

INSTITUTO POLITÉCNICO DE LISBOA
INSTITUTO SUPERIOR DE CONTABILIDADE
E ADMINISTRAÇÃO DE LISBOA



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FRAUDULENT FINANCIAL REPORTING AND THE AUDITOR'S
RESPONSIBILITY IN THE DETECTION OF FRAUD IN THE
FINANCIAL REPORTING

Maria Helena Nama D'Oliveira

Lisbon, July 2019

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Dissertação submetida ao Instituto Superior de Contabilidade e Administração de Lisboa para cumprimento dos requisitos necessários à obtenção do grau de Mestre em Auditoria, realizada sob a orientação científica de Pedro Roque, Professor Adjunto Convidado, Auditoria.

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Abstract

Fraud has been a prominent problem throughout the last few decades and has shaken many companies (economically), or to the point of shutting down, for example Enron and Arthur Andersen. The acts were intentional acts committed by the perpetrators, therefore an error committed cannot be considered as fraud.

Fraud can be described in three major categories according to the ACFE. Corruption being the first of these types, and an example being bribery, or conflict of interest. Whilst the second type is asset misappropriation, and an example of that is theft of cash or payroll schemes. Lastly, there is financial statement fraud, and an example of financial statement fraud Assets Overstatement or Understatement.

Financial statement fraud occurs when intentional misstatement occurs in the financial statements and not when an error occurs. «*Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred*» (ISA 240)

It is the auditor's responsibility to provide assurance that the financial statements are free from misstatements. This provides the users of the financial statements the assurance of the financial position that the audited organization finds itself. To ensure that the audit is well carried out, it is important that the auditor practice professional judgement and professional scepticism and most importantly independence.

The management of the audited organization is entirely responsible for the preparation and the outcome of the financial statements; therefore, all that results from the financial statements including the detection of fraud is of the responsibility of the management and or governance of the entity.

Keywords: Auditor, Fraud, Financial Statement, Auditor's Responsibility

Resumo

A fraude tem sido um problema prominente ao longo das últimas décadas e abalou muitas empresas (economicamente), ou ao ponto de desligar, por exemplo, Enron e Arthur Andersen. Os atos foram atos intencionais cometidos pelos perpetradores, portanto, um erro cometido não pode ser considerado como fraude.

A fraude pode ser descrita em três categorias principais de acordo com o ACFE. A corrupção é o primeiro desses tipos e um exemplo é suborno ou conflito de interesses. Enquanto o segundo tipo é apropriação indébita de ativos, e um exemplo disso é o roubo de caixa ou esquema de *payroll*. Por fim, há fraude nas demonstrações de resultados e um exemplo de fraude financeira ou sobreavaliação ou subavaliação de ativos.

Fraude nas demonstrações financeiras ocorre quando distorção intencional ocorre nas demonstrações financeiras e não quando ocorre um erro. «*Embora o auditor possa suspeitar ou, em casos raros, identificar a ocorrência de fraude, o auditor não estabelece determinações legais sobre se a fraude realmente ocorreu*» (ISA 240)¹.

É de a responsabilidade do auditor garantir que as demonstrações financeiras estão livres de distorções. Isso fornece aos usuários das demonstrações financeiras a garantia da posição financeira que a entidade auditada encontra. Para garantir que a auditoria seja bem executada, é importante que o auditor pratique o julgamento profissional, o ceticismo profissional e, mais importante, a independência.

A administração da entidade auditada é inteiramente responsável pela preparação e pelo resultado das demonstrações financeiras; portanto, tudo o que resulta das demonstrações financeiras, incluindo a detecção de fraude, é de responsabilidade da administração e ou governança da entidade.

Palavras Chaves: Auditor, Fraude, Demonstração Financeira, Responsabilidade do Auditor

¹ Free translation

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Abbreviations

ACFE – Association of Certified Fraud Examiners

ISA – International Standards on Audit

EOROC – *Estatuto de Ordem de Revisores Oficiais de Contas*

ROC – *Revisor Oficial de Contas*

SROC – *Sociedade de Revisores Oficiais de Contas*

CAQ – Center of Audit Quality

IAS – International Accounting Standards

CMVM – *Comissão do Mercado de Valores Mobiliários*

IIA – Institute of Internal Auditors

CIMA – Chartered Institute of Management Accountants

GAAS – Generally Accepted Auditing Standards

GAAP – Generally Accepted Accounting Standards

SAS – Statement of Auditing Standards

EY – Ernst & Young

PwC - PricewaterhouseCoopers

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Part I

1. Introduction

1.1 Objective of investigation

Over the past decades, fraudulent acts have had a very big impact on the business world, having shaken companies to even shutting some down. It has even had an impact on the economy seeing that with the closing of certain companies, people have lost their jobs and economies have lost businesses affecting the economy as a whole. In many instances, these fraudulent scandals involved financial statement fraud. Through studies conducted by the Association of Certified Fraud Examiners (ACFE), financial fraud only accounts for less than 10% of fraud committed in 2016, however it caused major losses.

The nature of fraud and the types of fraudulent acts will be identified throughout this dissertation. While it has been acknowledged that no matter how good, technology gets and how much these new programs may be effective fraudulent financial statements acts may never cease. However, there is a need to acknowledge that the people that work within these companies are the ones that commit such fraudulent acts and that with the aid of laws that were introduced after huge fraudulent scandals and with the aid of international and national auditing standards, financial statement fraud may decrease. Throughout the investigation of this dissertation, the aspects of fraud, of an auditor and the question of what responsibility an auditor has when fraud is detected in the audited company's financial statement will be researched.

1.2 Methodology

The methodology of this thesis will be done in two parts:

a) The first part will be the literature review. The literature review will be done through the study of books, academic articles, and scientific articles and through the study of previous dissertation.

b) The second part of this dissertation is the empirical part conducted through the distribution of a survey handed out to Chartered accountants (ROC), accounts and other professionals linked to this area.

1.3 Structure of this thesis

This dissertation is made up of two different sections and these sections are as follows:

The first part is the literature review, where the nature of fraud is described and discussed, from the classifications of fraud to the fraud triangle.

Following to the discussion of the nature of fraud, the nature of financial statements, auditing, and auditors and the detection of fraud.

The second part of this dissertation consists of the empirical study where the results of survey distributed is discussed.

2. The Nature of Fraud

Fraud occurs when someone wrongfully attains something, which often times is for financial gain. Moreover, is better defined as « *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*» (W. Albrecht, C. Albrecht, C. Albrecht & M. Zimbelman (2011).

One can also define fraud as an intentional act committed by one or more individuals among management, those in charge of governance, employees, etc., that involve the use of deception to obtain an unjust or illegal advantage (ISA 240). As mentioned at the beginning of this paragraph, fraud is an intentional act, so it is different from an error; for example, a person unintentionally enters incorrect numbers in a financial statement this should not be seen as fraud but rather as an error. However, if that person knowingly made that error, or did it to gain personal gain it could be considered as fraud.

Although all acts of fraud involve deception, not all acts of deception involve fraud. Therefore, in order for it to be considered as fraud, the following have to occur (J.T Wells, 2005):

1. A material false statement
2. The Knowledge that the statement was false when it was uttered
3. Reliance on the false statement by the victim
4. Damages as a result

When an employee commits fraud, it is considered as fraud committed against the organization, however, when management (or governance) commits the fraudulent act, usually through financial statement fraud, then it is considered as fraud committed on behalf of the organization.

Fraud committed on behalf of an employee is usually considered as fraud committed against the company, however, if a person(s) of management and above commit a fraudulent act it is considered as a fraud on behalf of the company.

Fraud can also be defined as “*The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets*”. Moreover, occupational fraud (as defined above) is a result of the misconduct of employees, managers, or executives. This can include any act from lunch break abuses to high-tech schemes.

2.1 Classification of fraud

Finlay (2009) mentions that fraud is categorized either by the victim involved, the technique or the activity used by the fraud perpetrator. In addition, throughout this dissertation, financial statement fraud will be discussed. Financial statement fraud is a type of occupational fraud. Occupational fraud is better described in three major categories according to the ACFE. These categories are such as asset misappropriation, corruption, and fraudulent financial statements. The three categories are defined as follows:

- Asset misappropriations involves the misuse or theft of assets pertaining to the organization;
- Corruption occurs when it involves the fraud perpetrator wrongfully using their influence to obtain personal benefits;
- Fraudulent financial statements involve the falsification of an organization’s financial statements.

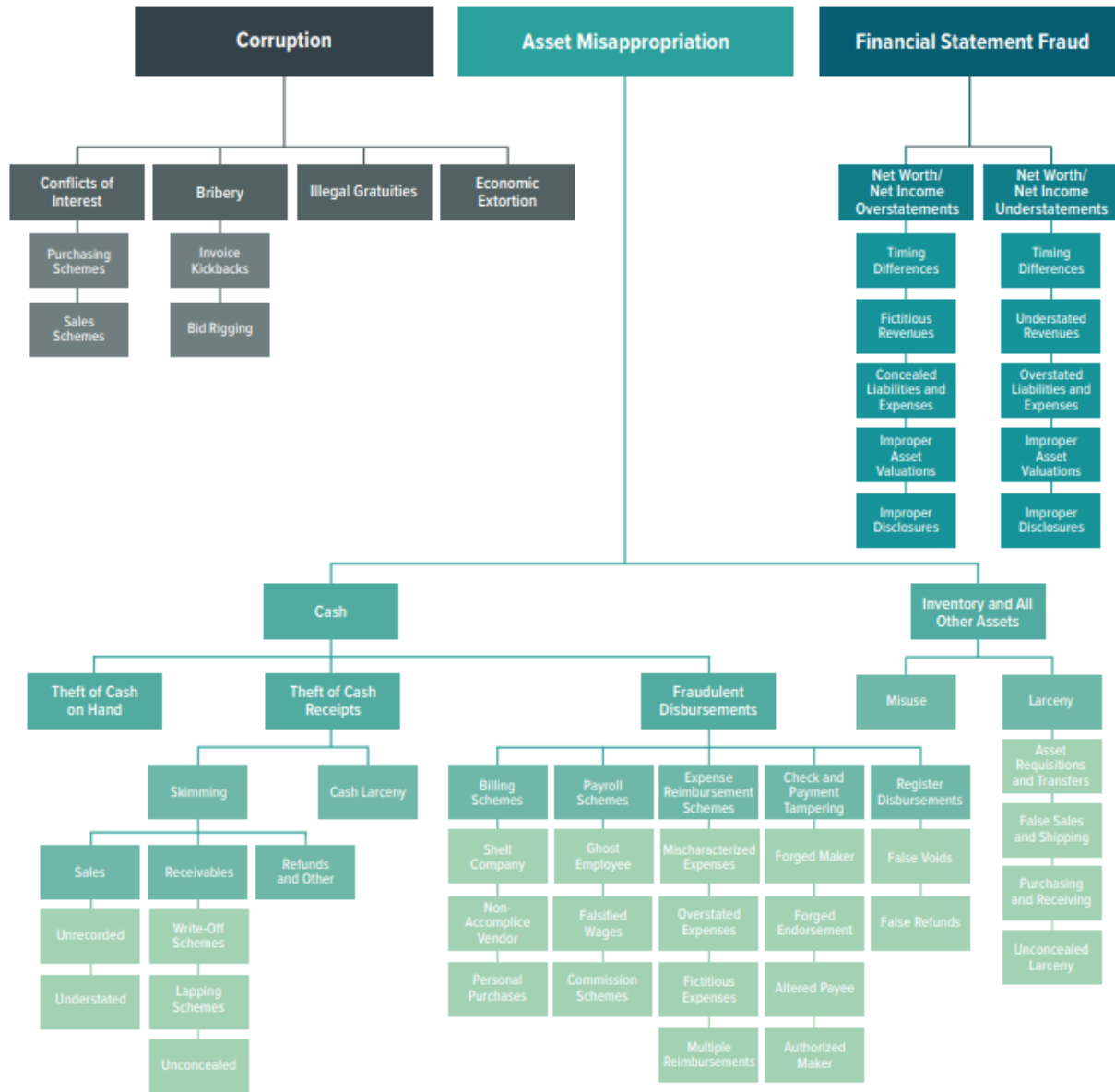


Figure 1: Fraud Tree

Source: ACFE

In the previous paragraph, the three major categories of occupational fraud were described. However, it is known that there is always a perpetrator behind every fraudulent act. For every perpetrator, there are victims² that are affected by the fraudulent acts, and W. Albrecht *et al* (2011) gives the example of management fraud whereas the victims are shareholders or debt-holders of the organization. Often times when management fraud is mentioned, it refers to financial statement fraud. Management fraud usually involves deceptive management tactics committed in the entity's financial statements committed by top management, for example General Manager or Financial Director. Well-known examples of alleged management fraud in recent years include WorldCom, Enron.

Any type of fraud that is not considered as one of the first three types of fraud, may have been committed for reasons other than financial gain, and can simply be considered as miscellaneous fraud.

