A Fundamental Weakness in Auditing: The Need for a Conspiracy Theory

Yun Dai\textsuperscript{a}, Morrison Handley-Schachler\textsuperscript{b,}\textsuperscript{*}

\textsuperscript{a}Senior Teaching Fellow, University of Southampton Business School, United Kingdom
\textsuperscript{b}Formerly Principal Lecturer in Fraud and Financial Crime at Teesside University, United Kingdom

Abstract

The existence of a conspiracy may make the detection of a fraud by an auditor less probable, because of the ability of conspirators to falsify apparently independent items of evidence. At the same time, the existence of a conspiracy makes detection by management or other agencies more probable because of the chance that one of the conspirators or someone who has been approached to join the conspiracy will report the fraud. However, the discovery of major conspiracies to commit fraud and financial crime in companies, such as Enron and the Madoff Investment Securities case, where the auditor was himself convicted as one of the conspirators, suggests the need to re-evaluate the reasonability of asking auditors to assess the risk of a criminal conspiracy existing and the probability of financial crimes committed by the conspirators remaining undetected. This paper proposes a model for the auditor to use in making such an assessment, thereby enhancing the auditor’s assessment of the reliability of the overall audit.

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1. Introduction

Amongst their “tentative postulates of auditing,” Mautz and Sharaf (1961) propose that external auditing in practice requires that “the financial statements and other information submitted for verification are free from

\textsuperscript{*} Corresponding author. Tel.:+0044-131-3314631
\textit{E-mail address:} MorrisonHandley@aol.com
What is an unusual fraud? The answer, in an audit context, is the one which cannot be reliably detected by some of the audit techniques commonly in use, specifically those tests which are conducted on individual transactions. In fact, it is not merely a matter of not reliably detecting the fraud. As the audit process is one by which the auditor requires a person making an assertion to provide sufficient positive evidence that the assertion is the truth, the auditor is not required to detect a fraud at all. It is sufficient for the auditor to be able to say that the statement being made is not proved by the evidence. In this respect, the external auditor stands in the same relation to the financial statements as the jury in a criminal case to the charges brought. The jury is required neither to uncover for itself the evidence that the defendant is or is not guilty nor to express a view on whether the defendant might be guilty of an offense which is not on the charge sheet. It is the responsibility of the prosecuting counsel alone to prove by evidence that the events on the charge sheet happened. In the same way, the auditor is under no obligation to provide the evidence that the financial statements are or are not true. The auditor is only required to form a judgment on the basis of the evidence presented by the accountant or finance director. The auditor may of course play a more active role than a jury in determining the rules of evidence to be followed, but cannot exclude relevant evidence which the accountant provides.

Unusual frauds are therefore not those which fail to leave a trail of evidence, as evidence is required before an audit opinion can be given to the effect that the accounts are true and fair. An unusual, fraud for audit purposes is one in which apparently reliable evidence has been falsified and produced for the auditor – an analogous situation to a prosecution witness being able to give false testimony in court without being successfully challenged.

In addition, the rules of evidence applied by the auditor usually require statements to be corroborated by the evidence provided by at least two individuals who have no motive to confirm each other’s statements. Four types of frauds in which evidence apparently originating from a second person is falsified.

First, conspiracy is where at least one other person is really involved in the production of corroborative evidence. However, the conspirators are acting together to produce evidence while believing that it is evidence for a false statement or knowing that it is for a statement which they have not verified. An unusual irregularity might also arise where the perpetrator of a fraud knows that the operator of a key control is systematically negligent and will produce evidence of any statement, whether true or false, even where the negligent operator is not consciously part of a conspiracy. However, this situation can be resolved by the rotation of operators and cannot be relied on by the perpetrator of the fraud. The conscious perpetrator and the negligent operator could also legally be guilty of separate individual offenses of false accounting without being guilty of a conspiracy.

Second, forgery is where a person deliberately creates a document which is not what it appears to be, as it does not originate from the source from which it purports to originate. This may be achieved by altering a real document to make it a false one or by creating a new document from scratch. This document can then be used to corroborate evidence that the person who has forged it. The forgery itself may be outsourced to a professional forger who has no direct interest in the accounts, but, in principle, any individual is capable of creating a forged document of any description.

Third is impersonation, where an individual pretends to be a real or fictitious person other than who they really are. This may be done face to face or through a phone line. With the progressive reduction in the use of the oral evidence by auditors, opportunities for financial statement fraud by impersonation are now rare. In addition, the appearance and voice of the person attempting the fraud may be well-known to the auditor. However, by pretending to be a separate person with independent corroboration of a statement that has already been made, a successful impersonator would have the opportunity to falsify oral evidence if such evidence were accepted.

