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WHAT IS FRAUD AND WHO IS RESPONSIBLE?

Michael D. Akers and **Jodi L. Bellovary**

Research shows that fraudulent activity affecting the financial statements is more prevalent than ever despite the increased attention devoted to the prevention and detection of fraud by companies and professional accountants. Fraud is a critical issue for preparers and users of financial statements, as well as auditors. Each group's association and involvement with the financial statements is from a slightly different perspective. Even though all individuals in the financial reporting process share the responsibility for the integrity of the financial statements, different perspectives of fraud can and do affect each group's interpretation of fraudulent activity and responsibility for the prevention and detection of fraud. Accordingly, two questions must be asked: What constitutes fraud, and who is responsible for the detection of fraud? This paper examines the similarities and differences in the definition of fraud, as documented by ten professional organizations, as well as who is responsible for fraud detection.

Introduction

According to the Association of Certified Fraud Examiners' (ACFE) 2004 *Report to the Nation on Occupational Fraud and Abuse*, fraud cost U.S. companies roughly $660 billion in 2003. The average organization loses approximately 6% of its annual revenues to fraud (AFCE 2004, iii). This problem is magnified by the fact that most organizational fraud goes undetected; or if it is detected, goes unreported (ACFE 2004, 8).

As the number of fraud cases continues to rise, the following questions arise: What exactly is fraud, and who is responsible for its detection? Is it the responsibility of the management team? The controller? The chief financial officer? The internal auditor? Or, is it the external auditors' responsibility to define and detect fraud? The question remains – which group is ultimately accountable? With regard to the question of what exactly is fraud, is there consistency in the definition of fraud utilized by various professional organizations? Is this definition consistent with the concept used by law enforcement agencies?

Fraud is a critical issue for both preparers and users of the financial statements, as well as auditors. The role that each group plays with respect to the financial statements is different. Accordingly, it is possible that there are different expectations concerning fraud. It is important that auditors, management and financial statement users understand which definition of fraud applies in each situation and who is responsible

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for fraud detection. The first section of the paper examines the definition of fraud that is documented in the authoritative literature of ten professional organizations. Specifically, the similarities and differences are discussed. The paper then discusses the responsibility for fraud detection by each of the organizations. Concluding comments and recommendations are provided in the final section.

What is Fraud?

The first dilemma in fraud detection is determining what exactly constitutes fraud. *Webster's Ninth New Collegiate Dictionary* (1990, 490) defines fraud as an "intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right" or as "an act of deceiving or misrepresenting". *Webster's New World Dictionary* states that "fraud is 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" (Albrecht 2003, 6). Albrecht (2003, 6) goes on to say that "fraud is a deception that includes the following elements: a representation about a material point which is false, and intentionally or recklessly so; which is believed and acted upon by the victim, to the victim's damage."

"According to *Black's Law Dictionary*, fraud is a calculated, deceptive act that results in damage to someone else… Those in law enforcement see fraud strictly in terms of whether laws are broken. Psychologists reference fraud according to individuals' intentions and motivations; they are not as concerned with objective criteria for defining fraudulent actions" (Kolman 1999, 88). Wells (2005, 8) states that any crime using deception for gain constitutes fraud. "Under common law there are four general elements that must be present for a fraud to exist: (1) a material false statement, (2) knowledge that the statement was false when it was uttered, (3) reliance on that false statement by the victim, (4) damages resulting from the victim's reliance on the false statement" (Wells 2005, 8).

Table 1 (beginning on page 253) outlines the definition of fraud that is documented in the authoritative literature of ten organizations including the AICPA, ACFE, IIA and SEC.

Similarities in Fraud Definitions

Examination of the definitions in Table 1 reveals certain similarities found among many of the organizations. These similarities are summarized below.

Similarities in Definition	Organizations
Includes the notion of intent, deception or concealment	AICPA/PCAOB, ACFE, ACCA, GAO, ISACA, IIA, IMA, IAASB
References the legal concept of fraud or illegal acts	AICPA/PCAOB, ACCA, ISACA, IIA, IMA, IAASB, SEC
Categorization of fraud into material misstatements arising from: (1) financial reporting and (2) misappropriation of assets	AICPA/PCAOB, GAO, IAASB

The most significant overlaps are (1) the inclusion of the notion of intent and (2) references to the legal concept of fraud or illegal acts. (Note

that the PCAOB definition of fraud references the AICPA literature.) Nine of the ten definitions state that the perpetrator must willingly cause some form of deception. This is distinguished from an error or a mistake, which is unintentional in nature. Further, the perpetrator must also realize that the act was wrong (Albrecht 2003, 283; Wells 2005, 390). Determining intent and proving knowledge that the act was wrong can be extremely difficult.