According to W. Albrecht *et al* (2011), studies have shown that *“Fraud perpetrators were better educated, more religious, less likely to have criminal records, less likely to have abused alcohol, and considerably less likely to have used drugs. They were also in better psychological health. They enjoyed more optimism, self-esteem, self-sufficiency, achievement, motivation, and family harmony than other property offenders did. Fraud perpetrators also seemed to express more social conformity, self-control, kindness, and empathy than other property offenders”*. The typical fraud perpetrator was between the ages of 36 and 45 and held a senior management position within a company where these fraudsters were employed for at least six years. These perpetrators seemed to have had a decent life and had no-good reason to commit such fraudulent act. (KPMG's Global Profiles of the Fraudsters report in 2013)

It is of an entity's benefit to try to eliminate the issue at hand, once a fraudulent act has been committed. It is also important that the company try to prevent any future occurrences. However according to Phil Oswalt, Global Coordinator for Investigations for the Global Forensic practice at KPMG, *“The intriguing thing about fraud is that it is always morphing, like a strain of flu; you can cure today's strain, but next year it evolves into something as bad if not worse”*. (KPMG's Global Profiles of the Fraudsters report in 2013) Making it difficult to eradicate the issue at hand immediately.

² Those majorly affected by this typed of fraud.

In addition to better understanding how fraud can be prevented in an organization, there is a need to understand the reasons as to what motivates a fraud perpetrator and who commits the crime.

This is understood through the illustration of the fraud triangle, which explains, «*The potential fraudster sees a door opened by opportunity. Motivation or rationale propel this person towards the doorway and capability takes this person through it*» (KPMG’s Global Profiles of the Fraudsters report in 2013)

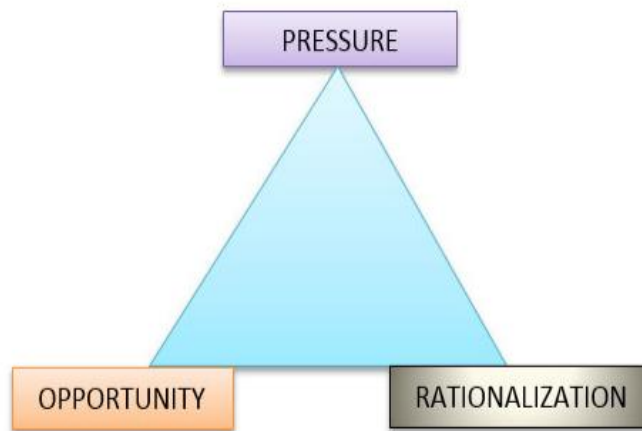


Figure 2: Fraud Triangle

Source: R. Abdullahi, et al (2015)³

The three elements that make up the fraud triangle are considered as the drives of fraud and are explained as follows:

Before the fraud perpetrator even considers the given opportunity to commit the crime there has to be a motive behind wanting to commit such a criminal act. “*Typically a person commits fraud to fund an extravagant or at least very comfortable lifestyle; we seldom see people turn fraudster to make ends meet, already well off, we often wonder why they take the risk*” (KPMG’s Global Profiles of the Fraudsters report in 2013)

³ The diagram was retrieved from R. Abdullahi, et al (2015) article, who retrieved the fraud triangle from J.T Wells (2005).

As seen in the previous paragraph, one of the main reasons that a perpetrator commits fraud is to better their lives or to better meet targets in their careers and not because there is any necessity to commit the crime.

Other triggers to committing fraud were the pressure of reaching financial targets. As previously discussed, the opportunity is the reason why a person commits fraud. Such opportunities arise when personal or professional pressures arise. It is clear to see that financial pressure to commit fraud is not always influenced by one's desperate situations in life, rather at times influenced by greed. This could also be triggered by seeing peers achieving a lot more than what the perpetrator desires to have.

Once a fraud perpetrator has a motive and has perceived an opportunity to commit fraud, this person usually provides a rationale to commit the deed. The main rationale that these perpetrators have is the need to feel superior. However, it has been shown that these perpetrators are already exercising a level of superiority in their careers.

2.2 Financial Statement Fraud

International Standards on Auditing (ISA) 240, mentions how there is a difference between an error and a misstatement in the financial statements when considering if the financial statements are fraudulent or not. Financial statement fraud occurs when a person falsifies the financial statements by overstating revenues or understating liabilities and expenses. (Deterrence and detection of financial fraud - EY). Financial statement fraud may not be considered as the most common type of occupational fraud⁴, it however is considered the costliest of occupational fraud. (Report to the nations on occupational fraud and abuse)

Statement on Auditing Standards (SAS) 99 mentions that fraudulent financial reporting does not need to be the result of a grand plan or conspiracy. However, it may also be that management representatives rationalize the appropriateness of a material misstatement may be seen as an aggressive indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements that include interim statements, that are expected to be corrected later when operational results improve.

⁴ Occupational fraud as discussed in previous paragraphs

Financial statement fraud occurs when corporations deliberately deceive and mislead users of the published financial statements such as investors and creditors by preparing and publishing materially misstated. Financial statement fraud involves intent and deception of knowledgeable perpetrators (e.g. top executives) with a set of well-planned schemes and a considerable competitiveness. Zabihollah Rezae (2002) mentions that their financial statement fraud involves fraud set up by the knowledgeable perpetrators. Some of these schemes are as follows:

- Falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions;
- Material intentional misstatements, omissions, or misrepresentations of events, transactions, accounts or other significant information from which financial statements are prepared;
- Deliberate misapplication, intentional misinterpretation, and wrongful execution of accounting standards, principles, policies and methods used to measure, recognize, and report economic events and business transactions;
- Intentional omissions and disclosures or presentation of inadequate disclosures regarding accounting standards, principles, practices, and related financial information;
- The use of aggressive accounting techniques through illegitimate earnings management (Z. Rezae, 2002)

As discussed in previous paragraphs the fraud perpetrator was identified as someone who is usually in levels of superiority in a company. According to the Center of Audit Quality (CAQ), members of management are responsible for the overseeing of the financial statement process within a company and have a principal role in the detection and deterrence of financial statement fraud. This may, however, cause conflict if the person(s) that commits the fraudulent act is the exact same person(s) in charge of auditing the financial statements⁵.

2.3 Financial Statements

Considering that this dissertation is based on fraudulent financial reporting, it is important to define a financial statement is and what it consists of and mention some of the principles that an organization may use during the preparation process of its financial statements.

⁵ This occurs when the auditor is a perpetrator in the fraud scheme but is also in charge of auditing the financial statements and detecting any misstatements in the financial statements.

According to the IAS 1, a financial statement is prepared to in order to provide information on the entity's financial position, performance and cash flows that is useful to the users that are involved in the economic decision making of the entity. In order to provide such information to the users, the financial statements should consist of information about the entity's assets, liabilities, equity, income and expenses, contributions by and to the equity holders of the entity, and the cash flow of the entity.

The Conceptual Framework states that information in a financial statement must be useful and it must provide faithful representation for it to be beneficial to the user. In order for it to be useful, the information must be both relevant and reliable.

According to P.R Delaney *et al*, when financial information is relevant, it makes a difference to the decision maker of such information, to be able to predict future events or confirm certain expectations. The relevance of financial information aids the decision maker in reducing uncertainty even though it might not change the outcome of the decision made. P.R Delaney *et al*, also states that information is relevant if it provides knowledge concerning past events and future events and most importantly, it is timely, (this is because information must be timely for it to be relevant before it loses its ability to influence the decision maker).

Financial information is also useful for decision making when it is reliable. Information is reliable when it verifiable and neutral. In addition, for reliability, the financial statements should consist of important financial relationships (P.R Delaney *et al*, 2001).

Another principle financial statements are based on is Fair Representation. According to IAS 1, fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income, and expenses set out in the Conceptual Framework.

The conceptual framework states that the financial statements are prepared to assume that the organization will continue its activities in the near future⁶. In addition, amongst other characteristics of useful financial information, one of the most important concepts is the concept of materiality and aggregation.

Materiality states that an item of information is only material and should be reported if it is significant enough to have an effect on the decision maker.

⁶ This refers to the on Going Concern principle

With all the characteristics of the conceptual framework regarding financial information, this financial information can be represented in financial statements as follows (IAS 1):

- Statement of Financial Position for the period
- Statement of Profit or Loss or Comprehensive Income for the period
- Statement of Changes in Equity for the period
- Statement of Cash Flow for the period
- Notes

2.4 Internal controls

When preparing the financial statements, it is crucial that an organization have proper internal controls in place. This is so that the organization not only have a better chance at reducing the possibility of fraudulent financial reporting, but it also serves as crucial to add credibility to the financial statements.

The only way a fraud perpetrator can even have the opportunity to commit fraud is because the organization has weak internal controls in place. Too often, these organizations do not set up proper controls until it is too late.

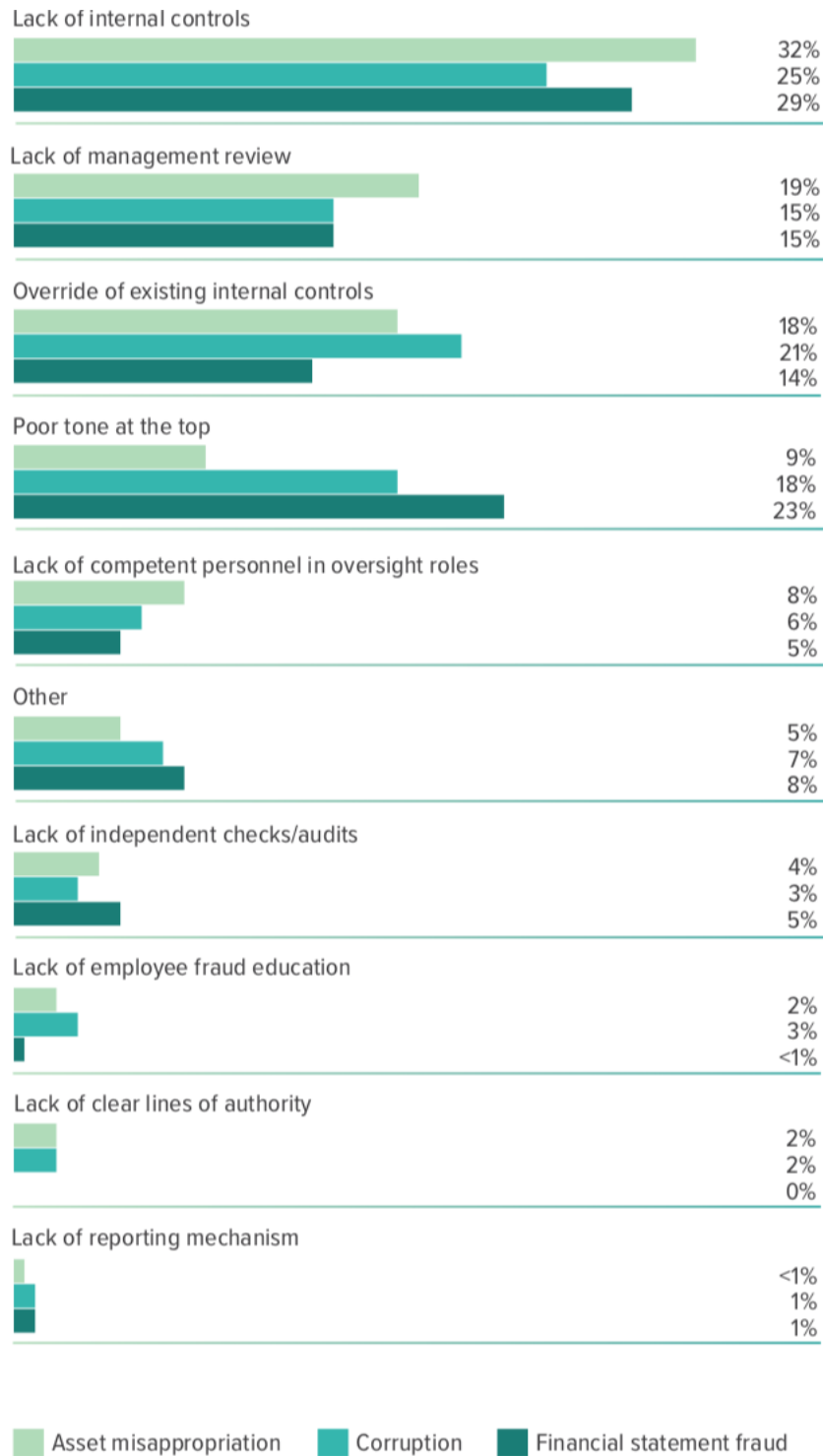


Figure 3: How do internal controls weakness vary by scheme type

Source: ACFE Report to the Nations on Occupational Fraud and Abuse 2018

Strong internal controls do not prevent all fraud, simply because some fraud perpetrators commit fraud recklessly and some fraud perpetrators are already well acquainted with the controls in place and just manipulate them. According to the KPMG Global profiles of the fraud perpetrator shows that around 11 percent of perpetrator plot to circumvent the controls.

“Having good internal controls is important, but with any control, you are ultimately relying on the human element” (Niamh Lambe, Director of KPMG, head of KPMG Forensic Ireland)

Internal controls are measures taken to detect and prevent losses due to fraud or negligence, and there several well-established procedures. *«Internal control is recognized as a key corporate governance mechanism and disclosure of information about internal control systems is viewed as a significant component in the process of restoring public trust in corporate probity in the wake of financial scandal. »* (Spira & Gowthorpe, 2008).

