The disappearance of Auditors’ Responsibility for Fraud Detection in Auditing Standards

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Abstract: This paper aims to comprehend the auditor’s responsibility in connection with discovering fraud and discuss the framework adopted in auditing standards. The responsibility for detecting fraud is arguably the most significant issue causing the expectation gap. Although auditors had direct responsibility for fraud detection in earlier periods of the auditing profession, this responsibility disappeared later on audit standards. The disappearance may result from an increase of institutional complexity faced by auditors, and thus standard setters may be finally on the favor of the auditors, compared to wider public interests. Standard setters attempt to help auditors by providing a model of fraud risk identification and assessment to assist with fraud detection in auditing standards. However, numerous empirical studies also find that the model does not help auditors in practice. Notwithstanding the expectation gap, a series of accounting scandals and fraud is a test for the effectiveness of the model. Otherwise, it may need to set back a greater auditors’ responsibility for detecting fraud, which is somehow impossible.

Keywords: Auditor’s responsibility, Fraud detection, model of fraud risk identification


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1. Introduction

A series of accounting scandals has been damaged the public trust in business around the world. The nine scandals (Enron, Lehman Brothers, Citigroup, Tyco, WorldCom, Qwest, and Global Crossing, Parmalat, Satyam) are widely blamed as the most extreme examples of corporate destruction in this century and the beginning of the severe economic and financial crisis (Grove and Basilico, 2011). These companies experienced massive frauds and accounted for total market capitalization losses of US$714 billion, with the highest record for Citigroup (US$240 billion) and WorldCom and Enron losing around US$ 180 billion and US$70 billion respectively (Zabihollah, 2005; Grove & Basilico, 2011). WorldCom capitalized its expenses by US$3 billion and US$797 million in 2001 and the first quarter of 2002, respectively, to increase the company's profit and key managers at Tyco committed fraud on unauthorized loans (Clarke, 2005). KPMG (2003) reveals that the likelihood of fraud occurring in companies increased by more than 40% from 1998 to 2003. Also, PwC surveyed 3,000 company officers in 2005 and found a similar pattern that the trend of committing fraud was even higher (140%) after the enactment of the Sarbanes-Oxley Act (SOX) of 2002. Besides financial losses, the fall of Enron caused the laying off of thousands of employees in 40 countries, the collapse of Arthur Anderson, one of the Big 5 firms of accountants, and rocketing energy prices, and led to an erosion of trust (Albrecht, Albrecht, Albrecht, & Zimbelman, 2009).

After the collapse of Enron, the US government enacted the SOX as a response to the series of financial and accounting malpractices. Standard setters of auditing also issued or renewed standards on auditing which put more responsibility on management and auditors to prevent and detect fraud. The American Institute of Certified Public Accountants (AICPA) in 2002 issued Statement on Auditing Standards (SAS) No.99 (superseding SAS 82): Consideration of Fraud in Financial Statement Audit. The issuance followed by the UK’s Auditing Practices Board (APB)
with International Standards on Auditing (ISA) No. 240 (superseding SAS 110): *The Auditor’s Responsibilities Relating to Fraud in Audit of Financial Statements* in 2004, and International Federation of Accountants (hereafter, IFAC) with its ISA No. 240 in 2004 which has same title with UK auditing standards. IFAC (2011) reports that 125 countries also acted in similar ways by strengthening the rules of corporate governance and improving auditing standards\(^1\). In a similar vein, the Indonesian Institute of Accountants (hereafter the IAI, in Indonesian stands for Ikatan Akuntan Indonesia) through a national accounting convention in 2004 has decided to move closer to international accounting and auditing standards – International Financial Reporting Standards (IFRS) and ISA – to prevent and deter fraud.

