possibility of overriding the accounting system or ignoring the internal controls completely.

A lack of transparency within a company can materialize in numerous ways, but this occurs most often in difficult to understand financial transactions, and thus, these financial transactions are often ignored. An example of this could be an employee making numerous miscellaneous journal entries at the end of the month or reporting period to hide fraudulent activities. The lack of internal controls within a company highlights the presence of an opportunity to commit fraud to the potential fraudsters. This section of the fraud triangle is the area that the company has the most control in preventing frauds from occurring.

Many times, companies can become lax with certain aspects of their internal controls because management trusts employees who have worked at the company for many years or because management would never expect the company's employees to purposefully harm the company. Organizations can blindly trust employees and thus, think "fraud won't happen in this company." For example, complacency with controls can be detrimental to an organization as it was within the Dixon, Illinois city government for many years.

Rita Crundwell was a long-time employee of the Dixon, Illinois city government. Rita was sentenced to nineteen and a half years in jail in 2013 for using fifty-three million dollars of city funding for her own personal benefit. She had been working in the city government for over forty years, and she was one of the most trusted employees.

The company unknowingly presented Rita with opportunities to commit fraud seeing as she was both the comptroller and treasurer of the government. This lack of segregation of duties gave her the opportunity to open a bank account disguised as one for the city and deposit checks into it with no proper authorization (Messier, 2017). This further illustrates even the most long-term employees can commit fraud, if given incentives, opportunities, and rationalizations.

The final piece of the fraud triangle is rationalization. The employee needs to rationalize the fraudulent act. Most people are not inherently corrupt, but if given the right opportunity and the right reasons, one can justify anything. An example of this would be an employee's thought process of: 'Well, they don't pay me enough here. I work harder than most people here, and I still have yet to receive a raise like X employee over there.' Employees also could justify it by thinking to themselves: 'I will give the money back when I pay back my loans, etcetera.' Both reasonings can lead the fraudster down a dangerous path which can prove difficult to return.

One such rationalization is an employee's sense of arrogance with him or herself. "Some people believe they are better than 'the system' and that they can get away with anything" (Frost, 2012). The best way for a company to control this is by focusing on human resources. They can interview potential future employees and attempt to keep any candidates who possess this arrogant attitude from working at the company in the first place.

Companies can utilize ways to prevent fraudulent activities from occurring. Companies need to implement preventative measures, such as requiring employees to take vacations, segregating duties, hiring employees who possess the right attitude, and encouraging employee tip-offs (Brown, 2015). Many times, however, these preventive measures are not taken, especially in smaller, private companies that find it difficult to justify the cost (Tysiac, 2012). As a result, this lack of preventative measures can facilitate fraud within companies.

Comparison of Fraud in Public and Private Companies

A public company freely trades its shares on the stock exchange. A private company, on the other hand, has shares that are owned by a select group of individuals, such as employees or investors. This thesis focuses on private corporations more so than public companies because the financial reports of public companies are publicly available. As a result, there are many rules and regulations governing public companies to help mitigate the risk that a company's financial health is fraudulently stated.

On the other hand, the government does not regulate private companies as strictly as public companies, and as such, there can be fraudulent activities within a company that virtually go undetected. State governments only require private companies to file certain documents and adhere to shareholder compliance laws ("Public vs. Private Companies," 2011).

There are some key distinguishing features between private and public companies that illustrate the differences between both types of companies such as: common stock, raising funds, and reporting requirements (Bank, n.d.).

The issuing of common stock to the general public initially happens when public companies go through the process of an initial public offering or IPO. In order for a company to sell its shares to the public market with an IPO, those shares must be registered with the U.S. Securities and Exchange Commission (Bank, n.d.). A private corporation cannot freely trade its stock with the general public. The SEC regulation D requires private corporations to follow SEC registration requirements in order for investors to own shares in the companies (Bank, n.d.).

In my independent research, many privately-owned companies listed a potential IPO as a reason for which they chose to have an external audit conducted. An external audit, while the company remains private, helps to facilitate the IPO process should a private corporation choose to go public. It also can help prevent unforeseen issues during this process due to fraud being uncovered after the announcement. One such example of this was with Topaz Energy and Marine, where its IPO was cancelled because its parent company uncovered fraud, valued at a loss of almost three million dollars in asset misappropriation, within one of its subsidiaries ("Equities: IPO Candidate Reveals Fraud," 2011). Topaz then faced issues of raising capital for further research, which is another contrasting feature between public and private corporations.

Public and private corporations generate funds in different ways. Because a public corporation's stock is traded publicly on the stock exchange, a public corporation can easily generate more funds through issuing more shares of common and preferred stock. On the other hand, private corporations do not publicly trade their stock, and as a result, they have to rely on income, bank loans, and private investments for operations and expansion. Venture capitalists can purchase the shares of private corporations, but those shares cannot be resold for six months unless they file for an exemption (Bank, n.d.). This can cause issues in private companies because they may need to get funds fast, and as a result, management could be tempted to manipulate the financial data in order to receive bank loans because they do not have the option of issuing more shares to generate funds as their public counterparts do.

