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Financial Reporting Fraud: Are Standards' Setters and External Auditors doing enough?

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Abstract

Following the fraud scandals in large companies like Enron, WorldCom, and Xerox, investors' concern about fraud in general and fraudulent financial reporting in particular increased and is on the rise. In response to these concerns, auditing standards setters have issued fraud standards that have expanded what is required of the external auditors in relation to fraud detection. However, regardless of these efforts, academic research studies indicate that more efforts are still needed from audit regulators and external auditors. The current paper provides insights into two areas. Firstly, it explores the reasons behind the audit expectation gap, and secondly, it assesses the efforts of standards' setters and external auditors to narrow the gap in relation to fraud detection. The paper provides a set of recommendations to regulators and external auditors in an effort to fight fraud.

Keywords: Fraud, fraudulent financial reporting, audit professional standards, audit expectation gap

1. Introduction

Following the fraud scandals in large companies like Enron, WorldCom, Xerox, and recently alleged fraud cases like Lehman Brothers, AIG, and Freddie Mac, investors' concerns about fraud in general and fraudulent financial reporting in particular has increased. Although fraudulent financial reporting is the least common type of occupational fraud, it is the most costly fraud type as cited by the *Association of Certified Fraud Examiners (ACFE)* in its "2010 Report to the Nation on Occupational Fraud and Abuse". Results from the 22,927 questionnaires sent to qualified certified fraud examiners worldwide showed that fraudulent financial reporting caused a median loss of more than \$4 million. These concerns placed the blame on external auditors for not detecting fraud and, at the same time, have put tremendous pressure on audit regulators to meet the public's needs.

In response, audit regulators (i.e. the American Institute of Certified Public Accountants (AICPA) and the International Auditing and Assurance Standards Board (IAASB)) have issued a number of professional fraud audit standards (Statement on Auditing Standard No.1 (SAS No.1): "*Responsibilities and functions of the independent auditors*", Statement on Auditing Standards No.99 (SAS No.99): "*Consideration of fraud in a financial statement audit*", and International Standard on Auditing No.240 (ISA No.240): "*The auditor's responsibilities relating to fraud in an audit of financial statements*") which directly address and specify the role of external auditors in relation to fraud detection. However, academic research studies into the audit expectation gap to date indicate that the gap is still wide. This paper reviews prior academic literature to provide insights into two important areas. Firstly, the reasons behind the audit expectation gap, and secondly, determining whether the efforts of standards' setters and external auditors in fraud detection are enough.

2. The Audit Expectation Gap and the Role of Standards' Setters in Addressing the Gap:

There are varying perceptions over the role and level of assurance that could be expected from auditors especially when it comes to fraud.

This difference in perception about the auditors' responsibilities was known as "the audit expectation gap" and was defined as a gap between what the public or financial statements users expect and what they actually receive (Humphrey et al., 1993; Porter, 1993; Monroe and Woodliff, 1993; Epstein and Greiger, 1994; Koh and Woo, 1998; Gay et al., 1998; Alleyne and Howard, 2005). Financial statement users believe auditors are responsible for detecting and preventing fraud, however in fact the responsibility of fraud detection lies upon management and not external auditors. External auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud (SAS No.1, 1997). Thus, auditors are not directly responsible for detecting every fraud in an organisation, but only the material misstatements arising from them.

The main reason behind this difference in perception is because the role of the auditor has not been well defined throughout its history. In the early development of the profession (in the nineteenth century), auditors were engaged to provide almost absolute assurance against fraud and intentional mismanagement. By the 1930s, the profession had had a transition from the role of detecting fraud by verifying all transactions and amounts to determining truth and fairness in financial reporting (Lee 1986). This was due to the increase in size and volume of companies' transactions. However, despite this transition, the high expectations among users remained unchanged (Carmichael, 1975; Fadzly and Ahmad, 2004; Alleyne and Howard, 2005).