2. **Theoretical Review**

2.1 **Modern History of Corporate Fraud**

The literature documents that the Vereenidge Oost-Indische Compagnie (VOC) or the Dutch East Indies Company was the first share issuer to go public in 1602 at the Amsterdam Stock Exchange (bourse), which was the first stock exchange in the world founded in 1602. The VOC was the first multinational company, and the Dutch Government granted the right for VOC to monopolize Asian trade. For this purpose, the VOC empowered itself by building forts, establishing armies, and signing treaties with the Asian countries. The firm used the army to maintain its monopoly and constructed a central commander at Batavia (now Jakarta, Indonesia) to manage trading activities and later as a colonial camp in the Asian area. It earned huge profits from the trade of *rempah-rempah* (spice) which was planted and harvested mostly from around Maluku Island (eastern part of Indonesia) and brought to Europe. At that time, VOC’s accounting period was for ten years duration, and the company only produced financial statements twice in its existence as a company (Sarna, 2010). The VOC’s success continued until the late 1800s when it started to decline because of the emergence of British companies in Asia and *Vergaan Onder Corruptie* (translated as, perished under corruption) by its employees.
VOC’s defeat in several wars against British companies caused negative consequences. Besides disrupting the traffic of VOC’s ships between Asia and Europe, the wars reduced VOC’s market share and competitive advantage in Asia as well as in Europe. While the firm faced much pressure from the defeat and competition, employees had to serve for company’s interest. It encouraged them, especially who worked far away from Netherland, used their power to make gains at the expense of the company (Nierstrasz, 2008). For instance, they used forced labors (slavery) in the production of spices in Indonesia to enrich themselves, rather than to send the commodities and cash resulted from illegal tax (upeti) to the Netherlands. This kind of fraud spread out the company and led it to bankruptcy. A series of corporate fraud cases follows corruption in VOC, and it continues up to recent frauds as introduced in the previous section.

2.2. Auditors’ Responsibility for Fraud Detection

After revelations of undetected fraud in the past until the recent days, the question is raised of, “Where were the auditors?” (Humphrey, Turley, and Moizer, 1993; Cullinan and Sutton, 2002; Hassink, Bollen, Meuwissen, and Vries, 2009). The issue is unlikely to be resolved by the profession of auditor concerning auditor responsibility to detect fraud when conducting audit, and it is indicated by an expectation gap between what the public perceives about the auditor can do and what auditor actually does (Humphrey et al., 1993; Cullinan and Sutton, 2002; Hassink et al., 2009). Humphrey et al. (1993) state the profession intentionally avoids taking responsibility for detecting fraud by deflecting criticism. For example, the costs (staffs/auditors, expenses/budget, and time) of detecting fraud may be higher than the benefits resulting from it (Humphrey, et al. 1993; Hudson, 2007). Also, the growth of multinational companies and the increase in transaction volumes may cause difficulty for auditors to detect fraud and ensure that financial statements are free from material misstatement (Humphrey et al., 1993).

The beginning of the debate on auditors’ responsibility can be traced back to the 1800s when auditing textbook, Auditing – A Practical Manual for Auditors in Britain,
mentioned fraud detection as a primary objective of audit, as well as in the US in 1912 with the first American textbook on auditing, *Auditing Theory and Practice* by Robert Montgomery (Lisa, 2010). For instance, Dicksee (1912) described the objective of an audit as follows:

The object of an audit may be said to be threefold:

1. The detection of fraud *emphasis added*
2. The detection of technical errors
3. The detection of errors of principle…

…the detection of fraud is a most important portion of the auditor's duties. Auditors, therefore, should assiduously cultivate this branch of their activities. (Dicksee, 1912, pp. 7-8).

However, the responsibility for detecting fraud started to disappear from statements of auditing standards by the 1940s, and the client began to take over the duty from the auditor (Humphrey *et al.*, 1993). The Benson Report (still in Humphrey *et al.*, 1993) supported this disappearance by arguing that the auditor should protect client’s information confidentially and not disclose it to other parties, except as the standard requires to do so and it should be first communicated to the client. Regulators and the profession seem to favor this stance.

In response to fraud, the audit profession has attempted to improve auditing standards. According to International Standards on Auditing (ISA) 240, an objective of financial statement audit is to provide an opinion on whether the financial statements fairly stated following generally accepted accounting principles. Fairness of financial statements means that they do not contain material misstatement resulting from either errors or frauds. Auditors have to be aware of material misstatements, especially due to fraud, since it is more challenging to detect misstatement due to fraud than errors. ISA 240 notes the auditor responsibility is: (i) to identify and assess the risks of material misstatement of the financial statements due to fraud; (ii) to
obtain sufficient appropriate audit evidence regarding the assessed risks; and (iii) to respond appropriately to fraud or suspected fraud during the audit.

ISA 240, however, does not provide detailed guidance on how to implement these responsibilities on audit procedures. Ramos (2003) argues that standards do not include this because of predictability of audit procedures will help perpetrators to conceal fraudulent activities and go undetected and, for that reason, the standards only provide cues to use such surprise audit procedures.