Reporting requirements is another way in which private and public corporations differ. Public companies are required by the SEC and stock exchanges to provide information on their operations, finances, and investments annually. One element within this information is audited financial statements of public companies, along with quarterly earnings (Bank, n.d).

Unlike public corporations, private corporations have no such obligation to publicly report their financial statements. If a private corporation wanted to place stock shares, that information must be disclosed to any and all potential investors through what is called an offering memorandum, which is also known as a private placement memorandum (PPM). This document informs the investor of any necessary information about the company before making an investment ("Private Placement Memorandum," n.d.). The financial data of private corporations is not issued to the public or reviewed by external auditors, and as such, it can be easier for management to hide fraud for longer than frauds in their public counterparts.

These are just a few brief illustrations of the key differences between public and private corporations. These differences provide insight as to why this thesis focuses on the prevention of fraud in private companies. Fraudulent activities may go unnoticed in a small, private corporation for longer than it would in a public corporation because private companies do not have the same regulations and reporting requirements as a public company (Tysiac, 2012).

Audit Introduction:

The public demands auditing because of its important role in maintaining contract agreements between companies and both stockholders and debt holders (Messier, 2017).

Put simply, auditing exists to eliminate information asymmetry between financial parties. As mentioned before, the purpose of audited financial statements is for creditors and shareholders of companies to have information about the financial health of companies in which they invest (Vitez, 2017). These investors and creditors do not know as much about the numbers in those statements as the managers and executives of the companies. This creates information asymmetry, which is when one side does not have all of the information the other side has. This is where auditing becomes relevant.

The Economic Times defines auditing as account examination by auditors, along with physical inventory counts to reasonably assure that the departments follow a documented system of recording transactions. Auditing reasonably assures external users that the financial statements provided by management do not contain material misstatements (What is Audit?, n.d.). Auditors' relationships with their clients and the general public only exist because of their trustworthiness and credibility.

Audit Tests:

Auditors build up company credibility and trustworthiness by reviewing financial statements, conducting tests of controls, and performing substantive procedures. After performing these tests, auditors issue an opinion as to whether management presents the financial statements fairly.

Auditors first conduct tests of controls. They use these tests to evaluate the effectiveness of the client's controls in preventing or discovering and fixing material misstatements. If auditors do not test internal controls, then they factor a high control risk when assessing the potential risks of the audit client to determine the extent of substantive procedures. This helps the auditor achieve the overall desired amount of audit risk for the engagement.

Substantive procedures are used to detect material misstatements in a class of transactions, account balances, and disclosure components of the financial statements (Messier, 2017). Financial statement fraud is the expertise of external auditors; therefore, it is justifiable to have them at least conduct substantive procedures and determine if any fraudulent activities exist within the company leading to material misstatements in the financial statements.

To prevent another Enron-type fraud, the AICPA strengthened auditor independence regulations. Therefore, auditor independence is crucial to ensure auditors maintain objectivity during the audit when testing controls and performing substantive procedures. The AICPA used the newly required independence rules to encourage the public to once again place its trust in audited financial statements, accounting firms, and both internal and external audits after the Enron scandal broke the public's trust in auditors.

Internal and External Audits:

In public corporations, both internal and external audits are required. Neither audit types are required in private corporations. In my independent research, of the private companies interviewed, none had an internal audit team. However, the majority of interviewed private companies did conduct yearly external audits.

Many differences exist between internal and external auditing, and it all starts with the purpose of each type of audit. An internal audit focuses on the business practices of the company and ensuring that the company manages its risks and accomplishes its objectives. An external audit analyzes whether the financial statements demonstrate a fair view of the company's financial position and if those financial statements are prepared according to GAAP (Lewis, 2015).

Internal and external auditing require a different type of auditor. Internal auditors can work at the business or they can be outsourced by the company. Contrary to internal auditors, external auditors are required to be 'registered auditors' from an outside firm of accountants (Lewis, 2015). This helps to assure the auditors maintain independence from their clients.

The timing of internal and external audits is also different. Internal audits can be conducted throughout the year, especially if the company has its own internal audit team. CPA firms generally conduct external audits annually, especially in private companies because of its high cost.

Another distinguishing feature between internal and external audits is regarding how the auditors set the audit agenda. Internal audit focuses on the company's risks, and therefore, internal auditors mainly focus on the company's business risks and objectives. For example, if a weak internal control exists, then the internal audit emphasizes evaluation of that internal control. The CPA firm sets the agenda for the external audit based on the auditor's assessment of the risks of materially misstated accounts (Lewis, 2015).

Internal and external auditors also report to different entities. Internal auditors report mainly to the company management, the audit committee, or the company board, whereas external auditors report primarily to the shareholders and other external users of the financial statements. However, if a material misstatement is found, they report this both to the audit committee and management to request the misstatement be fixed.