In an effort to narrow the audit expectation gap, audit standards' setters issued a number of standards that directly address the boundaries of external auditors' responsibility for fraud detection. For instance, in 1988, the AICPA issued "*Statement on Auditing Standards No.53 (SAS No.53): The auditor's responsibility to detect and report errors and irregularities*". The statement held the auditor responsible for detecting errors and irregularities that materially impacted on the financial statements. However, critics of SAS No.53 argue that it did not differentiate between errors and irregularities or how the results of reviewing the factors are translated into a likelihood of fraud (Loebbecke et al., 1989). They also believe the standard gave no attention to the auditors' qualifications, organisational factors, and audit procedures that could be very important in the detection of fraudulent financial reporting (Moyes and Hasan, 1996). Further, Loebbecke and Willingham (1988) developed a model to detect management fraud by considering the content of SAS No.53 in terms of assessing the likelihood of management fraud. They also tested the model against the contents of management fraud cases reported in the Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Releases (AAERs). Their results indicated that the risk factors in the SAS required some modification. In addition, academic research studies into the audit expectation gap during this period (Humphrey, et al., 1993; Epstein and Geiger, 1994; Sweeney, 1997) found that the standard did not close the expectation gap, especially when it comes to external auditors' fraud detection role (see table 1 in the appendix).

In 1997, the AICPA issued *SAS No.82: "Consideration of fraud in a financial statement audit"* to address the weaknesses in SAS No.53. This new standard differentiated between errors and fraud and required auditors to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud. It also provided guidance on how the auditor should achieve this by looking at areas and categories of heightened risk of fraud, how the auditor should respond, how to evaluate audit test results as they relate to the risk of fraud, and how to communicate about fraud to management, the audit committee, and others. However, critics of SAS No.82 argued that it did not increase the auditors' responsibility to detect fraud, and that auditors' responsibility is still framed by the key concepts of materiality and reasonable assurance (Mancino, 1997). They also believed that the standard could make things worse by creating a checklist mentality which could never cover all possible ways in which fraud could occur (Hoffman, 1998). Others mentioned that factors cited in SAS No.82 are subjective and difficult to assess, and risk factors may exist in circumstances where fraud does not exist, and even when risk factors are present, the auditor's response to them is not definitively prescribed by the standard (Public Oversight Board, POB, 2000, Shelton et al., 2001). Another criticism of SAS No.82 is that it focused on a typical list of fraud risk factors that, in practice, were usually reduced to a checklist that individual auditors completed without practical application and included in their working papers (AICPA, 2007). Further, in a survey study carried out by Johnson and Rudesill (2001) where 1000 questionnaires were mailed to Certified Public Accountants randomly selected from the AICPA to identify the perceived impact of SAS No.82 on audits of small businesses, results showed that SAS No.82 would do little to close the expectations gap.

Another study was conducted by Shelton et al. (2001) to determine whether there are differences in auditing firms' fraud risk assessment practices. They conducted conference-call interviews with directors/partners in charge of auditing/assurance policy, and developed a questionnaire to be used in the structured interview and be filled by each researcher. The questionnaire was based on their review of SAS No.82 and the firms' audit manual sections/practice aids. Their results revealed that not all risk factors mentioned in previous academic studies were included in SAS No.82, and that the standard requirements would not ensure that the auditor will select the right audit procedures to address identified risk factors.

