Current Affairs Noticeboard

Expansion of auditor’s duties for fraud detection

One of the important outcomes of the fallout relating to the recent corporate collapses in both Australia and United States and the accounting scandals in United States is that the audit profession has willingly expanded its duties in relation to fraud detection. One major factor resulting in this expansion of duties is the use of earnings management by companies who collapsed or later had to restate their earnings figures. Auditing standards in Australia, United States and the International Auditing and Assurance Standards Board (IAASB) have revised standards that have expanded the auditor’s duty to detect fraud. In this edition of *Current Affairs in Auditing* we shall discuss these expanded duties. Also, we note that there have been some articles in the media that deal with fraud and the implications of the content of these articles to the expanding duties of auditors for fraud detection are noted.

Most changes to auditor’s duties occur in an evolutionary, incremental fashion. Through court rulings and changes in auditing standards, duties relating to an auditor increase. Often these changes occur as a result of rounds of corporate collapses. The changes are incremental as they build on prior law or guidance provided in auditing standards. As a result of the recent corporate collapses and in particular the problem of earnings management, the auditing standards have been revised in relation to fraud detection.

The starting point for a revision of auditor’s duties in fraud detection occurred in the United States where the *Panel of Audit Effectiveness* (2002) reviewed the independent audits of the financial statements of public companies. The Panel was concerned about the fraud detection ability of auditors. The Panel stated that it is:

> concerned that the auditing profession has not kept pace with a rapidly changing environment. The Panel believes that the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management (para. 3.27).

As a result of the recent collapses in Australia and United States and accounting scandals in United States there has been much criticism of the auditing profession. In United States the use of earnings management was rampant. Prominent insiders of the accounting profession have severely criticised the auditing profession (Johnson, 2004, p.151). It is thus not surprising that the auditing profession reacted by extending its duties in relation to fraud. The profession is trying to maintain its relevance in an ever increasing complex business environment.

In July 2003 edition of *Current Affairs in Auditing* we noted that the Institute of Chartered Accountants in Australia issued a discussion document relating to increasing the scope of the audit in several areas that included fraud. See this edition for further details. The expansion of the scope of the audit was contingent upon the profession obtaining liability reforms. These liability reforms have been granted and thus the expansion of the auditor's duties in relation to fraud detection may seem to be a logical reaction to the granting of these legal reforms. However, Johnson, 2004, states that expanding auditor's duties in relation to fraud detection merely recognises forces in play with the American Institute of Certified Public Accountants (AICPA) issuing a standard in October 2002 expanding the guidance to auditors for detecting material fraud in an effort to restore investor confidence and confidence in financial reporting (Johnson, 2004, pp.157-158).

The United States is not the only accounting body that has revised their auditing standard on fraud. Both Australia, and the International Auditing and Assurance Standards Board (IAASB) have revised standards that expanded the auditor's responsibilities for detecting fraud. Evidence of increasing expectations and responsibilities being placed upon auditors to detect fraud can be seen from the following:

- In February 2004, the International Auditing and Assurance Standards Board (IAASB) issued ISA 240 *The Auditors Responsibility to Consider Fraud in an Audit of Financial Statements*. A media release announcing the release of the revised ISA 240 stated that "auditors (are required) to be more proactive in considering the risk of fraud in the audit of financial statements" (IAASB, 2004a).

- The title of ISA 240 has been changed to exclude error. Previously the title included both fraud and error. This is an indication of the growing importance of fraud detection as an objective of a financial statement audit.

- In Australia, a media release announcing the release of AUS 210 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* in June 2004 repeated the comments about auditors being more proactive in considering fraud during an audit (AARF, 2004).

In Australia, the Australian Securities and Investment Commission also expects auditors to be more active in detecting fraud. Jeffrey Lucy, the then Acting Chairman of the Australian Securities and Investments Commission in a speech delivered to the Queensland 2004 CA Business Forum organised by the Institute of Chartered Accountants in Australia stated;

> I would say that there is, in fact, now a clear market expectation to this effect – that is, that auditors are bloodhounds, not just watchdogs. Simply put, the market expects auditors to pick up instances of fraud (Lucy, 2004, p.15).

In the past it has been argued that auditors have limited responsibility to detect fraud and thus auditors are watchdogs rather than bloodhounds. The reference to bloodhounds indicates that fraud detection was not a primary objective of the financial statement audit. However Lucy is suggesting the auditors' responsibility for fraud is increasing whereby auditors have to actively undertake work to consider detecting fraud and thereby become more of a bloodhound.

References

International Auditing and Assurance Standards Board (IAASB), 2003, *ISA 200 - Objective and General Principles governing an Audit on Financial Statements,* February, October, www.ifac.org

International Auditing and Assurance Standards Board (IAASB), 2004a, *IAASB Calls on Auditors to Take Greater Action to Consider Fraud in an Audit and to Establish Rigorous Quality Control Processes*. February, www.ifac.org

International Auditing and Assurance Standards Board (IAASB), 2004b, *ISA 240 (Revised) - The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements,* February, www.ifac.org

Johnson R., 2004, "The future of auditing and corporate governance", in Johnson R (ed), *Readings in Auditing*, John Wiley & Sons Australia, Ltd, Brisbane, pp.150-164

Lucy Jeffrey, 2004, *FSR, CLERP 9 and surveillance programs: ASIC priorities over the next 12 months,* www.asic.gov.au

Panel of Audit Effectiveness, 2002, *Report and recommendation*s, Public Oversight Board, 31 August, www.pobauditpanel.org