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Auditors' Responsibility for Fraud Detection: New Wine in Old Bottles?

Lawrence Chui
Byron Pike*

Fraud is costly. According to the Association of Certified Fraud Examinations (ACFE), an estimated \$3.5 trillion worldwide were lost due to fraudulent financial statements, asset misappropriation, and corruption in 2011 (ACFE, 2012). In the U.S. alone, the ACFE projected an annual revenue loss of \$994 billion due to fraud. These staggering losses represent approximately 7% of the U.S. Gross Domestic Product (ACFE, 2008; ACFE, 2009). Based on the U.S. fiscal year 2011 budget, losses resulting from fraud exceeded the net costs of the department of defense, homeland security, transportation, and education combined for fiscal year 2008. Fraud is not only costly, but it also damages the reputation and the credibility of the audit profession. The loss of public trust seems justified when audited financial statements turn out to be unreliable and must be restated due to fraud. As a result, the investing public is elevating its expectations for auditors to detect fraud (Eillot and Jacobson, 1987; Hooks, 1991; Nicolaisen, D. T., 2005; Silverstone and Davia, 2005; Hogan et al., 2008).

Accounting researchers, practitioners, and standard setters alike expressed concern for auditors' apparent failures in detecting fraud during an audit. Joseph T. Wells, founder of the ACFE, criticized auditors for their lack of training and readiness in fraud detection. He contends that "[a]s a group, CPAs are neither stupid nor crooked. But the majority are still ignorant about fraud...for the last 80 years, untrained accounting graduates have been drafted to wage war against sophisticated liars and thieves" (Wells, 2005b). Jamal (2008) agrees with Wells'

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sentiment by arguing fraud detection has become the audit profession's Achilles heel. Even convicted felons agree that auditors lack the ability to detect fraud. For instance, Sam Antar, from the infamous Crazy Eddie case, made some insidious remarks on his website (<http://www.whitecollarfraud.com>) about how easily he was able to deceive the auditors. He remarked that as a general practice, "most large accounting firms use relatively inexperienced kids right out of college to do basic audit leg work. They are supervised by slightly more experienced senior auditors who unfortunately depend on feedback from these inexperienced kids in making informed decision." Antar further explained how he was able to corrode the auditors' professional skepticism as the auditors "did not want to believe we were crooks. They believed whatever we told them without verifying the truth."

In an effort to restore public trust in the audit profession, accounting standard setters have increased the steps auditors are expected to take in order to detect fraud. As a result of the Enron and WorldCom debacles, auditors are currently required to adhere to the requirements of Statement on Auditing Standards (SAS) No. 99. Under the guidance of this standard, auditors are required to participate in brainstorming sessions and consider the possibility that a material misstatement due to fraud could be present (AICPA, 2002). Standard setters expected SAS No. 99 to increase auditors' awareness of the prevalence of fraud during their audit engagements. Despite the standard setters' intentions to improve auditors' abilities to detect fraud, the Public Accounting Oversight Board (PCAOB) inspection team observed numerous instances where auditors failed to appropriately implement SAS No. 99 (PCAOB, 2007). In addition to SAS No. 99, the American Institute of Certified Public Accountants (AICPA) released a series of audit risk standards (SAS Nos. 104 – 111) to help provide auditors guidance in regard to the risk assessment process. Similarly, the PCAOB in August 2010 adopted a suite of eight auditing

standards (AS Nos. 8 – 15) to enhance the effectiveness of auditors' risk assessments. Daniel L.

Goelzer, PCAOB Acting Chairman, stated these standards are designed to promote sophisticated risk assessments in audits and to minimize the risk that auditors fail to detect material misstatements (PCAOB, 2010).

Though the PCAOB inspection report proves to be disappointing, its findings are not all that surprising. For years, the ACFE reported only a small percentage of fraud cases were uncovered by external audit. Hence, external audit may not be the most effective way to detect or limit fraud (ACFE 2012; ACFE, 2010; ACFE, 2008; ACFE, 2006; ACFE, 2004; ACFE, 2002). Financial statement auditors are not fraud examiners. They are trained to determine whether the company's financial statements are presented fairly, in all material respects, in accordance with Generally Accepted Accounting Principles (GAAP). Fraud detection, unlike a financial statement audit, requires a unique skill set and forensic techniques developed for the sole purpose of detecting the evidence of fraud (Davia, 2000). Specifically, the skill set and techniques include applying investigative and analytical skills related to the areas of accounting records, gathering and evaluating financial statement evidence, interviewing all parties related to an alleged fraud situation, and serving as an expert witness in a fraud case (Hopwood et al., 2008; Rosen, 2006; Singleton et al., 2006). Therefore, merely requiring auditors to be aware of the possibility of fraud in a financial statement audit is not enough to detect fraud.

We observe a trend that standard setters often resort to issuing additional auditing standards as a response to restore public trust after widely publicized frauds. However, time and again, auditors appear to fail in fraud detection as the response of additional standards is primarily symbolic in nature. We contend the failure in fraud detection is attributable to the differences in skill sets and task objectives between financial statement auditing and fraud

auditing. Although standard setters have gradually realized the need to involve forensic specialists in a financial statement audit after a fraud risk factor has been identified, auditors have not made much progress in fraud detection.