Fourth is hacking. This is usually an electronic variant on impersonation, in which the hacker pretends to be a person who has the authorization to change the data or programs on a computer system. Occasionally there may not be a necessity to pretend to be a particular person, but the maintenance of access and input logs normally makes this a requirement of hacking. Merely entering false data into a system or programming a system to process data in an incorrect fashion does not fall within the definition of an unusual irregularity given above, as it can be reliably prevented by properly designed and implemented internal controls and reliably detected by thorough systems auditing procedures.

In all these cases the main fraudster might be considered as a quick-change artist, who is able to generate a number of characters who are the same person acting in disguise, or as a screenwriter, who can script the actions of
others.

Failure to detect fraudulent or erroneous misstatements as a result of self-review by the originator is not, as such, unusual irregularities. This failure may result from the holder of a position within the organization being responsible for the verification of their own work or by an individual being transferred from a position in which they can review and sign off their own past work, for example, if a payroll manager is moved to operations management and enabled to sign for the existence of ghost employees on the payroll. This can be reliably prevented by good controls over the organization and redeployment of staff and detected by standard audit tests. Where a system's weakness allows an individual to operate multiple parts of a control and documentation system which should usually be subject to segregation of duties, this fact can be uncovered by auditors in the course of systems evaluation and be taken into account in determining the level of substantive tests required.

It is therefore essential that auditors consider the following questions at the planning stage of every audit.

1. Whether there is any person with the pressures and opportunities necessary to become the co-ordinating figure in an unusual irregularity
2. How to assess circumstantial risks of collusive frauds generally, including the risks of good controls being overridden by conspiracy, forgery, hacking or impersonation
3. How to detect any collusive frauds or other unusual frauds which might occur in the circumstances of the organization being audited
4. How to detect an actual fraud if there are conspirators colluding to cover the fraud up.

2. Risk of Conspiracy to Defraud

International Standard on Auditing 240, para.12, (International Federation of Accountants 2010) requires auditors to “maintain professional scepticism throughout their audit, recognizing the possibility that a material misstatement due to fraud could exist.” The same standard requires the auditor to use exceptional audit procedures in cases where there is a suspicion of fraud, such as the use of a document examiner (para.A9) in cases where a reasonable suspicion exists that a document presented in evidence is not genuine. This is in line with the principle enunciated in English law in Re Kingston Cotton Mill (1896) which stated that “If there is anything calculated to excite suspicion he must probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.” There is some discussion in the standard of circumstances which present a risk of fraud, including “domination of management by a single person or a small group (in a non-owner managed business) without compensating controls. However, there is no clear guidance on how to detect the operation of an actual conspiracy or even of how to detect whether such a dominant person or clique exists.

The exercise of professional skepticism is generally expected of auditors (Payne and Ramsay 2005) and the use of red-flag questionnaires and decision aids has been shown to be one method of improving auditor performance in the assessment of fraud risks (Alon and Dwyer 2010, Chong 2013), with questions about employees influenced by peer pressure being among the items on the checklist. Little explanation, however, is available on how individual circumstances are to be ascertained without the assistance of vigilant and honest client management.

3. Cases of Conspiracy to Defraud

Haynes (2012) provides a general description of 51 cases of conspiracy to defraud in the UK, with these being the only cases which were actually detected, not necessarily by an external auditor. In many cases, victims, including the HM Revenue and Customs, will have had the motivation, resources and legal authority to investigate the fraud for themselves.

In fact, conspiracies and unusual frauds have been shown to be a common occurrence, in cases such as that of Jerome Kerviel (Société Générale), where online impersonation of others was used to circumvent trading limits; the use of a forged document at Parmalat to give the impression of the existence of independent evidence from a bank; the conviction of directors Andrew Fastow, Kenneth Lay and Jeffrey Skilling for securities fraud at Enron; and the case of Madoff where the auditor, David Friehling himself pleaded guilty to being one of Madoff’s co-conspirators.
4. Theoretical Effect of Conspiracies and Other Unusual Irregularities

The overall effect of a conspiracy, forgery, impersonation or hack is to negate the auditor’s assessment of key controls and compensating controls in the accounting system. This assessment is illustrated in Fig. 1.

![Fig. 1. Auditor’s Assessment of Two Compensating Chains of Control over Financial Information](image1)

The possibility of a conspiracy negates or at least modifies this by introducing a single operator, who uses impersonation, hacking, forgery or the use of co-conspirators to override the controls and force the entire system and every document or file accessible to the auditor or at least those likely to be seen by the auditor read in a consistent but untruthful fashion, as illustrated in Fig. 2.

