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# What added value can the fraud auditor provide when investigating business fraud?

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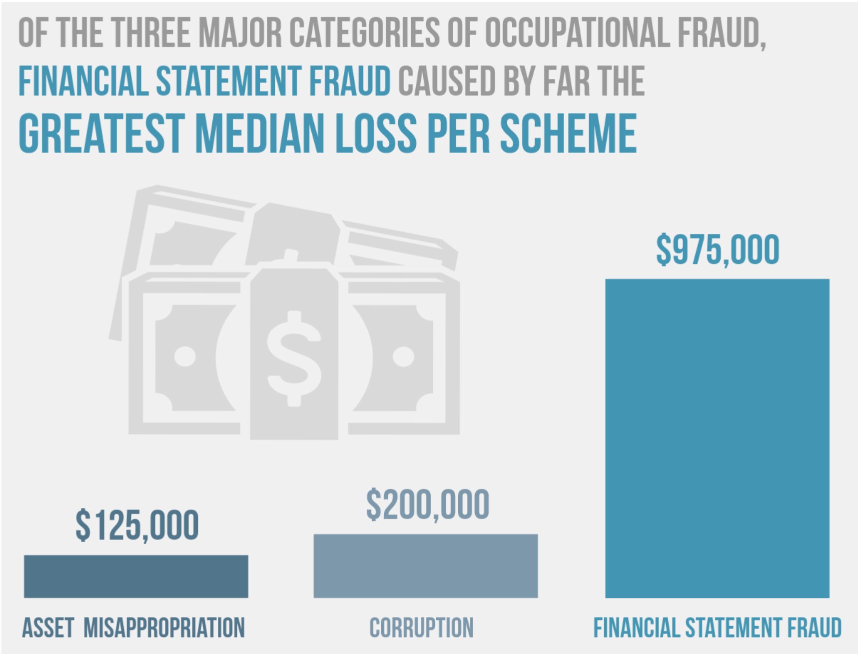
# Fraud: definition & cost

- Fraud = The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets (IFAC)

- ACFEs estimate the typical organization loses 5% of annual revenues to fraud





Source: ACFE's 2016 Global Fraud Study

# Auditing & forensic accounting

- Auditing = "A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users" (AICPA)

- Forensic accounting = "The application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence" (Bologna & Linquist 1995)

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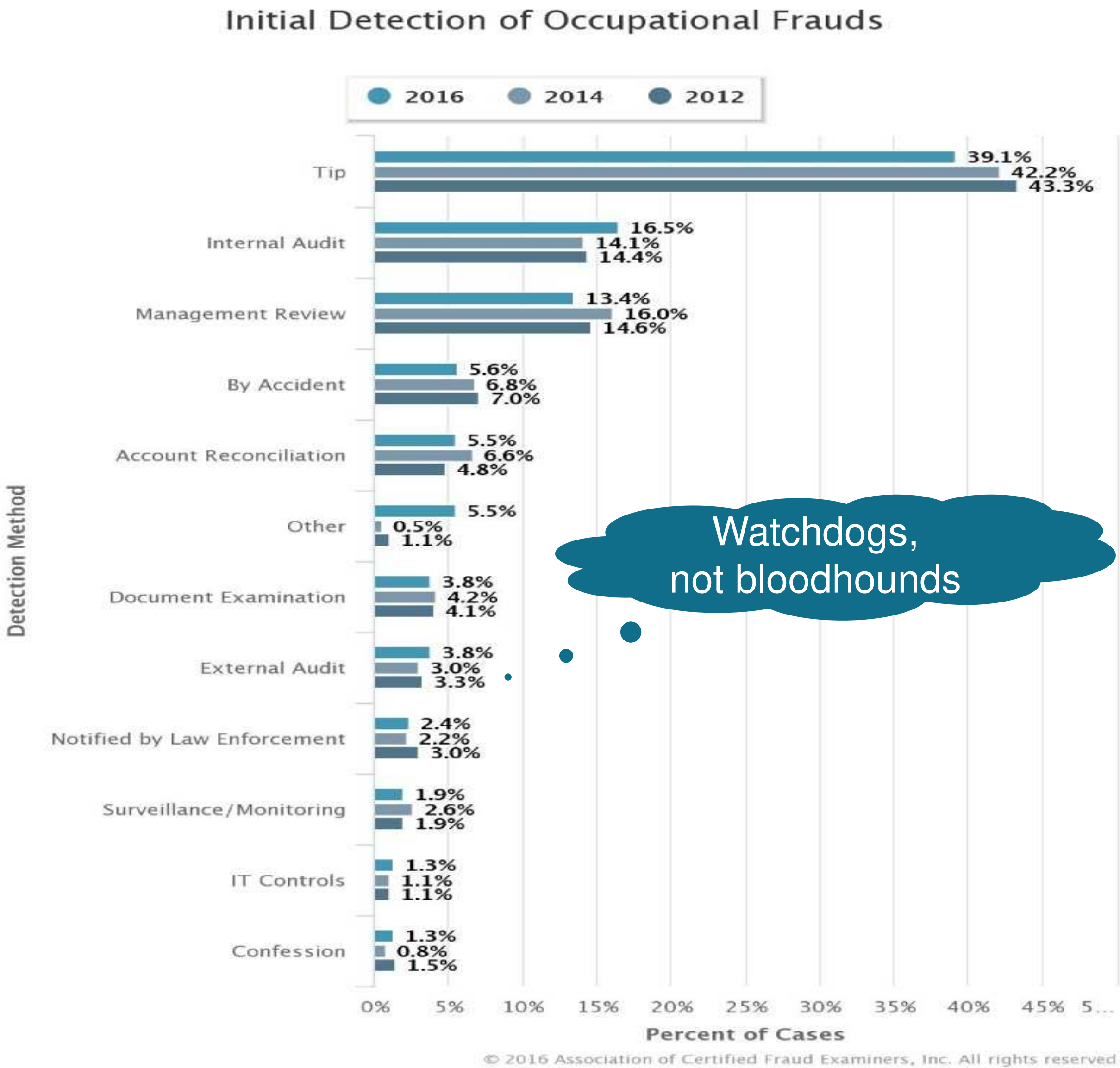
# Auditing & forensic accounting