The situation became even worse in 2001 with the collapse of Enron as a result of financial statement fraud. This collapse eroded the public's trust in the audit profession and increased the audit expectation gap. In response, the AICPA superseded SAS No.82 by SAS No.99 in 2002. The statement was implemented to expand audit procedures to detect fraud and requested auditors to approach the audit with professional scepticism and to avoid placing excessive reliance on representations from clients. This standard also requires external auditors to discuss among the audit team members the risks of material misstatement due to fraud, identify fraud risk and management incentives, opportunities, to rationalise occurrence of fraud, and design audit tests responsive to the risks of fraud. SAS No.99 lists various fraud risk factors to help the auditor in considering whether fraud is present as in SAS No.82, however in SAS No.99 the fraud risk factors reflected the three factors in the fraud triangle which helps to explain why fraud is committed: Incentives/Pressure, opportunity, and attitude/rationalisation. It also introduced a new audit procedure, namely a brainstorming session which external auditors have to perform on every engagement requiring the audit team members to discuss how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, and how management could perpetrate and conceal fraudulent financial reporting. The standard also emphasised the importance of enquiries as an audit procedure that increase the likelihood of fraud detection, expanded use of analytical procedures to gather information used to identify risks of the material misstatements due to fraud, and to consider other information such as client acceptance and continuance procedures during the information gathering phase.

However, critics (Casabona and Grego, 2003; Wells, 2004 Hoffman et al., 2009) of SAS No.99 believe that it did not mention how auditors can decide on the quality or weights of red flags for fraud. This will make auditors assume that all indicators are equally important, thus limiting the predictive usefulness of the system. Others (Shelton et al., 2001; Pedneault, 2004; Smith and Baharuddin, 2005; Hogan et al., 2008; Sirvastava et al., 2009) argue that the standard omitted specific guidance for responding to fraud once the fraud risk factors are identified and did not require all procedures to be followed but merely suggested that auditors consider implementing them. This might result in an inconsistency in applying those guidelines, as each audit firm has developed its own approach to such assessments.

In a study conducted by Marczewski and Akers (2005) to determine Certified Public Accountants' (CPAs) perceptions of the impact of SAS No.99 and the extent to which it differed from SAS No.82. A questionnaire was sent to a random sample of 300 CPAs from the Wisconsin public accounting firms. The results showed that despite the perceived increase in responsibility, there has been no apparent change in the assignment of audit personnel. The overall assessment indicates that the changes to audit procedures due to SAS No.99 would moderately increase the effectiveness of audits, but may not increase the public's confidence in audits. In an experimental study conducted by Hoffman and Zimbelman (2009) to explore potential policies that may improve auditors' effectiveness at detecting fraud, they found that both strategic reasoning and brainstorming lead to more effective audit procedures even if standard audit programmes are used. However, they noted that SAS No.99 did not discuss strategic reasoning but only implied that brainstorming will help auditors achieve the benefits of strategic reasoning.

In 2009, the IAASB issued a revised version of ISA No. 240: "*The auditor's responsibilities relating to fraud in an audit of financial statements*", which provided similar directions to external auditors as SAS No.99 with respect to fraud. The standard also mentioned that: "The auditor shall maintain professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance" (paragraph A7-A8).

Professional scepticism is defined by ISA 200: “Overall objectives of the independent audit and the conduct of an audit in accordance with international standards on auditing” (2010; Paragraph 13) as “An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatements due to error or fraud, and a critical assessment of audit evidence”. However, whether scepticism is enough has been criticised by Higson (2011) who suggested that the auditing profession should employ “critical thinking”. The Public Oversight Board (POB) (2000) noted that Generally Accepted Auditing Standards (GAAS) do not provide sufficient guidance to adequately implement the concept of professional scepticism because management usually is judged as possessing integrity despite the fact that management may have at least some motivation to perpetrate fraudulent financial reporting.

Despite the fact that audit responsibility has been detailed in auditing standards, academic research into the audit expectation gap worldwide (see table 1 in the notes) show the gap is still wide especially when it comes to external auditors’ responsibility for fraud detection.