Eight of the ten definitions make reference to the legal concept of fraud or illegal acts being committed. The legal aspect of fraud itself is not defined, but merely referenced in the definition of fraud. The legal concept of fraud requires interpretation of the law by a party with legal expertise to make a determination as to whether fraud has occurred. Both the AICPA and ISACA explicitly state that the auditor is not responsible for making a final legal determination of fraud/illegal acts. Under SAS No. 99, the auditor is concerned only with "acts that result in a material misstatement of the financial statements". "The IS auditor will ordinarily be concerned with suspected, rather than proven, fraud or other illegal acts" (ISACA 2004, 20).

Four of the ten organizations categorize fraud into material misstatements arising from financial reporting and those arising from misappropriation of assets. SAS No. 99 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users." This may involve manipulation of accounting records and/or supporting documents, omission of significant information or misapplication of accounting principles (SAS No. 99). Misstatements from misappropriation of assets occur when the theft of assets causes the financial statements to be materially misstated (SAS No. 99).

Differences in Fraud Definitions

Although there are some notable similarities in the definitions, there are also distinct differences outlined below that set the definitions apart.

Differences in Definitions	Organizations
Specifically addresses money laundering as a concern	ACCA
IS auditor is concerned with suspected rather than proven fraud	ISACA
Specifies that fraud is perpetrated to obtain money, property or services, or to avoid payment/loss of services	IIA
Intention is to induce another to part with something of value, or to surrender a legal right	IMA
Definition is tied to ethical standards	IMA
Violation of law or any rule/regulation with force of law	SEC

These differences create unique challenges when applying the definition of fraud to specific circumstances. The ACCA professional literature discusses money laundering and specific procedures relating to this act at length, but makes no mention of other fraudulent acts (ACCA 2004). The IIA definition of fraud is specific as well, stating that fraud is perpetrated to obtain money, property or services, or to avoid paying for or losing services (IIA 2004). The IMA's definition also holds that fraud is committed to obtain something of value, but adds that it may also be to induce someone to surrender a legal right (Davia 1992, 202). The IMA's concept of fraud is unique in that it is tied to the organization's ethical standards. "IMA members are bound by the

Ethical Standards... [and] have a responsibility to perform their professional duties in accordance with relevant laws" (IMA).

So which definition is most relevant in the preparation and presentation of the financial statements? Since more than one group is associated with the financial statements, should multiple definitions apply? If so, should there be a hierarchy of definitions, similar to the hierarchy of GAAP? For example, the AICPA/PCAOB, GAO and IAASB define fraud as an intentional act resulting in material misstatement of the financial statements either due to fraudulent financial reporting or misappropriation of assets. However, the SEC's definition of fraud hinges on the violation of a specific law [Securities Exchange Act of 1934, Section 10A(f)]. An act may violate generally accepted accounting principles, but not a federal or state law. Is it fraud? On which concept, legal or accounting, is the decision based?

Who is Responsible for the Detection of Fraud?

The discussion thus far has established that fraud has more than one definition. To further magnify the problem, there is also the question of who is responsible for fraud detection. According to the Accountant's Guide to Fraud Detection and Control, management accountants, independent auditors, internal auditors, Certified Fraud Examiners and criminal investigators all have responsibility for fraud detection (Davia 2000, 48). The Association of Certified Fraud Examiners sets forth similar responsibilities in the Fraud Examiners Manual (ACFE 2003, 1.201-203; 1.205; 1.219-220; 1.303). Management accountants are responsible for setting strong internal controls and keeping the accounting system (Davia 2000, 48) – in other words, acting as the "watchdog" of the system. Independent auditors claim limited responsibility for "discovering fraud to financial statements which may be fraudulently distorted" (Davia 2000, 48). Internal auditors, "with adequate fraud-specific training and sufficient audit resources... could become significant factors in fraud control" (Davia 2000, 49). Certified Fraud Examiners are traditional auditors who have been cross-trained in the rules of evidence and investigative skills. This group plays a proactive role in fraud detection, searching out and finding fraud (Davia 2000, 49). Criminal investigators play a reactive role in fraud detection, entering the picture once it is reasonably certain that fraud has occurred to collect evidence for prosecution (Davia 2000, 49).