KPMG (2003) finds that fraud discovery by external auditor relatively diminished after the enactment of US SAS 82 of 1998 from 5% in 1994 to 4% in 1998 and increased again to the level of 12% in 2003 after promulgation of US SAS 99 of 2002. The same survey conducted KPMG in 2009 reveals that even though the US SAS 99 provides aid at the beginning, it is less effective in the following years as indicated by a decrease in the number of fraud detection by auditors (9% in 2009). Consistent with this finding, Association of Certified Fraud Examiners (ACFE) (2008, 2010, 2016) confirms that auditors’ ability to detect corporate fraud has decreased from 12% (2006) to 9.1% (2008) to 4.6% (2010). Also, by studying juror perceptions regarding auditor’s responsibility for detecting fraud under US SAS 99, Lisa (2010) notes that even though auditors are more responsible under SAS 99, auditors less feel guilty when they do not discover fraud in their audit. These studies assert that the auditing standards on fraud may only provide a little help for auditor in detecting fraud and, because of it, the expectation gap arguably still exists.

2.3 US Auditing Standards on Fraud

In the US, the Auditing Standards Board (ASB), previously known as the Committee on Auditing Procedures (1939-1972) and the Auditing Standards Executive Committee (1972-1978), of the American Institute of Certified Public Accountants (AICPA) is the standard setter who issues Statement on Auditing Standards (SAS). The responsibility of auditors in the US in respect of fraud was mentioned in the first auditing standards in the 1970s with SAS 1 Section 110
Suyanto

(1972), superseded by SAS 16 (1977), replaced by SAS 53 (1988), replaced by SAS 82
(1997), later superseded by SAS 99 (2002) as in Table 1.

Table 1.
List of Fraud-Related Statement on Auditing Standards (SAS)

<table>
<thead>
<tr>
<th>Year</th>
<th>Statement Number</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>1</td>
<td>Codification of Auditing Standards and Procedures</td>
</tr>
<tr>
<td>1977</td>
<td>16</td>
<td>The Independent Auditor's Responsibility</td>
</tr>
<tr>
<td>1988</td>
<td>53</td>
<td>The Auditor's Responsibility to Detect and Report Errors and Irregularities</td>
</tr>
<tr>
<td>1997</td>
<td>82</td>
<td>Consideration of Fraud in a Financial Statement Audit</td>
</tr>
<tr>
<td>2002</td>
<td>99</td>
<td>Consideration of Fraud in a Financial Statement Audit</td>
</tr>
</tbody>
</table>

SAS 1 consisted of several sections and bundled them as one package, including The responsibility of the auditor for detecting fraud (see Section 110). SAS 1 was originally from Statement on Auditing Procedures (SAP) No. 33-54 which were in the pamphlet forms in the Journal of Accountancy and issued by the Committee on Auditing Procedure from 1939 to 1972

Concerning auditor responsibility for detecting fraud,

SAS 1 Section 110 para. 05, Detection of Fraud notes:

...the independent auditor is aware of the possibility that fraud may exist...The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made following generally accepted auditing standards, considers this possibility. However, the ordinary examination directed to the expression of an opinion on the financial statement is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result.... The responsibility of the independent auditor for failure to detect fraud (which
responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

SAS 16 para. 5, *The Independent Auditor's Responsibility* notes:

The independent auditor's objective in examining the financial statement following generally accepted auditing standards is to form an opinion on whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied. Consequently, under generally accepted auditing standards the independent auditor has the responsibility, within the inherent limitations of the auditing process, to plan his examination to search for errors or irregularities that would have a material effect on the financial statement and to exercise due skill and care in the conduct of that examination. The auditor's search for material errors or irregularities ordinarily is accomplished by the performance of those auditing procedures that in his judgment are appropriate in the circumstances to form an opinion on the financial statements.

SAS 53 para. 5, *The Auditor’s Responsibility to Detect and Report Errors and Irregularities* notes:

The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

states:
The auditor has 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.