3. Assessing External Auditors’ Efforts for Fraud Detection

External auditors play a crucial but a secondary role in fraud detection. They are not guarantors of the accuracy or the reliability of financial statements but they are only responsible for giving a reasonable assurance that the financial statements are free from material misstatements whether caused by errors or fraud (AICPA in SAS No.1, 1997). The primary role in fraud detection lies upon the company’s management. This does not mean, however, that external auditors should exert less effort in fraud detection. In fact, paying more attention to financial statement fraud detection will not only narrow the audit expectation gap, but will also save audit firms huge litigation costs resulting from lawsuits against external auditors who fail to detect material misstatements arising from financial statement fraud. This view was supported by Jayalakshmy, et al. (2005), where they reviewed a wide range of articles and journals to highlight the pressures that would be faced by auditors and the challenges they should be willing to accept in order to maintain trust and integrity, including their responsibilities for fraud detection. They suggested that auditors should be ready to change themselves in the new era and shall avoid high litigation costs. Other researchers (Pincus, 1994; Palmrose, 1987 as cited by Uddin and Gillet, 2002; Golden et al., 2006, as cited by Reffett, 2010) believed that fraudulent financial reporting is a critical problem for external auditors because of the possible legal liability for failure to detect false financial statements and because of the damage that might be caused to the reputation of the audit profession as a result of public dissatisfaction about undetected fraud.

Apart from the role of standards’ setters in narrowing the audit expectation gap, some academic researchers (Zimbelman, 1997; Glover et al., 2003; Payne and Ramsay, 2005; Zikmund 2008; Louwers et al., 2008; Brazel et al., 2010) were interested in assessing the efforts of external auditors in fraud detection as required by standards setters. Results from their research studies indicate that external auditors may not be exerting enough effort when it comes to their responsibility for fraud detection. Some of them found that external auditors are not following the standards’ requirements when it comes to fraud risk assessment. For instance, Zimbelman (1997) found limited evidence of an increase in the extent of audit procedures and no evidence of a change in the nature of procedures in response to fraud risk assessments. Johnston and Bedard (2001) conducted a study where they used an archival database of 336 audit engagement proposals from one audit firm that employed a checklist of 20 fraud risk factors similar to those in the current auditing standards to make fraud risk assessments. Results showed that the presence of fraud red flags increased audit pricing by 19% but did not affect total planned audit hours.

This was consistent with existing studies (Jakubowski et al., 2002; Rezaee et al., 2003; McKee, 2010) where findings revealed that when auditors actually do increase their audit effort in response to fraud risk, the increased audit effort results in auditors and that changes in auditing standards and regulatory changes have not resulted in an increase in auditors’ ability to detect fraud or in an improvement of audit effectiveness in discovering fraud. This was also supported by Shelton et al. (2001) who conducted a study to determine whether there are differences in auditing firms’ fraud risk assessment practices. They obtained audit manual sections and practice aids related to fraud risk assessment from each of the Big 5 audit firms and two second-tier firms, and conducted conference-call interviews with national office directors/partners in charge of auditing/assurance policy from each of the firms. They further developed a questionnaire to be used in the structured interview and be used by each researcher. The questionnaire was based on their review of SAS No.82 and the firms’ audit manual sections/practice aids.

Results revealed that the auditor's assessment of the right risk factors occurs during client-acceptance/continuance work in some firms and during audit planning in other firms. They also found auditors' responses to identified fraud risk factors are different across firms, and the identification of a fraud risk factor did not cause a modification to the planned audit approach. The PCAOB issued a report in 2007 to determine external auditors' overall approach to the detection of financial fraud, brainstorming sessions and fraud-related inquiries, response to fraud risk factors, financial statement misstatements, and fraud associated with management override of controls. They have noticed that in some situations, auditors fail to respond appropriately to identified fraud risk factors, failed to determine whether departures from GAAP were indicative of fraud, did not hold or document a brainstorming session, held the brainstorming session after substantive testing had already begun, or did not have all key members of the audit team present at the session. The Auditing Inspection Unit reported in its annual report, that "audit firms are not always applying sufficient professional scepticism in relation to key audit judgments. In particular, audit firms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates, rather than challenges the judgments made by their clients" (2011, p.10).