| Issue | Auditing | Fraud examinaion |
|---|---|---|
| Timing | Audits are conducted on a regular, reoccurring basis | Fraud examinations are conducted with sufficient prediction, and are nonrecurring |
| Scope | The scope of an audit is conducted for the purpose of expressing an opinion on the financial statements | Fraud examinations are conducted to resolve specific allegations |
| Objective | An audit is conducted for the purpose of expressing an opinion | The fraud examination is conducted to determine whether fraud has occurred, or is occurring, and to determine who is responsible |
| Relationship | The audit is nonadversarial in general | Because the purpose is to affix blame, fraud examinations are adversarial in nature |
| Methodology | Audits are conducted by examining financial data and obtaining corroborating evidence | Fraud examinations are conducted by document examination, review of outside data, and interviews |
| Presumption | Auditors are required to approach audits with professional skepticism | Fraud examiners approach examination by attempting to establish sufficient proof to support or refute fraud allegation |

Source: Fraud Examiners Manuel (ACFE 2003)

# Auditing & forensic accounting




Watchdogs,
not bloodhounds

# Fraud detection: evolution of responsibilities of auditor

- 1900s: The Lawrence Dicksee textbook on Auditing provided a clear perspective of the objective of what an audit was: “The detection of fraud is the most important portion of the Auditor’ duties”

- 1938-39 McKesson and Robins scandal & AICPA issued SAP No. 1: Extension of Auditing Procedure
  - Shift auditors’ focus away from fraud detection
  - Focus on fairness of financial statements

- 1960 AICPA issued SAP No. 30: Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements
  - Auditors should ‘be aware’ of the possibility that fraud may exist
  - But little or no obligation to detect fraud

- 1973 Equity Funding Corporation scandal
  - AICPA founded Cohen commission: “it is challenging for auditors to detect frauds that are concealed”
  - SAS No. 16: The Independent Auditor’s Responsibility for the Detection of Errors or Irregularities: a list of red flags to detect fraud

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# Fraud detection: evolution of responsibilities of auditor

- 1980s: Huge competition among audit firms
  - Decrease in time and resources for fraud detection
  - Scandals → Treadway Commission: “auditors insufficiently recognize the red flags”
  - In 1988: SASs 53– 61 on external auditors’ role on fraud prevention and detection: “Professional skepticism” to assume management is neither honest nor dishonest (PCAOB, 1993)

- 1990s: Despite these efforts no decrease in audit failures to detect fraud
  - 1997: SAS No. 82: Consideration of Fraud in a Financial Statement Audit
    - Two distinct fraud categories: intentional falsification of financial statements and theft of assets
    - List of risk factors that need to be assessed
    - But no increased responsibility for detecting fraud

- 2000s
  - Enron scandal → SAS 99 + SOX (section 404) + PCAOB
  - In 2009 - ISA 240: The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements: management is responsible for detecting fraud; auditors are not

  - SO still ambiguity: where does the auditor’s responsibility end?