2.3 UK Auditing Standards on Fraud

The authority for issuing auditing standards in the UK is the Auditing Practices Board (APB) of the Financial Reporting Council (FRC). The APB was established in 1991 to replace the Auditing Practices Committee (APC) that existed since 1976. Fraud related auditing standards in the UK can be traced back to 1995 when the APB issued Statement of Auditing Standards (SAS) No. 110, Fraud and Error. International Standards superseded SAS 110 on Auditing (ISA) of APB No. 240 (2004), and finally superseded by the ISA 240 (2009) with same number and title of ISA of 2004, the Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements. The last two are the same in substance, but the newer one has incorporated the clarified ISAs issued by the International Auditing and Assurance Standards Board (IAASB) (APB, 2009). Concerning the responsibility for discovering fraud, SAS 110

Sec. 1, para. 2 states:

Auditors should plan and perform their audit procedures and evaluate and report the results thereof, recognizing that fraud or error may materially affect the financial statements.

ISA 240 (UK and Ireland) states:

An auditor conducting an audit following ISAs (UK and Ireland) is responsible for obtaining reasonable assurance that the financial statements taken as a whole
are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitation of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed following the ISAs (UK and Ireland).

2.4 International Standards on Auditing

At the international level, the Accountants International Study Group started an initiative to form auditing standards in 1969 by studying different practices in Canada, UK, and the US. In 1978, the Council of the International Federation of Accountants (IFAC) established the International Auditing Practices Committee (IAPC), which worked on three key areas: object and scope of audits of financial statements; engagement letters; and general auditing guidelines from 1980 to 1991. Also, in 1991, the IAPC recodified its auditing guidelines to become International Standards on Auditing (ISA).

The International Auditing and Assurance Standards Board (IAASB) was founded in 2002 to replace the IAPC. In 2004, the IAASB started to work on the Clarity Project, a program to update and clarify the ISAs so that the ISAs are more understandable and compatible with regulatory frameworks.

The first fraud-related standard was issued in March 2001 by the IAPC, ISA No. 240. After reviewing and obtaining an understanding of revision of US SAS 82, the IAASB revised ISA 240 by extending it with the audit risk model and adopting the basic principles and essential procedures contained in the US SAS 99. The new ISA 240 entitled *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, eliminates ‘errors’ from the title. In connection with the auditor’s responsibility for discovering fraud, this standard is the same as ISA 240 (UK and Ireland).

2.5 Fraud Taxonomy
ACFE (2007) classifies fraud into three categories: corruption; asset misappropriation; and fraudulent financial statements (see Figure 1). These frauds are usually perpetrated by employees, management, and/or the owners of the business so that it is also known as occupational fraud. Meanwhile, accounting standard setters group it into two of these types, asset misappropriation and fraudulent financial statements (ISA 240, 2009, para. 3; SAS 99, 2002, para. 6). This paper focuses on fraud, as promulgated in auditing standards, especially to detect fraudulent financial statements.

Figure 1
Classification of Occupational Fraud

2.6 Definition of Fraud and Fraud Triangle

Fraud has a broad definition depending on the point of views such as economics, law, accounting, or psychology. Albrecht et al. (2009) define fraud as:

A generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery. (p.7).
ISA 240 (IFAC, 2016) defines fraud as:

An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. (p.170).

The auditing standards on fraud use the fraud triangle as a framework for auditors to detect fraud in an audit of financial statements. Figure 2 illustrates the fraud triangle. The origin of the fraud triangle dates Cressey (1953) who interviewed inmates convicted of violations of financial trust.

He noted that perpetrators committed fraud when three conditions existed: perceived pressures; perceived opportunities; and rationalizations or attitudes. Perceived pressure is the incentive to commit fraud, and perceived opportunity is when conditions allow perpetrators to commit fraud, and rationalization is the fraudster's ability to justify the fraud for him or herself. The AICPA and IFAC recognize that it only needs one of these factors to exist for perpetrators to commit fraud, and therefore, auditors must have professional skepticism when conducting their audits.

Albrecht et al. (2009) provide an illustration of the fraud triangle where pressure could be due to financial, vices, work-related, and other reasons. Financial incentives include greed, living beyond one’s mean, high bills or personal debt, poor credit, personal financial losses, and unexpected financial needs. Vice pressures include gambling, drugs, alcohol, and expensive extramarital relationships. Work-related issues can also cause pressure such as getting little recognition, job dissatisfaction, fearing losing one’s job, being overlooked for a promotion, and feeling underpaid. The element of opportunity can be a lack of control, inability to judge the quality of performance, failure to discipline fraud perpetrators, a lack of access to information, incapacity, and a lack of audit trails. The third element, rationalization, usually uses justification to excuse fraudulent activities such as the organization owes it to
perpetrators, fraudsters just borrow it and will pay it back, nobody will get hurt, fraudsters deserve more, it’s for a good purpose, perpetrators will fix it later after getting over this financial difficulty, or something has to be sacrificed. The AICPA and IFAC examples of each of the fraud triangle elements and auditors need to be sceptical throughout their audits when these conditions exist.

