Evaluating Fraud Concept in Audit Profession: Past & Present

Munshi Samaduzzaman, Assistant Professor, Department of Accounting
American International University - Bangladesh (AIUB)

Farah Rezwan, Lecturer, Department of Finance
American International University – Bangladesh (AIUB)

Kashfia Sharmeen, Lecturer, Department of Finance
American International University – Bangladesh (AIUB)

ABSTRACT
As the classic fraud triangle theory developed over the years, New Standards such as SAS99, SAS104, and SAS111 came into action in USA and ASA 240 in Australia. The new standards provide explanatory guidance on the auditor’s responsibility to consider fraud in an audit of a financial report. The new standards require the audit team to always maintain an attitude of professional skepticism, recognizing the possibility that a material misstatement due to fraud could exist. The standards are now implemented as legislations under corporation’s law and are legally enforceable on auditors. Auditing standards have been developed all these years in response to uncovered frauds and today auditors are held more accountable and responsible for their job. Expectations from auditors have also increased but it is still difficult to completely prevent the possibility of any future collapse.

INTRODUCTION
Lack of accountability in the past, have lead to number of high profile corporate failures. In most cases it was difficult for auditors to identify fraud at early stage; in many of these cases auditors themselves were involved in the fraud. Lack of guidelines and clear understanding of the concept of fraud were also responsible to some extent for such collapse. Audit is to be designed to provide reasonable assurance of detecting material misstatement in financial report arising from irregularities including fraud, other illegal acts and errors. Auditor communicates judgment as to the reality and justice of financial statements. Thus Auditors play an important role in the society. It has always been the primary responsibility of Auditor to detect and prevent fraud.

FRAUD TRIANGLE – DETAIL DESCRIPTION OF ELEMENTS
Occurrence of fraud related to Financial Statements is very high. Investors and industry professionals depending on the truth of financial statements should watch for these three organized risk factors. The main stone of SAS99 Classic fraud theory describes fraud as a triangle of perceived opportunity, perceived pressure, and rationalization. Every fraud takes place due to either pressure for better performance; challenges in the workplace and competition among companies encourage fraud. The three corners of the Fraud Triangle as described below

(Source: The CPA Journal Online)
Pressure
Nowadays, management is in considerable pressure to show improved performance, which may act as a trigger to issue fraudulent and misleading financial information. For example management may be given large amount of encouragement bonuses based on accounting profit. On the other hand, an employee may have major financial responsibilities that surpass employee earning power. There are continuous encouragements to perform a dishonest act. These also include financial need to meet ones expensive medical bills, desire for material goods, habit of drugs, alcohol and gambling etc. People often take wrong action, when under stressful situation.

Managers should be watchful for signs of these problems in employee especially those in contact to accounting records and asset. Investigation is a mandatory factor while appointing new employee or for employees who may have access to assets. Dealing fairly with employee and being sensitive to employee problems can reduce fraud risk.

Opportunities
This type of fraud results due to poor or weak internal controls. Lack of monitoring in purchase and use inventory items may cause reporting of inflated inventories in future. These situations provide an opportunity for management or employees to misstate financial reports. More importantly inventory store room employee also maintains records, it is highly possible for them to take inventory items and cover the theft by adjusting the accounting records.

Opportunities for theft exit in all companies for example theft of laptops or desktops. It is possible to reduce these thefts by the use of surveillance methods and inventory coding and tracking system. In addition to these, supervision, separation of duties, management approval and system controls can also be used as controlling measures.

Action of Rationalizing
Rationalization takes place when the individual extend a justification for their fraudulent activities. Employees are sometimes consciously involved in fraudulent actions but feel no sense of guilt. However, others feel they are correcting a perceived wrong, for instance salary inequity among employees. They are convinced that they have earned more than the company is recognizing, so they feel that there is nothing wrong in stealing company asset.

If management frauds customers by overpricing for goods and services, employee may follows the management and behave in the same through cheating on expenditure or time reports. All in all, owners and management must take control of fraud by working on the part of the fraud triangle over which they have the most control, i.e they must reduce the scope to commit cheat. It may be difficult for executives do anything about a workers personal needs or his way of rationalizations, but by limiting opportunities for fraud, the company can decrease fraud to some extent.

