THE EFFECTS OF EXPERIENCE AND EXPLICIT FRAUD RISK ASSESSMENT

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Abstract

This paper reports the aftereffects of an investigation that analyzed the impacts of audit insight and express fraud risk assessment directions on the adequacy of logical systems in recognizing financial explanation fraud. The consequences of this examination propose that audit directors are more powerful than audit seniors in evaluating the risk of fraud with insightful techniques. Furthermore, express fraud risk assessment directions brought about more viable assessments of the presence of fraud. These outcomes have suggestions for the task of auditors to assignments and the organizing of these errands.

Keywords: Fraud Risk, Assessment, Audit

This paper reports the consequences of a trial that inspected the effect of audit insight and unequivocal fraud risk assessment guidelines on the adequacy of scientific methods in distinguishing financial proclamation fraud. The test materials utilized in this investigation incorporate fraudulent financial explanations gave by a public organization and the thusly rehashed and reissued financial assertions of a similar organization. Audit seniors and directors applied a scientific methodology to financial explanations and surveyed the risk of fraud. The subjects were partitioned into four gatherings, every one of which got one of four mixes of financial articulations and unequivocal fraud risk assessment directions. The financial assertions introduced to the auditors were either fraudulent or genuinely expressed. One-portion of the subjects got unequivocal guidelines expressing that the goal of their assignment was to survey the risk of financial proclamation fraud, while the excess subjects didn't get such directions. The aftereffects of this investigation recommend that audit chief are more effective than audit seniors in surveying the risk of fraud with insightful strategies. Furthermore, express fraud risk assessment directions brought about more effective assessments of the presence of fraud.

The rest of this paper is coordinated as follows. Segment two builds up the inspiration and speculations for the examination. The exploration plan and results are introduced in Sections three and four, individually. At last, Section five examines the outcomes and their possible ramifications for training and examination.

Motivation and hypotheses

In 1988, the Auditing Standards Board (ASB) issued a Statement on Auditing Standards No. 53, Zhe Auditov'z Responsibility to Detect and Report Evvovz and Ivvegulavitiez (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, Conzidevation of Yvaud 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.

Yard 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 suAcient 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 (Loeb- Becke, Mining & Gillingham, 1989; Shibano, 1990). Explicit fraud risk assessments are included as a required audit procedure in SAS No. 82, Con- deviation of Yvaud in a Yinancial Statement Audit (AICPA, 1997).2 Recent research on SAS No. 82 indicates that implementation of the specific fraud risk assessment varies greatly across firms (Shel- ton, 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- time 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 to 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 rather than at the client acceptance] continuance stage.

In addition, the practice aids used to assess fraud risk by the firms studied by Shelton et al. (2000) almost all involve checklists. Prior research on practice aids has provided evidence that the use of checklists may not be effective in assessing the risk of fraud (Eining, Jones & Loebbecke, 1997; Pincus, 1989). The present research indicates that for experienced auditors performing an explicit fraud risk assessment with analytical procedures, effectiveness is improved. Hopefully, the current study will contribute to the accounting pro- fession's continuing effort to improve the fraud detection capability of financial statement audits and the implementation of SAS No. 82.

Analytical procedures as a method of fraud detection

In 1987, the Treadway Commission reported, ''The potential of analytical review procedures for detecting fraudulent financial reporting has not been realized fully (National Commission on Fraudulent Financial Reporting [NCFFR], 1987).'' Based upon a review of actual fraud cases, the Treadway Commission observed that financial statement frauds tend to be very similar in terms of how they are perpetrated. Most fraudulent cases involve improper revenue recognition, overstatement of assets, and/or improper deferral of expenses. Typically, analytical procedures involve comparing actual financial statement amounts with expected amounts that are derived from the application of a naive or complex prediction model. Since the misstatements resulting from fraudulent misrepresentations result in differences from predicted amounts, they should be potentially detectable with analytical procedures.

The central task of an auditor in applying analytical procedures is to develop expectations. The expectations the auditor develops will be based upon both the external information that the auditor encounters and his/her own existing knowledge stored in memory. An auditor's existing knowledge is an important factor in his/her understanding and interpretation of information and can be expected to influence the auditor's effectiveness in assessing the risk of financial statement fraud. Research on experience and expertise suggests that an individual's knowledge changes as experience increases (Chi, Glaser & Rees, 1982), thus an auditor's per- performance of analytical procedures may be affected by the experience.

Previous research in both psychology and auditing has found that as individuals gain relevant experience their knowledge structures change and develop (Chi et al., 1982). Generally, the findings indicate that experienced individuals have greater total knowledge (Christ, 1993; Hnapp, 1995; Libby & Frederick, 1990; Tubbs, 1992), more understanding of relationships between variables (Chi et al., 1982; Frederick, 1991; Moeckel, 1990), and an ability to go beyond the surface features of information and identify the true, underlying pro- blem (Biggs, Mock & Uatkins, 1988; Chi et al., 1982; Christ, 1993; Moeckel, 1990). All of these characteristics of knowledge are potentially important to the task of fraud risk assessment with analytical procedures.