Figure 2
The Fraud Triangle

Auditing standards provide operational guidance for auditors to identify and assess fraud risks (Ramos, 2003). Risk assessment complements other procedures for detecting fraud such as exercising professional skepticism, holding brainstorming or discussion sessions, identifying and assessing the risk of material misstatement due to fraud, responding to the assessed risks of material misstatements, and obtaining written representations (AICPA 2002; IASB, 2009).

Prior research on fraud attempts to specify fraud risk factors using financial and non-financial data (Persons, 1995; Kaminski et al., 2004; Skousen, 2008, Kirkos et al., 2007). Table 2 summarizes fraud risk factors derived from ISA 240 and SAS 99. Panel A exhibits Pressures, categorized into financial stability, external pressure, personal financial need, and financial targets. Panel B demonstrates Opportunities,
grouped into the nature of the industry, ineffective monitoring, and organizational structure. The last panel shows Rationalization.

Table 2
Summary of Risks due to Fraudulent Financial Statements Based Auditing Standards

Panel A: Pressures

<table>
<thead>
<tr>
<th>Categories</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Stability</td>
<td>- High degree of completion or market saturation</td>
</tr>
<tr>
<td></td>
<td>- High vulnerability to rapid changes (in technology, obsolescence, interest rate)</td>
</tr>
<tr>
<td></td>
<td>- High declines in customer demand or increasing business failures</td>
</tr>
<tr>
<td></td>
<td>- Operating losses</td>
</tr>
<tr>
<td></td>
<td>- Recurring negative cash flows</td>
</tr>
<tr>
<td></td>
<td>- Rapid growth or unusual profitability</td>
</tr>
<tr>
<td></td>
<td>- New accounting or regulatory requirements</td>
</tr>
<tr>
<td>External Pressure</td>
<td>- Profitability or trend level expectations</td>
</tr>
<tr>
<td></td>
<td>- Need for obtaining debt or equity financing requirements</td>
</tr>
<tr>
<td></td>
<td>- Meeting exchange listing requirements</td>
</tr>
<tr>
<td></td>
<td>- Effects of reporting poor financial results</td>
</tr>
<tr>
<td>Personal Financial Need</td>
<td>- Significant financial interests in the firm</td>
</tr>
<tr>
<td></td>
<td>- Significant portions of management or those charged with governance’s compensation</td>
</tr>
<tr>
<td></td>
<td>- Personal guarantees of debts of the entity</td>
</tr>
<tr>
<td>Financial Targets</td>
<td>Sales or profitability</td>
</tr>
</tbody>
</table>

Panel B: Opportunities

<table>
<thead>
<tr>
<th>Categories</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of Industry</td>
<td>- Significant related-party transactions</td>
</tr>
<tr>
<td></td>
<td>- Domination in a certain industry</td>
</tr>
<tr>
<td></td>
<td>- Accounts which based on high estimates/subjective judgments</td>
</tr>
<tr>
<td></td>
<td>- Significant, unusual, or complex transactions</td>
</tr>
</tbody>
</table>
Ineffective Monitoring

- Many subsidiaries in abroad
- Use of business intermediaries
- Domination of management by a single person/small group
- Ineffective oversight by those charged with governance
- Inadequate monitoring of controls
- High turnover rates or employment of accounting/audit staff
- Ineffective accounting and information systems

Incentives/Pressures

Panel A illustrates the conditions in which a fraud perpetrator is encouraged to commit fraud: uncertainty on financial stability or profitability; excessive external pressures; high personal financial need; and excessive pressure to meet financial targets. If financial stability is threatened by some factors such as a high degree of competition or market saturation, rapid changes in technology, significant decreases in customer demand, huge operating losses, or new regulations, firms may be likely to manipulate its earnings so that financial stability or profitability changes appear smoothly over two or more years or even to engage in fraud. Most of the studies use financial ratios as risk factors since the ratios can be useful for detecting fraudulent activities (Albrecht et al., 2009) and unusual changes in financial ratios may indicate an occurrence of fraud (Kaminski et al., 2004). For example, financial stability is measured by using capital turnover which reflects the sales are generating power of a firm's assets and also management's ability to deal with competitive situations (Persons, 1995). Persons (1995) argues that compared to no-fraud firms, fraud firms may be less competitive in using the firm's assets to generate sales. Also, Persons (1995) contends that under competition pressure, if a firm is not able to compete successfully, it may encourage management to manipulate the financial statements.