Another group that has fraud-related responsibilities is the audit committee. Under the Sarbanes-Oxley Act of 2002, audit committees have increased responsibilities, including addressing complaints regarding internal controls (Wells 2005, 305). "Audit committees may receive information about possible financial statement fraud from employees, internal auditors, or external auditors" (Rezaee 2002, 127). The audit committee can minimize fraud by thoroughly investigating and reporting possible fraudulent acts to the board of directors (Rezaee 2002, 127).

Table 1 also lists who holds the primary responsibility for fraud detection according to the ten organizations. As with the definition of fraud, there are similarities and differences as to who the organizations hold responsible for fraud detection. The AICPA, ACFE, ISACA, IIA and PCAOB all point to management as the primary group responsible for the implementation of controls that prevent and detect fraud. The AICPA,

ACFE, GAO, IAASB, PCAOB and SEC agree that auditors are responsible only so far as fraud relates to a material misstatement in the financial statements. The IMA focuses its efforts on ensuring that the established policies of the company are followed, thereby reducing the chances of fraud. The IIA claims that while internal auditors should be knowledgeable of fraud indicators, they do not have the expertise or the responsibility of a person whose primary purpose is to investigate and detect fraud. The question is who is that person?

Public expectations with respect to detecting fraud have differed from the requirements set forth in the auditing standards for many years. This disparity could only lead to problems. A 1974 survey conducted by the Opinion Research Corporation for Arthur Andersen & Co. found that "66% of the investing public believed that the most important function of the public accounting firm's audit of a corporation is to detect fraud" (Davia 1992, 66). In 1978, the Commission on Auditors' Responsibilities (or Cohen Commission), sponsored by the AICPA, issued a report which attempted to clarify the auditor's responsibility.

The report stated:

> Independent auditors have always acknowledged some responsibility to consider the existence of fraud in conducting an audit. Nevertheless, the nature and extent of that responsibility have been unclear. Court decisions, criticisms by the financial press, actions by regulatory bodies, and surveys of users indicate dissatisfaction with the responsibility for fraud detection acknowledged by auditors (Davia 1992, 66).

The report recommended:

> The prudent auditor will seek knowledge of methods perpetrating, concealing, and detecting fraud. Conditions indicating fraud and the methods of perpetrating fraud are not always obvious and change as the business environment changes. Auditors should recognize those changing conditions and be knowledgeable about the latest methods of perpetration and detection (Davia 1992, 69).

However, the question still remained, is being knowledgeable about fraud the same as having responsibility for detecting it?

The issue of auditor responsibility was addressed again in 1987 by the Committee of Sponsoring Organizations of the Treadway Commission (also known as COSO or simply the 'Treadway Commission'). One objective of the Report of the National Commission on Fraudulent Financial Reporting was to "examine the role of the independent public accountant in detecting fraud... and whether the ability of the independent public accountant to detect such fraud can be enhanced" (COSO 1987). The Commission concluded that the primary responsibility for reducing fraudulent reporting rests with management. "Independent public accountants play a crucial, but secondary role... Their role, however, can be enhanced, particularly with respect to detecting fraudulent financial reporting, and financial statement preparers and users should be made to understand the enhanced role" (COSO 1987). Specifically, the Commission recommended that the audit report should "explain that an audit is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements arising as a result of

fraud or error... [and] should describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control" (COSO 1987).

The auditing profession has attempted to further address the concerns of regulatory agencies and public expectations through the issuance of SAS No. 82 and the subsequent issuance of SAS No. 99. SAS No. 82 Consideration of Fraud in a Financial Statement Audit, issued in 1997, was labeled "the most highly publicized statement on auditing standards in years... [providing] expanded operational guidance on the auditor's consideration of material fraud in conducting a financial statement audit" (Mancino 1997, 32). SAS No. 82 clarified, but did not increase, the auditor's responsibility for fraud detection (Mancino 1997, 32). Part of its purpose was to "[help] meet the public's expectation that independent auditors obtain reasonable assurance that financial statements are free of material misstatement – caused by error or fraud" (Reinstein and Coursen 1999, 34).