Management chooses what to do with the information obtained from an internal audit. However, because the internal audit includes recommendations for the betterment of the company, there may be a follow-up to see if any of the suggestions were implemented. There can also be a consultation to help management apply the recommendations given by the internal auditors. With an external audit, the auditors do not need to follow-up. However, when performing an audit the following year, any issues found in the prior year's audit would be considered in the audit of the current year, especially if not corrected by management. This provides auditors with a reasoning base as to how any material misstatements originated.

Auditing in the Public Sector

After high-profile fraud accounting scandals occurred, a new oversight board, the Public Accounting Oversight Board, or PCAOB, was created with the Sarbanes-Oxley Act of 2002 (SOX) solely for the purpose of overseeing the accounting industry and regulating how auditors conduct an audit. The PCAOB requires auditors and the CPA firms conducting the audit to be independent of the clients they audit. The Sarbanes-Oxley Act of 2002 disallowed executives from receiving company loans and gave protection to those reporting the fraud. It also worked to strengthen the independence and financial knowledge of boards of directors. Furthermore, SOX holds CEOs responsible for any errors discovered in the external audits (Armadeo, 2017). Many private companies follow the framework of Sarbanes-Oxley because of previous accounting scandals that occurred in public companies before its implementation.

The cost of doctoring the financial statements has greatly increased because of SOX, while the benefits of which have remained unchanged. This has helped to prevent fraudulent financial reporting because the costs of which now exceed the potential rewards. Although the Sarbanes-Oxley Act is not specifically mandated for private companies to follow, most of them still tend to follow the framework of public company regulations to mitigate fraud occurring within private companies.

In addition to SOX, the SAS 99 regulation has also worked to mitigate fraud after its implementation. The Statements of Auditing Standards are the bare minimum for what auditors should do throughout the audit engagement. All auditors must follow the Statements of Auditing Standards, regardless of what type of company they are auditing. This ensures that auditors think about fraud in both public and private companies. The AICPA, which governs private company audits, requires auditors to follow these standards to ensure that auditors maintain high quality work in an audit (Messier, 2017). The AICPA issued SAS 99 following certain high-profile fraud scandals, such as Enron and WorldCom, to ensure that auditors would consider fraud during an audit.

The key components of SAS 99 highlight the importance of fraud consideration in different areas of the audit. It does so by first describing fraud and its characteristics. It also requires auditors to have a “brainstorming meeting” about fraud and how it can occur within the client’s company or industry. This meeting includes every member on the audit engagement in order to provide diverse thoughts and opinions about fraud and how to look for it within the client’s internal controls and financial statements. Auditors discuss accounts in which fraud could be more prevalent in this meeting as well. SAS 99 also focuses on identifying risks of material misstatement throughout the audit, assessing the risks of material misstatement due to fraud, and following the necessary documentation procedures throughout the audit (Brickner & Pearson, 2013).

SAS 99 requires auditors to assess the risk of fraud in the audit engagement, consider fraud in planning and performing the audit, take specific steps when auditors suspect fraud, and document any work related to fraud (Messier, 2017). All of these requirements were implemented to have auditors be mindful of the possibility of fraud throughout the audit in order help prevent another Enron-type scandal from occurring.

The Statements of Auditing Standards have proved to be helpful by requiring that auditors consider the fraud potential in the companies they are auditing. They are important and utilized throughout all audits because all auditors must follow these requirements when conducting audits of both public and private companies.

Private Companies and Fraud:

Private companies tend to face more issues regarding fraud than their public counterparts because there is less regulation that is required for these companies to follow (Tysiac, 2012). Anyone can commit fraud under the right circumstances, and therefore, fraud can happen in any size company (Reed, 2014). Therefore, it is imperative to understand fraud can still happen in family-owned businesses or small companies with trusted employees. In fact, fraud is even more likely to occur in small companies and family-businesses. These frauds account for almost thirty-two percent of reported fraud cases (Ochs, 2005).

Private companies face more issues regarding fraud than their public counterparts, and therefore, they should consider adopting SOX-related procedures and controls. If not, private companies will most likely have more difficulty when trying to raise capital. They will also face higher insurance premiums and greater civil liability. All of these difficulties cause company reputation damage among potential customers, investors, and donors (Armadeo, 2017). These difficulties are just a small sample of the issues private companies can face.

The enactment of SOX in 2002 hurt private companies, especially smaller private companies, more than their public counterparts. SOX increased the cost of an external audit, which made it more difficult for small, private companies to commit capital to an even larger annual expense. This cost increase could have prompted some businesses to use private equity funding instead of issuing new stock through an IPO where it is easier to generate capital (Armadeo, 2017). Private equity funding would eliminate the external audit requirement. Auditors have more regulations to follow, due to SOX, which increased the time of the audit and therefore, costs. CPA firms also had to hire more employees in jobs that did not exist before. Now, there are people whose sole job is to help ensure that both the CPA firm and members on each engagement team maintain their independence. This requires CPA firms to cover these added employment costs with their external audit costs.

The increased costs of audits are also due to the elevated complexity of conducting the audit. The heightened complication of an audit engagement requires higher-level audit engagement members, such as senior managers and partners to put more time into the audit, which contributes to the increased cost of the external audit.