We propose it is necessary to integrate forensic specialists into all audit engagements to reduce the risk of fraud. In addition, we believe it is of paramount importance to train financial statement auditors in the area of forensic accounting and fraud auditing. Without proper and adequate forensic training, expecting financial statement auditors to detect fraud is similar to pouring new wine into old bottles. In order to better protect the public from fraud and to maintain the credibility of the audit profession, it is necessary for accounting researchers to explore new ways of improving auditors' abilities to detect and limit fraud.

Our contribution to the literature consists of providing a synopsis of auditors' responsibility for fraud detection and the standard setting progression. More importantly, we provide a critical assessment of the profession's reaction to fraud and identify the deficiencies in auditors' approaches for detecting fraud that still exists today. Through doing so, we utilize an expert panel to demonstrate the demarcation between auditors and forensic specialists. Finally, we make the contribution of proposing an audit model that could potentially overcome the identified deficiencies.

In the next section, we provide a brief overview of the changes in auditors' responsibility for fraud detection over the years. We then highlight the differences between financial statement auditors and forensic specialists. Finally, we conclude by identifying future actions and research opportunities that can be used to improve auditors' abilities to detect fraud.

AUDITORS' RESPONSIBILITY FOR DETECTING FRAUD

Shift in Audit Focus on Fraud Detection

Auditors' responsibility for fraud detection has changed dramatically over the years. Fraud detection was once the chief audit objective dating back to 1500 and beyond (Brown, 1962; Albrecht et al., 2001). Early British auditing objectives, which centered on the discovery of defalcations, formed the basis of American auditing during its formative years when auditors were taught that the primary objectives of an audit were to detect and prevent fraud and error (Dicksee, 1909; Montgomery, 1921; Brown, 1962). The ability of auditors to detect fraud was considered a virtue of the profession:

“The detection of fraud is a most important portion of the auditor's duties, and there will be no disputing the contention that the auditor who is able to detect fraud is – other things being equal – a better man than the auditor who cannot. Auditors should, therefore, assiduously cultivate this branch of their functions – doubtless the opportunity will not for long be wanting – as it is undoubtedly a branch that their clients will most generally appreciate.” (Dicksee, 1909, p. 23)

The emphasis on fraud detection gradually dissipated during the period from 1933 to 1940 (Brown, 1962; Albrecht et al., 2001). Long before the Enron debacle, the audit profession was confronted with the infamous McKesson and Robbins scandal in late 1938.¹ The McKesson and Robbins scandal was “like a torrent of cold water” that “shocked the accountancy profession into breathlessness” (Carey, 1939, p. 65). The Securities and Exchange Commission (SEC) opened an investigation into McKesson and Robbins shortly after the massive fraud was uncovered. McKesson and Robbins' auditor, Price Waterhouse & Co, was under intense scrutiny for its inability to detect and prevent the massive accounting fraud. In the aftermath of the McKesson and Robbins scandal, auditors were required to perform additional audit procedures

¹ McKesson and Robbins was a wholesale drug company acquired by F. Donald Coster in 1926. Coster and his brothers ran an elaborate accounting scheme to inflate the company's reported assets for more than a decade. By 1937, this translated into over \$18 million of fictitious sales and \$19 million worth of non-existent assets.

on accounts receivable and inventories (Baxter, 1999). To limit potential liability exposure for auditors, the audit profession came to the consensus that “auditor(s) could not, and should not, be primarily concerned with the detection of fraud” (Brown, 1962, p. 700).

The change in the audit profession’s focus on fraud detection was reflected in the Statement of Auditing Procedures (SAP) No. 1, *Extension of Auditing Procedure*:

“The ordinary examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant is not designed to discover all defalcations, because that is not its primary objective, although discovery of defalcation frequently results...To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises – a cost which would pass all bounds of reasonable expectation of benefit or safeguard there from, and place an undue burden on industry.” (AICPA, 1939)

SAP No. 1 effectively shifted auditors’ foci away from fraud detection during an audit. Auditors were instead concerned with determining the fairness of their clients’ reported financial statements in accordance with the accounting standards (Brown, 1962). Subsequent to the issuance of SAP No. 1, the audit profession came under mounting pressure from the public and the SEC to clarify auditors’ responsibility with respect to fraud detection (Brown, 1962; Albrecht et al., 2001). As a result, the American Institute of Certified Public Accountants (AICPA) issued SAP No. 30, *Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements* in 1960. Although SAP No. 30 acknowledged that auditors should be aware of the possibility fraud may exist during an audit, it was so negatively stated that auditors felt little or no obligation to detect fraud (Scott and Frye, 1997; Albrecht and Willingham, 1993).

The Cohen and the Treadway Commissions

The Equity Funding scandal was the next major fraud case that ultimately prompted congressional inquiry about auditors' failures in fraud detection (Treadway, 1987).² In response to the Congressional inquiry, the AICPA formed the commission on auditor's responsibility, commonly known as the Cohen Commission, to re-examine auditors' responsibility to detect fraud (Treadway, 1987; Albrecht and Willingham, 1993; Scott and Frye, 1997).³ The Commission acknowledged that while auditors should be actively considering the potential for fraud, the inherent limitation in the audit process dampened auditors' responsibility for detecting all material frauds. Specifically, the commission recognized it is difficult for auditors to detect frauds that are concealed and derived from forgery or collusion by members of management. Statement on Auditing Standards (SAS) No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, was issued as a result of the Cohen Commission. SAS No. 16 implicitly acknowledged that auditors have a responsibility to search for frauds that may have a material effect on a company's reported financial statements. It also contained a list of red flags auditors should consider when searching for financial statement fraud (Albrecht et al., 2001). However, the language of SAS No. 16 was viewed as ambiguous as it did not provide adequate guidance for auditors to search for fraud during an audit (Treadway, 1987; Madison and Ross, 1990).

