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The Role and Responsibility of Auditors in Prevention and Detection of Fraudulent Financial Reporting

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Abstract

This research examines the roles and the responsibilities of the key stakeholders of the financial reporting in the prevention and detection of fraud. The methods used and types of transactions most vulnerable to fraudulent financial reporting are examined. For the need of the empirical part of the paper, the questionnaire survey was conducted. The respondents, external auditors, evaluated how often they encounter circumstances indicating the possibility of fraud. In accordance with the conducted research the most common technique used to fraudulent financial reporting involved overstatement of assets.

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Keywords: fraud, fraudulent financial reporting, asset misappropriation, prevention, detection, auditor

1. Introduction

All over the world organizations face the problem of fraudulent activities, which can take many forms. Due to numerous accounting scandals, confidence in the reliability and the objectivity of the financial statements of interested parties has been significantly reduced. Management, boards of directors, audit committees, external auditors and internal auditors have a significant role in ensuring the reliable financial reporting. In this paper the roles and responsibilities of these key stakeholders in the prevention and detection of fraudulent financial reporting in the companies is examined. This paper offers a description of some main characteristics of the fraud and explains the most commonly used classifications of fraud. Most academic studies are conducted on external fraud (Jans et al.,

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2009, p.1). Thus, taking into account the deficiency of research in the field of internal fraud and the need for such research, this paper is concentrated on the fraudulent activities, such as fraudulent financial reporting and asset misappropriations, committed by the employees of the company. In addition, the purpose of this paper was to gather information on types of the transactions that are the most vulnerable to the fraudulent financial reporting, which is done through a review of existing research and conducted empirical research in Croatian companies. For the needs of the empirical part of the paper, a questionnaire survey was conducted. The sample of subjects consisted of external auditors, who were asked to provide information on the fraud cases familiar to them. The respondents also evaluated how often they encounter circumstances indicating the possibility of fraud.

2. Theoretical background

2.1. Overview of the research in the field of fraudulent financial reporting

Fraud can be defined in many different ways. „In business environment fraud is an intentional deception, misappropriation of a company's assets, or manipulation of its financial data to the advantage of the perpetrator" (Hall, 2007, p. 118). In accordance with the International Standards on Auditing (ISA) fraud is "an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage" (IASB, 2009). The Institute of Internal Auditors' (IIA's) defines fraud as "any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage" (IIA, 2009, p. 4). Singleton et. al. stated that there is no definite and invariable rule that can be laid down as a general proposition in defining fraud, as it includes surprise, trick, cunning and unfair ways by which another is cheated (Singleton et al., 2006, p. 1). Fraud always involves a deliberate action by one person to gain an unfair advantage over another person, and can take many forms (Vaassen, 2004, p.236).

The Association of Certified Fraud Examiners (ACFE) has identified three primary categories of fraud based on the numerous investigated fraud cases. These are asset misappropriations, corruption schemes and financial statement fraud schemes. According to ACFE, asset misappropriations are those schemes in which the perpetrator steals or misuses an organization's resources. The corruption schemes involve the employee's use of his or her influence in business transactions in a way that violates his or her duty to the employer for the purpose of obtaining a benefit for himself or herself or someone else. Financial statement fraud schemes are those involving the intentional misstatement or omission of material information in the organization's financial reports. (ACFE, 2010) For the purposes of the International Standards on Auditing, although fraud is a broad legal concept, the auditor is concerned with fraud that causes a material misstatement in the financial statements, and accordingly two types of intentional misstatements relevant to the auditor are misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets (IASB, 2009).

There are also other ways of classifying fraud. Bologna and Lindquist make the distinction between internal versus external fraud, a classification based on whether the fraud perpetrator is internal or external to the victim company; transaction versus statement fraud, where statement fraud is defined as "the intentional misstatement of certain financial values to enhance the appearance of profitability and deceive shareholders or creditors", while in transaction fraud the intention is asset misappropriation; fraud for versus against the company, where in the first the organization benefits from fraud and in the latter the organization is victimized by it; or management versus non-management fraud, a classification based on the perpetrator's characteristics (Jans et al., 2009, p.3-4). Nevertheless, the most prominent division of fraud is on internal and external fraud, since all of the fore mentioned classifications are actually allocated within internal fraud (Jans et al., 2009, p. 5). This division is directly focused on fraud perpetrator, i.e. depends whether the perpetrator is the employee of the company or is the person from outside the company.

Since intention is necessary in committing fraud and „the only boundaries defining it are those which limit human knavery"(Singleton et al., 2006, p. 1), it is obvious that human is the essential factor in genesis of a fraud. The first to investigate why people commit fraud was American criminologist Donald Cressey in 1950 (Kassem, Higson, 2012, p. 191). As a result of his research the „fraud triangle" model was developed. This triangle consists