

DEFRAUDING THE PUBLIC INTEREST: A CRITICAL EXAMINATION OF REENGINEERED AUDIT PROCESSES AND THE LIKELIHOOD OF DETECTING FRAUD

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In the past few years, most of the major international public accounting firms have reengineered their audit processes to improve the cost effectiveness of completing an audit and to focus on value-added services for clients. The reengineered audit processes generally focus on a client's business processes and the information systems used by the client to generate financial information. In essence, the new audit approaches deemphasize direct testing of the underlying transactions and account balances. Such an approach emphasizes analytical procedures as the main source of substantive evidence. During this same time period, however, the profession (through the AICPA) explicitly acknowledged the profession's responsibility for fraud detection.

The main premise of this paper is that the increased emphasis on systems assessments is at odds with the profession's position regarding fraud detection because most material frauds originate at the top levels of the organization, where controls and systems are least prevalent and effective. As such, the profession may be paying lip service to fraud detection, while at the same time changing the audit process in a manner that is less effective at detecting the most common frauds.

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We cannot permit thorough audits to be sacrificed for reengineered approaches that are efficient, but less effective.

*Arthur Levitt
Former Chair, Securities and Exchange Commission*

In the last few years, most of the major international public accounting firms have reengineered their audit processes to improve the cost effectiveness of an audit and to focus on value-added services for clients. These reengineered audit processes generally focus on a client's business processes and an evaluation of the information systems used by the client to generate financial information. In fact, an audit

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Received 4 June 1999; revised 6 November 2000; accepted 15 September 2001

manager at one major firm's office in Hartford (USA) recently noted that for the bulk of the office's major clients (over half of the current audit work for that office), an audit constituted a review of the client's information systems and associated internal controls over those systems. The audit manager noted that they would also complete "a handful of accounts receivable confirmations and some inventory observation so that the partner wouldn't stroke out". (It should be noted that these latter two tests are mandatory under current US audit standards.) In essence, other than cursory completion of these obligatory tests, the new audit approach ignored any direct substantive testing of the underlying transactions and account balances¹.

An audit approach emphasizing controls is similar in philosophy to other firm's reengineered audit approaches whereby the only substantive testing completed in many cases are analytical procedures—procedures that were not even considered substantive audit tests prior to the "great discovery" with the 1988 *expectation gap audit standards* intended to alleviate the public outcry over the failure of audits to detect fraudulent financial reporting and to identify companies that are questionable going concerns. Additionally, the profession's recent move to "continuous auditing" would place almost exclusive reliance on control assessments (CICA, 1999).

At the same time, the profession has formalized its fraud detection authority with the promulgation of SAS #82, which requires the auditor to provide "reasonable assurance" of detecting material fraud. However, the recent KPMG *1998 Fraud Survey* (KPMG, 1998) indicates that fraud discovery by external auditor review amounted to only 4% of discovered frauds—down from 5% in 1994. On the other hand, the average loss from false financial statements increased from \$765 000 in the 1994 survey to \$1 239 000 in the 1998 survey. It is not surprising that the public is often found asking the question, "Where were the auditors?"

At the heart of the emerging perspectives that seem to dominate contemporary accountancy firm beliefs, as evidenced by the reengineered audit approaches, is that fraud is something lower level employees are responsible for. The nature of internal control systems is that the lower level employees can be controlled through relatively low cost control implementations, while it is neither feasible nor perhaps possible to build effective control systems for upper management. Hence, a shift toward greater reliance on a systems auditing approach involves an implicit adoption of the belief that if lower level employees are controlled, the prevalence of fraud will decrease.

A detailed review of the SEC's accounting and auditing enforcement releases (AAERs—which are predominantly related to instances of fraud) demonstrates that the preponderance of financial statement frauds are perpetrated by the very top levels of management—generally the CEO or equivalent level. This finding is the antithesis of the inherent assumption that has been adopted by the accountancy profession via the implementation of reengineered audit processes focused on internal control monitoring.

The main premise of this paper is that the increased emphasis on systems assessments is at odds with the profession's position regarding fraud detection because most material frauds originate at the top levels of the organization, where controls and systems are least prevalent and effective. In the remainder of this paper, we expand upon the basic propositions that we have put forth. This

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