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Contemporary auditing problems: Proceedings of the Touche Ross/University of Kansas Symposium on Auditing Problems, pp. 047-056;

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Relationship of Auditing Standards To Detection of Fraud

George R. Catlett

Arthur Andersen & Co.

The accounting profession is facing a wide diversity of difficult challenges. One of the current problems facing CPAs in public practice is how to achieve a proper understanding on the part of the public and others of 1) the relationship of auditing standards to the detection of fraud, and 2) the responsibilities of auditors for the detection of fraud.

Nature of Fraud

Dishonesty and deceit have always been present to some degree not only in the business community but in all walks of life. However, fraud in business enterprises has been increasing in recent years. While most managements and employees are honest, there are enough material cases of dishonesty to cause concern among independent auditors.

Fifteen years ago, most accounting firms had only an occasional fraud case, and many of those were not of any great significance. Today, with fraud cases becoming more common, and with investigations by governmental agencies and resulting litigation exploding in all directions, this disturbing trend is becoming a major factor in the operation of accounting firms. Some of the reasons for this situation are interesting, but time limitations do not permit us to discuss that topic.

What constitutes fraud is not always clear. In cases of bankruptcies and failures, fraud is sometimes alleged when what really may have occurred was bad management decisions and/or adverse business conditions, with a resulting loss of money by investors and creditors. The tendency to allege "fraud" under these circumstances frequently seems to be irresistible. In any event, what is referred to as "fraud" in some cases may not actually be "fraud."

Legal liability of independent auditors for alleged negligence and other deficiencies in their work has many ramifications. Mr. A. A. Sommer, Jr., now a Commissioner of the SEC, discussed this area at the Symposium here in 1972. The number of court cases involving the question of whether and under what circumstances an auditor may have legal liability is still somewhat limited; but more such cases will probably go to trial in the next few years, and the guidelines may become clearer than they are at the present time.

Many different kinds and magnitudes of fraud exist, with some not affecting the financial statements at all or only in a minor way, while others have a

material effect on the financial statements. Some examples of the various types of fraud are:

1. Misappropriation of assets.
2. Overstatement of assets or understatement of liabilities to present more favorable financial position and/or results of operations.
3. Siphoning off of assets through transactions with affiliated entities or in other ways.
4. "Kickbacks" and other irregular transactions between officers or employees of an enterprise and outside parties.
5. Lack of disclosure of significant information.

Fraud in a business entity may be covered up in many ways, but major cases usually include collusion among officers and/or employees, or collusion with outside persons. The cover-up may involve false accounting entries or misleading information, forgeries, unrecorded transactions, or other such means.

Responsibilities of Management

Management has the primary responsiblity for the use and safeguarding of corporate assets and the incurrence of liabilities of the business enterprise on behalf of the stockholders. An additional responsibility runs to creditors and other parties and agencies with a legitimate interest in the enterprise.

The responsibilities of the board of directors in monitoring the management are becoming of increasing concern to many directors, particularly the outside directors. Even though the directors, as representatives of the stockholders, review or approve management actions in various ways, the responsibilities of directors for various kinds of management fraud are still somewhat undefined from a legal standpoint.

One of the important functions of management is the establishment of an adequate accounting system along with appropriate administrative and internal accounting controls and the necessary internal auditing. The resulting financial statements are the direct representations of management, setting forth the financial position and results of operations of the enterprise along with the necessary disclosures for interpretation of the financial statements.

Primary reliance for the prevention and detection of fraud should be placed on an adequate system of internal control because such a system is in constant operation and covers a great many periods and transactions when the independent auditor is not present. It is not feasible for the auditor to check these transactions later in any detail. Management should realize that a good system of internal control can be circumvented by collusion among employees or by collusion between one or more employees and persons outside the enterprise. This possibility must be considered by management, and internal auditing is an additional safeguard.

When collusion to circumvent the accounting system is directed by management, an additional and complicating dimension is added to the problem of deciding when and how an auditor might detect fraud, assuming that generally accepted auditing standards have been followed.

Managements involved in some fraud cases have been held legally responsible from a civil and/or criminal standpoint. However, the number of cases is

disturbing in which the independent auditor appears to be the main "target" in governmental investigations and class action suits rather than the individuals who perpetrated the fraud.