Changes in Federal regulations during the 1970s also dampened auditors' senses of obligation to detect fraud. As the Department of Justice and the Federal Trade Commission

² The Equity Funding scandal involved the booking of fictitious receivables and income to inflate earnings per share in order to beat earnings expectations. Equity Funding sold insurance to fictitious customers by selling phony policies. Although there were sufficient red flags to cause auditors to be more skeptical, they missed the ongoing fraud. Equity Funding's auditors missed 64,000 phony transactions with a face value of \$2 billion, \$25 million in counterfeit bonds, and \$100 million in missing assets (Hancox, 1997).

³ The commission was led by former SEC chairman, Manuel F. Cohen.

(FTC) pressured professional organizations to “eliminate elements of their codes of professional behavior that the government deemed to violate federal anti-trust statutes,” the FTC wanted the AICPA to allow audit firms to engage in unrestricted advertising (Kinney, 2005, p. 91). Under unrelenting pressure, the AICPA lifted its ban on “competitive bidding, the prohibition on advertising, and the ban on contingent fees and commissions for nonattest clients” from the professional code of conduct (Windsor and Warming-Rasmussen, 2007, p. 3). As a result of the removal of the AICPA’s ban on competitive bidding for audit services, the profits margins of auditing narrowed significantly among the big audit firms. Stephen A. Zeff claimed he recalled hearing a senior practitioner state “the worst thing a Big Eight partner can possibly do these days is to lose a client over a matter of principle” (Zeff, 1987, p. 67). The FTC’s mandate to increase competition in the audit profession not only fundamentally changed the relationship between auditors and their clients, but it also increased cost pressure and subsequently affected audit quality in the years to come (Kinney, 2005). Toby Bishop, former president of the ACFE, contended competitive bidding placed tremendous pressure on audit firms to limit hours in an audit engagement. He argued that such action inadvertently discouraged auditors to look for fraud during an audit (as cited in Weil, 2004).

By the mid-1980s, it was obvious that SAS No. 16 was insufficient and auditors’ unwillingness to accept increased responsibility to detect fraud was increasing the expectation gap (Albrecht and Willingham, 1993).⁴ The public expects auditors to detect all financial statements fraud; however, auditors’ failures in fraud detection continue to widen the expectation gap. This widening comes as a result of several publicized business failures, characterized by some as audit failures (Scott and Frye, 1997). One in particular, the savings and loan crisis

⁴ The expectation gap is the difference between auditors’ performances and public expectations of their responsibility.

during the mid-1980s, created a new wave of public concern and Congressional inquiry which eventually led to the formation of the Treadway Commission (Glover and Aono, 1995). The goal of the Treadway Commission was to “identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence” (Treadway, 1987, p. 1). One of the main purposes of the Treadway Commission was to:

“Examine the role of the independent public accountant in detecting fraud, focusing particularly on whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced, and consider whether changes in auditing standards or procedures – internal and external – would reduce the extent of fraudulent financial reporting.” (Treadway, 1987, p. 2)

The Treadway Commission further asserted “the ability of the independent public accountant to detect fraudulent financial reporting is related directly to the quality of the audit” (Treadway, 1987, p. 54). Nevertheless, the commission cautioned that although it is important to increase auditors’ awareness of financial statements fraud, the investing public ought not to expect that fraudulent financial reporting will be completely eradicated (Treadway, 1987).

Based on the commission’s review of fraudulent financial reporting cases, at least 36 percent of the cases involved auditors’ failure to recognize, or to pursue with sufficient skepticism, certain fraud-related warning signs or red flags that existed at the time the audit was conducted. The commission believed if auditors had been more diligent in investigating these red flags, the fraudulent activity would have had a greater likelihood of being uncovered (Treadway, 1987). In 1988, the Accounting Standards Board (ASB) issued nine statements of auditing standards (SASs) based on the Treadway Commission’s report. These standards (Nos. 53 to 61) were designed to clearly outline the external auditor’s role concerning fraud and enhance the overall audit procedures for detecting and preventing fraud (Glover and Aono, 1995). Two of these pronouncements, SAS No. 53 and No. 54, dealt specifically with congressional concerns

about the detection of financial fraud and the potential illegal activities of audit clients (Madison and Ross, 1990). Unlike prior standards, auditors were required to apply professional skepticism to assume management is neither honest nor dishonest (Albrecht and Willingham, 1993).

However, in the early 1990s the Public Oversight Board (POB) recognized these new SASs had little impact on the way audits were conducted, as they did not help to reduce liability lawsuits against auditors. The POB also found that auditors neither consistently complied with these standards nor applied the proper degree of professional skepticism required to detect fraud (POB, 1993). There was a widespread public belief that while auditors have a responsibility to detect fraud, they were neither willing nor capable of doing so. Mounting criticisms on the audit profession over its failure to detect fraud prompted the POB to propose a number of recommendations to improve auditors' willingness to detect fraud. The POB asserted auditors must accept responsibility for fraud detection. Nevertheless, the POB emphasized "the profession cannot, and it cannot be expected to, develop methods that will assure that every fraud, no matter how cleverly contrived, will be unearthed in the course of the audit, but it must develop means of increasing significantly the likelihood of detecting fraud" (POB, 1993, p. 41).