M. F. Trebesh states that in every company a set of internal controls are established to oversee financial, operational and other areas in the business to guarantee that the company is adhering to the ethical conduct. These controls are usually set by according to the intention and expectation that top management has for the company. All properly designed control systems are based on the following six basic principles:

- Segregation of duties: Within the company, the person who signs off the financial statement before released to the users of the financial statements should not be the person that prepares the financial statements. For example, the responsibility for record keeping for an asset should be separate from the physical custody of the asset;
- Establishment of responsibility and accountability: Internal controls are more effective when tasks are assigned to the responsibilities of a given task is better established. In other words, it is when people within an organization is clear about what tasks are of their responsibilities;
- Proper documentation of transactions;

- Physical and mechanical security devices: Physical controls relate primarily to the safeguarding of assets. Mechanical and electronic controls safeguard assets and enhance the accuracy and reliability of the accounting records. Use of physical, mechanical, and electronic controls is essential;
- Independent internal verification: Independent internal verification involves the review, comparison, and reconciliation of data prepared by employees. In large companies, independent internal verification is often assigned to internal auditors;
- Other controls: Rotating employees' duties is essential to verify that the internal controls that were established are followed through and to minimize the chances of the person who would most likely commit fraud. In the case of external auditors, it helps to minimize biased opinions due to the familiarity of the company and its financial statements.

3. Auditing

Audit is a word that is derived from the Latin word meaning 'a hearing'. When it comes to auditing there can be a few definitions of what an audit means, however, Porter *et al* (2008), define the act of auditing as, « *A systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organization making the assertions had been engaged, to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to users of the report in which the assertion are made*».

Porter *et al* (2008) conclude that the statement above of the definition of an audit transmit that:

- Auditing is a process of ordered series of steps
- Auditing mainly involves gathering and evaluating of evidence
- An auditor critically and carefully examines the assertions of the organization audited

- The auditor conducting the examination of the assertions assesses how closely the assertions were prepared according to the principles of the organizations set for the process of all assertions
- Once all evaluations and examinations are done, the auditor then communicates the findings to the organization through a written report.

Different types of audits exist. These types of audits can be defined according to Porter *et al* (2008) as:

- The primary objective of the audit;
- Primary beneficiaries of the audit

When referring to the primary objective of the audit it can further be subdivided into the following types of audits:

- Financial statement audits
- Compliance audits
- Operational audits

Since this dissertation is focusing on financial statements, only the financial statement audit will be defined. Financial Statement can be defined as an examination of the entity's financial statements, that are prepared by the organization's management and/or those charged with governance of the organization, for shareholders and other interested parties of these financial statements. Auditors do not only examine financial statements but also validate supporting information of the financial statements.⁷

Qualified and experienced professionals (external auditors) who are independent of the organization, conduct these audits. It is essential that the auditor be independent to be able to express an unbiased opinion on whether the financial statements provide a true and fair view of the organization financial performance and financial position and if the statements comply with required regulatory (Porter *et al*, 2008).

Gathering the facts and information also entails identifying the key inputs and assumptions to the transaction, event, or situation. For example, this may include understanding the

⁷ Examples of the supporting documents include examples such as invoices of purchases of inventory.

underlying economic considerations of a particular transaction or series of related events, or consideration of the transaction's legal form and its economic substance. Obtaining such an understanding often includes considering whether other corroborating information exists, as well as identifying disconfirming or conflicting information, and an assessment of the sources of such information and whether those sources may be subject to bias⁸.

3.1 The nature of an Auditor

«The CMVM defines Independence of an Auditor as a general principle that an auditor (ROC) must not only be independent but also appear to be independent». Barrote (2010, p. 29)

“The quality of an audit is the basis for assessing the reputation and independence of the auditor” Kohlbeck et al. (2010)

According to the EOROC, the members of the board must participate in an exercising profession with zeal and competence, avoiding any contraction of their dignity.

There are two types of auditors. Internal and external auditor, however this dissertation distinguishes the duty and responsibility of that of an external auditor. And an external auditor is described as an independent third party that ensures that the audited financial statements have been properly maintained, are accurate and comply with established concepts, principles, accounting standards, legal requirements and give a true and fair view of the financial state of the entity”. (Guidelines on the contribution external audit experience may make towards a successful application for membership of CIMA)

3.2 Auditor's independence

The ISA 200 mentions that according to the IESB Code the independence of an auditor can be defined to «comprise *both independence of mind and independence in appearance.* »

The independence of an auditor allows the auditor to form an opinion on the financial statements audited without any influence. This means that the auditor will not be influenced to either give a good or bad opinion on the financial statements that might come to benefit the audited organization; rather the opinion given will be based on evidence detected by the auditor.

⁸ Retrieved from Professional Judgment Resource report by CAQ

According to the *Estatuto dos Revisores Oficial de Contas* (EOROC), it is of an auditor, (*Revisor Oficial de Contas (ROC)*) or the audit firm's (*Sociedades de Revisores Oficial de Contas (SROC)*) duty, as well as any person in a position to directly or indirectly influence the outcome of a statutory or voluntary audit, to be independent while performing an audit.

The auditor (ROC) or the audit firm (SROC) are not permitted to participate in the audited entity's decision making as that may put into question the independence of the auditor or audit firm as this will compromise the independence of the auditor or the audit firm.(EOROC articles 70 and 71).

Auditors (ROC) are responsible for taking all appropriate measures to ensure that, in the performance of their duties, their independence is not affected by existing or potential conflicts of interest. This can be through business relationships or other relationships that directly or indirectly involve the auditor and, any other person whose services are available to or under the control of the auditor or audit firms. (EOROC articles 70 and 71)

A auditors (ROC) or audit firm may not give a professional opinion (through an audit report) of accounts if there is a threat to the self-review, self-interest, work or other matters between the auditor or audit firm, its network or to any person in a position to influence the outcome of the audit process (EOROC articles 70 and 71).

Auditors (ROC) and audit firms (SROC), their partners, employees and any other people directly linked to the audit firm and directly involved in the audit process (legal review activities of the accounts), cannot hold or have any direct economic interest in the audited entity. The auditor or audit firm may not have any direct interest that falls within the scope of its activities of statutory audit, except for interests in collective investment undertakings, including funds under management, namely pension funds or life insurance (Retrieved from EOROC articles 70 and 71).

The people referred to in the previous paragraph may not participate in or influence in any way the result of the audit process of a particular audited organization if:

- They have financial instruments (shares) of the audited entity,

- Hold financial instruments (shares) of any organization associated with an audited organization whose ownership may cause or is generally considered to cause a conflict of interest.

Auditors (ROC) and audit firms (SROC) shall record in the audit working papers all relevant threats that may jeopardize their independence, as well as the safeguard measures applied to mitigate them.(EOROC articles 70 and 71).

3.3 Professional Judgement

ISA 200 mentions that for an audit to be properly conducted the auditor needs to practice professional judgement. This is essential because ethical requirements and decisions made by the auditor throughout the audit engagement cannot happen without applying professional judgement. Such as materiality and audit risk, or even the evaluation of management's judgments in applying the entity's applicable financial reporting framework for example.

It is important to recognize that sound professional judgement is key to audit quality (Kriz (2016)).

“The judgment is defined as a process of making a decision or drawing a conclusion from among some possible alternative solutions in uncertain and risky conditions. The word ‘professional’ was introduced after a while after the introduction of the word ‘judgment’ in the 13th century. This word derives from the word ‘profession’. It is applied to a profession or occupation, which requires special knowledge and often long termed and compressed scientific preparation” (Asadi and Nemati, 2014).

Financial statements audit valuation is derived from the auditor's professional judgment, and the collective judgments are based on the audit standards. According to the Canadian Association of Accountants professional judgment can be defined as the following: *“The professional judgment in audit means the application of knowledge and experience in the frameworks of accounting and audit standards, and the procedure of professional behaviour to select an option from among different options”*

A lack of professional judgment can lead to the making of incorrect decisions that can negatively affect the quality of an audit process and the audit company and its financial statements.

Other than professional judgment, an auditor must put into practice professional scepticism. According to the ISA 200, professional scepticism includes being alert to the following:

- Audit evidence that contradicts other audit evidence obtained
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence
- Conditions that may indicate possible fraud

ISA 200 also states that it is necessary that the auditor maintain professional scepticism in order to reduce the risk of the following:

- Overlooking unusual circumstances
- Overgeneralizing when drawing conclusions from audit observations
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

3.4 Professional Scepticism

During an audit process, it is of obligation that an auditor maintains professional scepticism, as the possibility of the financial statements presenting significant misstatement due to fraud may exist. This is also relevant to auditors that have extensive experience with the audited entity. Although the auditor has had experience with the audited organization and the organization is known to have individuals with integrity, it is important that the auditor always practice professional scepticism.

The Center for Audit Quality (CAQ) describes scepticism as, «*A questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain and that it involves the validation of information through probing questions, the critical assessment of evidence, and attention to inconsistencies.*»

According to CAQ, scepticism is an essential element that is required for the objectivity in the financial reporting process. It not only increases the likelihood to detect fraud but also reduces the risk that fraud will be attempted.

SAS 18 mentions, «*Professional scepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional scepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.* ». Scepticism reduces the risks of overlooking unusual circumstances (IAASB (2012a)).

3.5 Expectation Gap

Conflict is part of life and it can occur in any area of life, let it be on a personal level or on a professional level. Conflict may arise in the process of performing an audit when the auditor and the company-audited expectations are different. Throughout an audit, conflict may arise when there is an expectation gap between the audited organization and the auditor's performance.

Porter defined expectation gaps as the difference between what society's⁹ expectations of the auditor is and the auditor's performance. This is seen as what the society expects in comparison to what the society perceives to receive from the auditors.¹⁰

According to Hian Chye Koh, Porter (1993) did an empirical study of the audit expectation-performance gap and defined the expectation gap as the gap between society's expectations of auditors and auditors' performance, as perceived by society. It is seen to comprise two components:

- 1) reasonableness gap (i.e. the gap between what society expects auditors to achieve and what the auditors can reasonably be expected to accomplish); and
- 2) performance gap (i.e. the gap between what society can reasonably expect auditors to accomplish and what auditors are perceived to achieve).

These two components are shown through the figure above.

⁹ This is said to be the users of the financial statements

¹⁰ Retrieved from The Audit Expectations Gap and the Role of Audit Education: Evidence from Sri Lanka J.S. Kumari et al, cited Porter

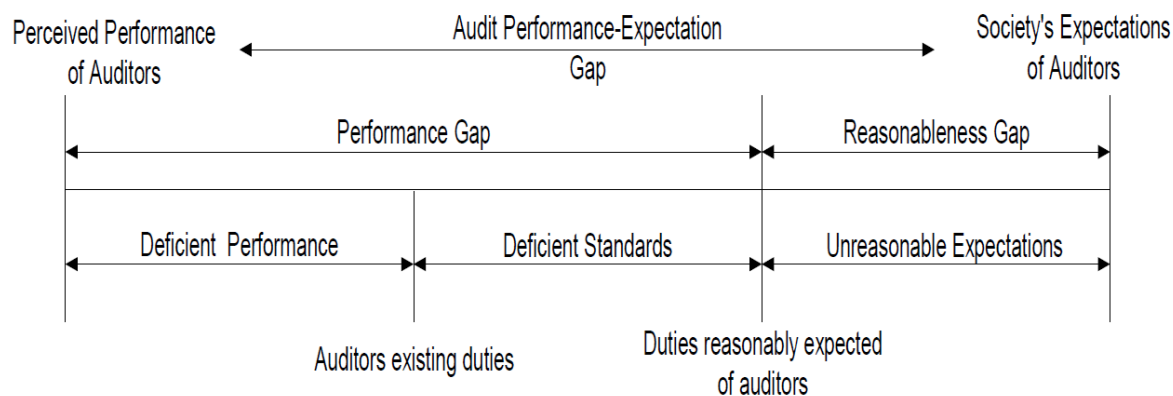


Figure 4. Structure of the audit performance-expectation gap

Source: J.Füredi-Fülöp (2017)

With the expectation gap in place, in order to reduce this gap Epstein and Geiger (1994)¹¹ found that more educated investors (with respect to accounting, finance and investment analysis knowledge) are less likely to demand higher auditor assurance. Hence, they proposed that one way to narrow the expectation gap is through increased public awareness of the nature and limitations of an audit.

3.6 Auditor's Rotation

As company financial scandals increased and along with the world financial crisis, there was a need to increase audit quality. Auditors were being accused of not being sufficiently competent and their independence was questioned. *“the financial crisis and more recent inspection reports by national supervisors highlighted major shortcomings in the European audit sector. To address these deficiencies, we made ambitious proposals in November 2011 to clarify the role of statutory auditors, to strengthen their independence and to enhance supervision” [Barnier (2014)].*¹²

¹¹ Retrieved from Hian Chye Koh, *The expectation Gap*

¹² Retrieved from the EY Global Financial Services Institute, *The audit mandatory rotation rule: the state of the art* that cited this quote

Out of these concerns, came the concern of the mandatory rotation rule. The mandatory rotation results in the periodical break of audit engagements, and in turn, it is implemented to avoid long relationships between the auditor and the audited organization.