All of these added costs to the external audit have hurt private companies. These extra costs have also made it more difficult for private companies, specifically smaller private companies, to commit to a yearly external audit. Therefore, it can diminish the potential opportunity for private companies to expand into the public sector.

Reasons for Small/Private Companies to be Audited:

Although conducting an external audit is not required for private corporations, external auditors have significantly helped public corporations reduce fraud in recent years, and therefore, the management of private companies should at least consider conducting an external audit. The proof of this is in the numbers. Over eighty percent of large corporations believed that SOX increased the confidence of investors in these large corporations. Over thirty percent of those believed external auditing reduced fraud (Armadeo, 2017).

In conducting my independent research, numerous private companies headquartered in South Carolina with revenues ranging from $999 million to less than fifty million dollars were interviewed. The number of employees at these companies ranged from twenty-one to 1000. In my research, more private companies were externally audited than I expected. However, the majority of the time, these reasons are not for the purpose of preventing fraud. These other reasons will be discussed in detail later in the thesis.

Reasons Given against External Audits:

The private companies interviewed that do not have external audits performed gave numerous reasons why they either discontinued or never considered an external audit. These reasons included having financially aware executives/presidents present, many CPAs already in the finance and accounting departments, and cost and time savings.

Even if a company has ”financially aware executives,” this does not replace the external financial statement review that an external audit provides to the company because it does not provide the same reasonable assurance. The high-level executives do not have independence with the company seeing as they work for the company. The auditors, in contrast, maintain independence from the company and can provide reasonable assurance when they issue the audit opinion.

Although companies may have numerous CPAs in both the finance and accounting departments, the principal importance is that they do not have an independent opinion because they operate internally within the company. As discussed earlier, auditors are required to maintain independence with audit clients for which they are on the engagement team. An employee working at the company does not have the same independence as auditors.

Further to this point, in my research of private companies and fraud, many of the companies interviewed highlighted the importance of an external review of both the financial statements and the internal controls of the companies. CPAs within the company, despite the integrity and trust they have, cannot provide the same external review of auditors.

Another rationale that private companies, especially small, private companies, have regarding the decision not to implement an external audit is that their companies are family businesses. Former U.S. Treasury Department investigator, James Blanco, discussed the number of times that business owners have told him they do not need an external audit because they are like a family. He then discusses studies from the Association of Certified Fraud Examiners where they found privately held companies, which are often family-owned, made up the greatest percentage of fraud cases at almost thirty-two percent (Ochs, 2005).

Many family-owned businesses do not see the need to have an external audit conducted because their family is built on trust. However, that trust can easily be exploited, even by a family member. As mentioned before, most people are not inherently corrupt. However, under the right circumstances, given the need and opportunity, even the least suspecting person can commit fraud.

In fact, studies have proven that anyone can commit fraud. Generally, the public cannot determine those who commit fraud by demographic or psychological characteristics. Fraudsters tend to look like any other person (Albrecht, Albrecht, Albrecht & Zimbelman, 2016). Therefore, family members cannot be relied upon to manage a company's finances without external review. This research effectively problematizes this reasoning to not conduct an external audit.

In my research, however, some family-owned businesses have implemented a yearly external audit for varying reasons, such as assurance that the executives properly manage the company, the financial statements contain accurate information, and external auditors can express a clear audit opinion as to the fairness of the financial statements. If even families externally audit their businesses, other small companies should at least consider an external audit.

Although the family business I interviewed implemented an external audit for reasons other than fraud, the external auditors would still consider fraud, along with exercising due care and professional skepticism throughout the audit to mitigate fraud risks. Private companies also provided valuable insight into reasons to conduct external audits.

Reasons Private Companies Utilize External Audits:

Some other reasons the private companies interviewed chose to have an external audit conducted were: potential initial public offering (IPO), accurate information for investors, lending requirements, and an external review of the financial statements of the company. Although not an extensive list of all the benefits an external audit provides, it gives insight into the logic of private companies that choose to implement an external audit when it is not a federal mandate.

The first reason, a potential IPO, is something that could be likely depending on how the executives wish to handle the company in the future, along with the company's growth rate and need for investment capital, among other factors. During the IPO process, companies generally are required to be audited. This provides the reasonable assurance of external auditors that the financial statements do not contain material misstatements before entering the public market. The IPO process can move faster if companies were previously audited. This then tells potential investors of the company that this potential investment has the reasonable assurance of auditors behind it.

The second reason was that companies want to provide their investors with accurate information. This accurate information gives an authentic depiction of such ratios as liquidity, profitability, asset turnover, debt, dividend policy, and earnings per share. These ratios have importance for both current and potential investors in the company because they help to facilitate investment decisions. Therefore, it is important for investors that the financial statements do not contain material misstatements in order to provide reasonable assurance that these essential ratios are accurate. As necessary as this information is to investors, they are not the only external party looking at the financial statements and audit report.

