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Perceived importance of red flags across fraud types

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ABSTRACT

The purpose of this study is to examine whether internal auditors, external auditors and economic crime investigators perceive the importance of red flags as significantly different across two fraud types: fraudulent financial reporting and misappropriation of assets, as well as across within-subject categories. A total of 471 useable responses were collected using a web-based survey. The findings indicate that significant differences exist on both single and aggregate mean levels among the participant groups. Internal auditors report a higher perceived importance of the red flags related to detecting misappropriation of assets than of those related to fraudulent financial reporting, whereas the opposite is true for economic crime investigators. For external auditors, only small differences in aggregate means between misappropriation of assets and fraudulent financial reporting were found. As the sensitivity to fraud type may affect professional planning, procedures and techniques with regard to fraud prevention, detection and investigation, the results may have both practical and theoretical implications. Further, the focus on both fraud types adds to prior literature on fraud.

1. Introduction

Previous research indicates that fraud[2] remains one of the most problematic and prevalent issues for business worldwide. A survey of global economic crime by PwC (2009a,b) reported that almost one-third (30%) of all firms had faced economic crime in the past twelve months, and these crimes cause huge losses for business and society. As one of the steps to fight fraud, regulators prescribe the use of fraud risk indicators, commonly called red flags, even though research provides evidence on

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[1] Tel.: +358 40 3521 727; fax: +358 6 3533 703.
[2] The Concise Oxford Dictionary defines fraud as "criminal deception; the use of false representations to gain an unjust advantage". The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) defines fraud in the International Standard on Auditing (ISA) 240 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".

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the limited accuracy and power of red flags in fraud risk detection and prediction (e.g. Pincus, 1989). Nevertheless, it has been noted that utilizing the red flag method raises auditors' sensitivity to the possibility of fraud (Krambia-Kapardis et al., 2010).

Prior research on the importance of various red flags (e.g. Apostolou et al., 2001; Hackenbrack, 1993; Loebbecke et al., 1989; Majid et al., 2001; Mock and Turner, 2005; Moyes, 2007; Smith et al., 2005) has primarily examined external or internal auditors' perceptions of the fraud risk indicators related to management fraud (Coram et al., 2008; Liou, 2008). Findings from these studies indicate various and inconclusive results with regard to which fraud risk indicators are the most important. Over time, regulators and researchers addressing fraud prevention and detection have also identified new fraud risk indicators and taxonomies, making comparisons difficult. In recent years, professional standards, among them the International Standards on Auditing (ISA) 240 (IFAC (International Federation of Accountants), 2004), have been revised, and include an updated and comprehensive set of cues and conditions associated with fraud risk, which are, contrary to previous ISA standards,[3] categorized according to fraud types. Although existing professional standards prescribe identical detection responsibilities regarding fraud type, relatively little is known about how various professionals, with regard to fraud risk detection, stress the importance of red flags across the specific nature of fraud. A recent study among internal auditors appears to have derived various results in different countries (DeZoort and Harrison, 2008a). However, no known prior study on red flag importance across fraud types has included three participant groups.[4]

The purpose of this study is to examine how Finnish internal auditors, external auditors, and economic crime investigators stress the importance of red flags in their consideration of intentional fraud risk in the financial statements. Specifically, this study evaluates whether the three participant groups perceive the importance of red flags differently across fraud types and within-subject categories. Following ISA 240 (IFAC, 2004) and the lead of the Finnish Institute of Internal Auditors (IIA-F, 2007), this study focuses on two distinct fraud types that are of great relevance to auditors and other professionals concerned with fraud. These two fraud types may cause material misstatements in the financial statements: misstatements resulting from fraudulent financial reporting (FFR, also known as management fraud), and misstatements resulting from misappropriation of assets (MoA, also known as employee fraud).[5] Although neither fraud type is emphasized to a greater or lesser extent than the other in current professional guidelines and standards, it is, however, proposed in this study that the participant groups will perceive the importance of red flag indicators differently, with regard to single red flags as well as across fraud types and within-subject categories. This is justified by the differences among the participant groups in their professional roles and responsibilities within the fraud detection and corporate reporting processes. Further, it is suggested that the perceptions of materiality[6] when judging fraud risk differ between participant groups, which may also cause differences in judgements regarding the importance of red flags. The assessment of what is material by each professional group working at different stages of the corporate reporting process is considered a matter of professional judgement. External auditors have been criticized for mainly applying a quantitative threshold in assessing materiality in practice (see Messier et al., 2005 for a review). Internal auditors usually adopt a cost-benefit approach, and crime investigators associate materiality with matters such as violation of laws and criminal intent.

The remainder of the paper is structured as follows: Section 2 provides a brief overview of the extant literature, resulting in the formulation of hypotheses. Section 3 presents the design of the empirical survey used to collect data. Section 4 reports the tests of the hypotheses. Section 5 includes a discussion of the findings and some suggested implications. Section 6 concludes this paper with some directions for future research as well as a summary of the limitations of the study.

2. Literature review and hypotheses development

The bulk of prior research on fraud prevention and detection methods has addressed fraud risk indicators. These so-called red flags are events, conditions, situational pressures, opportunities, or personal characteristics that may cause management or employees to commit fraud on behalf of the company or for personal gain (Romney et al., 1980). Most prior research on fraud detection has focused on FFR (Coram et al., 2008; Liou, 2008), and there is a paucity of prior research focusing on both the FFR and MoA.

[3] Colbert (2000) found that one difference between the ISA standards and Statement on Auditing Standards (SAS) issued by the American Institute of Certified Public Accountants (AICPA) was that fraud was not broken into types in the ISA standards.

[4] Overall, there appear to be few fraud studies that include more than two participant groups, e.g. internal and external auditors. See, however, Bierstaker et al. (2006) on perceptions of fraud detection and prevention methods, as well as DeZoort and Lee (1998) on perceptions of SAS No. 82.

[5] Fraudulent financial reporting (FFR) involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users. Misappropriation of assets (MoA) involves the theft of an entity's assets, and is often perpetrated by employees, in relatively small and immaterial amounts (IFAC, 2004).

[6] Many definitions exist for the concept of materiality. The IASB's (Framework for the Preparation and Presentation of Financial Statements) states: "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements". Factors affecting materiality are the size of the item and the nature of the item (IASB, 2009). International Standards on Auditing (ISA 320 and ISA 450) deals with the determination of materiality and its application in planning and performing an audit of financial statements, as well as how materiality is applied in evaluating misstatements identified during the audit of financial statements. The definition of ISA (320) draws on the IASB definition, stating: "Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both".