The Sarbans-Oxely Act of 2002 amongst other reasons for its existence is aimed as a response to the risks of the auditor's independence by bringing about the concept of auditor rotation. This act brought upon the mandatory rotation of the responsible partner for audit every five years.

Within the European Union, «*The objective of this reform was the enhancement of audit reports' quality. The audit firm tenure for PIEs will be limited to 10 years and the same audit firm can be reappointed for another 14 years in case of joint audits (the company is being audited by more than one audit firm) or for another 10 years in the case of a public tender. After the expiry of the maximum tenure, the PIE may reappoint the audit firm for a further two years, leading to a "10+14+2" rule in case there is a joint audit during the second period or to a "10+10+2" rule in case a single firm provides the audit service. The partner rotation remains mandatory after the seventh engagement year; both firm and partner rotation period can be shortened by Member States. These specific requirements will automatically apply on 17 June 2016.* » E&Y Global institute (2015)

Mandatory auditor rotation has its pros and cons and the audit mandatory rotation rule: the state of the article by E&Y Global institute defines the pros and cons as follows:

Pros

- a) As mentioned in previous paragraphs, auditor rotation increases the audit independence. The independence may be defined as being made up of two components: independence in appearance and in fact. The former indicates that the auditor only appears to be independent, whereas the latter indicates that the auditor has an independent mind set when planning and executing an audit. (Dopuch *et al*, 2003)¹³

¹³ Retrieved it from the state of the art article by E&Y that cited Dopuch *et al*. (2003)].

- b) When an auditing firm is reaching the end of the audit period before the rotation, they will do the best to make sure that the job possible is made to avoid the next audit firm to be too critical of previous audit firm when referring to previous statements audited.
- c) With mandatory rotation of auditors in place, this could reduce economic dependence that an audited organization has on its external auditor.

Cons

- a) Mandatory rotation may bring about new costs by both the auditor and the auditee.
- b) With mandatory rotation of auditors, it means that specific information regarding the auditee is lost with the previous auditors or auditing team¹⁴.

4. Detecting Fraud

The process of auditing financial statements is done to obtain reasonable assurance that the financial statements are free of material misstatements whether due to fraud or errors. It is important to remember that the assurance of the financial statements is free from misstatements is reasonable and not absolute, due to the fact that an audit does not test every economic event that occurred throughout the financial year. The auditor instead tests samples because the audit report needs to be timely for the financial statements to be useful. Love (2012) mentions that this, however, does not give the auditor a ‘free pass’ to fail to detect a material misstatement. When conducting an audit process, an auditor has to abide by the standards, the Generally Accepted Audit Standards (GAAS) and in accordance with the Generally Accepted Accounting Principles (GAAP).

As mentioned in the previous paragraph, an audit process is to provide the audited organization reasonable assurance that the financial statements are free from material misstatements whether due to fraud or error and that the audit is timely. When an audit is checking if the financial statements are free from material misstatements, this also involves the detection of fraud in the case that fraud is suspected to exist. When detecting fraud, the auditor relies on evidence that is persuasive and not evidence that is convincing.

¹⁴ For example internal controls, or the accounting systems.

Detection of fraud has not always been part of the main purpose of an audit engagement. Porter (1997) reviews the importance of fraud detection throughout the years. Prior to the 1920s fraud detection was seen as a primary audit objective.

However, between the 1920s and the 1960s, auditors had acknowledged less responsibility in detecting fraud and then the auditors had denied all responsibilities in the detection of fraud, and that the responsibility was to fall entirely on the management of the entity. Auditors throughout the 1920s to the 1960s focused on the verification of all of the audited company's accounts because companies had grown immensely in size over those last decades. In order to avoid irregularities, such as errors in the financial statements and fraud, management of companies had established systems of internal controls.

By the 1960s, the public was unhappy with the fact that auditors were refusing to assume responsibility for the detection of fraud in a company, the usefulness of an audit had been put into question. However, during auditors had continued to minimize the role played in detecting fraud and stressing that the responsibility was that of the company's management.

In accordance with the ISA 315, when working on an engagement, it is important that the auditors evaluate the effectiveness of the company's risk management framework in the prevention of misstatements, whether through fraud or error.

SAS 82 mentions that audit teams have to consider all information that may be of use in identifying the risks of material misstatement due to fraud and it is through this that the auditors or audit team may discuss the audit risk. When identifying fraud risks, the fraud triangle plays a major part, however, factors such as the size, complexity, and ownership attributes play a part in the identifying of fraud risks.

SAS 82, highlights that *«Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. For example, liabilities resulting from a restructuring may be deemed to have high inherent risk because of the high degree of subjectivity and management judgment involved in their estimation. Similarly, revenues for software developers may be deemed to have high inherent risk because of the complex accounting principles applicable to the recognition and measurement of software revenue*

transactions. Assets resulting from investing activities may be deemed to have high inherent risk because of the subjectivity and management judgment involved in estimating fair values of those investments. »

In addition to connecting with that is, *“Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period).*

Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.”

Upon the evaluation of the effectiveness of the audited company’s risk management framework in the prevention of misstatements, ISA 330, states that the auditor is to obtain as much evidence as possible in regard to the material misstatement of the financial statements of the audited company. The auditor is to do this through the implementation of appropriate responses to address the risks of the misstatements in the financial statements obtained.

4.1 Fraud Detection Methods

The implementation of detective methods should be established when the preventative measure fails, or unmitigated risks are realized. These detective methods introduced allow for the effectiveness of the risk management. This is due to the fact that this provides evidence that the preventative methods put into place in the organization are actually effective, however it is important that the organization be aware that although these methods provide evidence that the fraudulent act has occurred, these methods are not meant to prevent fraud from occurring or reoccurring. (Managing the Business Risk of Fraud: A Practical Guide)

The detective methods implemented in an organization is based on the fraud risk that is identified specifically for the organization. In addition, it is important that there it is clear that, management make it clear as to what detective methods are implemented in the organization because these may not be as apparent to the employees as the preventive measures in the organization.

As mentioned in the previous the detective methods that put into place have to be adapted to the organization. When implementing these methods, the organization needs to have in consideration what may or may not be cost effective.

PwC's 2007 Economic Crime Survey 2007 for Australia showed that fraud detection did not come about by sophisticated methods however; fraud was detected *through external or independent business functions*.

The article mentions that the key success to detecting fraud is through the facilitation of tip-off through programs such as whistle blowing programs, while also implementing programs such as suspicious transaction analysis.

4.1.1 Whistleblowing

As mentioned in the previous paragraph one of the most effective fraud detection method is through whistleblowing where the auditor receives a tip-off from the employees working at the company. According to the CAQ, in order for whistleblowing to be effective and be credible, the auditing committee needs to immediately proceed to an investigation and the proper penalties should be imposed against the perpetrator. However, the people who suspect the perpetrator need to have felt as though the person or program to which they are reporting the fraudulent act is a safe and confident place. The Sarbanes – Oxley Act makes the auditing committee of that audit engagement responsible for organizing a safe and confidential reporting mechanism. The auditing committee should also make sure that these reporting mechanisms can be made in confidence and anonymously, where it is made known to the person that is reporting the suspected criminal act is reassured that there will be no record of retaliation.

“Boards and audit committees should set a culture in the organization of highly ethical behaviour and communicate to those within the organization that if there is a problem, a vehicle exists for those inside the organization to report it in an anonymous way so that they don't feel jeopardized.” (Michael A. Moran, Vice President, Global Markets Institute, The

Goldman Sachs Group, Inc. mentioned in the Deterring and Detecting Financial Reporting Fraud A Platform for Action, 2010)

Some whistleblowing well-designed programs (T. Malone and R. Childs, The Network, 2009)¹⁵ may include an option for anonymity through the implementation of the following:

- Organization-wide (global) and available 24/7, ideally by telephone, with professionally trained interviewers in all local languages
- Single hotline for all ethics-related issues

4.1.2 Other methods

An audit engagement is considered a fraud detective method. This is considered a proactive fraud detection method.¹⁶ Whereas the continuous auditing of the organizations financial statements can result in rapid identifying and reporting of fraudulent suspicions.

Other methods that can be used in the case of a suspicion of fraud are as follows:

- Training employees to know what to look out for when fraud has occurred.
- Data analysis that uses technology tools that effectively detects fraudulent activity.

¹⁵ Mentioned in the Deterring and Detecting Financial Reporting Fraud A Platform for Action ,2010)

¹⁶ This is according to the Managing the Business Risk of Fraud: A Practical Guide

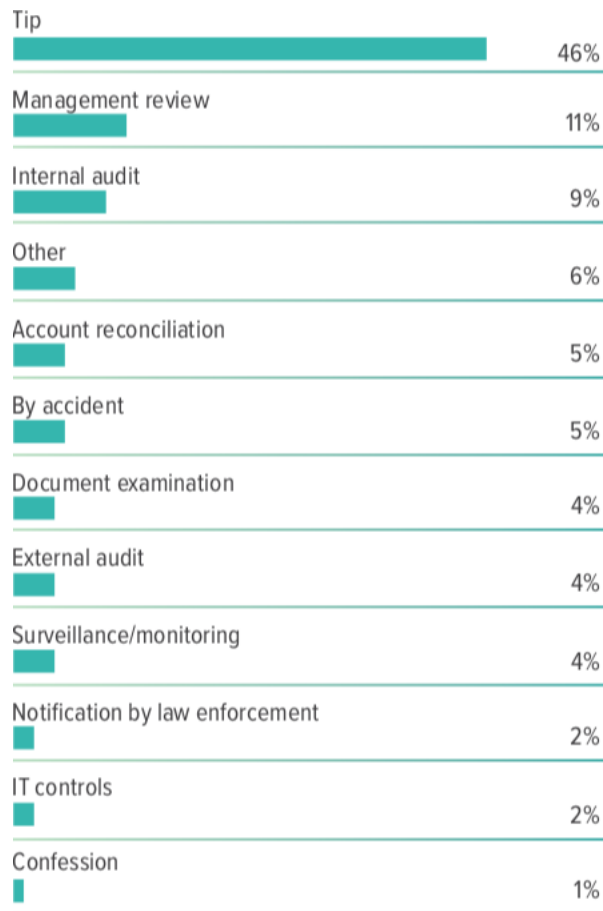


Figure 5: Fraud Detection Methods

Source: ACFE's Report to the Nations on Occupational Fraud and Abuse 2018

The ACFE mentions a few underlying techniques that an auditor may use as an indicator that fraud is present in the financial statements of the auditee. The auditor does it by asking various questions of certain accounting relationships in the financial statements. Such questions include «if sales increase, how should the cost of sales respond? If commission expense decreases, what would be expected of sales? »

Auditor's also test relationships in the financial statements such as the balance between the assets and liabilities of audited entity. «A sudden change from historical norms means something has changed with management's view of its business. It also could indicate that management is trying to hide something. » (ACFE). The auditors may as well teste the profit margin relationship whereas the profit margin is to stay consistent, in other words even though

the organization has to decrease their sales prices (for example), the profit margins needs to stay consistent, and the organization needs to decrease its costs for instance.(ACFE)

4.4 Auditor's responsibility throughout the detection of fraud

Throughout any audit engagement, it is important that the management of that company understand that an auditor could not detect all fraud that may be present, no matter how sophisticated the scheme may be, and that happens because the auditor is aware of the inherent limitations in an audit process.

As mentioned at the beginning of this chapter it is essential that the auditor assess the risk that may occur in the audit process. H.A.A Alrawashdeh *et al* (2016) mentions that auditors are not responsible for the prevention of errors and fraud in the financial statements, [...] *«in case the auditor discovers errors or fraud or illegal behavior in the financial statements they should start the process of taking notes to be presented to the higher management concerned with the auditing to determine the measures which should be taken as a result of those remarks.»*

In previous chapters, it was discussed that although financial statement fraud only represents a small part of occupational fraud, it has ever shown to have the greatest financial loss. According to Gepp. (2005), financial statement fraud and asset misappropriation fraud are only detected about 3% of the time.¹⁷ *«The use of external audits did reduce the loss involved, but it was amongst the least effective methods analyzed»* Gepp. (2005)

Humphreys *et al.* (2011)¹⁸ mention that most external auditors do not have experience in the detection of fraud in financial statements. In addition, it is in these cases that management of the audited organization take advantage of this fact to try to deceive the auditor. While external audits are important, they should not be relied upon to detect fraud (A.C.B Gepp, (2005).¹⁹

Over the years, it was unclear as to what an auditor's responsibility when financial statement fraud was to be detected. This is because an auditor's main responsibility during an engagement is to obtain reasonable assurance (not absolute) about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. It

¹⁷ A.C.B Gepp. (2005) financial statement fraud detection using supervised learning methods cited this from ACFE's 2014 report.

¹⁸ Retrieved from A.C.B Gepp.(2005) Financial statement fraud detection using supervised learning methods as a secondary citation.