Present Auditing Standards

What effect, if any, should recent fraud cases and the resulting governmental investigations and litigation have on auditing standards? Are the present standards satisfactory? Have we learned as much as we should have from our experiences? Have the fraud situations gone undetected by auditors because of ineffective work or inadequate auditing standards; or has the cause been fraudulent concealment by management or other actions not detectable by normally appropriate auditing procedures? The answers to these and many other related questions are not self-evident.

The auditor should constantly exercise his professional judgment in deciding whether it is reasonable to assume that he has all the pertinent facts and what auditing standards and procedures are necessary in attempting to obtain the facts. Auditing cannot be done entirely by rules and forms.

The greater use of electronic computers and all sorts of sophisticated equipment for accounting and related purposes also represents new challenges in developing audit techniques. Some of the basic concepts of auditing may be changed. However, the standards of auditing should not be thwarted by equipment. People, not machines, commit fraud.

The AICPA has a special committee reviewing the Equity Funding case to determine whether in the light of that case consideration should be given by the AICPA to possible changes in any auditing standards and procedures. The report of that committee has not been issued.

The most authoritative statement by the AICPA of the independent auditor's responsibility for the detection of fraud is set forth in Statement on Auditing Standards No. 1 (paragraphs 110.05-110.08), and this is quoted in Appendix A.

Chapter 6, "Due Audit Care," from *The Philosophy of Auditing* by Mautz and Sharaf, contains this statement: "Independent auditors should accept responsibility for the discovery and disclosure of those irregularities which the exercise of due audit care by a prudent practitioner would normally uncover." A summary of some of the views expressed in that chapter is quoted in Appendix B.

The membership of the AICPA adopted ten standards that are referred to as "generally accepted auditing standards," and these are classified as general standards, standards of field work, and standards of reporting. These standards contain such requirements as technical training and proficiency, independence, due professional care, adequate planning, proper study and evaluation of internal control, and sufficient competent evidential matter. Careful distinction should be drawn between these "auditing standards" and the "auditing procedures" to be selected and executed in accordance with the standards.

All of the items referred to above are well written and pertinent to the subject under discussion. When we relate what is said in those documents to the situation in which the accounting profession finds itself today, it is evident that controversial questions and misunderstandings exist.

Internal Control

Internal control, for many reasons, has become an increasingly important factor in the conduct of audits. The AICPA second standard of field work states: "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

The evolution in auditing over many years in the direction of greater reliance on internal controls and the use of test-checking in reviewing those controls is not just a theoretical or philosophical development. This trend is the result of practical necessity. With the large business enterprises that now exist, detailed auditing to any significant extent is not economically feasible.

When there are millions of transactions in a single enterprise in a year, an auditor must rely on test-checks for much of his work. Therefore, the effectiveness of the accounting system and internal controls and the integrity of management are crucial to the auditor.

Most of the significant fraud cases publicized in the financial press are the result of a breakdown in internal control as a result of management direction, collusion of officers and/or employees, deterioration of internal control from neglect, or a combination of these and similar factors.

The auditor's evaluation of internal control is an important phase of an audit engagement. Management has a responsibility to its shareholders to see that adequate internal control exists. An absence of adequate control raises a serious question; one to which professional judgment must be applied as to whether the auditor can compensate by expanding the scope of his work or should withdraw from the engagement.

Representations by Clients

Representations by management and employees take many forms in the conduct of an audit. If an auditor is precluded from relying on such representations and should be required to assume that all of them are wrong until he can prove them correct, an audit would have to be viewed from a vastly different perspective. An auditor certainly does not accept all information and data given to him by a client without question. On the other hand, when an auditor is given misinformation or information is withheld without his knowledge, there are limits to the steps he should be expected to take to find something he does not know exists. If each audit is to be approached with the viewpoint that the client is dishonest until proven otherwise, not only would an entirely new approach be needed but also the auditor may well be placed in an untenable position.

The credibility and integrity of management are an important factor for an auditor to assess in the conduct of his work. If the auditor finds that a management does not have sufficient integrity to rely on its representations, he is running a serious risk that frequently cannot adequately be dealt with by an extension or expansion of the audit procedures. On the other hand, an auditor may assume that integrity exists and then find to his dismay that his trust and confidence in this regard were misplaced.