FRAUD TRIANGLE CONCEPT, AUDIT PROFESSION & ACCOUNTING
The three conditions of the fraud triangle are attitude, opportunity and incentives. Input from forensic experts, academics and others, consistently show that evaluation of information about fraud is enhanced when auditors evaluate in the context of these three conditions. Fraud occurs with an organizational context, and is often perpetrated by many individuals within an organization. An organizational fraud triangle will take into account important organizational elements such as ethical climate, culture, and leadership.

As history suggests, Fraud has been strongly organized to operate in goods. For example smuggling goods to avoid custom charge or cover up the true source of a manufactured goods and earnings. The fraud triangle has altered over the years. (Blanque, 2002).
In 1940s, Donald R. Cressey developed the concept of fraud triangle describing the presence of three conditions incentive, opportunity and rationalization for fraud to occur at workplace. The term fraud is not a new term or an action. It happens constantly more or less everywhere in the world and is of many types. History gives us examples of many fraudulent acts. We have several examples of fraud in every part of life including accounting. Fraud has become a social problem. There is no significant difference between normal fraud and accounting fraud. The one major thing in common between the two is the interest of a fraudster or an auditor who is doing fraud. It is important to recognize how fraud has evolved and advanced historically. The reasons or the fundamentals behind fraud both in accounting and society are the same. Even though the reasons are same the effect to the people or an individual may be different. Someone stealing $50 note will always be different from someone overstating assets by $1 million. One leading case on this is the Arthur Anderson case.

Fraud in society can be verified or controlled by police but then if the police are part of a fraud circle, fraud cannot be controlled. The same result is expected, if auditors (who are part of the final resulting statements) help to prepare or approve fake financial statements.

In the leading case of Arthur Anderson the auditors of Arthur Anderson had opportunities to do the fraud. The case formed a basis for development of several fraud literatures in the past years and today it is incorporated in Accounting Standards all over the world as a guideline for auditors to help them detect and prevent fraud.

Conditions of fraud triangle were first accepted in developing Auditing Standard SAS 99 in U.S. Traditionally, detection & prevention were a part of auditor’s responsibility. But the need for adoption of fraud triangle in auditing standards gradually developed as it became more important for auditors to understand the concept of fraud in order to prevent the fraud. Today it is the responsibilities of auditors to also provide corrective measures to prevent fraud. Initially SAS 47 - Audit Risk and Materiality in Conducting an Audit provided guidelines about material misstatements. Later in 1997, SAS 82 - Consideration of Fraud in a Financial Statement Audit emphasized that auditor needs to consider if the misstatements were from error or fraud. According to Ratcliffe (2000), Auditors had no responsibility to plan and perform an audit to obtain reasonable assurance that misstatements resulting from error or fraud will be detected.

SAS 99 was developed in Nov 2002 in wake of more accounting scandals related to intentional misstatements. It aimed to address the inadequacies of SAS 82. While SAS 82 focused more on detection, SAS 99 gave more understanding about auditor’s responsibility in prevention. Today the fraud risk factors have become more apparent and new audit risk standards SAS No. 104 - SAS No. 111 -effective from March 2006 are issued to enhance auditors’ application of the ‘audit risk model’ in practice. They guide auditors in assessment of risks of material misstatement by error or fraud, lays down procedures to respond to Assessed Risk and ways to evaluate the Audit evidence obtained.

In accordance to the recent issued SAS99 in USA, fraud is designed as “an intentional act that results in a material misstatement in financial statements that are subject of an audit” (AICPA, 2002, par. 05). It explains one important test that auditors execute in the examination of fraud risk factors such as auditors must plan and perform to get practical declaration about whether financial statements are free of material misstatement by error or fraud. SAS improves auditor’s detection of fraud and be successful the previous standard. Especially SAS99 says that audit team requires to think together and to produce ideas about how and where they believe the client’s financial statements may be at danger of material misstatements. It improves the auditor’s chances of detection of fraud but does not change the auditor’s responsibilities for fraud detection. Auditor’s main duty is to inform management if they have detected fraud during the ordinary way of the audit. Auditors use the fraud triangle tool to measure fraud risk factors and to study fraud perpetration. Auditors do not create their own fraud risk factors for each organization; they observe fraud risk factors through the use of an industry guide that
includes the red flags that were expanded in SAS No.99. Moreover, auditor must use qualified judgment and maintain professional uncertainty when analyzing fraud risk factors (Peterson 2004).

