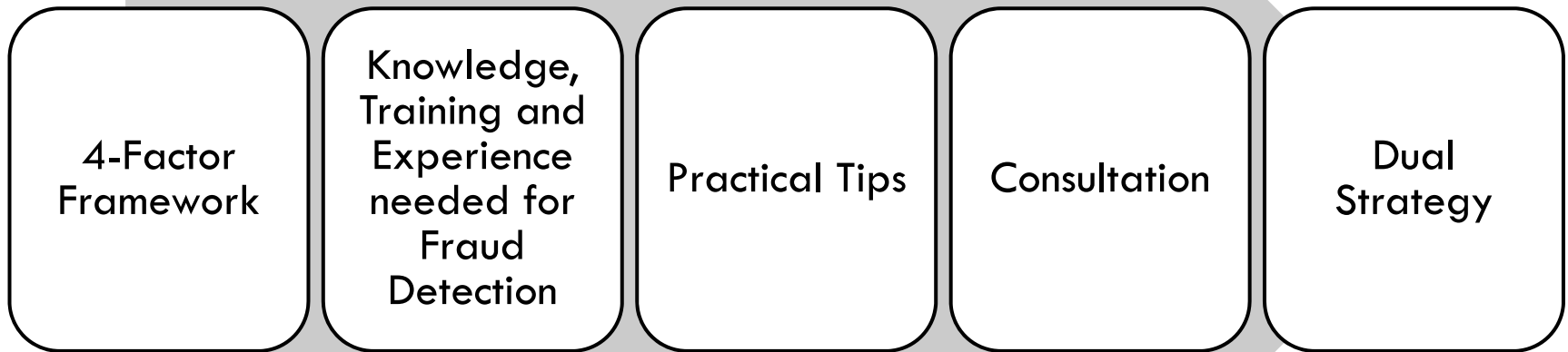


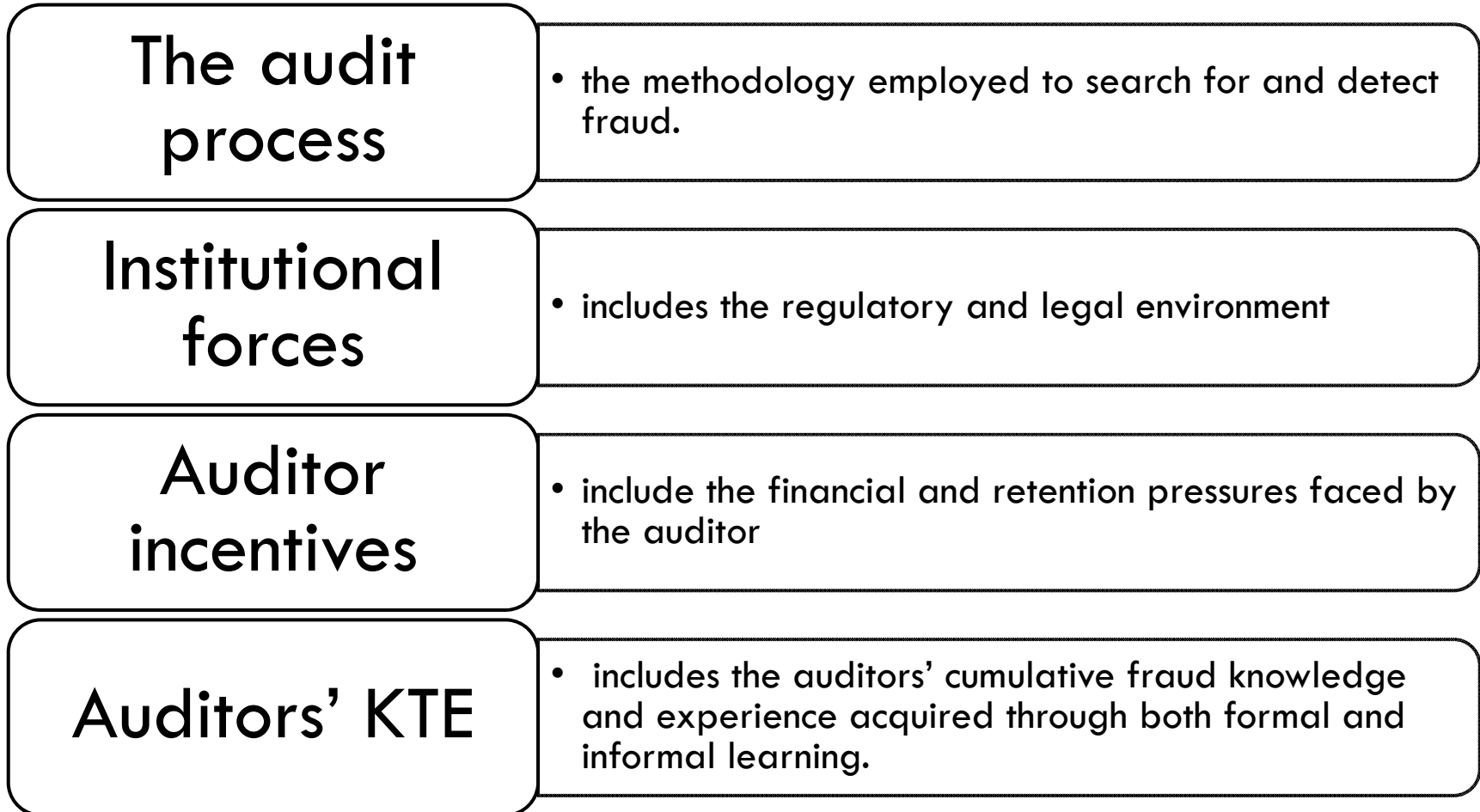
# WHY DO AUDITORS FAIL TO DETECT FRAUD?