¹⁹ Retrieved from A.C.B Gepp.(2005) Financial statement fraud detection using supervised learning methods as a secondary citation

was not explicit as to what the auditor's responsibility was once fraud was detected in the financial statements.

Through the ISA 240, it is said that *«if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. »*

In the previous paragraphs, it was shown that in financial statement fraud, those in management levels can be perpetrators, and the standard ISA 240 mentions that when management is seen to be involved in the fraudulent act detected in the financial statements or those that have a significant role in the implementation of the internal controls, *«the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit».*

«Auditors are not responsible for detecting fraud per se, but for detecting material misstatements caused by fraud. Auditors are not responsible for detecting immaterial misstatements caused by fraud» (SAS 82)

This therefore demonstrates the outcome of the fraud detected is up to those charged with governance of the company and that the auditor's responsibility is to ensure that that the financial statements have reasonable assurance that these are free from material misstatement

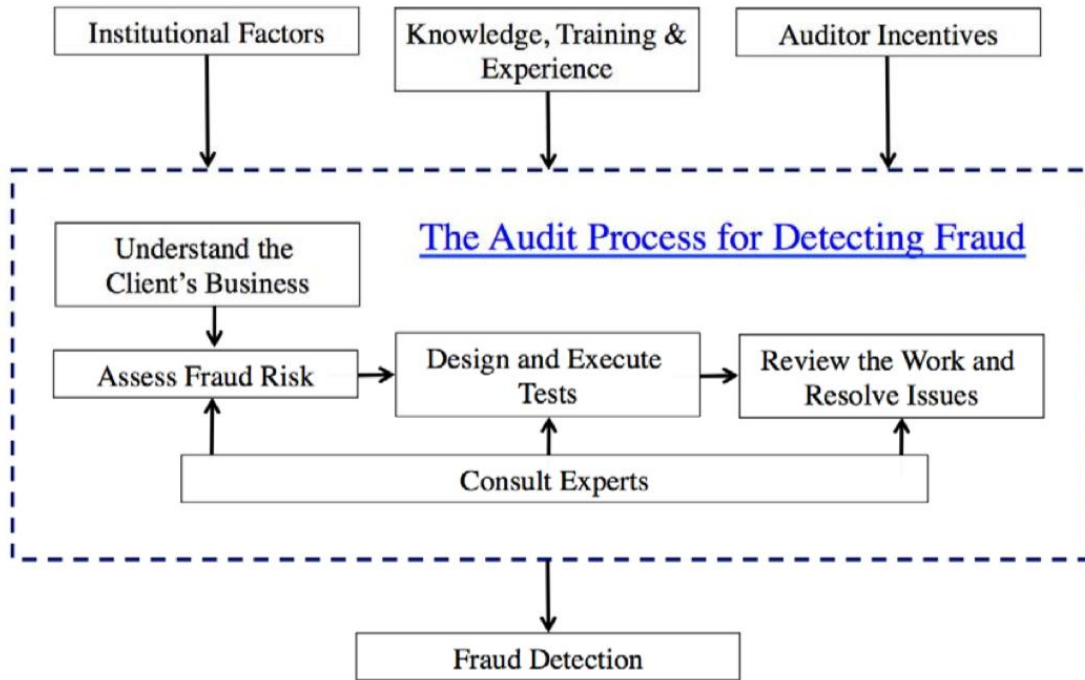


Figure 6: The Audit Procedure to Detecting Fraud

Source: Illustrated by Stephen Kwaku Asare

The figure above demonstrates examples of what an audit procedure looks like when an auditor detects fraud in the audited entity's financial statements.

Part II

5. EMPRICAL STUDY

In the introduction of this dissertation, it was defined that the objective of this dissertation is to the question of what responsibility an auditor has when fraud is detected in the audited company's financial statement. It is also an objective of this dissertation to identify methods an auditor can suggest to help businesses lower the risk of financial statement fraud will be explored.

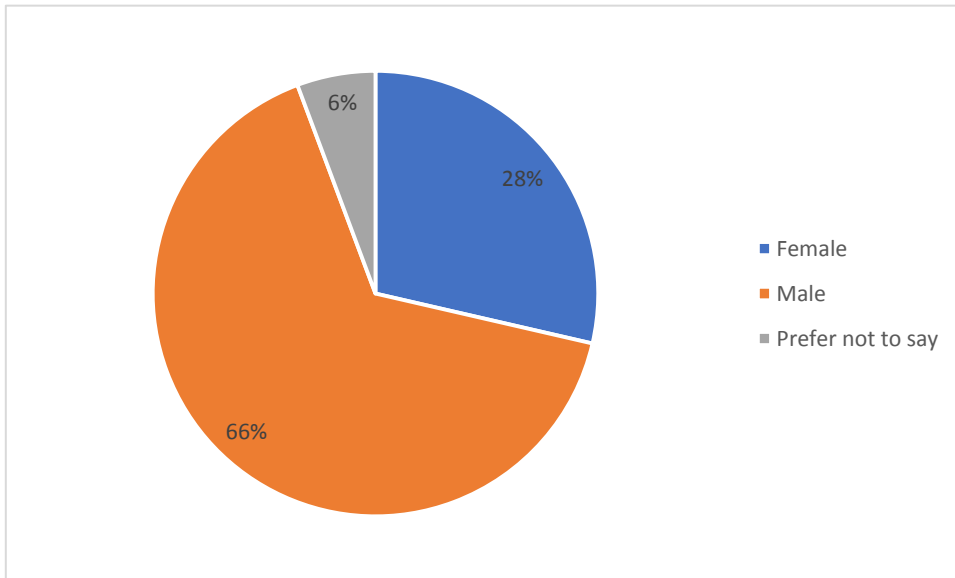
To obtain the answers to the question of this dissertation a survey, that is found in the appendix, was distributed to the likeness of auditors, accountants and other professionals to obtain their opinion on what degree of responsibility an auditor has in the detection of financial statement fraud.

The survey distributed consisted of simple questions that aided in reaching a conclusion of the investigation. Firstly general information of these professionals where retrieved to get a perspective of the demographics of the professionals and throughout the remainder of the survey questions such as "Do you agree that independence is a key factor during an entity's audit?" and "Who do you believe is responsible for financial statement fraud?" were a part of the survey.

It is important to mention that the survey distributed were in two languages (Portuguese and English) and the subtitles are on the charts below will be Portuguese due to the fact the results of the survey were obtained in Portuguese. The translation to these subtitles will be found on the page before the appendix.

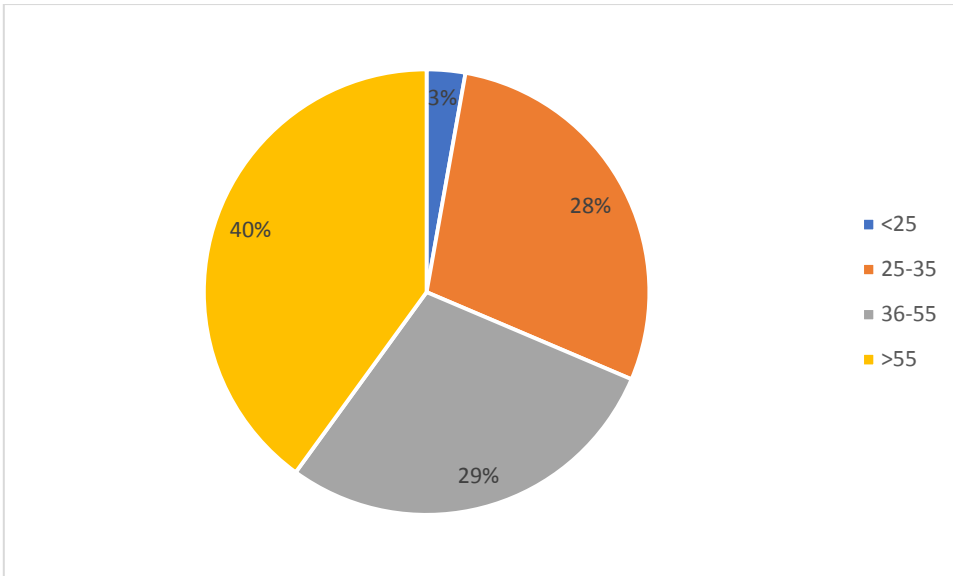
Of the surveys distributed, 35 people to reply to the survey and the results for each question are as follows:

1. Sex



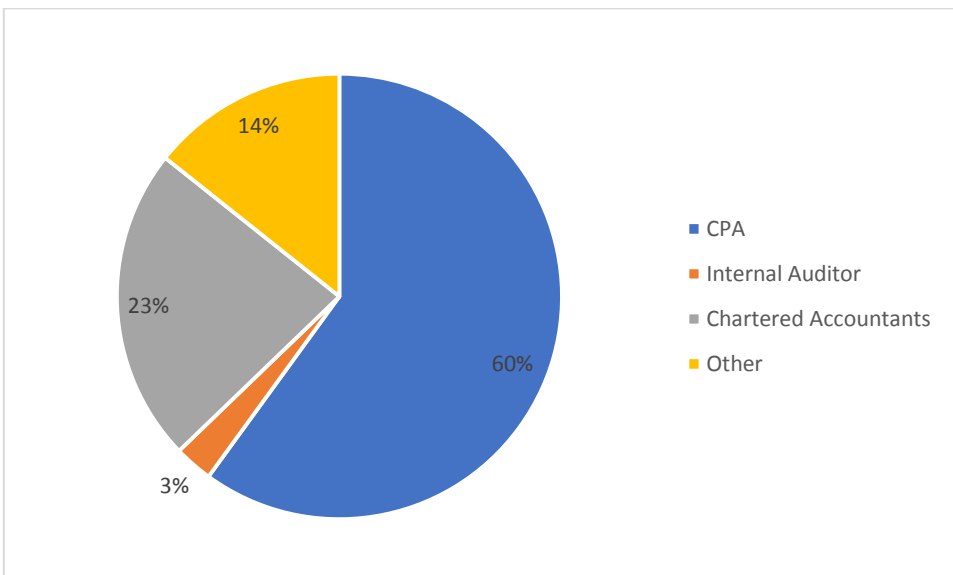
The professionals that answered the survey had the option of identifying their sex or not disclose their sex. The results show that majority of the respondents are male with a percentage of **65.7%**, and **28.6%** female and **5.7%** representing those that chose not to disclose their sex.

2. Age



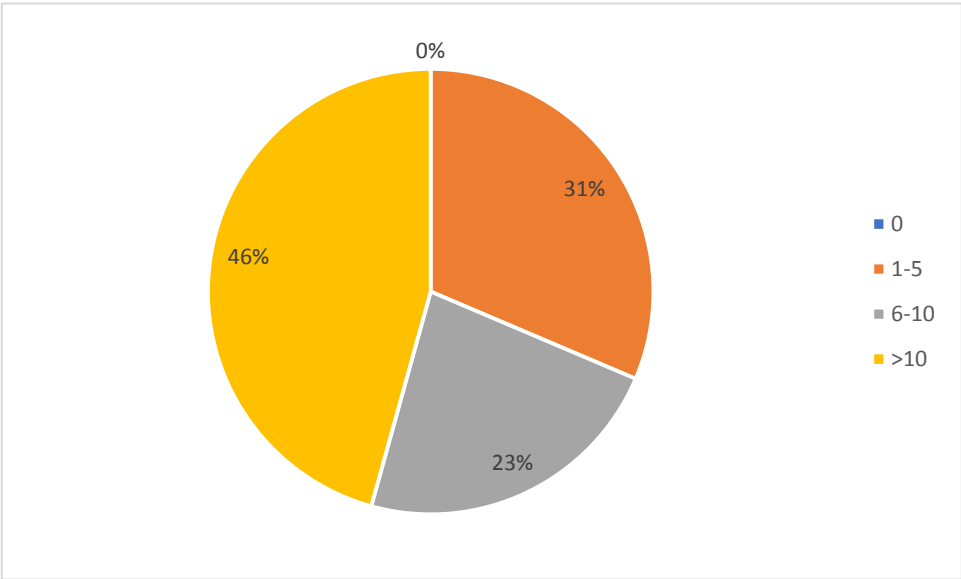
The results from the survey shows that majority of the professionals that answered the survey are either in the age group are in the age range of above 55 representing **40%**, followed by the age groups 25 to 35 and 36 to 55 both representing **28.6%**. Whilst only **2.8%** representing the age group below 25.

3. Profession



The results from the survey shows that majority of the professionals that answered the survey are **CPA (ROC)** representing **60%** of the respondents, with a few of them belonging to other fields such as accounting (**22.9%**), even a project manager.

