Questions and answers: an auditor's responsibility to detect fraud

American Institute of Certified Public Accountants. Communications Division

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Dear Member:

We are pleased to provide the questions and answers document you requested regarding an auditor's responsibility to detect fraud. The AICPA Communications Division worked with the Institute's technical staff to develop the Q's & A's so that they would be most useful to the membership.

To help you understand an "outsider's" perspective of the audit process as it relates to fraud and fraud detection, the Q's & A's identify some of the key questions asked of the Institute and the profession by the media, congressional leaders, investors, and the public. State CPA societies also have received the Q's & A's as a reference tool for dealing with those involved with the accounting profession.

If you need additional information, please call the Communications Division.

Sincerely,

Geoffrey L. Pickard
Vice President - Communications

Encl.
QUESTIONS AND ANSWERS

AN AUDITOR'S RESPONSIBILITY TO DETECT FRAUD

Q. Are we seeing an increase in business fraud or fraudulent financial reporting? If so, how are CPAs responding to the trend?

A. No, we are not seeing an increase in fraud or fraudulent financial reporting. About 50 lawsuits alleging audit failures involving public companies are filed each year, and that number has remained relatively constant over the last 10 years. Unfortunately, we have seen some very significant incidents of fraud that make us tend to forget that the other 12,000 companies registered with the SEC are conducting business ethically and issuing honest financial statements.

Q. What auditing standards apply to fraud detection?


Q. What is the AICPA doing to strengthen auditing standards to require efforts to detect fraud?

A. In addition to defining the auditor's responsibility regarding fraud, SAS No. 53 includes useful guidance on situations that may signal the existence of fraud.

Q. How would a CPA go about trying to detect fraud?

A. First, the CPA assesses the risk of material fraud. If that risk is high, the engagement may be changed in a number of ways. Ordinarily, higher risk suggests the need to assign more experienced personnel to the engagement and to provide more supervision. Higher risk also suggests the need to expand the extent of the audit procedures applied, to apply them closer to the balance sheet date, or to modify the nature of the procedures to obtain more persuasive evidence. Most importantly, higher risk will cause the CPA to exercise a heightened degree of professional skepticism when conducting the audit.

Q. Should CPAs approach each audit as if fraud were committed?

A. CPAs are aware that they are obligated by professional standards to design the audit to detect fraud that is material to financial statements. However, a presumption of fraud or management dishonesty is contrary to the accumulated experience of auditors. An audit conducted under a presumption of management fraud or dishonesty would be never-ending. Moreover, if dishonesty were presumed, the CPA would need to question the authenticity of all client
records and documents. An audit coordinated on these terms would be unreasonably costly and impractical. But neither does the CPA approach each audit as if all client personnel are completely honest and competent. An approach that reflects objective, professional skepticism is the answer, and that is what the professional literature requires.

Q. Why have CPAs failed so often to detect fraud?

A. Material fraud is infrequent, but when it does occur, it often involves elaborate schemes to conceal it through collusion, including management collusion, or forgery. Therefore, there are cases in which even a prudent auditor will not detect a fraud on a timely basis.

Q. If CPAs cannot detect fraud, what good is an audit – just to check arithmetic?

A. CPAs do detect fraud. CPAs are obligated by authoritative standards to design their audits to detect material errors and fraud. The fact that the effects of some acts of fraud have become so extreme before being detected simply illustrates the difficulty of catching competent criminals in the act.

Q. What is the AICPA doing to help firms train their CPAs and better equip them to detect fraud?

A. To help CPAs better assess the risk that financial statements may contain material misstatement due to error or fraud, the AICPA annually publishes specialized information to alert auditors to significant auditing-related developments. The Institute also publishes industry-specific information highlighting 17 individual industries, as well as audit manuals, various practice aids and checklists for CPAs. The AICPA also conducts an extensive number of continuing education courses that help CPAs to maintain and upgrade their auditing skills.

Q. What are CPA firms doing to train CPAs, especially young CPAs, to do a better job of fraud detection?

A. In their audit training, CPA firms are emphasizing the importance of an assessment of the risk of fraud and the use of professional skepticism.

Q. Are auditing standards used today "obsolete"? Are they "tough enough"? When was the last time auditing standards were reviewed and changed by the AICPA?

A. Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities, was published in 1988. That standard is not obsolete and it is tough. It calls upon the auditor to have reasonable assurance -- there is no such thing as absolute assurance in an uncertain world -- that the financial statements are not materially misstated by fraud or error.
And it provides specific guidance on what should be done when a material fraud is found. In the case of a public company, this will lead to notification of the SEC through appropriate disclosure in the financial statements or through other means, including notification of the resignation of the auditor.

Q. Do CPAs have the skills to detect fraud?

A. Yes, and CPAs are constantly honing their risk assessment skills, especially as related to fraudulent financial reporting and other management fraud. However, it's essential to remember that because of the characteristics of fraud, particularly those involving forgery and collusion, even a properly designed and executed audit may not detect a material fraud.

Q. Should CPA firms do postmortems on major fraud cases? Should they communicate the results to the public and government agencies?

A. When frauds occur, the entire profession must learn how the financial statements were manipulated, how detection was initially avoided, what audit procedures (if any) might have discovered the fraud, and what should be done to make sure the chance of future fraud detection is increased. The AICPA has published general articles on lessons auditors need to learn from alleged audit failures. The Institute is currently studying other ways to obtain and disseminate such information.

Q. If fraud is found by an auditor, what are the CPA’s professional and legal responsibilities? Are CPAs required to report fraud they have found to the public or the government?

A. When fraud is found, the CPA is obligated to report the fraud to the audit committee of the client company's board of directors. If the financial statements are materially misstated as a result of the fraud, the CPA must also make sure that the statements are revised and, if they are not, express a qualified or adverse opinion on them. If the client hinders the CPA's investigation of the matter or refuses to accept the audit report, the CPA should withdraw from the engagement.

In addition, when deciding whether to continue the client relationship, the CPA considers the diligence and cooperation of senior management and of the board of directors with regard to their investigating the circumstances of fraud and taking remedial action. If the client is a public company, upon withdrawal, the CPA is obligated to submit a letter to the SEC stating agreement or disagreement with the client's disclosure of the factors causing the auditor's resignation as filed on Form 8-K.
Q. Will the newly proposed Wyden "Whistle Blowing" legislation help reduce fraudulent financial reporting?

A. The Wyden bill (H.R. 574, "Financial Fraud Detection and Disclosure Act") requires, among other things, more rapid notification of corporate illegal activities and reaffirms the CPA's obligation to assess an audited company's continued existence. This legislation should bolster public confidence in the nation's financial reporting system.

Q. Why can't independent CPAs be the public "watchdog"?

A. CPAs are public watchdogs. They accept their public responsibility to detect and report fraud within the parameters of generally accepted auditing standards. When CPAs find problems, they are dealt with in conformity with those standards. This includes, if necessary, the issuance of a qualified or adverse report by the auditor. In the case of publicly held companies, those problems may have to be reported to the SEC in 8-K reports.