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AUDIT COMMITTEE INSTITUTE

Confronting the "Expectations Gap" Regarding Fraud Detection

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What are the auditor's responsibilities for detecting fraud or intentional material misstatement of financial information?

The leaders of six of the largest global audit networks[1] jointly published their thoughts on the future of financial reporting in November 2006[2]. Amongst the many issues discussed, the paper considered the role of the auditor in detecting fraud and the expectations of stakeholders. What follows is an extract from that paper.

"Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud or intentional material misstatement of financial information by public companies. After all, fraud was at the centre of various corporate financial reporting scandals earlier this decade. Allegations of fraud are central in the ongoing lawsuits brought by investors against individuals and companies, as well as against audit networks for alleged failures to uncover them.

It is essential that all parties engaged in business reporting – employees, management, directors, auditors and policy makers – put in place appropriate procedures and policies to prevent and detect fraud. Nonetheless, there is a significant "expectations gap" between what various stakeholders believe auditors do or should do in detecting fraud, and what audit networks are actually capable of doing, at the prices that companies or investors are willing to pay for audits.

The challenges of detecting fraud

By definition, fraud is difficult to detect by any outsider because the essence of the activity is concealment – hiding from managers, directors, and ultimately investors material information about the company and often the diversion of company funds to the perpetrators.

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1 The audit networks that participated in this report were KPMG, PWC, Deloitte, Ernst & Young, Grant Thornton, and BDO.
2 *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Network*, November 2006.

The US fraud standard (SAS 99) and its international counterpart (ISA 240) contain very similar directions to auditors relating to fraud. Both require auditors to conduct their audits with a "healthy degree of skepticism". And both lay down a number of specific requirements that auditors are instructed to follow, including:

- Considering the company's internal controls and procedures, and how these are actually implemented, when planning the audit;
- Designing and conducting audit procedures to respond to the risk that management could override the internal controls and procedures;
- Identifying specific risks where fraud may occur;
- Considering whether any misstatement uncovered during the audit may be indicative of fraud;
- Obtaining written representations from management relating to fraud;
- Communicating with appropriate managers and the board if the auditor finds indications that fraud may have occurred.

Even when auditors follow all these guidelines, there are inherent limits to what any outside audit can uncover relating to fraud, especially if senior management has been involved in perpetrating it.

But there are limits to what auditors can reasonably uncover, given the limits inherent in today's audits. Specifically, unless companies or investors are willing to pay auditors to police all of a company's transactions, auditors are limited to using indirect means to ascertain whether fraud has occurred. These methods include examinations of accounts and records where the principal aim is to look for anomalies, interviews of company employees and management that are not "under oath", and reviews of the companies' "internal controls" over the spending of funds (a specific requirement in the United States under Section 404 of the Sarbanes-Oxley Act, enacted in 2002). These methods clearly are useful, indeed essential, to preventing and discovering fraud. But they are not foolproof, nor can they be expected to be.

Hence, the "expectations gap" arises because many investors, policy makers and the media believe that the auditor's main function is to detect all fraud, and thus, where it materializes and auditors have failed to find it, the auditors are often presumed to be at fault. Given the inherent limitations of any outside party to discover the presence of fraud, the restrictions governing the methods auditors are allowed to use, and the cost constraints of the audit itself, this presumption is not aligned with the current auditing standards.

What is sorely needed is a constructive dialogue among investors, other company stakeholders, policy makers and our own professionals about what should be done to close or at least narrow the "expectations gap" relating to fraud. Given the globalization of capital markets, it is vital that this

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conversation includes stakeholders in public companies and capital markets throughout the world. We are committed, also, to working with others to develop ways to prevent fraud from occurring.

These conversations must recognize, however, that our profession is committed to continuously improving our abilities and methods to detect fraud. We are doing this through the commitment of resources to support research into new methodologies and technologies that should expand our ability to uncover fraud.

At the same time, we believe it is useful to consider additional ideas for enhancing fraud detection, which we briefly outline below. There are arguments for and against each of these concepts, and thus we do not necessarily embrace anyone or all of them. But we believe that, collectively, they have sufficient merit that those options ought to be seriously debated by stakeholders and policy makers. We welcome and encourage others to offer their suggestions as well.

Subject all public companies to a forensic audit on a regular basis

The most aggressive, but costly and intrusive way of rooting out fraud is to require all public companies to undergo a forensic audit on a regular basis (perhaps every three or five years). Unlike the indirect means already described that are employed to detect fraud in a conventional audit, a forensic audit is akin to a police investigation. Forensic auditors scrutinize all records of companies, including emails, and would be able, if not required, to question all company employees and to require statements under oath. It might be necessary for an audit network or a specialized forensic auditor to complete a forensic audit with the aid of independent attorneys (not those who have represented the audit client in other engagements).

Subject all public companies to a forensic audit on a random basis

A less onerous and costly version of the forensic audit proposal would be to subject a sample of public companies on every exchange to a forensic audit on a random basis. Though such a system might uncover fewer frauds, the deterrent effect could still be the same, as all companies, and their managements, would know that they could be subject to forensic-level scrutiny at any time.

Other "choice-based" options

Whether or not policy makers choose to require or suggest forensic audits on any bases, it may be possible to close the "expectations gap" by introducing more choice regarding the intensity of audits for fraud. For example, since forensic audits are conducted primarily for the benefit of investors, one

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possibility would be to let shareholders decide on the intensity of the fraud detection effort they want auditors to perform. Shareholders could be assisted in making this decision by disclosure in the proxy materials of the costs of the different levels of audits, as well as the historical experience of the company with fraud. A different choice model would be to allow boards, or audit committees of boards as elected representatives of shareholders, to decide on the level of fraud-detection intensity.

A principal advantage of allowing investors or board or audit committee members to choose the fraud detection level is that this would move away from a "one-size-fits-all" approach to fraud detection to one tailored by investors' expectations about the company. In addition, the possibility that the relevant decision makers might at any time vote to conduct a forensic audit could act as a powerful deterrent to managers or employees from engaging in fraud."

A copy of the complete paper from which this is extracted is available at: http://www.globalpublicpolicysymposium.com/index.html

Implications for the audit committee

Audit committees should take steps to narrow their own fraud expectations gap.

The Audit Committee Institute acknowledges that there is an expectations gap between what various stakeholders believe an auditor does or should do in detecting fraud and what an auditor actually does. This paper explores several options for future consideration by the auditing profession and policy makers.

However, individual audit committees should also seek to narrow their own fraud expectation gap by:

- Reviewing with the auditor the fraud detection procedures carried out as part of the external audit. The committee should ask the auditor to explain what the auditor views as the areas of greatest risk, outline the auditor's response to dealing with those risks and ask whether the auditor is satisfied that sufficient procedures are in place to minimize the risk of fraud.
- Reviewing with management and the auditor the company's policies and procedures to help prevent fraud and unethical activities. The committee should question whether management's policies are appropriate and effective, and whether they have been adopted by all business units.
- Reviewing all known or suspected instances of fraud, including those instances identified by the company's whistle-blowing procedures. The committee should question management and the auditor as to whether independent investigations were carried out and appropriate follow-up action taken, and whether procedures are in place to prevent or detect such instances in the future.

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