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA) to discourage abusive lawsuits due to fraudulent financial reporting. Among its provisions, the PSLRA codified auditors' existing responsibilities to search for and disclose fraud (Andrews and Simonetti, 1996). Nevertheless, researchers argued the PSLRA alone was not sufficient to curb financial statements fraud as any litigation reform acts need to work in unison with other mechanisms to help detect and prevent fraud (Dyck et al., 2010).

Increased Fraud Detection Responsibility and SAS No. 99

The AICPA supported the POB's recommendations and concluded it was crucial to develop an auditing standard focused solely on financial statement fraud (Mancino, 1997). The AICPA formed a fraud task force and subsequently issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, in February 1997. For the first time, fraud was included in the title of an auditing standard. SAS No. 82 classified fraud into two distinct categories: *intentional falsification of financial statements* and *theft of assets*. It provided auditors with a list of risk factors covering instances of fraudulent financial reporting and misappropriation of assets that they should assess during an audit. Under SAS No. 82, auditors must document their assessment of fraud risk and their modifications to the audit plan if and when conditions of potential fraud appear during the audit. SAS No. 82 was the AICPA's attempt to clarify auditors' role in fraud detection. The intention of the standard was to provide assurance to the public that when external auditors signed their names to an opinion finding a company's financial statements free of material misstatements, they have taken extensive steps to ensure they did not overlook any underlying fraud (Demery, 1997). Nevertheless, SAS No. 82 did not increase auditors' responsibility to detect fraud beyond the key concepts of materiality and reasonable assurance (Mancino, 1997).

In addition to the issuance of SAS No. 82, the POB appointed a panel to conduct a comprehensive review of audit effectiveness at the request of the SEC. In 2000, the panel issued its report and recommended auditors perform forensic-type procedures on every audit to enhance the likelihood of detecting material financial statement fraud.⁵ The panel further recommended audit firms use forensic specialists to provide auditors with fraud-related training (POB, 2000).

⁵ According to the panel, these forensic procedures range from conducting surprise inventory or cash counts to performing substantive tests directed at the possibility of fraud (POB, 2000).

However, none of these efforts appeared to be adopted by firms and did not prevent the waves of fraud and earnings restatements that rocked the nation at the turn of the 21st century. Restating firms lost over \$100 billion in market capitalization between 1997 and 2002 (Coffee, 2003). The public was outraged about the fall of Enron, the seventh largest company in the U.S. at the time of its demise. Thousands of Enron employees lost their life's savings when their pension plans were depleted as a result of Enron filing for bankruptcy (Klass, 2004). The audit profession came under heavy criticism for failing to carry out its fiduciary duty as gatekeepers who protect the public's interest. In an attempt to restore public confidence, Congress passed the Sarbanes-Oxley Act (SOX) and created the Public Accounting Oversight Board (PCAOB). Standard setters expected SOX, which is considered the strongest regulation passed since the 1930s, to help auditors prevent and limit corporate fraud (Klass, 2004).

In 2002, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, was issued to replace SAS No. 82 and provide auditors with better guidance on how to enhance their abilities to detect fraud during a financial statement audit. The purpose of the standard is to help auditors take a proactive approach to prevent and detect fraud by increasing their knowledge of their clients, which should result in more meaningful risk assessment procedures (Marczewski and Akers, 2005; Kiel, 2008). SAS No. 99 calls for auditors to maintain a questioning mind regarding the potential for material misstatements due to fraud throughout the audit. They are expected to exercise professional skepticism in gathering and evaluating audit evidence and to set aside prior beliefs that management is honest and has integrity. More specifically, it requires auditors to engage in brainstorming sessions to discuss the risks of material misstatements due to fraud (AICPA, 2002). Additionally, SAS No. 99 recommends audit firms use forensic specialists to provide auditors with forensic audit training. While the intent of SAS No. 99 is to improve

auditors' performances related to fraud detection, auditors did not anticipate it would

substantially affect audit effectiveness (Marczewski and Akers, 2005; Gogin and Johnson, 2008).

The above discussion demonstrates that auditors' responsibility for fraud detection has changed significantly over time. Table 1 presents a timeline of major scandals and subsequent audit changes that impacted the relationship between auditors and fraud detection.

TABLE 1. Timeline of Major Scandals and Subsequent Audit Changes

Major Scandal – 1930s	<ul style="list-style-type: none"> • The McKesson and Robbins scandal
Subsequent Audit Changes – 1930s to 1960s	<ul style="list-style-type: none"> • The issuance of the Statement of Auditing Procedures (SAP) No. 1, <i>Extension of Auditing Procedure</i> • The issuance of the Statement of Auditing Procedures (SAP) No. 30, <i>Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements</i>
Major Scandal – 1970s	<ul style="list-style-type: none"> • The Equity Funding scandal
Subsequent Audit Changes – 1970s to 1990s	<ul style="list-style-type: none"> • The formation of the Cohen Commission to investigate the expectation gap and auditors' responsibility in detecting fraud during an audit • The issuance of the Cohen Commission's report • The issuance of the Statement on Auditing Standards (SAS) No. 16, <i>The Independent Auditor's Responsibility for the Detection of Errors or Irregularities</i> • The formation of the Treadway Commission to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence • The issuance of the Statement on Auditing Standards (SAS) No. 53, <i>The Auditor's Responsibility to Detect Errors and Irregularities</i> • The issuance of the Private Securities Litigation Reform Act • The issuance of the Statement on Auditing Standards (SAS) No. 82, <i>Consideration of Fraud in a Financial Statement Audit</i> • The formation of a Public Oversight Board panel to conduct a comprehensive review of the effectiveness of the auditing
Major Scandal – 2000s	<ul style="list-style-type: none"> • The Enron scandal
Subsequent Audit Changes – 2000s to present	<ul style="list-style-type: none"> • The passage of the Sarbanes-Oxley Act • The formation of the Public Accounting Oversight Board • The issuance of the Statement on Auditing Standards (SAS) No. 99, <i>Consideration of Fraud in a Financial Statement Audit</i> • AICPA released series of risk suite – SAS No. 104 – 111 • PCAOB adapted eight risk auditing standards – AS Nos. 8 – 15