Auditors do have responsibilities in the conduct of an audit, but these

responsibilities do not include infallibility or clairvoyance. Management should be held responsible for misrepresentations and withholding of material matters from the auditor. An auditor should not be held responsible when he follows customary auditing procedures, those procedures do not disclose the deception, and no apparent reason exists to expand the customary audit procedures.

What are Some of the Pertinent Questions?

A few pertinent questions regarding auditing standards and procedures as they relate to the detection of fraud are set forth below in order to serve as a basis for discussion.

The first question is: Should an unqualified auditor's opinion be construed to constitute a representation that there is no undetected fraud having a material effect on the financial statements?

A second and somewhat related question is: Should an auditor be held to be a "guarantor" of the financial statements or of the fairness with which they are presented insofar as fraud is concerned? Put another way, should the auditor be held to have a joint responsibility with the management for the financial statements in this regard?

The third question is: Can fraud become so extensive or massive that the answers to the first two questions are different?

A fourth question, especially if the first two are answered affirmatively, is: Are any basic changes needed in current auditing standards and procedures?

A fifth question is: Should auditors rate clients as to quality and take only the better ones? If so, what are the criteria for this purpose?

A further question is: Should legislation be passed establishing greater responsibility on the part of everyone not to intentially mislead auditors?

I will not try as a part of my formal remarks to answer these questions in detail, but I will make a few comments on them.

Hindsight is a wonderful faculty. There is no area in which hindsight is more readily applied than to undetected fraud after such fraud is later discovered. It inevitably seems to appear obvious that the fraud should have been detected. The circumstances at the time are most difficult to recreate and comprehend, and little effort is really made to do so. Second-guessing becomes prevalent, and the less experience or knowledge one has about auditing, the more certain one becomes of the righteousness of his condemnation. Subsequently judging the effectiveness of a professional person in doing his work under the stress and strain and actual conditions at the time should not be taken lightly.

Auditors should not be presumed to have represented or guaranteed that no undetected fraud exists or to have guaranteed that the financial statements are a fair presentation of the financial position and results of operations. Those who suggest that the auditor has a joint, and presumably equal, responsibility with management for the financial statements do not in my view understand the relative roles of management and the auditor. There is no more justification for an auditor to be a guarantor than there would be for a lawyer to guarantee that he will win a lawsuit or a doctor to guarantee that an operation will be successful. A lawyer does not have a joint responsibility for a client's morals, and a doctor does not have a joint responsibility for a patient's health habits.

Insofar as the extent or massiveness of a fraud is concerned, about all to be said about this is that the larger the fraud the more likely it is to be detected by the auditor in following proper audit procedures. However, counter forces to detection may be the extent of the collusion inside and outside of the enterprise, the existence of expert forgery, or other sophisticated deterrents to detection.

Generally accepted auditing standards and procedures should be constantly reevaluated in the light of improved knowledge and current developments. This should be done by the accounting profession and by accounting firms. As an example, some of our past ideas in this regard may be changed by computers. Some improvements can undoubtedly be made in auditing techniques and procedures, but I see no particular evidence that any revolutionary change is needed in the standards.

Our free-enterprise system will be hampered and the tradition of opportunity for all will be affected, if the accounting firms decide only to perform audit services for "safe" clients. A relatively new enterprise with a first-time registration statement is frequently of greater risk for an auditor than an established business. The new enterprise is more likely to result in failure or disillusioned investors. However, the public interest may not best be served if auditors are forced to avoid such risks. The auditor should be able to perform a professional service for these entitles in a proper manner without being subjected to the threat of a lawsuit whenever one of them fails.

As to whether legislation is desirable with respect to putting greater penalties on misleading the duly appointed auditors of a company, many factors are involved. I would not advocate such legislation at this time, but something needs to be done to protect the auditor, who all too frequently is left "holding the bag" as a result of management misconduct.

Auditors are well aware that fraud can occur. They are also concerned about the possibility of fraud being so material as to have a significant effect on the financial statements upon which they are reporting. On the other hand, the accounting profession must not permit itself to be destroyed by assuming responsibilities or accepting a role that cannot be successfully fulfilled.