This information is also crucial for banks in determining if the bank should provide a loan to the company. They use the same information in order to determine if given a loan, whether or not the company will be able to pay that loan back in the specified amount of time. This reason is important for companies because loans help facilitate growth. It also proves to the banks that the company is financially stable and has at least some level of business continuity.

As mentioned throughout this thesis, companies choose to have an external audit in order to have an independent outside party review the financial statements. This was the most common response to my question during company interviews of "what benefits do you hope to obtain from an external audit?" This external review provides reasonable assurance to the external users that the financial statements do not contain material misstatements.

However, as many reasons as there are for companies to have an external audit, sometimes, there are more compelling reasons for companies not to conduct an external audit. As mentioned previously, this can be due to cost and time savings or the company believes that an external audit is unnecessary or not feasible at the moment. Because of this, it is important to look at the cost-benefit ratio in order to determine whether or not to conduct an external audit, as the costs and benefits and their respective weights can vary widely between companies.

Cost Benefit Analysis and Alternatives to Audits

Audits can consume a vast of amount of time and be costly for companies. In public companies, an external audit in 2013 averaged out to be an expense of over four million dollars for a company. For private companies, the average cost of an external audit was over $520,000 (Bramwell, 2014). Like most things, the cost of an external audit has increased in the past few years, making it even more expensive for a company to have an external audit conducted by a public accounting firm.

The benefits of an external audit are clear, and if a company has the opportunity and resources to implement an external audit, it would prove valuable for the company, especially when looking at the foregone opportunity costs for a company subjected to fraud. Fraud can stunt the growth of companies because it can stop them from receiving bank loans, money from investors, or other financial opportunities that can facilitate company growth (Funk, 2015). Although the opportunity cost of fraud can be difficult to quantify, it is an important cost to consider because it can be high, depending on how pervasive the fraud actually is within the company.

Fraud affects a company in three ways: losses in business revenues, increases operating expenses because of fraud detection and recovery, and lastly because of the decrease in revenue. It can greatly decrease a company's overall profitability (Pan & Skeels, 2016). This cost of fraud can be mitigated with external audits.

Fraud prevention costs significantly less than the cost of the actual fraud (Reed, 2014). Therefore, companies need to consider all aspects of fraudulent activity prevention in order to find the prevention strategy that has the lowest cost but provides the highest benefit. This will vary among companies, depending on company size, organizational structure, financial stability, and management’s ability to rationalize expenses incurred to prevent fraud, among other things.

External audits are costly and denying this would only provide a false impression of external auditing. CPA firms provide options to companies in order to minimize costs. To mitigate the amount of time an external audit demands, and therefore the high costs, smaller private companies should consider two alternatives: an external audit review or an external audit of specific accounts that tend to be the most misappropriated, such as cash and accounts receivable. These options take less time, and therefore, companies spend less capital on their implementation. This can be especially beneficial for smaller, private companies that cannot afford such a large, annual expense. Both of these audit alternatives can prove viable for companies. The level of assurance required by a company’s interested external users determines the option a company implements.

Although not an alternative to an external audit, companies can choose to have a compilation of their financial statements. In a financial statement compilation, the CPA firm assists the client in preparation of their financial statements (“Financial Statement Compilation,” 2017). However, this type of service does not provide any assurance to external users that these prepared financial statements do not contain material misstatements.

Auditors also do not need to conduct tests to provide audit evidence in order to express an audit opinion or a review conclusion (“Guide to Financial Statement Services,” 2015). In the compilation report, the auditor affirms that there was no audit or review of the financial statements, and therefore, they do not need to give an opinion, draw a conclusion, or provide any assurance as to whether the financial statements contain material misstatements. This illustrates why financial statement compilations are not an alternative to external audits. However, they still provide benefits to companies because lenders and other interested external users can still utilize the client's cooperation with a CPA firm, even if there is no assurance provided by the auditor.

Generally, companies utilize financial statement compilations when they desire initial financing or a lower amount of credit. It also can be used when companies place a high collateral on the loan, meaning that if companies cannot pay back the loan, the lender can use the company's provided collateral as payment. An example of this would be if the company has a large amount of inventory that they can use as the loan collateral. As mentioned previously, companies still have audit alternatives that provide reasonable assurance for the external users of the financial statements of companies.

The options companies have are an external audit review and a specific accounts audit. Both of these options provide reasonable assurance for interested outside parties of companies because an independent CPA firm reviews part or all of the financial statements. This can give financial executives confidence in the overall work of their respective companies. It can also encourage employees to place more trust into the company executives, along with the company as a whole. Furthermore, this can boost employee morale and strengthen employees' ties with the company.

Companies also have the option to implement an external review. An external review of the companies' financial statements, unlike a financial statement compilation, provides limited assurance to external users that the financial statements do not contain material misstatements after auditors conduct analytical procedures ("Guide to Financial Statement Services," 2015).

An audit review gives lenders and other interested external users a minimum level of assurance that the financial statements do not contain material misstatements. A review can be beneficial for growing companies who need more capital and more complex financing and lending terms. Reviews cost companies much less than an audit. Because of this, smaller companies may prefer audit reviews over external audits, especially for growing companies in their beginning stages that lack the necessary capital (Milone, 2017). One of the companies interviewed previously conducted an external audit, but then switched to the less costly option of an external audit review to cut down on its expenses.