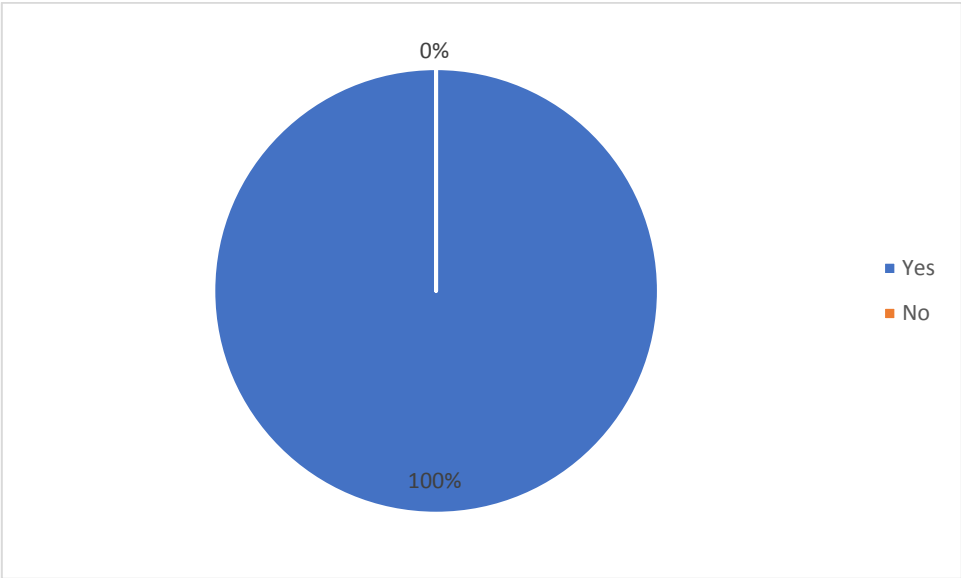
4. How many years of experience do you have?



The results from the survey shows that majority of the professionals that answered the survey have more than **10 years** of experience representing **45.7%** of the respondents. It is important to have a perspective of how many years of experience the professional has, as mentioned, that majority of auditors do not have experience in fraud detection, in order to have an understanding of exactly how this may affect the auditor’s capability to detect fraud in the

financial statements. This result therefore shows that the number of years of experience can be of essence because experience aids the auditor to have a better perspective of how audits are conducted and therefore the auditor has more sensibility as to what to look out for when conducting an audit.

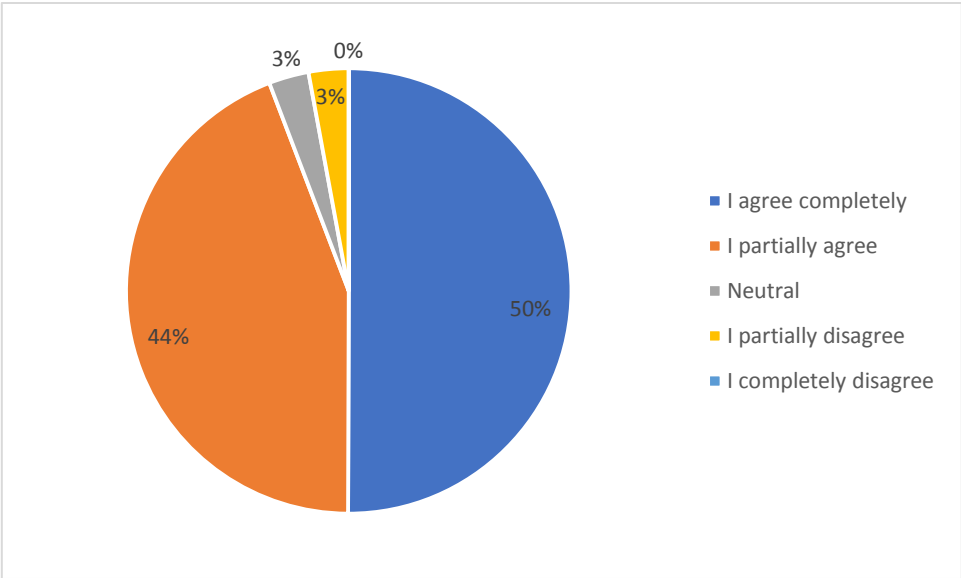
5. Do you agree that independence is a key factor during an entity's audit?



All of the respondents (**100%**) agree that independence is a key factor of an audit engagement. As discussed in the literature review part of this dissertation, «*The EOROC also mentions that*

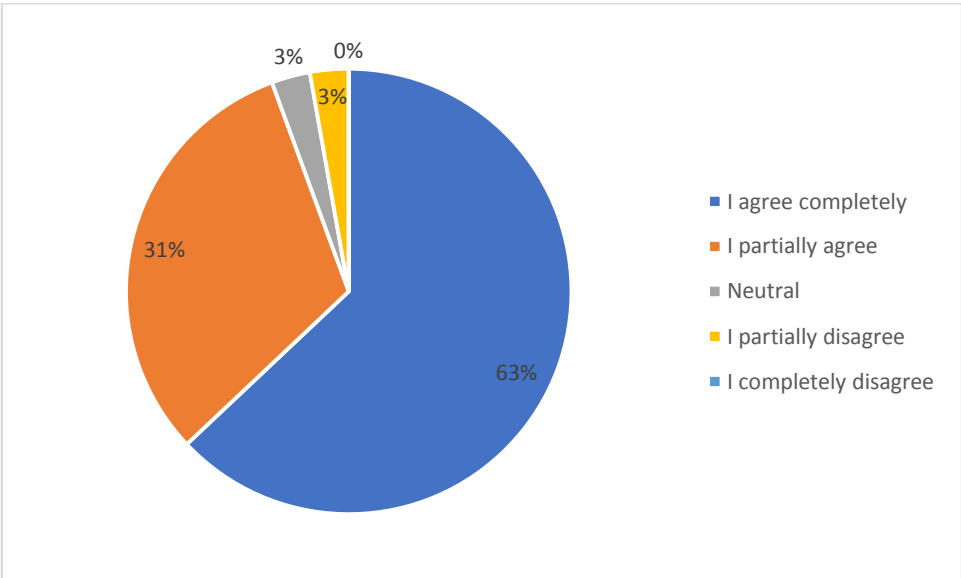
such CPA (ROC) and audit firms have the responsibility to exercise independence» (EOROC, articles 70 and 71). Auditors have the responsibility to exercise independence, as this means that an auditor is able to fairly form an opinion on the financial statements of an audit as the external auditor's interests are removed from the interests of the audited entity.

6. Can lack of independence affect the auditor's likelihood of detecting fraud in the financial statements?



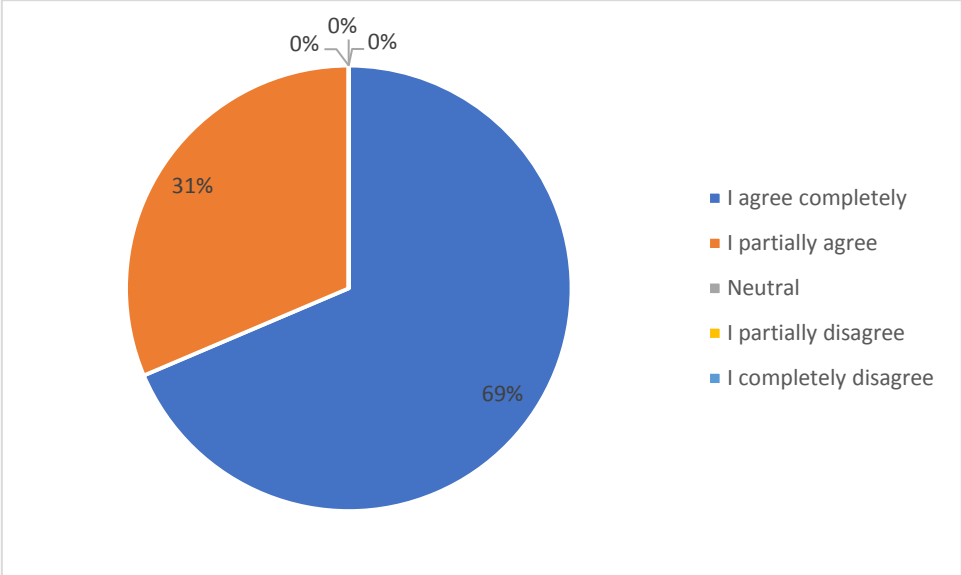
The respondents of the survey had a different array of whether they agreed or not that the lack of independence does affect the auditor’s ability to detect fraud. The results show that half of the respondents believe that it does in fact affect the auditor’s ability. While around **2.9%** of the respondents disagreed. Once again showing the importance of independence in audit engagement. *«The independence of the auditor from the organization whose financial statements are subject to audit safeguards the auditor’s ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor’s ability to act with integrity, to be objective and to maintain an attitude of professional scepticism»* (International Auditing and Assurance Standards Board, 2007). In other words if the auditor does not exercise independence the opinion formed may imply that the auditor is being influenced by the audited organization and the opinion may be a biased opinion.

7. Is professional scepticism essential during an audit engagement?



When answering the survey, majority (**62.9%**) of the respondents completely agreed that professional scepticism is essential for an auditor to practice when auditing an entity’s financial statements. This being because professional scepticism, as discussed in previous paragraphs, this helps the auditor to « *reduce the risks of overlooking unusual circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof*» (International Auditing and Assurance Standards Board, 2007). This result therefore shows that professional scepticism is of importance if the auditor wants to perform the audit engagement with the highest efficiency, verifying that there are the least risks involved that may affect the quality of the audit.

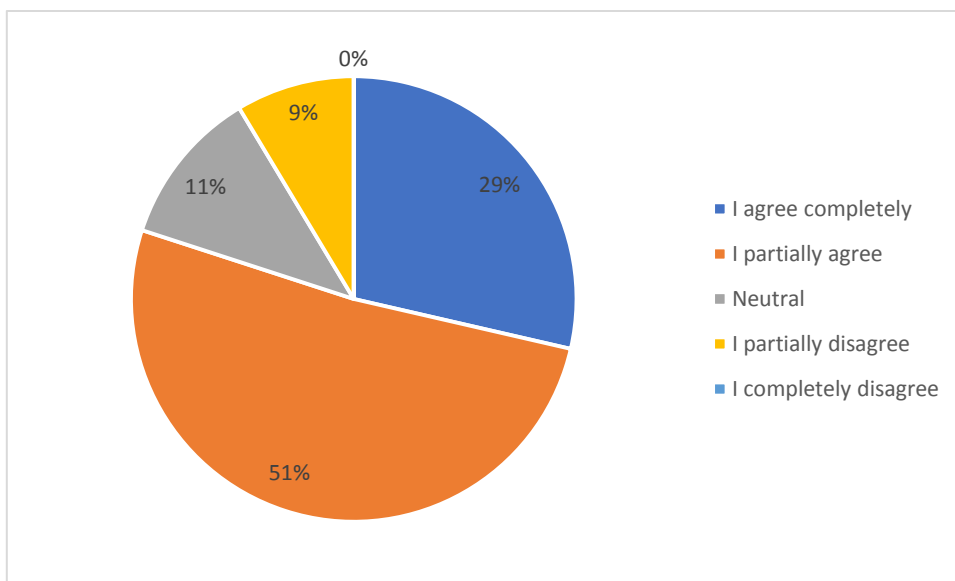
8. Is professional judgement essential during an audit engagement?



Majority of the respondents (**68.6%**) responded agreeing completely that professional judgement is essential in an audit engagement. However, all respondents agree that it is of

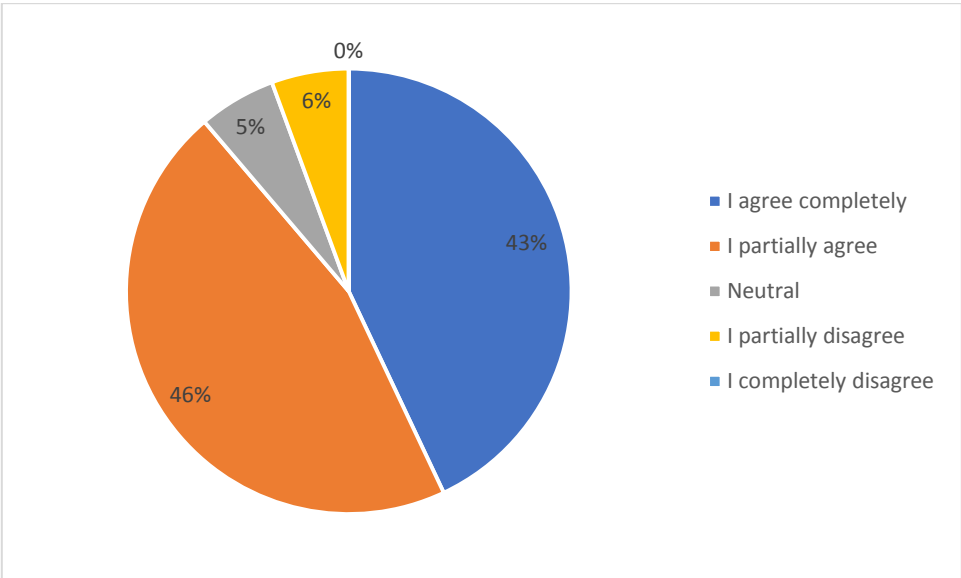
essence to have professional judgment in an audit engagement. «*A critical assessment of audit evidence – influences professional judgment.* » (Professional judgment: What it is and how to handle it). In other words, in order for an auditor to perform to the audit engagement to par, it is important that the auditor always apply professional judgment, as it helps the auditor in better “*making a decision or drawing a conclusion from among some possible alternative solutions in uncertain and risky conditions*”