SAS99 demonstrates that it is important to enquire the client recurrently or look at a few more source documents until the auditor is satisfied. Furthermore, auditor should not only focus on the account balances but also have normal discussion with the client and employee of the client. This discussion helps auditors to estimate possible risk factors. For example if employees complain regarding financial pressures it may help the auditor to measure fraud risk factors (Noblet et al. 2012).

AUS 210 was developed on the same lines of SAS 82 in U.S.; later in 2006 it was also incorporated with the concept of fraud triangle to give clear guidelines and came into existence as ASA 240. It provides importance on in-depth understanding of the entity’s environment and internal control to make auditors proactive.

The Auditing and Assurance Standards Board (AUASB) concerns Auditing Standard ASA 240 explains the auditor’s responsibility to think about cheat in an audit of financial report outstanding to the requirements of the legislative requirements. Under the Legislative Instruments Act 2003, AUASB may make Auditing Standards for the purposes of the corporation’s legislation. This Auditing Standard is performing for financial reporting periods beginning on after 1 July 2006.

ASA 240 improved and provides procedures to auditors to come in contacts with regulatory and enforcement authorities. In addition, if a misstatement from fraud or assumed fraud is detected, which was not noticed by the auditor, he meets special situations that bring into question the auditor’s capability to continue performing the audit and create documentation requirements.

It suggests the auditors to decrease audit risk of material misstatements in the financial reports due to fraud, to follow proper planning and performing while making the audit reports so that it is possible to reduce risk. Inadequate information can create difficulty in understanding important facts and create possible risk for auditors. Hence, connection between the nature, timing and extent of audit procedures are important measures to carry out audit and respond to audit risks.

IFAC is a non-state actor, founded in 1977, with headquarters in New York. IT is playing a major role in global financial control. It places international standards for auditors. It includes standards governing auditor education, principles and the auditing practices. The main purpose of IFAC was firstly defined as advancing “the development and enhancement of a coordinated worldwide accounting profession with harmonized standards”. The main job of IFAC is to create international standards on auditing. IFAC has launched an international code of ethics for professional accountants, international standards on accounting education issues and Standards for international public sector accounting.

International Federation of Accountants (IFAC) has played an important role to develop audit risk factors all these years. Its role is to establish and promote adherence to high quality international standards, to facilitate collaboration and cooperation with member bodies, and to serve as spokesperson for the international profession on relevant public policy issues. IFAC through its independent standard setting board, develop International standards on auditing and assurance, ethics and issues accounting standards (IFAC website). In Australia, Australian Accounting Standard Board (AASB) monitors implementation of accounting standards and its interpretations. It adopts form IASB and revises to domestic version of AASB standards to suit the local business and regulatory framework. While CPA, ICAA and IPA of Australia are member bodies of IFAC and jointly help AASB to implement accounting standards in Australia.

IFAC will remain to make the worldwide accountancy profession stronger and add to the valuable goal that has of meaningful suggestions for the financial system and for financial risk. The IFAC has
modified its approach to audit risk and has currently issued introduction drafts on audit risk (IFAC 2002) (Loft 2005).

EFFECTIVENESS OF THE NEW STANDARDS FOR RISK ASSESSMENT
The audit risk model identifies three main components of audit risk - inherent risk, control risk and planned detection risk. In order to keep audit risk to an acceptable low level the auditor can manipulate planned detection risk based on the level of inherent and control risk. ASA 240 helps to enhance auditors with the application of this ‘audit risk model’ in practice. While auditors can reasonably access control risk like effectiveness of internal controls it is difficult for the team to access inherent risks like management integrity.

The new standards require the audit team to always maintain an attitude of professional skepticism, recognizing the possibility that a material misstatement due to fraud could exist. The skepticism helps auditor to approach the audit with an unbiased and vigilant mind despite having past positive experiences. The requirement to document helps them establish and link-in various risks identified from different sources. The requirement to discuss their response to the susceptibility of material misstatement due to fraud with management helps them collect more information but if the fraud involves management contribution, it is unlikely that management will easily provide honest information to auditors as fraud itself means a deceptive conduct with the intention to deprive another party. It is only when a lower level employee or officer is aware about the fraud and is willing to share and disclose the same with auditors that a fraud can be exposed in such a case. But employees would be willing only if he is assured about his confidentiality.