Some banks accept an audit review for lending purposes because auditors provide some assurance. This can be useful in growing companies that require more loans from a bank in order to keep up with company growth. After the audit review, the CPA issues a review report that the company can choose to provide to external parties. An audit review can be a viable option for those smaller companies because it still provides some reasonable assurance to external users ("Financial Statement Services Guide," 2015).

Companies can also consider implementing an audit for specific accounts which provides a similar amount of assurance as an external audit, but only for a few accounts in the financial statements. An account or accounts specific audit can be beneficial for many companies in their beginning stages or with a growing number of employees. Certain accounts have more potential to be materially misstated for varying reasons, such as when the valuations of specific accounts require management's judgment.

For example, bad debt expense of accounts receivable has a high inherent risk of material misstatements because management has to estimate the number of receivables the company will not receive. The accounts most likely to be misappropriated are: cash, accounts receivable, accounts payable, expenses, and sales. Generally, auditors worry more about an overstatement of the asset accounts, such as cash, accounts receivable, and sales. With liabilities, auditors emphasize testing for understatement of expenses because companies could increase their net profit for the quarter or year-ended.

These accounts generally have more inherent risk because of their increased probability of material misstatements. Inherent risk is the risk that a material misstatement exists before the auditor reviews the client's internal controls, (Messier, 2017). Essentially, inherent risk already exists in the company due to the nature of the client's industry or the operations of the client. The fact that certain accounts are more likely to be misstated than others is an example of this type of risk.

Because of this, many companies can choose to have a CPA firm come in to externally audit just one or two accounts within the financial statements to reasonably assure that those with the highest amount of risk associated with them do not contain material misstatements. A specific accounts audit costs the client less than a complete external audit because it requires less time to audit a few accounts on the financial statements rather than the entirety of a company's financial statements. Therefore, this can be an optimum choice for companies that do not wish to spend capital on a full external audit. This type of audit still provides companies with an external look at those specific accounts of a company's choosing that tend to have a higher risk of material misstatement.

Both of these options provide companies with more opportunities for an external party to review their financial statements, which was one of the most common reasons the private companies interviewed gave for why they conduct an external audit. As not all companies can afford to take the amount of time or spend the resources to have an external audit, these options can help companies realize some of the benefits of an external audit without having to commit to the amount of time an external audit requires and save on costly expenses in the process.

In order to examine how private companies view external audits and alternatives to external audits, I conducted independent research by interviewing several private companies in Columbia, South Carolina.

Summary of Interviews:

After discussing independent research throughout this thesis, here is a framework for which this research was based. In the initial phases of research for the thesis, I discovered that information and data about fraud in private companies is limited.

The company interviews were centered around numerous private companies headquartered in Columbia, South Carolina. The goal of this was to increase the response rate when reaching out to companies for potential interviews, as they generally tend to be more familiar and supportive of the university, and therefore, were more apt to give insight for my thesis. After reaching out to twenty-six companies, I conducted interviews with nine firms. This gave me a response rate of almost thirty-five percent. Some companies never responded while other companies declined an interview. This lack of response could have been attributed to the fact that many companies were busy preparing their year-end financial reports.

The companies that did grant interviews provided valuable insight into private companies and fraud. The list of questions that the companies were asked in the interviews is provided in Appendix A. First, the interviewees provided the company name, along with their name and title, in order to obtain an understanding of the employee's position at the company. However, due to privacy reasons, company and interviewee names, along with their titles will not be mentioned in this thesis.

I also asked for the number of employees at the company in order to get a sense of the size of the company to determine if there was any correlation to company size and whether an external audit was conducted at their companies, but there was no such correlation. Companies with annual revenues ranging from fifty million U.S. dollars to three hundred and eighty-five U.S. dollars conducted external audits, while those with less than thirty million U.S. dollars in annual revenues did not conduct external audits. The smallest two companies based on annual revenues did not conduct external audits. This is consistent with prior research that smaller companies, in terms of revenue, opt out of a large and seemingly avoidable expense, such as an external audit.

Furthermore, none of the companies interviewed had an internal audit team, nor did they have yearly internal audits conducted. This may be due to the high cost of maintaining an internal audit department. Nevertheless, I was surprised to find that not one of the private companies interviewed had an internal audit team.

When asked whether they had an external audit, almost eighty percent of the companies interviewed chose to conduct yearly external audits. This was surprising because external audits are not mandated in private companies. A large percentage of affirmative responses to external audits was unexpected. However, as these companies generate large revenues annually, they deem it more necessary than smaller companies to have annual external audits conducted. Additionally, the majority of the companies that conduct external audits have been doing so since the inception of the company.