Whether or not auditors should be responsible for fraud detection remains both as a philosophical and a policy issue that is beyond the scope of this study. Nevertheless, the relationship between auditors and fraud detection has changed dramatically since the inception of the American audit profession. By the late 1930s, the audit profession “refused to accept primary responsibility” for detecting fraud in a financial statement audit (Costello, 1991, p. 267). In fact, as additional fraud standards were issued, auditors failed to wholeheartedly embrace the additional responsibility and procedures to actively search for and detect fraud. It appears auditors have maintained the attitude that they should not be responsible for and are not the best equipped to provide assurance regarding the presence of fraud. However, as the audit profession has been plagued by numerous corporate frauds, it is forced to find ways to improve auditors’ considerations of fraud during a financial statements audit. While there are no auditing standards that can provide absolute assurance in detecting all fraud, the audit profession has demonstrated a commitment to improve auditors’ abilities in fraud detection through the issuance of various fraud-related standards over the years. Nevertheless, the question remains whether or not the progression of fraud-related auditing standards has better equipped auditors for fraud detection and increased their propensity in detecting fraud, which would ultimately provide greater assurance to the users of financial statements.

AUDITORS ARE NOT FRAUD DETECTORS

Recent research has shown forensic specialists outperform financial statement auditors in fraud-related tasks (Rose et al., 2009; Bortiz et al., 2008). Although auditors appear to exhibit a lack of sensitivity in discerning the telltale signs of fraud, they are in no way inferior to forensic specialists in terms of their education, training, experience, and professionalism. In actuality, there are many commonalities between financial statement auditors and forensic specialists. Both

are required to maintain a high degree of independence and objectivity; to be innovative; to

avoid having any preconceptions and biases when evaluating evidence; to have in-depth

knowledge of GAAP as well as general business practices and processes (Bologna, 1984).

Although financial statement auditors and forensic specialists share similar characteristics, the primary difference that separates them is their mission. Auditors' primary objective is to examine whether the company's reported financial statements, taken as a whole, are stated fairly in all material respects in conformity with GAAP. Their goal is to provide reasonable assurance that these statements are free from material misstatements (AU Section 110). Alternatively, forensic specialists' primary objective is to make an absolute determination about the existence and source of fraud by gathering and evaluating evidence and interviewing all parties related to an alleged fraud situation (Davia, 2000; Silverstone and Davia, 2005; Rosen, 2006; Singleton et al., 2006; Singleton and Singleton, 2007; Hopwood et al., 2008).

Gerson et al. (2006) offered a simple analogy to help illustrate the differences between these two professions by likening financial statement auditors to patrolmen and forensic specialists to detectives. Similar to auditors, patrolmen circulate through their assigned districts with the objective of keeping peace in the community. Ideally, patrolmen would like to continuously patrol through every location in their districts, however, it would be both time and cost prohibitive for them to do so. Thus, to remain effective, patrolmen have to balance risk and expectations in order to determine whether to focus or expand their patrols. Unlike patrolmen, detectives do not go on patrol. They are tasked to investigate whether a crime has been committed. To successfully accomplish their task, detectives would examine everything in the alleged crime scene to gather any clues that may help them solve the case. Crime investigation is

a time consuming and costly endeavor as detectives are expected to keep searching and piecing different clues together until they solve the crime.

Recall, both the POB and SAS No. 99 encouraged the use of forensic specialists in conducting all audits. However, no evidence to date suggests firms have adopted these proposals. In 2004, the PCAOB Standing Advisory Group (SAG) recommended a series of fraud-related discussion questions as an effort to increase the likelihood of discovering fraud in an audit (PCAOB, 2004). Among the questions raised by the SAG was whether forensic specialists employ a different mindset than financial statements auditors. We constructed a panel of experts with the aim of validating and discerning the differences between auditors and forensic specialists as identified in the literature and to ascertain the question posed by the SAG. We selected various professionals to serve on our expert panel based on Bologna and Lindquist's (1987) criteria, which includes the experts' credentials, licensure, and certification, as well as writings and publications from his or her field of expertise. Our panel consists of four audit experts and five forensic specialists. See table 2 for the credentials and background of our experts.