![Fig. 2. Auditor’s Assessment of Two Compensating Chains of Control over Financial Information with the Possibility of a Conspiracy](image2)

The problem is that operator probability of intervention $e$ may be proven hard to assess. Consequently, the existence of the possibility of conspiracies and other unusual frauds may make audit risk very difficult to be calculated and the task of proving in audit files that audit risk has been assessed nearly impossible. This is likely to be a major task for auditors in the future and reliable methods of assessing the risk of conspiracy and other unusual frauds must be developed.
5. Unusual Irregularities and Audit Methods

The possibility of unusual irregularities does not preclude systems-based auditing or the use of evidence of mutually independent sources, but requires a reassessment of the probability of the independence of elements of the system and of the probability of independence of the sources used. This presents a necessity of relying on qualitative assessments of probability which invalidates the presentation of the assessment using mathematical equations and statistics. For the auditor, this presents a practical legal risk, in that the audit files cannot exactly state the probability that a conspiracy to falsify financial statements or other unusual regularity has occurred. Hence the audit files cannot be used to provide an exact numerical estimate of audit risk. At this point the auditor is faced with the common human condition of non-statistical uncertainty. This condition is of great value to bookmakers, who are able to make a living from varying human assessments of the probability of different outcomes, but it is a problem for auditors, who is required to make their own assessments or probabilities and “to obtain sufficient appropriate audit evidence the assessed risks of material misstatement” (International Federation of Accountants 2009, para.3). This leaves the auditor in the troubled position of taking a risk of paying damages in the event of failing to predict the existence of or participants in a conspiracy.

Possible responses to the problem include methods which can be used to bypass the use of audit evidence relating to specific transactions and even specific evidence relating to aggregate figures. These methods include the use of the business risk approach to auditing and the use of analytical procedures.

The business risk approach to auditing (Eilifsen, Knechel and Wallage 2001, Knechel 2007) requires the auditor to rely not primarily on an assessment of the documentation of transactions, but on the assessment of the auditee’s business risks and thereby of the types of misstatement which are likely to occur as a result of uncertainty, optimism or an economic motive to mislead investors or regulators. Although these business risks may include conspiracies of some kind or another (for example, between employees of clients and competitors to frustrate competitive tendering procedures), they are independent of the existence of a conspiracy to falsify accounts. Therefore, they may contribute to the assessment of audit risk without appeal to Mautz and Sharaf’s postulated assumption that the financial statements “are free from collusive and other unusual irregularities” (Mautz and Sharaf, 1961).

Analytical procedures (Hirst and Koonce 1996, Mulligan and Inkster 1999) as substantive tests have a number of advantages over sample tests of individual transactions, quite apart from their greater efficiency, in relation to potential conspiracies. The range of information required for effective analytical procedures, which is likely to include national and international economic statistics, encompasses data of a scope which is beyond what conspirators connected to individual industrial concerns can falsify. In addition, the conspirators cannot control the variables which an independent auditor will use in calculating expected values and ratios in the accounts.

The assessment of inherent risk is also a key audit technique (Miller, Cipriano Ramsay 2012) which does not rely on internal controls or specific information on economic events and is therefore capable of being carried out without interference from the conspirators. A low inherent risk would imply that accurate financial statements can be easily created. However, the assessment of inherent risk cannot by itself provide assurance that the financial statements do not contain false information.

Frauds committed by means of computer misuse may leave traces in computer logs which the perpetrators are unable to prevent, in terms of machine access codes and input addresses. An inspection of activity logs may be useful in order to provide evidence to support the supposition of independence of two matching inputs. However, this can be circumvented by a hacker who has gained access to more than one computer on the network and will, in any case, be of no use in detecting conspiracies.

Other avenues may be available to detect conspiracies, such as the use of whistle-blowing hotlines. However, as these are not the responsibility of the auditors, they lie outside the present topic.

6. Conclusion and Research Agenda

The assumption that financial statements are not affected by conspiracies to defraud is essential to the belief that auditors can obtain independent audit evidence to confirm the accounting data underlying financial statements. However, there is ample evidence that conspiracies to defraud, do exist in the real world, that there are often strong motives to enter into a conspiracy to defraud and that such conspiracies do affect the financial statements. Hacking, impersonation and forgery present similar risks of unusual misstatements.
The purpose of this paper is to raise the fundamental question of how auditors are going to adapt their working methods in order to reduce to an acceptable level of the risk of failing to detect an active conspiracy to defraud which involved conspiracy to falsify accounting information reflected in the financial statements. In order to address this overall question, it would be useful to conduct further research on the following topics: (i) Auditors already conduct their work in an environment in which conspiracies to defraud are possible. What methods are auditors already using which are aimed specifically at detecting collusive and unusual financial statement frauds and what are the other auditing techniques which are already in use which might increase the chances of detecting these unusual frauds? (ii) Do business owners, investors and regulators expect auditors to detect unusual frauds? If not, do they rely on the efforts of other professionals to do so? Overall, where do interested parties perceive the responsibility for detecting unusual frauds, beyond the responsibilities of the directors? (iii) What further methods might be introduced to reduce the risk of unusual frauds being undetected? Here conspiracies may be the most intractable problem, as they will not be detected by physical document examination or inspection of computer logs. (iv) What is the prevalence of the auditors themselves becoming involved as conspirators in collusive financial statement frauds?

References


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