9. The lack of professional scepticism and judgment cause conflict between management and the auditor



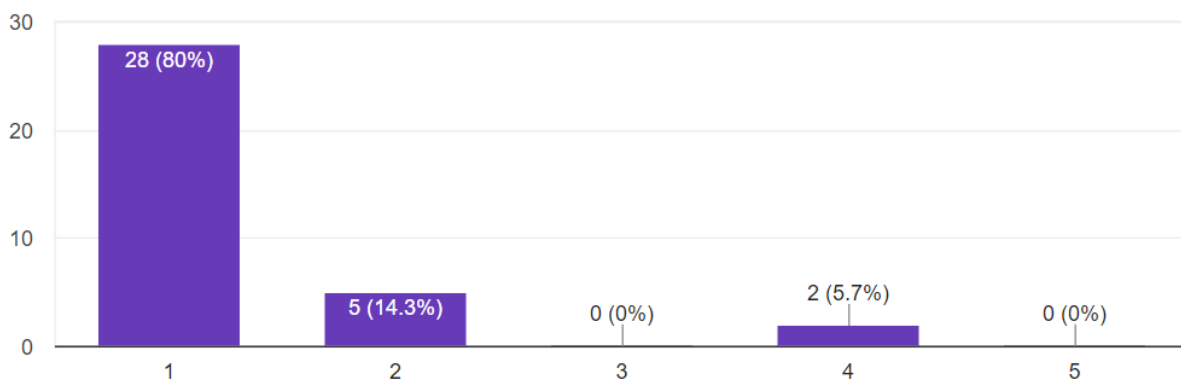
Majority of respondents agreed (51.4%) that lack of both professional judgement and scepticism could cause conflict between the auditor and the management of the audited entity. This is in connection with an expectation gap. In the previous question, it was seen that professional judgement exercised by the auditor allows the auditor to make decisions regarding the audited organization having in mind the risks that may be involved. While the lack of professional scepticism prevents the auditor to avoid overlooking certain circumstances.

10. Expectation differences between the auditor performing the audit engagement and the audited entity, can bring about some sort of conflict



Majority of the respondents of the survey agreed (**45.7%**) or completely agreed that that expectation differences (Expectation Gap) could bring about some sort of conflict between the auditor and that the management of the audited entity. Kolade, (2010)²⁰ refers to the role theory where the role of the auditor can be viewed according to the expectations of financial statement users. Conflict may arise when the management of the audited organization has placed multiple expectations on the auditor. This concludes that an expectation gap between the auditor and the audited organization can cause some sort of conflict because the organization expectation may be different in comparison to what the auditor may perform.

11. How important is it for an auditor/audit team to assess risk management before accepting an audit engagement?

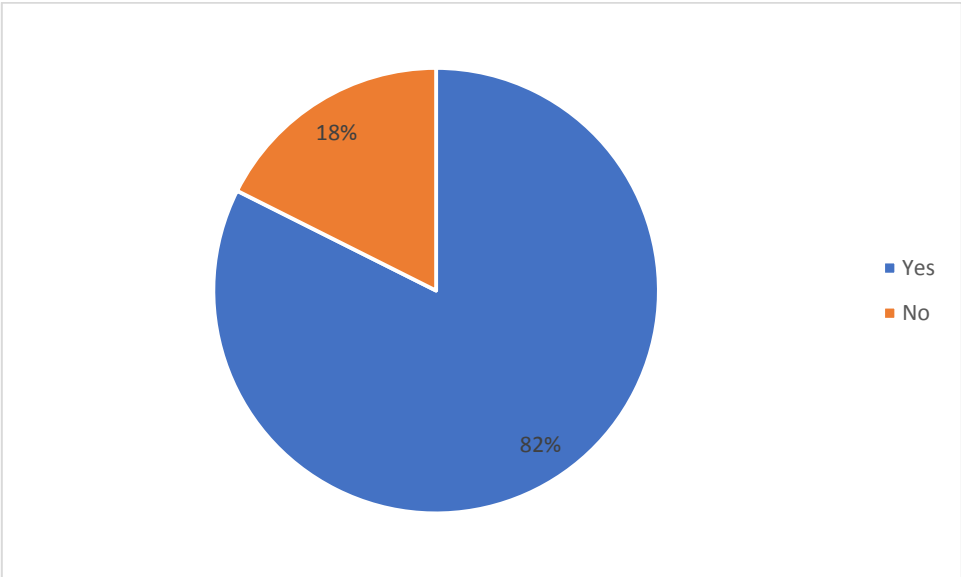


When answering the survey, majority (**80%**) of the respondents have said that assessing risk management before accepting is very important. As seen in the previous chapter (literature review), this gives the auditor an opportunity to assess the risk of certain criteria of the financial information provided “*For example, liabilities resulting from a restructuring may be deemed to have high inherent risk because of the high degree of subjectivity and management judgment involved in their estimation. Similarly, revenues for software developers may be deemed to have high inherent risk because of the complex accounting principles applicable to the recognition and measurement of software revenue transactions.*” (SAS 815). In other words by assessing the risk of an audit, it allows the auditor to be better prepared, by having a

²⁰ This Was Cited by A. James, Audit Expectation Gap: Auditors In Unending Role Conflict?

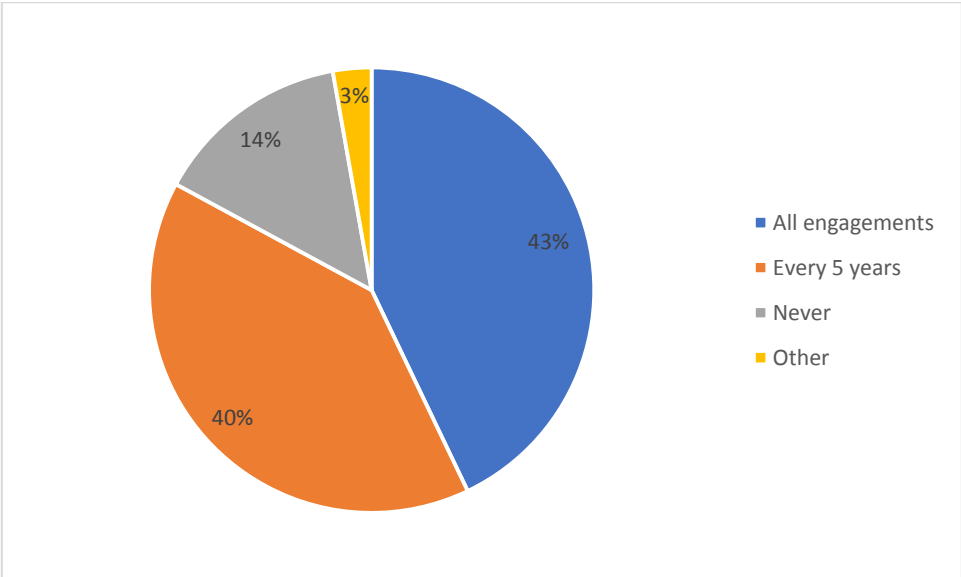
better perspective of the internal controls of an auditor, but to mostly assess the risks of the entity's financial statements due to fraud or due to material error. (ISA 315)

12. According to European Committee, it is important that an audited company rotate its external auditors. Do you agree?



Majority (**82.4%**) of the respondents agreed with the European Committee on the fact that external auditors should undergo rotation in the audited entities. Indeed the rotation of auditors allows for audit enhancement.

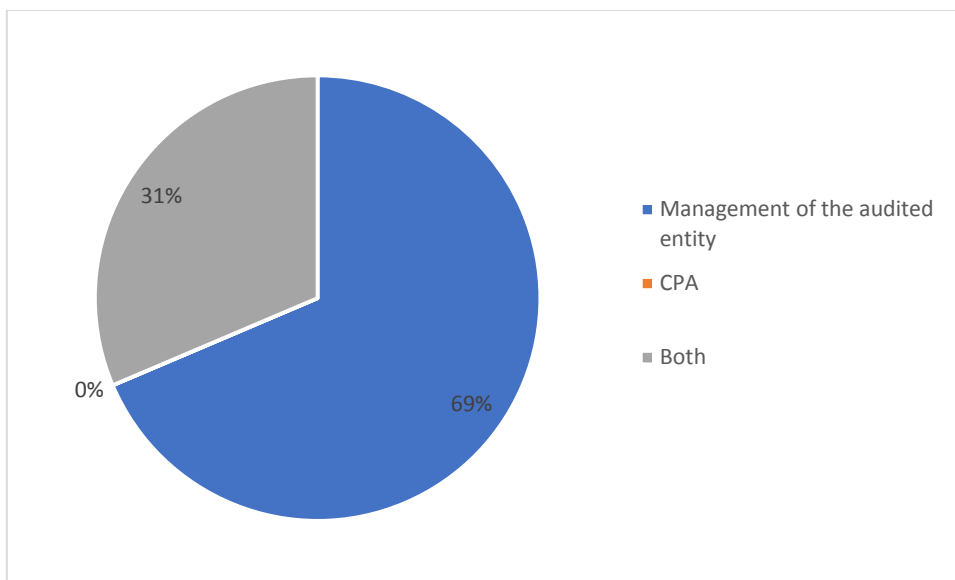
13. Concerning the rotation of the auditors, how often do you believe that the audited entities should rotate the external auditors?



The respondents were torn between either rotating the auditors with every audit engagement or following the European Committee. 42.9% though it would be better to rotate the external auditors every audit engagement, whereas 40% would rotate every 5 years. A small portion representing 14.3% would prefer that auditors be never rotated. However, the rotation of auditors is essential for the sake of the independence of the auditor, and the independence of an auditor in an engagement as well is closely linked to the quality of an auditor. Rotation of

either the auditor or the audited firm depends on the region of the year. In Portugal, the auditor is to be rotated within a maximum period of 10 years.

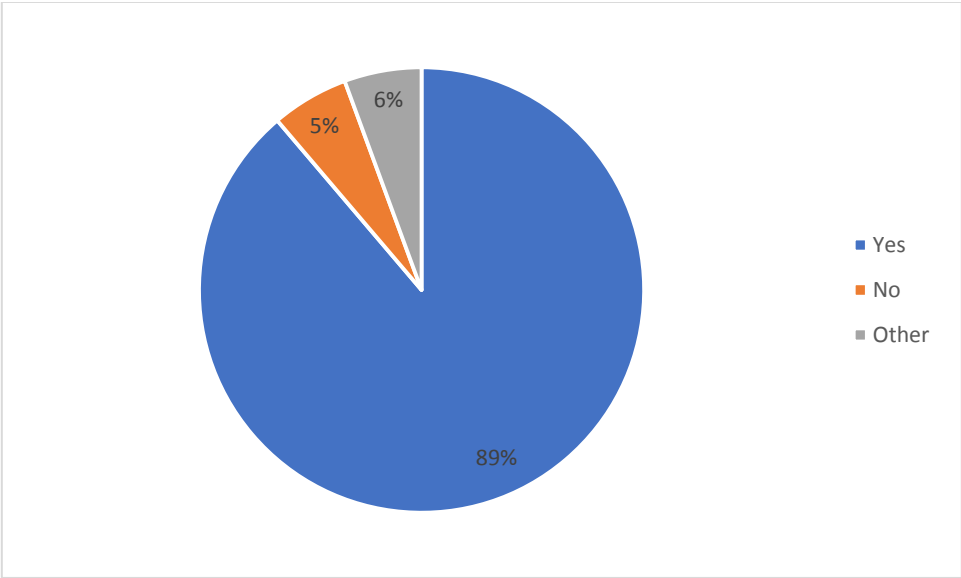
14. Who do you believe is responsible for financial statement fraud?



Majority (**68%**) of the respondents believe that fraud detected is solely of the responsibility of the auditor, whilst 31.4% believe that the responsibility is of both the auditor that detected the fraud and the audited entity. However, neither suggested that the responsibility falls solely on the auditor. *“Auditors are not responsible for detecting fraud per se, but for detecting material misstatements caused by fraud. Auditors are not responsible for detecting immaterial misstatements caused by fraud”* (SAS 82). SAS82 shows that auditors are not responsible for

the detection of fraudulent financial statements and suggests that it is of the management of the audited entity, since the management of this organization is responsible to oversee the financial statements released for auditing. The only responsibility that the auditor has to the audited organization is to ensure that the auditor provides reasonable assurance that the financial statements are free from misstatement.

15. When fraud in financial statements is detected, do you agree that the auditor is to report it to the audit committee right away?