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# Fraud detection: evolution of responsibilities of auditor

- AICPA, PCAOB and IFAC:
  - Provide auditors standards to follow in identifying fraudulent or illegal acts
  - Do not place the auditor in the aggressive investigative position
  - → **No “first responder” role to financial frauds**
  - → **But “true” professional skepticism requires more training**

- <-> Section 10A of the US Private Securities Litigation Reform Act of 1995:
  - Requires auditors:
    - To determine whether it is likely that an illegal act has occurred;
    - If so, determine the effect of the illegal act on the financial statements;
    - Inform the appropriate level of management making certain the audit committee or the board of directors is informed
  - → **“First responder” role**
  - → **Needs more forensic accounting skills (and/or hire forensic auditors)**

**→ Expectation gap**

# Integration of forensic accounting skills into audit process? (Digabriele, 2011)

**1.** *(Question One)*
*"The current regulatory environment, The Sarbanes Oxley Act of 2002 (SOX), Statement on Auditing Standards No. 99 (SAS 99), The Public Company Accounting Oversight Board (PCAOB) and the augmented responsibility for detecting management or employee fraud has increased the need for auditors to possess foundational forensic accounting skills."*

**2.** *(Question Two)*
*"SAS 99 also calls for auditors to exercise "professional skepticism" defined as being mindful of fraud; additionally, there has been a call for more forensic accounting education for accountants (per AICPA Discussion Memorandum on Forensic Services, 2004). The forensic accounting mindset represents an incremental shift in job skill requirements of the accounting profession."*

**3.** *(Question Three)*
*"If the future demand for audits will depend on the auditor's ability to detect & deter fraud, forensic auditing procedures (focusing on exceptions, oddities, accounting irregularities and patterns of conduct) should be added to current audit programs (sampling for material misstatements and focusing on errors, omissions,) in a cost efficient manner."*

**4.** *(Question Four)*
*"Auditing firms that use forensic audit techniques in their audits of financial statements send market signals that would have a positive valuation impact on audit clients."*

**5.** *(Question Five)*
*"The addition of foundational forensic auditing procedures in the auditing process helps to fulfill the expectation gap of third party investors/creditors/stakeholders?"*

# Integration of forensic accounting skills into audit process? (Digabriele, 2011)

Carpenter 2007: brainstorming audit teams generate more quality fraud ideas than individual auditors generate

**6.** *(Question Six)*
*"Prior research has indicated that auditors have had difficulty identifying fraud; SAS 99 has required brainstorming as a tool in the potential discovery of fraud. Brainstorming addresses the difficulty sufficiently"*