Two empirical studies of particular importance to the issues addressed here have both found significant knowledge differences between audit managers and seniors. Christ (1993) studied auditors' planning knowledge (of which preliminary analytical procedures are a subtask) with a recall task. She found significant differences in the knowledge structures of audit managers] partners as compared to senior and junior auditors. Hnapp (1995) examined auditors' knowledge of factors that may indicate the existence of financial statement fraud and found significant differences. Managers were able to recall a greater number of ''factors that may suggest the existence of fraud in a set of financial statements'' than were audit seniors. Given that significant knowledge differences have been identified between experience levels of auditors, this knowledge difference will likely affect auditors' understanding and inter- predation of information during analytical procedures and, thus, their ability to effectively assess the risk of financial statement fraud.

The first hypothesis of this study addresses the relationship between the level of experience and the ability of auditors to use analytical procedures for fraud detection purposes. Hypothesis one predicts that greater experience will positively affect auditors' performance in this context.

Unequivocal fraud risk assessment as a fraud location procedure

The broad mental examination has researched the presence and construction of information used by leaders, factors that impact the initiation of the right or most suitable information in a given dynamic setting, and the effect of information on the viability and proficiency of dynamic cycles (for example Lesgold, 1984; Lurigio and Carroll, 1985; Mandler, 1984; Rumelhart, 1980). This examination demonstrates that earlier information encourages the encoding of new data, the translation of the data being handled, and the recovery of important data (Alba and Hasher, 1983).

For logical methodology to be useful in empowering an auditor to successfully survey the risk of financial articulation fraud, an auditor should have the applicable information needed to reveal the fraud in the event that it is available and the capacity to ''trigger'', or initiate, that information when required. An individual prompt inside the financial articulations may trigger the auditor's fraud information on the off chance that it is sufficiently material. Or on the other hand, it could be important for an auditor to distinguish a few signals to trigger his]her fraud information. Financial articulation fraud includes an endeavour by the executives to ''fool the auditors''. One approach to attempt to conceal the fraud is with a progression of controls of records, none of which is material enough all alone to trigger the auditor's doubt of fraud.

It could be conceivable to improve fraud location by expecting auditors to expressly survey the risk of fraud. Zimbelman (1997) found that auditors unequivocally evaluating fraud risk focus closer on fraud signs than do auditors not making express fraud risk assessments. What's more, his outcomes propose that expecting auditors to expressly survey the risk of fraud will prompt expanded audit hours for both high-and low-fraud risk cases. Unan-addressed is whether or not unequivocal fraud risk assessments lead to more exact fraud risk assessments. It is conceivable that expecting auditors to independently survey the risk of fraud on a financial articulation audit will just diminish audit effectiveness by expanding audit hours. Likewise, fraud risk assessment directions may just expand fraud risk assessments for both fraud and non-fraud firms essentially in light of the fact that they increment auditors' assessment of the earlier likelihood of fraud.

Exploration in brain research offers help for more exact fraud risk assessments with unequivocal guidelines (Graesser and Nakamura, 1982; Rumelhart, 1980; Shank and Abelson, 1977; Taylor and Crocker, 1981). Unequivocal fraud risk assessment directions ought to actuate the auditor's fraud information and start a quest for proof that underpins the chance of fraud. The auditor's fraud information should direct the quest for applicable prompts characteristic of fraud. In the event that proof isn't distinguished that bolsters the chance of fraud, the auditor ought to survey the risk of fraud as low.

Conclusion

Risk the board isn't the obligation of a solitary office it is the duty of everybody, from the CEO down. Past corporate failings have been credited to the absence of responsibility, procedure, and straightforwardness. Harder assumptions by controllers and different partners presently imply that corporates and financial organizations ought to show better teach, control and obligation. Inability to keep on top of and agree with existing and arising guidelines could endanger notorieties and occupations. How strong is your administration, risk, and consistency program?

Financial risks have most likely never been more intense. Capital stores, credit portfolios, speculation approaches, and capital and obligation profiles all interest consistent investigation to sufficiently oversee and alleviate risk.

Organizations ought to likewise be careful about risks introduced by providers. A counterparty who defaults on an agreement, or whose business breakdowns, can have genuine financial and reputational consequences for associated parties.

Fraud risks can likewise increment when money is tight. A few representatives become more astute — and outside programmers more clever. They discover security remiss in territories of the business that used to be better resourced … and they strike. Are your frameworks and strategies adequately strong to avert the risk of fraud? Simultaneously, numerous organizations are bound to seek after case for misfortunes that they would somehow or another suffer on more prosperous occasions. Questions emerge as they look to distribute fault to different gatherings for unseemly or careless conduct that outcomes in financial or business misfortune. Could you end up as a troublemaker or respondent in a prosecution case?

With every one of these requests, an inward audit is in numerous organizations frequently raised from unadulterated consistency to a capacity that consistently surveys the risk profile for arising risks and recognizes patterns as it keeps its finger on the beat of business execution. The central risk official, in the interim, turns out to be progressively engaged with a vital dynamic where the accentuation is as much on risk for what it's worth on development. Invigorate your business. KPMG firms' experts give the experience to help organizations stay on target and manage risks that could unhinge their business endurance.

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