Reasons for conducting an external audit included a potential IPO, the comfort of an external review, lending requirements, accurate information, meeting compliance requirements, and a partner requirement in a joint venture contract. However, none of these companies specifically mentioned fraud. This could be due to the negative connotation of fraud in companies, especially after such reputation-damaging accounting scandals in 2002. When the companies that conduct external audits were asked specifically if asset misappropriation was a factor, less than fifty percent responded affirmatively. Again, this could be due to the negative connotation of fraud.

To choose an external auditing firm, fifty-seven percent of the interviewed companies conducted an extensive interview process with different CPA firms to determine which firm fit best with the company. This "best fit" was determined on the basis of the firm's track record, name in the industry, technical abilities, cultural fit, size, sufficient resources, peer reviews, professionalism, and cost. Each company that listed cost as a factor made a point to emphasize the fact that cost was the least important in choosing their auditor. Once companies decide to conduct an external audit and expend the resources to do so, the differences in cost between CPA firms become seemingly less important and almost negligible. Companies that did not go through an extensive interview process to choose the CPA firm either had the CFO choose the auditors, had a longstanding relationship with their current auditor, the CFO inherited the auditors, or they utilized contacts from employees who previously worked at CPA firms.

The companies that chose not to conduct an external audit gave reasons for not doing so such as: cost and time savings, financially aware president, many CPAs work in the accounting department, and one company even mentioned they did not feel certain misstatements and fraudulent activities were being caught. This company now conducts an external audit review because management at that company did not feel that an external audit at their company was worth the cost. The varying reasons given by companies when choosing whether or not to conduct an external audit hold different weights at different companies, due to differences in company structure, management, and executives, among other reasons. All of this data is summarized in table format in Appendix B. The graphs of this data are presented in Appendix C.

Conclusion:

Fraudulent activities have the potential occur at some point during a company's life. The average cost of which is one million U.S. dollars every two to three years (Brown, n.d.). This cost adds up, and as such, the prevention and early detection of fraud is crucial to the longevity and continuity of businesses.

This thesis illustrates the considerations private companies have in regard to external auditing and its detection and prevention of fraud in private companies. It provides insight, through independent research, into how managers and top executives of small, private companies view fraud and how they try, if at all, to mitigate fraud risk.

Many smaller, private companies choose not to conduct external audits due to their high cost, but studies have shown that small, family-owned businesses account for the highest percentage of fraud cases. Many companies place too much trust in employees, who then violate that trust by committing fraud.

Based on my research, many private companies chose to conduct an external audit in order to have an external look at their financial statements, despite no mandates requiring external audits. Many managers and executives stated they enjoyed a sense of comfort in reasonably assuring investors and creditors that the financial statements do not contain material misstatements.

However, companies with revenues under fifty million dollars decided to opt out of the expense of an external audit. These companies still have two options to provide the same external comfort of an external audit without the large expense: external audit reviews, and external audits of a few specific accounts. Both options can be viable for companies unable to afford such a large expense every year. Although an external audit is the best option for companies that can afford it, these other options provide ways for companies to reap some of the benefits of external audits without such a large expense.

Although this research provided insight into why private companies either choose to conduct or not to conduct an external audit, it does have limitations. For example, in an effort to obtain a high response rate, I only interviewed private companies headquartered near the University of South Carolina in Columbia. As such, my sample of interviewed firms may suffer from selection bias if these companies differ from those outside of Columbia.

Overall, auditing has added value to the economy of the United States because it encourages consumers to place trust in the financial statements of the companies with which they do business or invest. This stimulates economic growth in the U.S. economy. Auditors provide reasonable assurance to external users of financial statements, which has proved to be invaluable in both detecting frauds and expressing to external users that the financial statements of companies do not contain material misstatements.

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Appendix A:

Can I have your name and position at ___________________?

How many employees are at ___________________?

What is typical for ________________ in annual revenue?

Do you have an internal audit team?

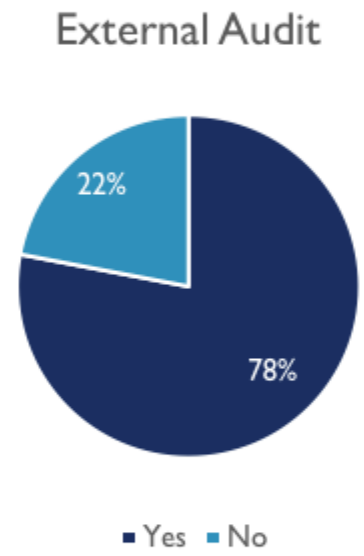
Do you have a yearly external audit conducted at your company?