TABLE 2. Expert panel

Expert	Background
1	Partner from a Big 4 firm with 10 years of forensic experience and is Certified in Financial Forensics (CFF)
2	Forensic services director from a Big 4 firm with 10 years of forensic experience and is a Certified Fraud Examiner (CFE)
3	Forensic services manager from a second-tier firm with 4 years of forensic experience and is a CFE
4	Risk advisory manager from a regional firm with 8 years of forensic experience and is a CFE
5	Professor and director of forensic services in a major university with 10 years of forensic experience and is a CFF
6	Audit partner from a Big 4 firm with 15 years of audit experience and is a CPA
7	Audit partner from a second-tier firm with 40 years of audit experience and is a CPA
8	Audit manager from a second-tier firm with 8 years of experience and is a CPA
9	Audit manager from a second-tier firm with 7 years of experience and is a CPA

We conducted our interviews with these experts via conference calls and face-to-face conversations. We explained the nature of our research to the experts and we asked them to comment on whether the differences between auditors and forensic specialists that we have observed from the literature were an adequate representation of their respective professions. Specifically, we asked our experts several open-ended questions regarding the role, objective, and expectations, as well as the thought process of an auditor and a fraud specialist. We summarized the interview comments from our experts in Table 3. Below are selected comments that were provided to us by our experts. To avoid applying our own value judgments, we used no materiality or weighting standard in our choices of these quotations.

“...unlike fraud specialists, auditors are only looking for material misstatements in the financial statements.”

“Because of the general misconception in the marketplace about the role of financial statement auditors in fraud detection, there are certain procedures that auditors will do to specifically address fraud risks that go beyond the risk-based approach on material accounts. A typical procedure here would be the review of journal entries. However, these are not our primary objectives and testing procedures.”

“Fraud specialists generally do not work with a materiality level and given today’s technology capabilities it is reasonable for a fraud specialist to examine 100% of a data set of transactions.”

“The requirement to obtain reasonable assurance regarding the detection of material misstatements is the same regardless of whether the misstatement results from unintentional error or from fraud; hence, financial statement auditors have no specific requirements to find fraud although SAS 99 requires us to perform fraud-specific procedures.”

“Financial audits tend to be procedural driven and linear. Fraud audits tend to be about the mindset, and tend to be cyclical such as finding evidence, evaluating evidence, revising procedures, finding more evidence, evaluating, revising, etc. Financial audits tend to be quite similar, especially from year to year or within the same industry. Fraud audits tend to be like snowflakes, each one takes on its own personality.”

TABLE 3. Expert panel interviews summary

Auditor	Fraud Specialist
<p>Role and objective as an auditor The primary responsibility of an auditor is to gather documentation to determine whether the company's reported financial statements taken as a whole (including footnotes) are stated fairly, in all material respects, in conformity with Generally Accepted Accounting Principles (GAAP).</p>	<p>Role and objective as a fraud specialist The primary responsibility of a fraud specialist is to determine whether fraud exists, regardless of its size or magnitude. The fraud specialist also has the responsibility to determine the overall extent of fraud (if it exists), how it occurred and how the risk of its future occurrences can be reduced or prevented.</p>
<p>Expectations for an auditor Auditors would be asked to look at their clients' accounts either individually or in aggregate with other accounts. They would especially focus on accounts with a reasonable possibility of containing a material misstatement.</p>	<p>Expectations for a fraud specialist Fraud specialists would be asked to examine either a single account or a single transaction to see if fraud exists. They may also be asked to look at a series of transactions since fraud may not necessarily occur in a single transaction.</p>
<p>Auditors work with a materiality level and they are primarily concerned with material matters in an audit. Materiality is relevant to them because it serves as a guide to their evaluation of audit evidence.</p>	<p>Fraud specialists do not work with a materiality level and they are not concerned with the concept of materiality. Materiality is irrelevant to them because fraud may often occur below the materiality level.</p>
<p>Auditors would not be expected to examine every transaction and they would generally rely on audit sampling.</p>	<p>Fraud specialists would be expected to examine everything in great depth and they would generally not rely on audit sampling.</p>
<p>Auditors would not be concerned with minor discrepancies in any single account. They would only be concerned if these discrepancies are indicative of larger or pervasive problems.</p>	<p>Fraud specialists would be concerned with any minor discrepancies. They would assess these discrepancies to understand their nature and to determine if they are indicative of fraud.</p>
<p>Auditors would generally have a predetermined time budget for work. If they spend too much time examining one area, they may have to spend less time somewhere else or they may run the risk of going over budget. While time is of the essence in an audit, auditors still have to do a sufficient amount of work and should not intentionally reduce or eliminate a procedure.</p>	<p>Fraud specialists would generally not be driven by a fixed budget. They would examine their work and review certain findings at the end of each phase. This will give them the opportunity to assess whether additional work is required. Fraud specialists may request more time and resources for their investigation until they are satisfied with their assessment of whether fraud exists.</p>

Auditors' thought processes

Auditors think about accounting records in terms of the availability of supporting documents and the authenticity of the audit trail. They have to decide whether there is valid documentation to support the recorded transactions and whether they are presented in conformance with Generally Accepted Accounting Principles (GAAP).

Auditors are required to maintain an appropriate level of professional skepticism by having a questioning mind when they are evaluating audit evidence. They are encouraged to consider risk factors relating to fraudulent financial reporting that include motive, opportunity, and rationalization.

Auditors are encouraged to keep in mind that the possibility that a material misstatement due to unintentional error or fraud could be present, regardless of their belief about their client's honesty and integrity.

Fraud specialists' thought processes

Fraud specialists think about accounting records in terms of the authenticity of the events and activities that are behind the reported transactions. They have to evaluate whether these transactions actually took place and are consistent with other information in their investigation.

Fraud specialists are expected to be sensitive to, and on the lookout for, the warning signs of fraud. To discover fraud, it is important for fraud specialists to be able to think like a thief by asking themselves how they would probe and exploit any weaknesses of a company.