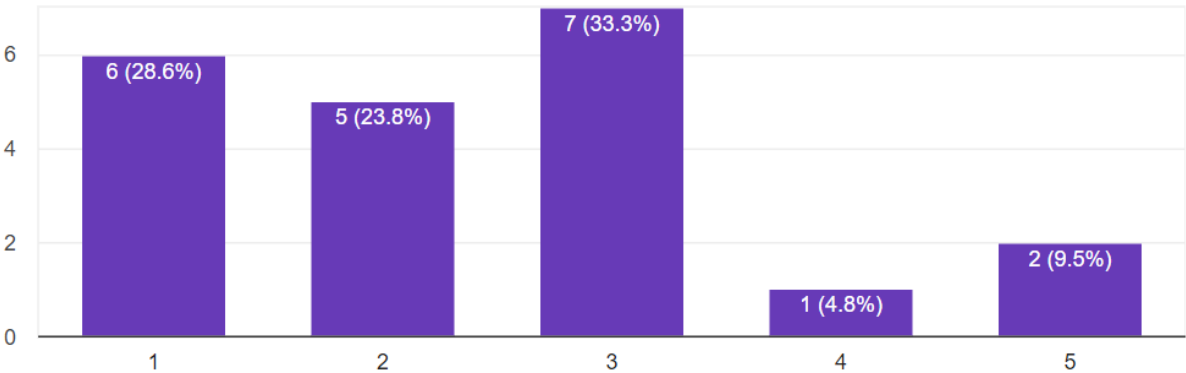
Of the respondents of the survey, 86% agree that once the auditor has detected fraud it is essential that the auditor report it immediately to the audit committee. Reporting the detected fraud immediately to the auditing gives the management of the organization to implement actions. In other words, once there is the suspicions of fraud or fraud is detected it is of the organization's management to proceed to the follow up process, where the management

evaluates the case at hand. This can entail in the implementation of better and or tighter internal control measures, where the management of the organization implements controls that can prevent future occurrences of fraud in the financial statements. It is important to remember that the reason why this is to be implemented by management is cause management is responsible financial reporting.

16. If other, please elaborate

One of the respondents agrees that it should be reported to the auditing committee unless there is evidence of involvement of members of the Audit Committee in the fraudulent act or where public crimes or money laundering situations are involved.

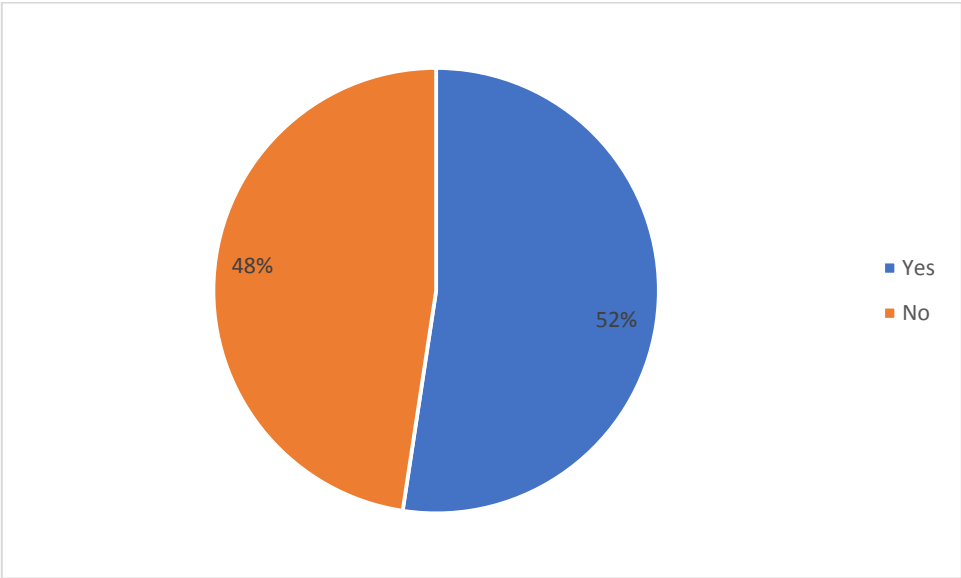
17. Among other fraud detection methods, how effective is whistle blowing?



About **33%** of the respondents, responded saying that the whistle-blowing method is not as effective, while **28.6%** and **23.8%** agreed that this method is indeed an effective method. The remaining responded saying that this method is not effective at all. *«In order for whistleblowing to be effective and be credible, the auditing committee needs to immediately proceed to an investigation and the proper penalties should be imposed against the perpetrator.»* The reason why the respondents do not find this method as an effective method is probably that the fraud that is denounced through whistle blowing is not done immediately. Another reason as to why people find this method to not be as effective is that there probably

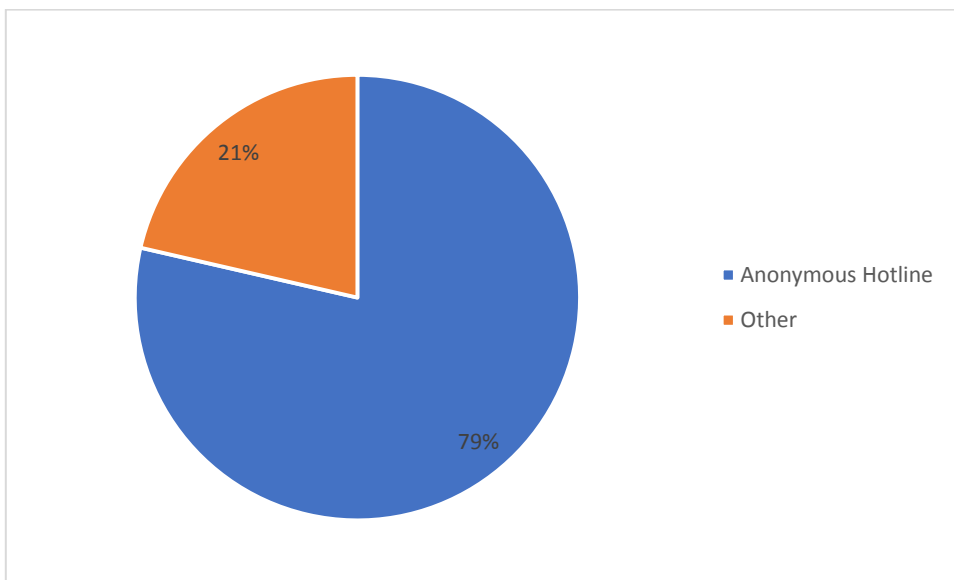
isn't enough awareness amongst employees of the organization that this there is a hotline made available to them in the case that there is a suspicion of fraudulent acts.

18. In your experience, do whistle-blowers feel that there is a safe program through which they can report fraud?



Majority of the respondents of the survey, **52.4%** to be specific do not believe that the Whistle blowing method is a safe method for people to denounce any suspicion of fraudulent acts. One of the reasons as to why this method is perceived to not be deemed safe is because there is a management has probably not fostered an environment where people feel comfortable enough to raise their concerns. (ACFE). The organization is to introduce an environment where employees and those that suspect fraudulent acts in the organization feel at ease and safe to denounce their suspicions without feeling that they may be in danger for being a whistle blower. After all when fraud suspicions as denounced in it is o the benefit of the organization and the case may be solved as soon as possible and they organization is to face less loss.

19. If yes, what programs are implemented in the audited company?



The respondents that responded saying they found the whistle-blowing method to be a safe method suggested that the best way to denounce fraud suspicions is through an anonymous hotline. Yes, an anonymous hotline might indeed be the best method because the whistle blower may denounce without facing the risk of being identified and the case may be solved as soon as possible causing less liability to the entity.

20. If other please elaborate

The respondents that choice the option of 'other' in the survey did not elaborate which programs these were.

Part III

Conclusion, Limitations and Future Expectations and Contributions

Conclusion

Throughout this dissertation, the nature of fraud and the nature of an auditor is discussed in order to have a better understanding of the auditor's responsibility in the detection of fraud in an audit engagement. The importance of professional judgment and scepticism in the audit process is discussed, where professional judgement and scepticism allows the auditor to be more objective when performing a financial statement fraud, or fraud in general. Moreover, professional judgement from the auditor gives the auditor more credibility.

In this dissertation (literature review), it was shown that the practice of independence by the auditor reduces the chances of conflict of interest between the audited organization and the auditor. The practice of independence also ensures the likeliness of detection of fraudulent financial statements, because there is not conflict of interest between the audited organization (management) and the auditor. It is however important that with these attributes, an auditor first assess the risks that come with the audit engagement.

In conclusion, to this investigation it is shown that the responsibility of the detection of fraud lies entirely on the management of the audited organization considering the fact that management is responsible for the preparation of the financial statements. In other words when the auditor detects fraud the financial statements of the audited entity, the auditor is not to take action for these findings but to merely report the findings. In addition, it is from there that the management of this company is responsible for the actions or the fraud and preventive measure to take from that point on. The only responsibility that an auditor has is to provide reasonable assurance that the financial statements are free from misstatements. The auditor discovers fraud during the audit engagement process; therefore, the auditor is not there no detect fraud.

Limitations, Future Expectations and Contributions

Throughout the process of writing this dissertation, the biggest limitation was getting people to respond to the survey. A few hundred emails were sent however, only 35 people responded to the survey.

As seen and discussed throughout this dissertation, fraud continues to still be a concern that management still has. It is also seen that fraud cannot be fully eliminated but can still be prevented, and it is of the management of the companies' responsibility to ensure that there are proper preventative measures implemented. Auditors may suggest such measures; however, the auditor is not responsible for the detection and prevention of financial statement fraud.

The 'solution' to mitigate fraud, is through the implementation of preventative measures. For future contributions to the study of fraud in financial statement fraud, considering that fraud is an impossible matter to fully eradicate the act²¹.

To ensure that fraud becomes less of a worry in companies, it is important that organizations better implement already existing preventative measure, or to study better or newer ways (better internal controls). Further studies need to be done considering the fact that with the aid of the ever-evolving technology, fraudulent acts are becoming more and more sophisticated acts. Therefore, there is a need to identify methods that will keep up with these rapid changes, as although some methods may still be effective there is still a need to discover newer methods or at least more updated methods.

In what concerns auditor's, further studies need to be implemented to better define what role an auditor has in the detection of financial statement fraud. Detection methods of external auditors could also be further studies so that auditors have a better perception of how to better deal with fraud in financial statements.

²¹ This is because people always come up with different and more innovative ways to commit fraudulent acts. With technology constantly advancing, it aids the perpetrator to find better and more sophisticated ways to commit the fraud.

Auditor's Responsibility in Financial Statement Fraud

Dear Sir/Mam, my name is Maria Helena D'Oliveira, I am currently doing my master degree in Auditing at ISCAL (Instituto Superior de Contabilidade e Administração de Lisboa). This survey serves as a method to collect data for the empirical part of my dissertation on the Fraudulent Financial Statements and the Auditor's Responsibility in the Detection of Fraud in such financial statements. I guarantee that all information shared will be kept confidential, that the questions answered will only be used for educational purposes. Should you need any further clarification to any of the questions found in this survey, you can contact me on mahe.doliveira@hotmail.com. Thank you for taking the time to respond to my questionnaire.

1. Sex

Mark only one oval.

- Female
- Male
- Prefer not to say

2. Age

Mark only one oval.

- <25
- 25-35
- 36-55
- >55

3. Profession

Mark only one oval.

- Auditor (ROC)
- Internal Auditor
- Certified Accountant (OCC)
- Other
- Other: _____

4. How many years of experience do you have?

Mark only one oval.

- 0
- 1-5
- 6-10
- >10

5. Do you agree that independence is a key factor during an entity's audit?

Mark only one oval.

- Yes
- No

6. Can lack of independence affect the auditor's likelihood of detecting fraud in the financial statements?

Mark only one oval.

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

7. Is professional skepticism essential during an audit engagement?

Mark only one oval.

- Strongly agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

8. Is professional judgement essential during an audit engagement?

Mark only one oval.

- Strongly agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

9. The lack of professional skepticism and judgment cause conflict between management and the auditor

Mark only one oval.

- Strongly agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

10. **Expectation differences between the auditor performing the audit engagement and the audited entity, can bring about some sort of conflict**

Mark only one oval.

- Strongly agree
- Agree
- Neutral
- Disagree
- Strongly Disagree

11. **How important is it for an auditor/audit team to assess risk management before accepting an audit engagement?**

Mark only one oval.

- | | 1 | 2 | 3 | 4 | 5 | |
|----------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|---------------|
| Very Important | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | Not important |

12. **According to European Committee it is important that an audited company rotate its external auditors. Do you agree?**

Mark only one oval.

- Yes
- No

13. **Concerning the rotation of the auditors, how often do you believe that the audited entities should rotate the external auditors?**

Mark only one oval.

- Every audit engagement
- Every 5 years
- Never

14. **Who do you believe is responsible for financial statement fraud?**

Mark only one oval.

- The management of the audited entity
- Auditor
- Both

15. **When fraud in financial statements is detected, do you agree that the auditor is to report it to the audit committee right away?**

Mark only one oval.

- Yes
- No
- Other

16. If other, please elaborate

17. Among other fraud detection methods, how effective is whistle-blowing?

Mark only one oval.

	1	2	3	4	5	
Very effective	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	Not effective at all

18. In your experience, do whistle-blowers feel that there is a safe program through which they can report fraud?

Mark only one oval.

Yes
 No

19. If yes, what programs are implemented in the audited company?

Mark only one oval.

Anonymous Hotline
 Other

20. If other please elaborate

21. What other methods of fraud detection can be used, when fraud is detected in the financial statements?

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