In 2002, SAS No. 99 superseded SAS No. 82. SAS No. 99 was issued in response to recommendations made by the Fraud Task Force (formed in September 2000). The objective of the task force was to monitor the effects of SAS No. 82 on practice and assess the need for further guidance (McConnell and Banks 2003, 27). SAS No. 99 is meant to provide more definitive standards, thereby improving auditor performance and increasing the likelihood that fraud will be detected (McConnell and Banks 2003, 27).

The Statement on Standards for Accounting and Review Services (SSARS) No. 10, addressing performance of review engagements, was issued in 2004. SSARS No. 10 expands management's required written representations to include acknowledgement of its responsibility for fraud prevention/detection and disclosure of knowledge of actual or suspected fraud. The accountant is expected to inquiry of management regarding actual, suspected and accusations of fraud. As this standard is put into place, further questions arise. Are the expectations/requirements for review engagements moving towards those for audits? Do accountants have increased responsibility for fraud detection with the issuance of SSARS No. 10? Will this further widen the expectation gap?

Conclusions and Recommendations

This paper contributes to current literature in the following ways. First, it shows that there are similarities and differences regarding the interpretation of fraud, by both public and professional organizations, and that there are several different groups that are responsible for the prevention and detection of fraud. Second, the paper illustrates that all parties associated with financial statements need to have a clear understanding of fraud. Lastly, because there are differences in both the interpretation and detection of fraud within professional accounting literature, the accounting profession should not be surprised that the expectation gap continues.

It is obvious that the professional organizations believe fraud is an important issue. However, the organizations have different views as to what constitutes fraud. The lack of a consistent definition of fraud makes the issue of interpretation a challenging one. It is no surprise that confusion results as fraud is viewed from different perspectives, depending on one's association with the financial statements and expectations. Also, because of varying perspectives, a number of groups are responsible for the detection of fraud. Educational efforts to enhance the understanding and responsibilities related to fraud have been marginally successful. Despite the attempts that

have been made to clarify management and auditor responsibility for fraud detection, there still remains an expectation gap between the professional literature and public expectations.

What is the solution? This paper, which examines the various definitions and responsibilities, is the first step. While there has been much discussion in the accounting and auditing literature regarding fraud, there has not been any discussion of the varying definitions of fraud by professional organizations and the related responsibilities for prevention and detection. The next step is to have professional accounting and auditing organizations attempt to develop a common definition of fraud related to the financial reporting process. While we raised the question of a hierarchy of fraud earlier in the paper, we do not believe that a hierarchy of fraud definitions is appropriate. A hierarchy would imply that a certain amount of importance should be placed on one definition over another definition. Each organization's perspective contains important elements which should be considered for a common definition. The common definition of fraud should take into account the fact that a number of parties play a role in fraud detection – management, the audit committee, internal auditors, independent auditors, Certified Fraud Examiners and criminal investigators, as well as other external parties such as financial analysts, investment bankers, lawyers and financial statement users. With a collaborative effort, the organizations could develop and agree upon a common definition of fraud that is satisfactory to all parties, helping to narrow the expectation gap.

Organization	Definition of Fraud	Primary Responsibility to Detect Fraud	Source
American Institute of Certified Public Accountants (AICPA)	Fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. The auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action is intentional or unintentional. Fraud is an intentional act that results in a material misstatement in financial statements that are the subject of an audit. Two types of misstatements are relevant to the auditor's consideration of fraud – misstatements arising from financial reporting and misstatements arising from misappropriation of assets. [1]	• Audit Engagements – 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 fraud or error. Absolute assurance is not attainable; even a properly planned and performed audit may not detect a material misstatement resulting from fraud.[1] • Review Engagements – Management is responsible for prevention and detection of fraud. The accountant is required to make inquiries of management regarding fraud, and to obtain representations regarding fraud in the management representation letter.[2]	[1] SAS No. 99 [2] SSARS No. 10
Association of Certified Fraud Examiners (ACFE)	The deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users.	Parties responsible for fraud prevention and detection include: • Management – set ethical code of conduct, design and assess internal controls • External auditors – plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error • Internal auditors – have sufficient knowledge to identify indicators of fraud, but not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud • Certified Fraud Examiners – direct fraud investigation; assist with proactive fraud prevention and detection programs	Fraud Examiners Manual (ACFE 2003, 1.201-203; 1.205; 1.219-220; 1.303)