Fraud specialists are mindful that a visible immaterial misstatement may appear to be inconsequential, but the hidden portion of the misstatement could be substantial.

Overall, our experts agreed there is a substantial difference between financial statement auditors and forensic specialists in terms of their responsibilities and task objectives. Financial statement auditors are expected to examine their clients' accounts either individually or in aggregate with other accounts. They are expected to focus on accounts with a reasonable possibility of containing a material misstatement. Auditors primarily work with a materiality level that serves as a guide to their evaluations of audit evidence. The implication of materiality is considered so that auditors do not become overly concerned with minor discrepancies in any single account, unless these discrepancies are indicative of larger or pervasive problems. Given that they have a predetermined time budget for their work, auditors understand that if they spend too much time examining one area, they may have to spend less time somewhere else or run the risk of going over budget. While time is of the essence in an audit, auditors understand it is vital to do a sufficient amount of work and should not intentionally reduce or eliminate a procedure.

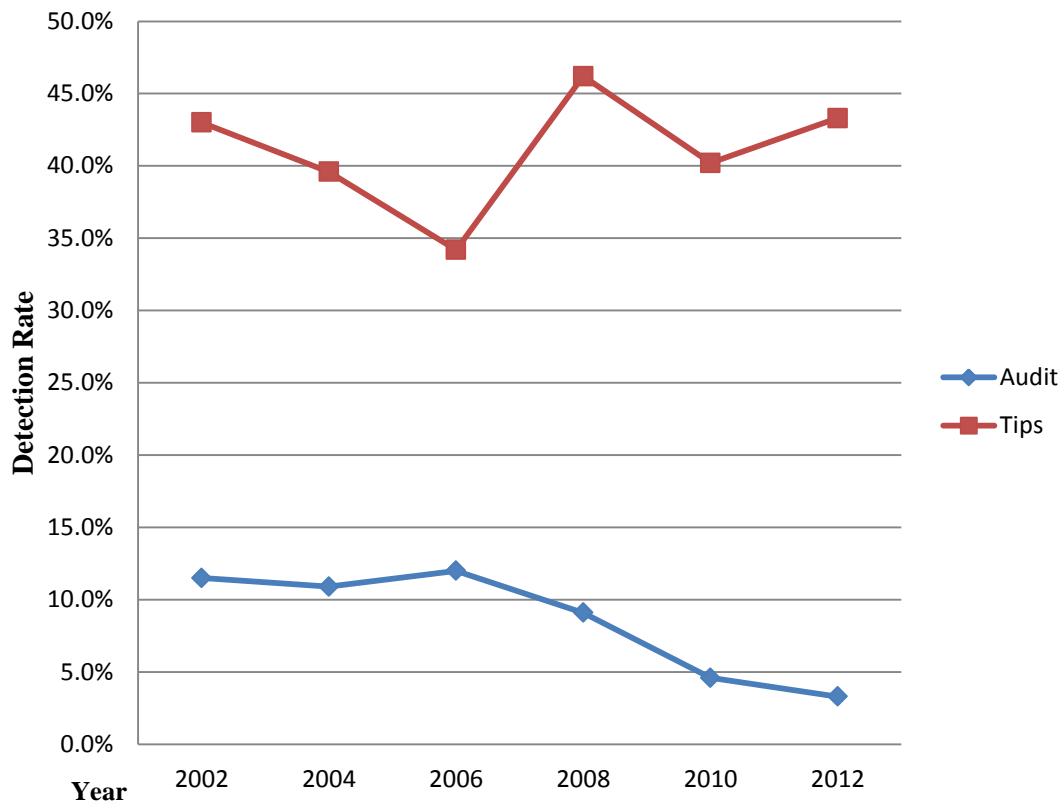
In addition, auditors are not expected to examine every transaction and would generally rely on audit sampling.

On the other hand, our experts indicated forensic specialists are typically called in to examine whether fraud exists in either a single account or a single transaction. They may also be asked to look at a series of transactions since fraud may not necessarily occur in a single transaction. Unlike auditors, forensic specialists do not deal with a materiality level. Materiality is irrelevant to forensic specialists because fraud often occurs below the materiality level. Similarly, forensic specialists would assess all discrepancies (whether major or minor) to understand their nature and to determine if they are indicative of fraud. They are expected to examine everything in great depth and would generally not rely on audit sampling. In addition, forensic specialists are typically not driven by a fixed time budget. They examine their work and review certain findings at the end of each phase to assess whether additional work is required. They may request more time and resources for their investigation until they are satisfied with their assessment of whether fraud exists.

Our experts acknowledged auditors' concerns with materiality and time budgets often hinder their abilities to detect fraud. In general, all of the experts confirmed to us that there is a vast difference between financial statement auditors and forensic specialists in regard to their training as well as their effectiveness in fraud detection. The experts agreed that without proper and adequate forensic training, it would be difficult, if not impossible, for auditors to uncover fraud in a financial statement audit. This perhaps helps to explain why the ACFE has found a deteriorating trend in external auditors' abilities in detecting fraud despite the emphasis and focus on fraud detection. The ACFE found the majority of fraud cases were detected by tips rather than through external audit (ACFE, 2012; ACFE, 2010; ACFE, 2008; ACFE, 2006;

ACFE, 2004; ACFE, 2002). Figure 1 depicts the percentage of fraud cases uncovered by external audit as compared to tips from 2002 through 2012.