In another study carried out by Louwers et al. (2008), where they examined 43 Securities and Exchange Commission (SEC) enforcement actions against auditors related to the examination of related-party transactions, results revealed that the audit failures in these fraud cases were due to a lack of auditor professional scepticism and due professional care than any deficiency in current auditing standards. Hammersley, et al., (2011) conducted an experimental study on audit seniors to examine their responses to fraud risk factors as a way of providing evidence about the effectiveness and efficiency of audit seniors' fraud risk assessments and fraud risk responses. Their findings revealed that auditors do not respond in an effective and appropriate way to heightened fraud risk. ISA 520: *Analytical procedures*, AICPA in SAS 56: *Analytical procedures*) called for the importance of considering non-financial measures in assessing fraud risk assessments however despite this, a study by Brazel, et al. (2010) where they conducted two experiments to investigate whether external auditors take into consideration non-financial measures when assessing fraud risk, showed that external auditors rely on prior year financial data and most of them do not use non-financial measures when developing expectations regardless of whether the non-financial measures are consistent or inconsistent with financial data.

Others argue that external auditors still need proper training in fraud detection. Glover, et al. (2003) compared pre and post SAS No.82 planning judgments and results showed that auditors still do not modify the nature of their audit plans to make planned procedures more effective at detecting fraud in response to fraud risk as required by SAS No.82. Payne and Ramsay (2005) carried out an experiment using professional auditors to examine whether planning-stage fraud risk assessments and audit experience affect the level of professional scepticism displayed by auditors during fieldwork. Results showed that scepticism appears to decline with increasing audit experience. Thus, they suggested audit firms need to use ongoing training with regard to professional scepticism and the requirements of SAS No.99. Further, in 2006, the Chief Executive Officers of the six international audit firms (PriceWaterhouseCoopers, Deloitte, Ernst & Young, BDO International, KPMG International, and Grant Thornton International) wrote a paper in the hope of making a dialogue about how global financial reporting and public company auditing procedures must adapt to better serve capital markets around the world. They mentioned in their report that they do not feel that current fraud detection efforts are adequate.

They state that there is an expectations gap when it comes to material fraud and the ability of auditors to uncover it at reasonable cost. They believe it is useful to consider additional ideas for enhancing fraud detection (Global Capital Markets and the Global Economy Report, 2006). Zimelman (1997), Glover et al. (2003), Zikmund (2008), and Brazel et al. (2010) found that auditors do not effectively change the design of their audit procedures in response to high fraud risk and in many cases they are not sure how much effort must be made to detect fraud. Dezoort and Harrison (2007) conducted an experimental study with 230 auditors from two Big 4 audit firms to evaluate whether auditors perceive different responsibility for detecting the three types of occupational fraud (fraudulent financial reporting, misappropriation of assets, and corruption). Results revealed that auditors reported higher perceived responsibility for detecting financial statement fraud than for the other two types of occupational fraud. This indicates that auditors might not be fully aware of the audit standards requirements because the standards require auditors to have the same responsibility for detecting the three types of occupational fraud. Others mentioned that audit firms are inconsistent in applying fraud related audit procedures. For example, Hassink et al. (2010) conducted a study in Denmark to determine the degree of external auditors' compliance with auditing standards once they encounter fraud.

They distributed a survey among 1,218 audit partners in 30 Dutch audit firms to gather data on the role of auditors in fraud cases and around 326 questionnaires were returned with only 296 were usable. Findings revealed that there are great differences among audit firms regarding compliance with the relevant auditing standards and auditors appear to encounter corporate fraud only incidentally and that in cases where the auditor has detected fraud, relevant procedures and regulations are not fully complied with.