Management also frequently has to meet requirements or expectations from external parties such as investment analysts, institutional investors, significant creditors, potential investors/creditors, stock exchange requirements, or other third
parties. If their requirements or expectations are unrealistic or unachievable for management, it fosters management to find an adverse way to approach them. For example, leverage is employed to quantify these pressures. Persons (1995) states that firms with higher leverage are associated with a higher likelihood of loan agreement violation, and they also have less ability to obtain additional funds from borrowing. To cope with its need of debt covenant, management is more likely to manipulate financial statement (Kirkos et al., 2007). Therefore, financial distress may be an indication that management has an incentive to perpetrate fraud (Loebbecke et al., 1989; Stice, 1991; Kirkos et al., 2007).

Management or those charged with governance are encouraged to protect their personal concerns when their interests such as significant financial matters (bonuses, stock options, investments, and others) in the firm are threatened. Beasley (1996) and Skousen (2008) state that management tends to do its favor, when its personal interests are threatened by firm's financial performance, resulting from management having significant financial interests in the entity.

Also, financial targets such as sales or profits which are established by those charged with governance can be pressures for management to engage in fraud. For instance, Persons (1995) claims that firms with lower profitability tend to overstate revenues or understate expenses. Moreover, Kreuzfeldt and Wallace (1986) and Persons (1995) suggest that a firm with lower profitability tends to have significantly more errors in its financial statement than a firm with higher profitability. Thus, low profitability is an incentive that may foster management to engage in fraud.

Detail fraud risk factors for Pressure/Incentive which provided by ISA 240 can be seen in Appendix.

**Opportunities**

Panel B shows opportunity when fraud exists, including the nature of the industry or the entity’s operation, ineffective monitoring of management, complex or unstable organizational structure, and weak systems of internal controls. The complete set of this guidance is provided in the Appendix. The nature of the industry can adversely condition perpetrators to commit fraud. It can be significant related-party transactions,
domination in a certain industry sector, accounts which involve significant estimates or subjective judgments, unusual or complex transactions, having many overseas subsidiaries, and use of business intermediaries. These factors can provide an opportunity for fraudsters to engage in fraud. For instance, related party transactions are a transaction between a company and an insider, in the form of a subsidiary or employee. Carmichael (1999) states this kind of transaction does not reflect arm’s length bargaining between independent parties which is a crucial point for revenue recognition and if a transaction materially differs from its economic substance, profit recognition should generally be deferred. For example, if a firm has established the other party and acted as buyer and seller, the general rule is that revenue recognition should not be taken into account, even when the transactions were disclosed (Carmichael, 1999). In many fraud cases – Enron, Tyco, Qwest, WorldCom, Global Crossing, related party transaction is allegedly used to manipulate earnings and commit fraud (Young, 2005; Grove and Basilico, 2011).

Another example of the nature of the industry, especially for companies which have significant inventory, changes in inventory. Inventory is one of the easiest accounts to manipulate (Stice, 1991; Persons, 1995), since it may involve a subjective estimation which makes it more difficult to be audited. Inventory fraud generally employs several methods such as valuing inventory at a lower rate and recording obsolete inventory (Kirkos et al. 2007). Persons (1995) discovers that fraud firms tend to undergo higher inventory/total assets than no-fraud firms.

Ineffective monitoring, such as the weak system of internal control, domination of management by a single or small group, ineffective those charged with governance, high turnover rates of employment, and inefficient accounting and information systems, frequently facilitates perpetrators to commit fraud. In empirical research, some studies use accounting firm size (Big 4 versus Non-Big 4) to measure the effect of ineffective monitoring on fraudulent activities. The term ‘Big 4’ (previously, Big 8, Big 6 and then Big 5) refers to the four largest international accounting firms (Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers). Prior studies show that there is a relationship between audit quality and audit-firm size (Palmrose, 1988;
DeFond, 1992) and between non-Big 4 audit firms and fraud (Faber; 2005). The Big 4 tend to have higher audit quality which is indicated by low litigation activities and their ability to mitigate agency problems (Palmrose, 1988; Defond, 1992). Another finding is that firms in which fraud occurs are more likely to employ a non-Big 4 rather than a Big 4 auditor (Faber, 2005). Thus, there is a tendency that firms which commit fraud will hire non-Big 4 since they perceive that non-Big 4 has lower audit quality.