Fig. 1 Percentage of Fraud Cases Uncovered by External Audit and by Tips



CONCLUSION

Our review of the changes in auditors' responsibility for fraud detection has shown standard setters have a tendency to issue additional auditing standards as a response to widely publicized fraud cases. On the same note, auditors have been reluctant to take on additional responsibility for detecting and providing assurance regarding the presence of fraud. In fact, as additional fraud-related audit standards are issued, auditors tend to minimize their impacts and fail to incorporate the provisions of the standards (PCAOB, 2007). Nevertheless, standard setters and the audit profession have demonstrated a consistent commitment to improving auditors'

fraud detection performances. Unfortunately, no audit standard can provide absolute assurance that auditors can detect all fraud (Wells, 2004a). Moreover, despite the efforts put forth by the profession, auditors are generally poor at detecting fraud.

Currently, SAS No. 99 is the law of the land in regards to how auditors should perform procedures to detect fraud within the financial statements. Empirical evidence indicates the percentage of fraud cases uncovered by external auditors has diminished in recent years (ACFE, 2012; ACFE, 2010; ACFE, 2008; ACFE, 2006; ACFE, 2004; ACFE, 2002). We contend the failure in fraud detection is not a reflection of auditors' lack of commitment in carrying out their audit task. Nor can the failure be attributed to inadequacy in the current fraud audit standards. Rather, we believe the failure of auditors is one of execution.

SAS No. 99 takes a red flags approach to fraud detection. That is, auditors, within the current audit methodology, are expected to obtain a detailed understanding of their audit client. Through doing so, auditors are to identify risk factors, especially pertaining to fraud. Once a fraud risk factor is identified, auditors are expected to modify their audit programs to perform detailed audit procedures to search for the presence of fraud (AICPA, 2002). This approach for detecting fraud derived from the perpetration of numerous fraudulent cases despite the existence of warning signs for auditors to detect. The failure in this model is individuals with expertise in forensic accounting/fraud auditing are brought onto the engagement only upon the identification of fraud by financial statement auditors. Thus, there is a mismatch between auditors' training and skills and what is required of them within SAS No. 99. Prior literature and our expert panel confirmed our belief that there is a vast difference between financial statement auditors and forensic specialists. In particular, auditors appear to exhibit a lack of sensitivity in discerning the telltale signs of fraud, or the red flags that are necessary to be identified within the current fraud

model. Moreover, typical audit firms provide little to no forensic training on how to uncover fraud in a financial statement audit. As a result, it is our conjecture that frauds will continue to go undetected by auditors unless there is a fundamental change to the current audit model.

To improve auditors' fraud detection abilities, we believe it is necessary to integrate forensic procedures and forensic specialists in all audit engagements. That is, for every audit engagement there should be at least one individual on the audit team who can be classified as a forensic specialist. Moreover, this individual needs to be present during the entire audit engagement, rather than either providing limited input or being called into the engagement once fraud is detected. We concede that this proposal could fail as a result of the additional cost burden related to such a requirement. Therefore, at the very minimum, we believe it is of paramount importance to train financial statement auditors in the areas of forensic accounting and fraud auditing. With such training, auditors' propensities to correctly identify and investigate fraud-related red flags should increase, resulting in a greater probability that more fraud will be detected by external audits as well as more confidence in auditors' abilities to protect the interests of stakeholders.

In order to better protect the public from fraud and to maintain the credibility of the audit profession, accounting researchers must continue to explore ways that can help improve auditors' abilities to detect and to limit fraud. We urge accounting researchers to develop fraud-research programs or studies by examining a series of questions posed by the PCAOB (see Appendix A for the categories of questions raised by the PCAOB). As stated previously, one of the questions raised by the PCAOB's Standing Advisory Group was whether forensic specialists employ a different mindset than financial statements auditors. Comments from our panel of experts provided evidence to support the notion that forensic specialists do indeed have a

different mindset than financial statements auditors. Using an experiment, Chui et al. (2012)

found individuals with a fraud specialist mindset made higher fraud risk assessments; were less likely to evaluate the company's accounts as fairly presented; and were more likely to take further investigation action to examine the company's accounts than those with the audit mindset. These results provide preliminary empirical evidence to suggest it is possible to increase auditors' awareness of fraud by priming them with a fraud specialist mindset. Decision aids typically have positive effects on the quality of cognitive processing (Bonner, 2007). Thus, we believe it would be beneficial for accounting researchers to explore possible decision aids that would help auditors to adapt to the fraud specialist mindset and to increase the likelihood of auditors identifying red flags and uncovering fraud during an audit.

Fraud is costly and it is often a moving target. Auditors are not fraud specialists and there are fundamental differences between financial statements audit and fraud examination. Nevertheless, the prevalence of fraud requires that auditors be vigilant when considering the possibility of fraud during the financial statements audit. It is important for us as a profession to continue the pursuit of finding ways to incorporate forensic training and procedures into an audit as a means to improve auditors' fraud detection performances.

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APPENDIX A

Categories of Fraud-related Questions by the PCAOB Standing Advisory Group

Categories

- SAS No. 99
 - Risk and Fraud Risk Factors
 - Revenue Recognition related
 - Significant or Unusual Accruals
 - Related Parties
 - Estimates of Fair Value
 - Analytical Procedures
 - Quarterly Financial Information
 - Journal Entries
 - Discussions with the Audit Committee
 - Detection of Illegal Acts
 - Forensic Accountants in an Audit of Financial Statements
-