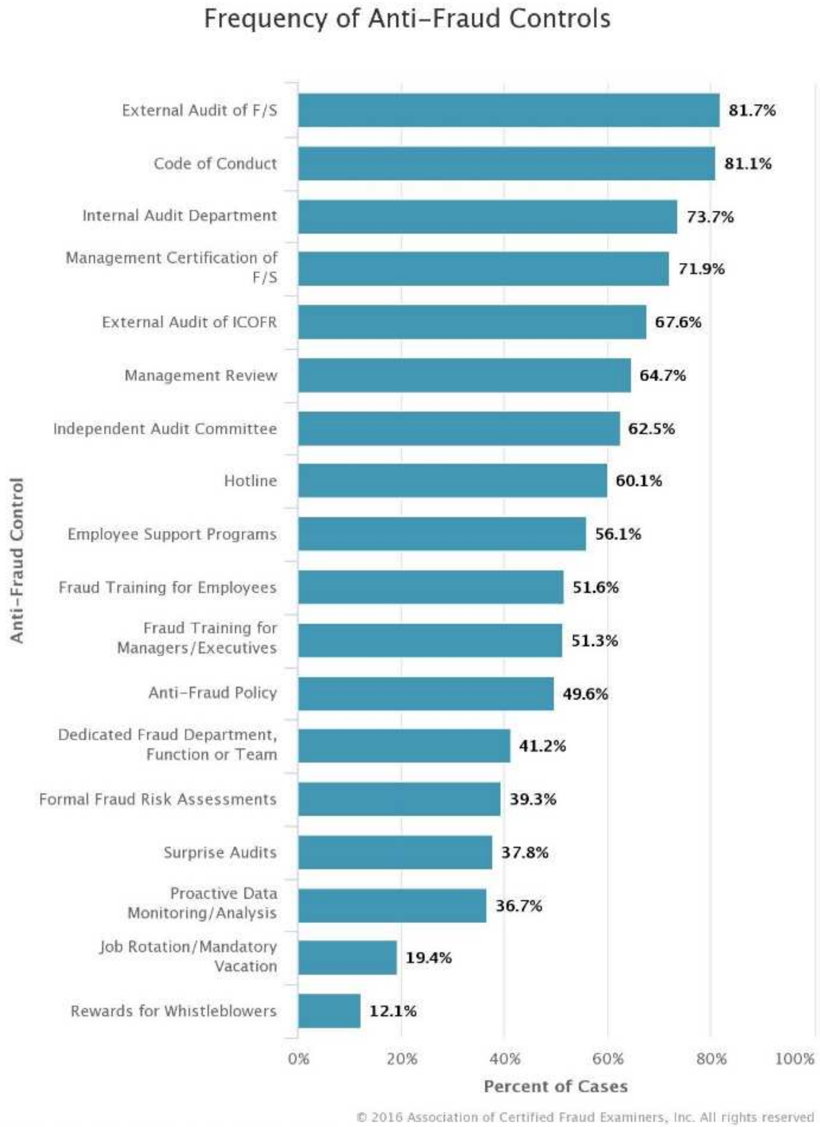
**7.** *(Question Seven)*
*"SAS 99 increases the emphasis on inquiry as an audit procedure that raises the likelihood of fraud detection; in addition, SAS 99 stresses the consideration of "other" information (a requisite level of client scrutiny) during the information-gathering phase."*

**8.** *(Question Eight)*
*"SAS 99 is a noteworthy start toward a framework for detecting fraud in financial statements. The addition of standards for forensic services in audits would be a more complete step in the detection of fraud in financial statements."*

**9.** *(Question Nine)*
*"The increased regulatory environment, SAS 99, Sarbox, PCAOB, has pushed toward a convergence of the financial auditing philosophy and the forensic accounting philosophy."*

# More than fraud detection

# Fraud prevention




External Audit of F/S = Independent external audits of the organization's financial statements
External Audit of ICOFR = Independent audits of the organization's internal controls over financial reporting
Management Certification of F/S = Management certification of the organization's financial statements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# Fraud response

- Fraud Response Management program allows to react to various types of fraud and misconduct allegations in a measured and consistent manner
- Goal: protect the organization from the economic, reputational and legal risks associated with the fraud allegation
- 2008 Guide by the Institute of Internal Auditors ("IIA"), the American Institute of Certified Public Accountants ("AICPA") and the Association of Certified Fraud Examiners ("ACFE") to help create a strong fraud risk management program: "Managing the Business Risk of Fraud: A Practical Guide"

Fraud Response Management:
Is your organization prepared to execute an efficient and effective response?

# Fraud response

- Managing the Business Risk of Fraud: A Practical Guide:

**Principle 1:** As part of an organization's governance structure, a fraud risk management program[6] should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

**Principle 2:** Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

**Principle 3:** Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

**Principle 4:** Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

**Principle 5:** A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

# How to extract the added value of the fraud auditor?

- Potential solutions:
  - External auditor “hires” forensic auditor
  - Regulation
    - Subject all public companies to a forensic audit on a regular basis
    - Subject all public companies to a forensic audit on a random basis
    - Let shareholders decide on the intensity of the forensic audit
    - Let the audit committee decide on the level of the forensic audit
  - Shareholders’ pressure
  - “Brave” CEO’s may experiment, after which the new model may spread

- Necessary conditions:
  - Legal recognition and legal framework
  - Adequate education/training
  - Internal disciplinary procedures
  - Chinese walls: one-to-one
  - Reporting obligation: separate cell

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