Opportunities for committing fraud can also be present when the structure of the organization is complex or unstable. It is often indicated by unclear organization structure, complex organizational structure, and high turnover of senior management, legal counsel, or boards of directors. Powerful CEO or insider board influence, for instance, always exists in fraud firms (Grove and Basilico, 2011). In a similar vein, Loebbecke et al., (1989) state that, in most fraud cases, operating and financial decisions were made and dominated by a single person. The absence of power-counterbalance may provide an opportunity to engage in fraud.

**Attitudes/Rationalizations**

The standards as shown in the Panel C supply fraud risk factors as an aid for auditors to assess rationalizations which may have been used by perpetrators, such as 1) ineffective communication, implementation, support, or enforcement of the entity’s ethical values, 2) known history of violations of laws, regulation, policy, etc., 3) low morale among senior management, and others (see Appendix). These factors are used by fraudsters to justify their actions to look legal or be accepted by others. For instance, if perpetrators know that a wrongdoer is not punished, then they can rationalize their fraud. This component is the most difficult factor for auditors to assess (IFAC, 2009), so in such cases, many studies do not attempt to find a relationship between fraud and its rationalization (Brazel et al., 2007; Skousen et al., 2008). Brazel et al. (2007) argue that it is challenging to know an individual's attitude or rationalize why fraudsters commit fraud by using public data. However, some of them still try to make a connection using relevant data. For instance, management
tends to switch its auditors in anticipation of some agency conflict – between the managers and the owners (DeFond, 1992). In regards to this change, Schewartz and Menon (1985) and Skousen et al. (2008) argue that unhealthy firms tend to change their auditors more often than do healthier ones and these failing firms are likely to switch to a different class of accounting firms. With these arguments, Chen and Elder (2007) show that firms with more frequent auditor changes are more likely to engage in financial statement fraud. The auditor switches may be an indication that a company has a problem, and therefore, auditors should be aware of this cue.

A nonfinancial management's excessive participation in the selection of accounting policies or determination of significant estimates can also contribute for perpetrators to justify their fraudulent activities. Vermeer (2003) and Skousen (2008) state that accruals are discretionary for management and it can provide various alternatives for management to rationalize its financial reporting in its favor. Modification or manipulation of these components could cause an increase or decrease of accruals. Thus, the excessive use of discretionary accruals may indicate the likelihood of financial statement fraud.

4 Discussion and Conclusion

As discussed above fraud is a challenging issue, and current auditing standards on fraud may be unlikely to help auditors in detecting fraud as shown by reports of ACFE from 2008 to 2016 which indicate that auditors' ability to detect fraud seems to diminish (ACFE, 2008, 2010, 2012, 2014, 2016). While institutional complexity faced by auditors may be impossible for the auditing profession to set back to auditors’ responsibility to detect fraud, the profession seems to do on its favour to avoid legal intervention enforcing new audit regulations or adverse court ruling claiming audit failures in fraud cases (Buckless and Peace, 1993; Holm et al., 2011). Moreover, revising auditing standards on auditor’s responsibility for detecting fraud by self-regulation body such as the auditing profession is viewed as a part of this effort to protect the profession (Holm et al., 2011). Notwithstanding this argument, the following section highlights three points concerning fraud risk factors (pressures,
opportunities, and rationalizations) as provided in auditing standards and also the responsibility of auditor for detecting fraud.

First, the auditing standards on fraud, in the UK, US, and more than 123 countries which adopt international standards on auditing, acknowledge that management and those charged with governance (especially boards of directors and audit committees) have a responsibility to prevent and detect fraud. However, several studies find that management and insider board members are individuals who are most likely to commit fraud (Cullinan and Sutton, 2002; ACFE, 2008, 2010). Top management and/or boards of directors committed fraud in the companies mentioned in the introduction. Thus, an independent party such as auditor is the most appropriate one to clarify and assess management’s assertions, since auditors have the knowledge and competencies.