To sum up, the current paper shows that investors' lack of knowledge about the role of external auditors and nature of the audit profession is not the only reason for the audit expectation gap. However, the gap pertains also to limitations in the audit professional standards and the efforts exerted by external auditors in detecting material misstatements arising from fraud. Despite the efforts of standards setters in narrowing the audit expectation gap, the nature of the audit standards allows inconsistencies in the application of fraud-related audit procedures by audit firms. This is because fraud-related audit procedures are suggested rather than required or enforced. Thus, standards' setters have to rethink about the inconsistency issue. Also the standards provided little guidance as to fraud risk assessment and response, and this might be the reason of some audit failures. This indicates that more efforts are still needed from the audit profession and the academic world in providing external auditors with more training on how to effectively and critically assess and respond to fraud risk factors. The current paper also shows that sometimes external auditors might not be either fully applying or consistently applying fraud-related audit procedures suggested by the audit professional standards, or simply lacking the proper knowledge and training necessary to detect misstatements arising from fraud.

4. Conclusion and Recommendation

This paper has reviewed academic research studies to provide insights into two important areas. The first is to explore the reasons behind the audit expectation gap, and the second is to assess the efforts of standards' setters and external auditors in narrowing the gap and detecting fraud. The audit expectation gap is a two-sided issue, dealing with the various professional and regulatory requirements that guide the auditor and the overall understanding of the nature and purpose of an audit by the users of financial statements. It cannot be denied that unless the public in general and the users of financial statements in particular are informed as to the role and intent of the auditing profession, the expectation gap will remain wide. However, this paper shows that this is not the only reason behind the audit expectation gap. The results of the review showed that the gap is still there for two other reasons. The first reason pertains to limitations in the professional audit standards. The second reason is that external auditors may not be exerting enough efforts to detect material misstatements arising from fraud.

Specifically it appears that external auditors still need guidance on how to rank risk factors while considering the likelihood of fraud to the business, impact of the fraud if it occurs, and pervasiveness of the fraud if found. The standards also provide very little guidance for external auditors on how to respond to heightened fraud risk factors which may lead to an ineffective fraud risk response. Further, the standards did not require all procedures to be followed but merely suggested that auditors consider implementing them which leads to inconsistency in the audit procedures used by different audit firms in response to these fraud risk factors. This raises the question of audit quality in some audit firms and in turn put investors' welfare at risk because simply not all audit firms are following the required procedures when it comes to fraud. It was also found that some external auditors still do not increase the extent of audit procedures or even change the nature of audit procedures in response to fraud risk assessments, inconsistently respond to identified fraud risk factors, do not modify the nature of their audit plans to make planned procedures more effective at detecting fraud in response to fraud risk as required by the standards, do not use professional scepticism, do not hold or document brainstorming sessions, and give more attention to fraudulent financial reporting than the other two types of fraud (asset misappropriation and corruption).

Thus, the current study recommends that standards' setters provide more guidance to external auditors with regard to fraud risk assessment and response. They should also require all fraud-related procedures to be followed by audit firms consistently, and there should be a mechanism that continuously monitors audit firms' performance to ensure they are following required procedures consistently and effectively. On the other hand, the academic world and audit profession should provide more training for external auditors on how to detect fraud and maintain professional scepticism (or consider "critical thinking"). The audit profession might need to alter the Continuing Professional Education requirements for external auditors to emphasize anti-fraud training and critical thinking skills, or they might consider putting the Certified Fraud Examiner (CFE) certificate as a requirement to get the CPA examination/qualification.

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6. Notes

Table 1: Academic research studies into the audit expectation gap worldwide

Authors	Year	Method	Country
Humphrey et al	1993	Questionnaire	United Kingdom
Porter	1993	Questionnaire	United Kingdom
Fadzly and Ahmad	2004	Experiment	Malaysia
Alleyne and Howard	2005	Face –to-face semi-structured interviews	Barbados
Dixon and Woodhead	2006	Questionnaire	Egypt
Ojo	2006	Questionnaire	United Kingdom
Sidani and Olayan	2007	Questionnaire	Lebanon
Haniffa and Hudaib	2007	Mail questionnaire and semi-structured interviews	Saudi Arabia
Chemuturi	2008	Literature review	United States
Hassink, et al	2009	Questionnaire	Netherlands
Katalinic	2010	Structured Interview and Questionnaire	Romania
Pourheydari and Abousaiedi	2011	Questionnaire	Iran