ASA 240 thus requires that auditor maintain the confidentiality of the person who discloses the fraud. In these circumstances auditor can prevent to communicate such information to management who may be involved is such fraud. Thus in a broad sense, ASA 240 effectively addresses major issues related to auditors approach in prevention and detection of fraud and holds them more accountable. Though it provides clear and enforceable guidelines to auditors it still cannot prevent a possibility of future failure of corporations due to fraud.

Auditors get access to internal information. They are in a position to identify misstatements and avoid a fraud. They are also held accountable if anything goes wrong but despite all the regulations, fraud still takes place and firms still collapse. In early 2000s, auditing firm Arthur Anderson was not in a position to consider relationships of elements of fraud triangle and collapsed. This then lead to the need of incorporating fraud triangle concept in auditing standards and the helped in strengthening the regulatory framework.

The classic fraud triangle theory has helped in clearly understanding the concept of fraud to provide clear guidelines to auditors in identifying fraud. In 2004, Wolfe and Hermanson have also mentioned about ‘fraud diamond’ by including fourth element ‘capability’ to the classic fraud triangle. According to them, personal traits and abilities play a major role in whether fraud may actually occur even with the presence of the other three elements. Though it was not incorporated in the accounting literature but is an interesting point to consider as opportunity opens the doorway to fraud, and incentive and rationalization can then draw the person toward it. But the person must have the capability to recognize the open doorway as an opportunity and to take advantage of it by walking through, not just once, but time and time again. (Wolfe and Hermanson, 2004).

In USA, Statement on auditing standard No.99 established standards and provided guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). SAS 99 did not change the auditors’ 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 (as described in AU
SAS 99 required, as part of planning the audit, that there be a brainstorming session among the audit team members to consider the susceptibility of the entity to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset professional skepticism. SAS 99 also required auditors to gather the information necessary to identify the risk of material misstatement due to fraud, by doing the following:

- Making inquiries of management and other within the entity;
- Considering the results of the analytical procedures performed in planning the audit;
- Considering fraud risk factors;
- Considering certain other information.

SAS 99 also required auditors to evaluate the entity’s programs and controls that address the identified risks of material misstatement due to fraud, and to assess those risks after taking into account this evaluation. It also required auditors to respond to the results of the risk assessment. SAS 99 did not change management’s responsibility to detect material fraud in financial statement audits nor did it change management’s responsibility to establish controls to prevent and detect fraud. SAS 99 did, however, require an auditor to gather and consider much more information in assessing fraud risks and provide guidance on how management can establish anti-fraud programs and controls. SAS 99 required that fraud be considered through the entire audit process and encouraged auditors to use non predictable audit procedures when performing audits.

With each collapse the deficiencies in the existing framework is identified and improvised. What framework we have today is a result of learning’s from all these years. The body which designs the auditing standards always makes an attempt to provide guidelines to avoid any further collapse due to fraud but such collapse are inevitable. The regulation laid by Sarbanes-Oxley Act and International Accounting Standards can only attempt to ensure that such failures are identified in early stage.

CONCLUSION
The auditor’s responsibility and role have undergone significant changes from traditional concept of detecting and preventing fraud to advising management with corrective measures to prevent fraud. Today the auditing standards which are also regulations under corporations Act 2001 (in Australia) enforce the auditors to have a more proactive approach in auditing rather than reactive. By making auditor liable the regulatory body is ensuring that fraud condition incentive don’t exist even for auditors. But still we cannot deny the possibility of more frauds and more involvements of auditors leading to corporate failures. The regulations can just ensure to reduce the intensity of corporate failures by detecting such frauds at early stage. If more corporate fails then these failures will prompt us to strengthen and improve our regulation and accounting standard further.

The guidelines provided in any auditing standard increases the expectations from the auditors. They lay down procedures to respond to Assessed Risk and ways to evaluate the Audit evidence obtained. Auditors must consider the standard requirements as just the minimum level of work required to detect fraud and prevent fraud. If they decide not to pursue any of the recommended procedure they must be able and prepared to explain such decision.

REFERENCE


IFAC website Online. Retrieved from http://www.ifac.org/About/

Loft, A 2005, In pursuit of global regulation changing governance and accountability structures at the International Federation of Accountants(IFAC), University of Manchester. (Online: Emerald).