Second, ACFE (2010) reveals that the likelihood of fraudulent financial statements increases every year, while the discovery of fraud by auditors tends to diminish. The findings show that even though the standards give extensive cues of risks to aid auditors in detecting fraud, they are unlikely to help auditors detect fraudulent activities. Shelton et al. (2001) and Srivastava et al. (2011) state that the standard only provides general guidance and the fraud risk assessment approach for each accounting firm is different. Also, they also claim that some studies on fraud risk assessment, which attempt to combine fraud risk factors from different sources – quantitative and qualitative information, are not grounded on a sound theoretical basis either for risk assessment or for combination itself. Even when the combination is justifiable, a problem still emerges, that is, how to combine multiple information sources in a quantifiable and measurable form (Srivastava et al. 2009).

Finally, the effectiveness of fraud risk assessment based on auditing standards is dependent on how to present and conduct the risk assessment. By studying the effect of several risk assessment approaches – standard risk checklists versus no checklists and standard audit programs versus no programs, Asare, and Wright (2004) find that auditors who use a no-checklists and no-programs approach tend to discover the fraud. They argue that the use of a standard checklist and a standard audit program impairs
auditor abilities to respond to fraud risk. Even though such tools may assist and direct auditors, especially junior staff, in detecting fraud, standardized aids can reduce auditor's sensitivity to fraud risks. Therefore, it needs a more strategic reasoning approach to generate fraud risk awareness (Asare and Wright, 2004). The profession has been advancing auditor's responsibility in detecting fraud through auditing standards, but they also recognize that the nature of fraud is more difficult to be detected than mere errors, and collusion on fraud makes fraud even more difficult to be discovered.

**References**

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## Appendix

### Fraud Risk Factors Excerpted from ISA 240 Relating to Fraudulent Financial Reporting

<table>
<thead>
<tr>
<th>Pressures</th>
<th>Opportunities</th>
<th>Rationalizations</th>
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<tr>
<td>1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions.</td>
<td>1. The nature of the industry or the entity’s operations provide opportunities to engage in fraudulent financial reporting that can arise from the following:</td>
<td>- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards that are not effective. Nonfinancial management’s excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management or those</td>
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<tr>
<td>- High degree of competition or market saturation, accompanied by declining margins.</td>
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<td>- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.</td>
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<td>- Significant declines in customer demand and increasing business failures in either the industry or overall economy.</td>
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<td>- Operating losses making the threat of</td>
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bankruptcy, foreclosure, or hostile takeover imminent.

- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.

- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.

- New accounting, statutory, or regulatory requirements.

2. **Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:**

- Profitability or trend level expectations of investment analysts, institutional

<p>| charged with governance alleging fraud or violations of laws and regulations. |
| - Excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend. |
| - The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts. |
| - Management failing to remedy known significant deficiencies in internal control over a timely basis. |
| - An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons. |
| - Low morale among senior management. |</p>
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<th>investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.</th>
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<tr>
<td>- Need to obtain additional debt or equity financing to stay competitive – including financing of major research and development or capital expenditures.</td>
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<tr>
<td>- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.</td>
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<td>- Perceived or real adverse effects of reporting poor financial results on</td>
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| - Use of business intermediaries for which there appears to be no clear business justification. |
| - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification. |

2. **The monitoring of management is not effective as a result of the following:**

| - Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls. |
| - Oversight by those charged with governance over the financial reporting the process and internal control is not |

| - The owner-manager makes no distinction between personal and business transactions. |
| - Dispute between shareholders in a closely held entity. |
| - Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality. |
| - The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters. Unreasonable demands on the auditor, such as unrealistic |
significant pending transactions, such as business combinations or contract awards.

3. Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:
   - Significant financial interests in the entity.
   - Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon

   effective.

3. There is a complex or unstable organizational structure, as evidenced by the following:
   - Difficulty in determining the organization or individuals that have controlling interest in the entity.
   - Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
   - High turnover of senior management, legal counsel, or those charged with governance.

4. Internal control components are deficient as a result of the following:

   time constraints regarding the completion of the audit or the issuance of the auditor’s report. Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work or the selection or continuance of personnel assigned to or consulted on the audit engagement.
<table>
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<th>achieving aggressive targets for stock price, operating results, financial position, or cash flow.</th>
<th>- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)</th>
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<td>- Personal guarantees of debts of the entity.</td>
<td>- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective</td>
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4. **There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.**