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The effects of experience and explicit fraud risk assessment in detecting fraud with analytical procedures☆

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Abstract

This paper reports the results of an experiment that examined the effects of audit experience and explicit fraud risk assessment instructions on the effectiveness of analytical procedures in detecting financial statement fraud. The results of this study suggest that audit managers are more effective than audit seniors in assessing the risk of fraud with analytical procedures. Additionally, explicit fraud risk assessment instructions resulted in more effective assessments of the presence of fraud. These results have implications for the assignment of auditors to tasks and the structuring of these tasks.

1. Introduction

This paper reports the results of an experiment that examined the effects of audit experience and explicit fraud risk assessment instructions on the effectiveness of analytical procedures in detecting financial statement fraud.[1] The experimental materials used in this study include fraudulent financial statements issued by a public company and the subsequently restated and reissued financial statements of the same company. Audit seniors and managers applied analytical procedures to financial statements and assessed the risk of fraud. The subjects were divided into four groups, each of which received one of four combinations of financial statements and explicit fraud risk assessment instructions. The financial statements presented to the auditors were either fraudulent or fairly stated. One-half of the subjects received explicit instructions stating that the objective of their task was to assess the risk of financial statement fraud, while the remaining subjects did not receive such instructions.

The results of this study suggest that audit managers are more effective than audit seniors in assessing the risk of fraud with analytical procedures. Additionally, explicit fraud risk assessment instructions resulted in more effective assessments of the presence of fraud.

The remainder of this paper is organized as follows. Section two develops the motivation and hypotheses for the study. The research design and results are presented in Sections three and four,

☆ Data availability: The data upon which this research is based may be obtained from the authors on request.

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[1] The type of fraud addressed in this paper is financial statement fraud: the intentional misstatements or omissions of amounts or disclosures in financial statements (American Institute of Certified Public Accountants [AICPA], 1997).

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respectively. Finally, Section five discusses the results and their potential implications for practice andresearch.

2. Motivation and hypotheses

In 1988, the Auditing Standards Board (ASB) issued *Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, 1988). This standard imposed greater responsibility on auditors to detect financial statement fraud. The ASB formed a task force in 1993 to reconsider auditors' responsibility for the detection of fraud. Among other recommendations, this task force concluded that the concepts of *professional skepticism* and *reasonable assurance* discussed in *SAS 53* needed to be developed further and that a new SAS devoted strictly to the issue of fraud detection was necessary. The new *SAS No. 82*, *Consideration of Fraud in a Financial Statement Audit* (AICPA, 1997), delineates auditors' responsibility for the detection of fraud more precisely than *SAS 53* and provides operational guidance to practitioners.

Fraud is an intentional act designed to deceive or mislead another party (Arens & Loebbecke, 1996). This study focuses specifically on financial statement fraud by business executives or managers who have sufficient authority to override an organization's internal controls. Generally, such fraud involves deliberate distortion of accounting records, falsification of transactions, or misapplication of accounting principles. Regardless of how the fraud is manifested, it is typically difficult for auditors to discover since the perpetrators take steps to deliberately conceal the resulting irregularities. Given the difficulty that auditors face in detecting financial statement fraud, coupled with their increasing responsibility to detect it, there is a definite need to develop audit procedures or strategies more specifically focused on fraud detection.

Analytical procedures have long been used by auditors, although the profession has required them to be incorporated in financial statement audits only since 1988. The potential for using analytical procedures for fraud detection purposes has been discussed widely in the professional literature. Nevertheless, there is little evidence that these procedures have been extensively applied by auditing firms for the specific purpose of detecting financial statement fraud.

Explicit fraud risk assessments have been recommended as an audit procedure that would improve the auditor's likelihood of detecting fraud (Loebbecke, Eining & Willingham, 1989; Shibano, 1990). Explicit fraud risk assessments are included as a required audit procedure in *SAS No. 82, Consideration of Fraud in a Financial Statement Audit* (AICPA, 1997).[2] Recent research on *SAS No. 82* indicates that implementation of the specific fraud risk assessment varies greatly across firms (Shelton, Whittington & Landsittel, 2000). Shelton et al. looked at the practices of all of the Big Five firms and two second-tier firms. Their study reported that three of the Big Five and both second-tier firms incorporate fraud risk assessment into the overall risk assessment process. The impact of requiring a separate fraud risk assessment on audit efficiency has been examined recently by Zimbelman (1997). He found evidence that requiring a separate fraud risk assessment increased auditors' attention to fraud cues and influenced audit planning decisions. The current study looks at the effect of separate fraud risk assessments on audit effectiveness. The findings indicate that fraud risk assessment is more effective when a separate, explicit fraud risk assessment is performed. Potentially, several audit firms could improve fraud risk assessment by requiring a separate assessment rather than incorporating it in the overall risk assessment.

Shelton et al. (2000) also reported that two of the Big Five and one second-tier firm perform the fraud risk assessment at the client acceptance/continuance stage of the audit. The remaining firms studied perform the fraud risk assessment during planning. In the current study, the fraud risk assessment is performed during planning with analytical procedures. Practice improvement may be possible for several firms by changing the fraud risk assessment to the planning stage of the audit

[2] At the time of this study, explicit fraud risk assessments were not a required audit procedure as they are now under *SAS 82*.