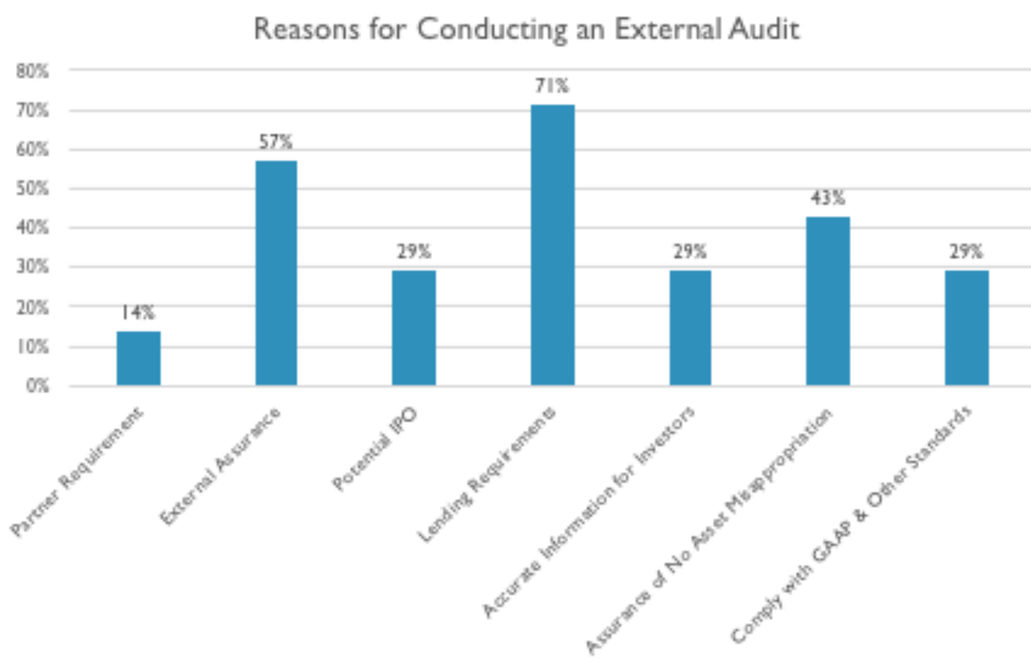
↙ Yes	↘ No
How long have you been audited?	Have you considered an external audit before?
What factors influenced your decision to have an audit conducted?	What factors influenced your decision to not conduct an audit? Ex: cost, time, effort, etc.
How did you choose an accounting firm to audit your books?	Is there anything that would make you consider an external audit? Ex: certain dollar amount lost to fraud or cost benefit analysis specific to your company
What benefits do you hope to obtain from an external audit?	
Is the detection and prevention of resource misappropriation a factor in having an audit?	

Appendix B:

Question	Company 1	Company 2	Company 3	Company 4	Company 5	Company 6	Company 7	Company 8	Company 9
Annual Revenue	$12-14 million	$25-30 million	$19 million	$28 million	$35-50 million	$85 million	$100-999 million	$325 million	$385 million
Number of Employees	68	70	45	250	21	185	--	240	1000
Internal Audit Team?	No	No	No	No	No	No	No	No	No
External Audit?	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
If yes:									
Length of Audit			8-9 years	Beginning of the company	25+ years	30+ years	25 years	Company start- 18 years	20+ years
Factors			Secure bank loans	Partner requirement of an external audit in the joint venture contract	Outside source to ensure proper management	Required by bank and comfort in having external party review	Potential IPO, lending purposes	Potential IPO, lending requirements, accurate information for investors	Lending purposes, execs enjoy having someone unaffiliated with company reviewing the financials
Choosing a Firm			Recent firm change- panel of auditors where they made a matrix with focuses on size, sufficient resources, peer reviews, professionalism, company fit, and cost (least important).	Extensive interview process and reviewed numerous proposals	Main exec chose the CPA firm.	Current CFO inherited the auditors	Extensive interview process where firm's track record, name in the industry & cost was considered.	Extensive interview process, utilized contacts from employees who previously worked at CPA firms where technical abilities and cultural fit were considered.	Longstanding relationship with their current auditor
Benefits			Loan covenants and ensure best practice.	Assurance of no asset misappropriation & the books are correct	Ensure following of GAAP & encourages efficiency.	Clear audit opinion, validation to other members of management that CFO is doing the job correctly & importance of accurate information	Ensure accounting regulations are followed and external firm reviewing financials	Verify internal management functions properly, investors and creditors get accurate information and ensure internal control properly fucntions	Meet compliance requirements, provide external comfort, although it's not 100% absolute assurance
Is Fraud a factor?			No (very curt)	Yes, one of the main reasons	Yes, they want to ensure no fraudulent activities are occurring.	No, family business	N/A	Not specifically-- no full internal control audit, but they feel it can be helpful	Yes
If no:									
Previously considered?	No	Yes, they used to have an external audit, but lots of CPAs in the department. They do conduct an audit review. They stopped the external audit about 3 years ago.							
Factors	Financially aware president, outsource accounting services	Cost and time savings. They felt certain misstatements and fraudulent activities were not being caught.							
What would make you consider an audit?	Small firm in the beginning & never changed the company structure	N/A							

Appendix C:


External Audit
22%
78%
Yes
No


Reasons for Conducting an External Audit
80%
70%
60%
50%
40%
30%
20%
10%
0%
14%
57%
29%
71%
29%
43%
29%
Partner Requirement
External Assurance
Potential IPO
Lending Requirements
Accurate Information for Investors
Assurance of No Asset Misappropriation
Comply with GAAP & Other Standards