Appendix A

Extract from Statement on Auditing Standards No. 1, American Institute of Certified Public Accountants (1973)

110 Responsibilities and Functions of the Independent Auditor

Detection of Fraud

.05 In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

.06 Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Acordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively. In the case of fidelity bonds, protection is afforded not only by the indemnification for discovered defalcations but also by the possible deterrent effect upon employees; the presence of fidelity bonds, however, should not affect the scope of the auditor's examination.

.07 When an independent auditor's examination leading to an opinion on financial statements discloses specific circumstances that make him suspect that

fraud may exist, he should decide whether the fraud, if in fact it should exist, might be of such magnitude as to affect his opinion on the financial statements. If the independent auditor believes that fraud so material as to affect his opinion may have occurred, he should reach an understanding with the proper representatives of the client as to whether the auditor or the client, subject to the auditor's review, is to make the investigation necessary to determine whether fraud has in fact occurred, and, if so, the amount thereof. If, on the other hand, the independent auditor concludes that any such fraud could not be so material as to affect his opinion, he should refer the matter to the proper representatives of the client with the recommendation that it be pursued to a conclusion. For example, frauds involving "lapping" accounts receivable collections, or frauds involving overstatements of inventory, could be material, while those involving peculations from a small imprest fund would normally be of little significance because the operation and size of the fund tend to establish a limitation.

.08 The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negligence on his part. He is not an insurer or guarantor; if his examination was made with due professional skill and care in accordance with generally accepted auditing standards, he has fulfilled all of the obligations implicit in his undertaking.

Appendix B

Extract from R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing,* American Accounting Association, 1961

Chapter 6—Due Audit Care, pp. 139-140

Summary. In this chapter we have tried to establish a concept of due audit care as the basis for judging the responsibility of independent auditors in the performance of their professional duties. This concept is based on an assumed prudent practitioner and the knowledge, skill, caution, and responsiveness that could be expected from him under the circumstances at issue. The usefulness of such a concept seems clear. If it can be developed, it will give to all concerned with the subject a more explicit statement than is now available in the literature.

The difficulty of formulating such a concept is closely related to the problem of irregularity detection. There are some irregularities which should be discovered in any standard examination; the obligation of discovering certain other irregularities would be so onerous a burden as to be unbearable. Between these extremes are perhaps innumerable cases varying from one extreme to the other. We are unable to find in the characteristics of irregularities themselves any significant clues which permit a precise statement of audit responsibility for detection. This leads us naturally and inevitably to consideration of the legal doctrine of a prudent man and its application to auditing.

It must be recognized that a concept of due audit care, founded on the legal concept of a prudent man acting reasonably with average knowledge and average judgment in the specific circumstances, cannot give us objective advance answers to the question of responsibility in any given case. We feel it does give a useful criterion to the auditor himself and to those who must judge the quality of his work, a criterion which will increase in usefulness as experience sharpens and strengthens the concept itself.

We also believe that a statement indicating the extent of responsibility accepted can be formulated in a manner that will make its usefulness apparent, both to practitioners in their daily affairs and to the profession as an indication of acceptance of its just and fair responsibilities. Like development of the concept of due audit care, this may take some time, but it is a worthy endeavor and will repay the effort. As a beginning, we suggest the following summary. It will be apparent to the careful reader that its component ideas have been borrowed from a variety of sources.

Independent auditors should accept responsibility for the discovery and disclosure of those irregularities which the exercise of due audit care by a prudent practitioner would normally uncover. A prudent practitioner is assumed to have a knowledge of the philosophy and practice of auditing, to have the degree of training, experience, and skill common to the average independent auditor, to have the ability to recognize indications or irregularities, and to keep

abreast of developments in the perpetration and detection of irregularities. Due audit care requires the auditor to acquaint himself with the company under examination, its method of operation and any significant practices peculiar to it or the industry of which it is a part, to review the method of internal control operating in the company under examination by inquiry and such other methods as are desirable, to obtain any knowledge readily available which is pertinent to the accounting and financial problems of the company under examination, to be responsive to unusual events and unfamiliar circumstances, to persist until he has eliminated from his own mind any reasonable doubts he may have about the existence of material irregularities, and to exercise caution in instructing his assistants and reviewing their work.