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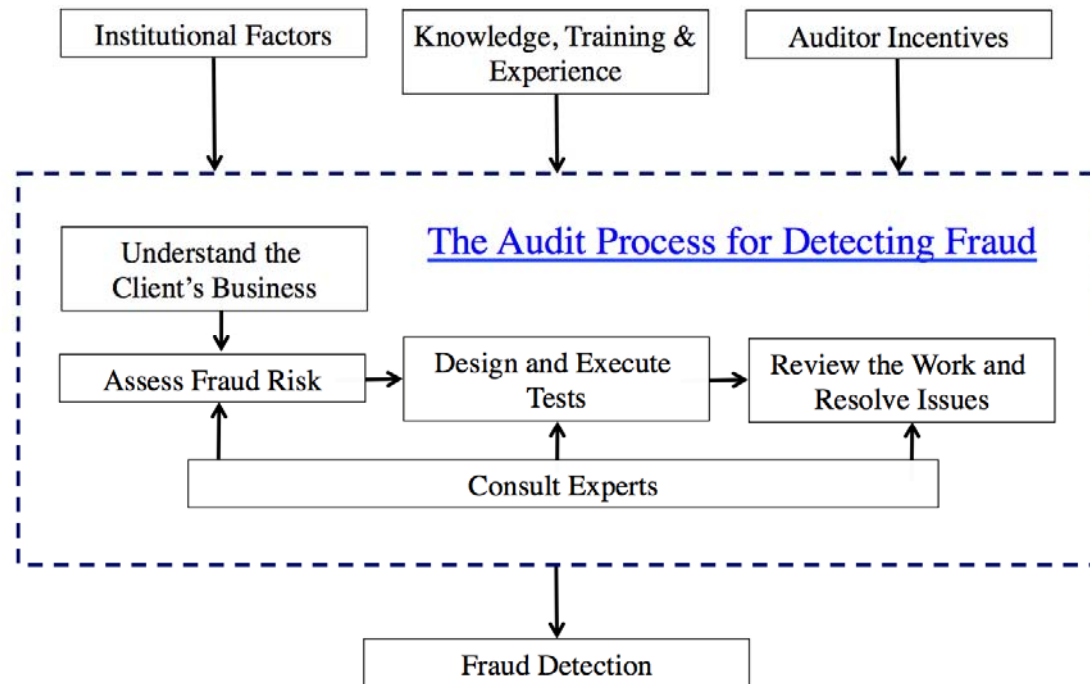
# Overview



# 4-Factor Framework



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# 4-Factor Framework



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



# Acquiring Fraud KTE

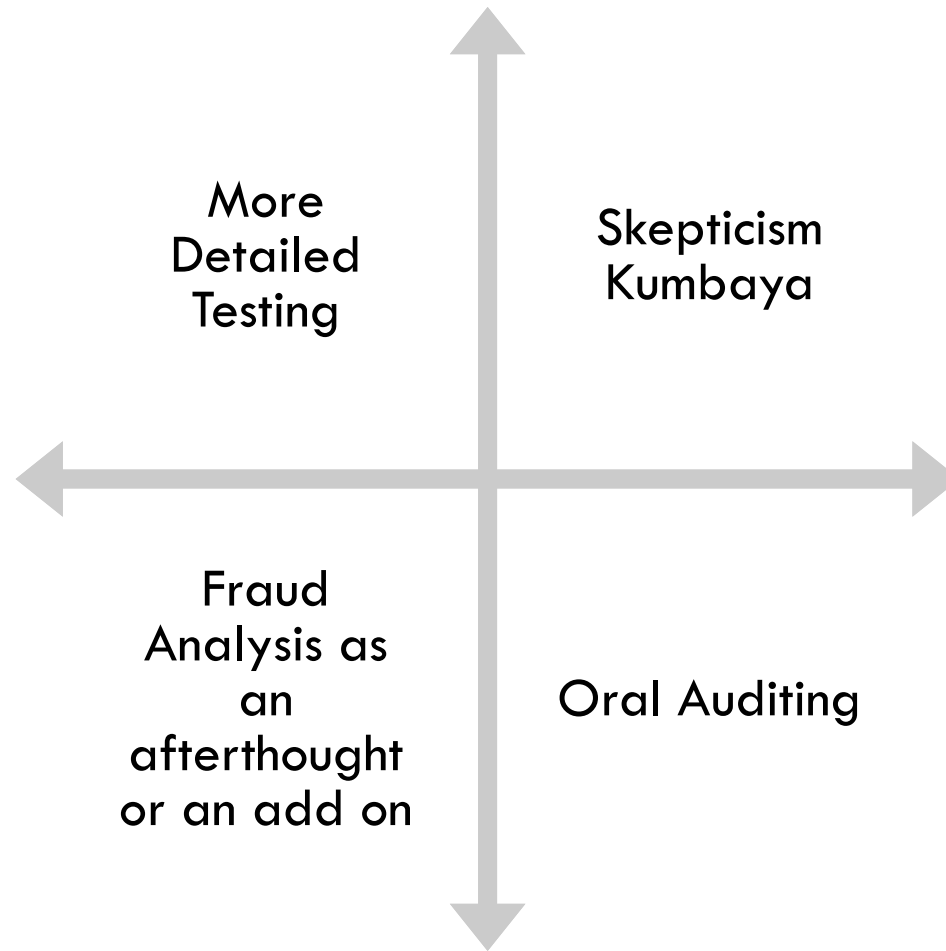


While experience is the best teacher, auditors' experience seldom teach them fraud detection skills

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



# 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)?

# Consultation: Some Preliminary Findings

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

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## 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