

## CURRENT CONTROVERSY ON AUDIT FUNCTIONS

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**Abstract:** *Are auditors responsible for detecting fraud in the companies they inspect? Most of the public thinks they are. Auditors often demur. The auditors' duties in the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing. This paper reports the findings of a survey that explores the financial report users' perceptions on the extent of fraud in Romania and their perceptions of auditors' responsibilities in detecting fraud.*

**Key words:** *fraud, auditors' responsibilities, audit expectation gap*

### 1. INTRODUCTION

Corporate failures and financial scandals have led to a significant increase in criticism of and litigation against the auditing profession. This phenomenon may be due to common beliefs that the stakeholders of the company should be able to rely on its audited accounts as a guarantee of its solvency, propriety and business viability.

On the background of the numerous financial scandals occurring on an international scale in the recent past, we found it interesting to explore the financial report users' perceptions of the extent of fraud in Romania and of auditors' responsibilities in detecting it (fraud).

The study also aims to ascertain whether the report users' perceptions of the auditors' responsibilities on fraud detection is consistent with the auditing profession's standards, assumed in Romania. Generally, there is a widely held misperception of the objectives of an audit, because of a much higher expectation, placed on the auditors' duties in detecting and reporting fraud, than audit standards require.

This lack of transparency/clarity between the financial report users and auditors, not only concerning the detection of fraud, but in a much broader meaning, the adequate defining of the role of the statutory auditor, has led to the emergence of the concept of „audit expectation gap”.

### 2. LITERATURE REVIEW

The research began with a study of the literature in the field of research, carried out on two levels: definition of fraud; auditors' responsibilities in fraud detection.

#### 2.1 Definition of fraud

The International Standard on Auditing 240(Revised) „The Auditor's responsibilities to Consider Fraud in an Audit of Financial Statement” refers fraud as „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”. In a study in 2005, KPMG defines fraud as „a **deliberate** deceit planned and executed with the intent to deprive another person of his property or rights...” (KPMG: 2005). What is to be noted is that all definitions in the speciality literature highlight the

concept of **intention**. So one cannot say there are clear boundaries between error and fraud, since the dividing line where error crosses into fraud is based on the psychological construct of intent. Fraud is more of a legal term which applies when intent can be proven in a court of law.

#### 2.2 Auditors' responsibilities in fraud detection

The role of auditors has not been well defined from inception. Porter (1991) reviews the historical development of auditors' duty to detect and report fraud over the centuries. Her study shows that there is an evolution of auditing practices and shift in auditing paradigm through a number of stages.

As Boynton argues, since the fall of Enron, the auditing standards have been revamped to re-emphasize the auditors' responsibilities to detect fraud.

This assertion is based on ISA 315 „Understanding the entity and its environment and assessing the risks of material misstatements” and ISA 240 „The auditor's responsibilities to consider fraud in an audit of financial statement” (revised)(e.g : ISA 315 requires auditors to assess the effectiveness of an entity's risk management; all staff members are required to communicate their findings, to prevent the failure of appreciating the significance of apparently minor irregularities; ISA 240 requires auditors to be more proactive in searching for fraud).

### 3. RESEARCH METHODOLOGY

We proceeded to the elaboration of an empirical research based on a questionnaire addressed to financial auditors. The questionnaire is adapted according to the one used by Alleyne and Howard (Alleyne & Howard :2005)

Along with the technique of the questionnaire we also used the survey, which relies on the sample as an instrument of research. The questionnaire was sent by means of electronic mail to the selected respondents.

Respondents are asked about their opinion on auditors' responsibilities regarding the detection and reporting of fraud).

The survey is applied on a national scale and the questionnaire contains Likert-like questions on a five-point scale, ranging from „strongly disagree” to „strongly agree”. Most of the questions are closed. Participants in the survey can be divided in three groups: auditors (active members of the CAFR), managers (of audited entities) and bankers (directors of Credit Departments). A limit of this study would be that the sampling error is high because of the low numbers of bankers, despite the fact that the response rate was high. This causes results not to be easily generalized.

### 4. FINDINGS OF THE RESEARCH

#### 4.1 Analysis of responses related to existence and extent of fraud

The results show that a large percentage of the respondents (62.9%) agree and strongly agree that fraud is a major concern

Questions	Position of the respondents				
	Users of financial reports N = 213				
	Strongly disagree	Disagree	Neutral	Agree	Strongly Agree
1. Is fraud a major concern for business in Romania?	5 (2.3%)	28 (13.1%)	46 (21.6%)	99 (46.5%)	35 (16.4%)
2. Do you think that the discovery of fraudulent activity would have a negative impact on users?	7 (3.3%)	19 (8.9%)	51 (23.9%)	112 (52.6%)	24 (11.3%)

Tab. 1 Perceptions of the extent of fraud

in Romania, while only 15.4% do not subscribe to this opinion. This tokens an increased level of mistrust in the Romanian business environment, which only shows indirectly the first aspect of the gap that we have been talking about at the beginning of our article, namely the expectation gap between the financial report users and the statutory requirements for auditors.