Organization	Definition of Fraud	Primary Responsibility to Detect Fraud	Source
Association of Chartered Certified Accountants (ACCA)	Specifically addresses money laundering, defined as the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity.	Obligations are designed to assist members to detect and prevent organizations being used for money laundering purposes. To achieve this, members must: • Implement systems, controls and procedures to ensure continuing compliance with the legislation • Make reports to the National Criminal Intelligence Service • Establish/enhance record keeping systems for all transactions and for the verification of clients' identities • Establish internal suspicion reporting procedures • Educate and train all staff, covering the requirements of the legislation	Professional Conduct Regulations (ACCA 2004)
General Accounting Office (GAO)	The primary factor that distinguishes fraud from error is that the action causing the misstatement in fraud is intentional. The auditor is concerned with two types of misstatements – those arising from fraudulent financial reporting and those arising from misappropriation of assets.	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. The auditor is responsible for obtaining reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement.	Financial Audit Manual (GAO/PCIE 2004, 260-9-260.10)
Information Systems Audit and Control Association (ISACA)	Any act involving deception to obtain an illegal advantage. In practice, the IS auditor will ordinarily be concerned with suspected, rather than proven, fraud. The determination of whether an act is illegal would generally be based on the advice of an informed expert qualified to practice law, or may have to await determination by a court.	Management is responsible for preventing and detecting illegal acts by maintaining a system of internal controls, setting policies and procedures to govern employee conduct, and implementing compliance validation and monitoring procedures. The IS auditor is responsible for assessing the risk that material illegal acts could occur. Unless information exists that would indicate that an illegal act has occurred, the IS auditor has no obligation to perform procedures specifically designed to detect illegal acts. The duty to investigate and report arises only in circumstances where evidence of an illegal act is identified.	IS Standards, Guidelines and Procedures for Auditing and Control Professionals (ISACA 2004, 20)
Institute of Internal Auditors (IIA)	Any illegal acts characterized by deceit, concealment or violation of trust. These acts are not dependent upon the application of threat or violence or of physical force. Frauds are perpetrated by parties and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage.	The internal auditor should have sufficient knowledge to identify indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.	International Standards for the Professional Practice of Internal Auditing (IIA 2004)
Institute of Management Accountants (IMA)	An intentional perversion of the truth to induce another to part with some valuable thing belonging to him, or to surrender a legal right.[3] IMA members are bound by Ethical Standards that cover four areas: competence, confidentiality, integrity and objectivity. Members have a responsibility to perform their professional duties in accordance with relevant laws, regulations, and technical standards; and to refrain from engaging in any activity that would prevent them from carrying out their duties ethically, or that would discredit the profession.[4]	IMA members should use the following steps to resolve an Ethical Conflict: • Follow the established policies of the organization. • Discuss issues with next higher level of management. • Clarify issues with a confidential, objective advisor. • If not satisfied after exhausting all avenues, the individual may have to resign. Depending on the nature of the conflict, it may also be appropriate to notify other parties. [3]	[3] Management Accountant's Guide to Fraud Discovery and Control (Davia 1992, 202) [4] Code of Ethics – Ethical Standards (IMA)

Organization	Definition of Fraud	Primary Responsibility to Detect Fraud	Source
International Auditing and Assurance Standards Board (IAASB)	The term "fraud" refers to 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. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and those resulting from misappropriation of assets.	The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. An auditor conducting an audit in accordance with ISAs obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.	International Standard on Auditing 240 (Revised) (IAASB 2004, 6-7; 9)
Public Company Accounting Oversight Board (PCAOB)	The PCAOB rules state that during the interim rule-making period, statement preparation shall comply with AICPA Auditing Standards and Code of Professional Conduct. Therefore, the definition is congruent to that of the AICPA.[5]	The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud.[6]	[5] Rules 3200T and 3500T (PCAOB 2003, 38-39) [6] Auditing Standard No. 2 (PCAOB 2004, 143-144)
Securities Exchange Commission (SEC)	An illegal act is defined as an act or omission that violates any law or any rule or regulation having the force of law.	Audit procedures shall be designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.	Securities Exchange Act of 1934 [SEC, Sections 10A(a); 10A(f)]

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