WHY DO AUDITORS FAIL TO DETECT FRAUD?
Overview

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Knowledge, Training and Experience needed for Fraud Detection
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## 4-Factor Framework

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<th>- the methodology employed to search for and detect fraud.</th>
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4-Factor Framework

Institutional Factors

Knowledge, Training & Experience

Auditor Incentives

Understand the Client’s Business

Assess Fraud Risk

Design and Execute Tests

Review the Work and Resolve Issues

Consult Experts

The Audit Process for Detecting Fraud

Fraud Detection
In a recent study, we obtain experiential based evidence on why auditors rarely detect frauds from fraud examiners (Asare, Wright and Zimmerman 2014, JFIA).

- Fraud examiners routinely make causal attributions for an audit failure that they are investigating, which requires them to focus on the effectiveness of the audit process,
- the adequacy of the auditors’ fraud knowledge or training,
- the extent to which an auditor following audit standards could have detected the fraud and
- the role of auditors’ incentives.
4-Factor Framework

Audit Process

• failing to effectively assess management’s incentives and opportunities;
• Failing to sufficiently modify audit tests as the primary drivers of audit failures.

Knowledge, training and experience

• Insufficient or Inadequate training;
• Lack knowledge of fraud schemes; and
• Undue trust in management.

Institutional Factors

• They perceive GAAS audits as not sufficiently focused on detecting fraud, as the primary institutional inhibitor of fraud detection.
Knowledge Training and Experience

Auditors are not effectively trained to detect or recognize fraud.

- One expert noted that fact patterns suggesting that fraud exists (i.e., fraud schemes) are unfamiliar to many auditors because they have not been trained in this area and because fraud is a rare event.

Auditors’ lack training in fraud detection methods or fraud investigation techniques.

Auditors are in constant interactions with management and may develop trust schema that interfere with their ability to effectively process fraud cues.

- While professional standards highlight the importance of professional skepticism, neither those standards nor the academic literature have paid adequate attention to the hurdles inherent in being skeptical of those with whom auditors regularly interact.
KTE needed for Fraud Detection

- Understand the conditions that allow fraud to occur
- The way that frauds are perpetrated (fraud schemes)
- Frequency of occurrence of fraud schemes by client type
- Cues that signal that such a scheme is operating
- How fraud schemes reflect in the financial reporting process
- How fraudsters respond to audit inquiries
- How to test hypotheses on various fraud schemes
- How to conduct fraud interviews
While experience is the best teacher, auditors’ experience seldom teach them fraud detection skills.

Formal education and continuing professional education provide the avenue to acquire fraud knowledge.

Alas, most auditing curricula around the country do not focus enough on providing fraud knowledge.
Practical Tips: What Will Not Help

- More Detailed Testing
- Skepticism
- Kumbaya
- Fraud Analysis as an afterthought or an add on
- Oral Auditing
Practical Tips: What Might Help

- **Strategic Risk Assessment** (ability to identify when companies are in stressful situations)
- **Better Analytics** (better integration of operating data)
- **Pattern Recognition** (anti-line auditing)
- **Big Data (DNA Coding)**

**During Interaction Phase**

- Are auditors outgunned?
- Victims of past misses (blackmailed?)
- Garden Path
- Verbal and Non-Verbal cues
Consultation

Transform audit engagements to involve forensic specialists

Creates a new work arrangement where the auditor is reliant on a secondary layer of expertise to fulfill a primary responsibility while still retaining overall responsibility for the audit outcome

What task sharing, communication and coordination issues arise in this new work arrangement (Asare and Wright 2014)?
Forensic specialists’ role in this work arrangement is to clarify how fraudulent transactions occur, identify idiosyncratic fraud risk and perform unique fraud procedures (such as document authentication and entity verification).

There is disagreement among auditors as to whether forensic specialists should be involved on all audit engagements.

• While some auditors think it is comforting to have the forensic specialist validate their work, even if it leads to no changes in risks or audit procedures, others think such required consultations exacerbate the “wild goose chase” effect.

• Nevertheless, current practice appears to require consultation in some target situations, including incidence of restatements, suspected fraud or scheduled consultation (e.g., triennially for some public clients).
Consultation: Some Preliminary Findings

The most significant challenges arise in the work arrangement when the forensic specialists’ task is not targeted or when there is unintended communication between the forensic specialists and the client personnel.

Auditors and forensic specialists sometimes disagree on what constitutes immaterial fraud risk, leading to what auditors refer to as “scope creep” or “wild goose chase.”

There is also the lurking danger that auditors could use the supervisory controls to direct the forensic specialists to adopt a more client perspective, with the concomitant erosion in their forensic mindset.
Dual Fraud Reduction Strategy

**For Clients**
- Make it less likely for clients to produce fraudulent preaudit financial statements.
- Make it less likely for clients to pressure auditor to allow biased reporting.

**For Auditors**
- Make it more likely for auditors to design audits that have a high probability of detecting intentional misstatements.
- Make it more likely for auditors to resist client pressure not to probe and report questionable transactions.