When asked whether the discovery of fraudulent activity would have a negative impact on users 11.3% strongly agreed and 52.6% agreed to this statement. This reflects the common market reaction to negative publicity, which has a negative impact on stock transaction price.

#### 4.2 Analysis of responses related to auditors' responsibility for fraud detection

Table 2 shows that 37.1% of the respondents agree that the responsibility of the auditor is to prevent fraud and error, while 43.6% disagree with the statement. The proportions are maintained for the rest of the questions. The results obtained are in contrast with the requirements of ISA (nr. 200) which requires the auditors to express an opinion whether the financial statements are prepared according to the applicable financial reporting framework. Given the large number of respondents who believe that fraud detection and reporting is the auditors' responsibility, it can be concluded that the users of financial reports do not possess a proper understanding concerning the matter.

In order to compare the answers of the three categories of respondents we calculated the average value of the responses. Responses with an average value over 3, show that users have higher expectations of the auditors' duties and responsibilities

Questions	Position of the respondents				
	Users of financial reports N = 213				
	Strongly disagree	Disagree	Neutral	Agree	Strongly Agree
3. Is it the responsibility of the auditor to prevent fraud and errors?	45 (21.1%)	48 (22.5%)	41 (19.2%)	40 (18.8%)	39 (18.3%)
4. Is it the responsibility of the auditor to prevent all fraud and errors?	40 (18.8%)	53 (24.9%)	38 (17.8%)	47 (22.1%)	35 (16.4%)
5. Is it the responsibility of the auditor to report all omissions and frauds in the auditors' report?	42 (19.7%)	63 (29.6%)	34 (16.0%)	43 (20.2%)	31 (14.6%)
6. Is the auditor responsible for any material weaknesses of the company's internal control system?	51 (23.9%)	58 (27.2%)	53 (24.9%)	25 (11.7%)	26 (12.2%)
7. Do you consider that there should be an audit standard that would make auditors responsible for detecting and reporting frauds?	42 (19.7%)	63 (29.6%)	34 (16.0%)	43 (20.2%)	31 (14.6%)

Tab. 2 Auditors' responsibility for fraud detection

Proposed questions	Auditors	Managers	Bankers
	Is it the responsibility of the auditor to prevent fraud and errors?	2,14	3,32
Is it the responsibility of the auditor to detect all fraud and errors?	2,36	3,68	3,9
5. Is it the responsibility of the auditor to report all detected omissions and frauds in the Auditor's Report?	2,63	3,47	4,6
6. Is the auditor responsible for any material weaknesses of the company's internal control?	1,98	2,91	3,3
7. Do you consider that there should be an audit standard that would make auditors responsible for detecting and reporting frauds?	2,41	4,47	4,1

Tab. 3 Average level of responses per group of respondents

than they should have. Responses with an average value below 3 show that users properly understand the matter.

The average values show that most managers and bankers believe that auditors are responsible for preventing and detecting fraud and errors (questions 3 and 4). A gap exists here because ISA 240 „Fraud and Error” clearly stipulates that the responsibility for prevention and detection of fraud rests with the management and the main responsibility of auditors is to detect fraud and error only insofar as they are related to risk assessment.

What is interesting is the increased level of the average among the bankers. This might suggest a relatively low understanding concerning the auditors' responsibilities in detecting and preventing fraud.

## 5. CONCLUSIONS

The results of the study show that respondents are very concerned about the problem of fraud in Romania and their perceptions of the official objective of an audit, is incorrect, as they placed very high expectation on auditors' duties on fraud prevention and detection.

Likewise, a lack of understanding of the statutory duties of auditors among respondents can be stated. This situation may be improved through different strategies, of which most likely to succeed being: i) educating the users on the role and actual duties of auditors; ii) by expanding the scope of the audit to meet market expectations. It is hoped that by implementing both approaches, the public expectations and the auditors' duties will be better attuned.

A further research line in addressing the issue of audit expectation gap, may consist in conducting a study to analyze the cost-benefit ratio for both beneficiaries and auditors, if the audit profession were to expand its scope to meet market expectations.

## 6. REFERENCES

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