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PROFESSIONAL SCEPTICISM AND FRAUD

The will and dedication of most people working in organisations will ensure a mindset that values professional scepticism, as a key audit criterion, over commercial considerations alone

Words Mario Fazekas

'My relationship with the auditors was based on lies and deceit ... I instructed my staff to take whatever action was necessary to keep the auditors from discovering the fraud' – Pat Finn, PharMor CFO.

In the PharMor case, the directors perpetrated a \$500 million inventory fraud over six years and the auditors were found guilty of 'reckless auditing'. In the court case, the director of enforcement at the US Securities and Exchange Commission (SEC) said: '[The auditors] have a responsibility to dig deeper, to be skeptical, to ask questions and to impose a discipline on management ...'¹

Being 'sceptical' seems to be an important trait for auditors but before we carry on with the article, let's look at a few definitions to put things in perspective.

WHAT IS SCEPTICISM?

The Oxford Dictionary defines scepticism as 'a sceptical attitude; doubt as to the truth of something, the theory that certain knowledge is impossible'.

WHAT IS PROFESSIONAL SCEPTICISM?

In accordance with the International Standard on Auditing, ISA 200,²

professional scepticism is 'an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'.

WHAT IS FRAUD?

According to South African law, 'fraud is the unlawful and intentional making of a misrepresentation which causes actual prejudice, or which is potentially prejudicial to another'.

So, from the above definitions we can see that professional scepticism, as it relates to auditing, is essential in achieving audit quality. This is because

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the public depends on auditors to obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement, whether the misstatements are due to error or fraud.

Auditors are not required to be 'sceptical' mistrusting all their clients, but they are required to be 'professionally sceptical', meaning that they neither trust the client implicitly nor do they mistrust the client – they are neutral. The saying 'trust but verify' sums it up – auditors should trust their clients (unless there are obvious red flags) but require convincing evidence. ISA 200, paragraph A24, describes this mindset aptly when it states, 'a belief

that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance'.

HOW ARE AUDITORS DOING WITH REGARD TO PROFESSIONAL SCEPTICISM?

The cases being referred to in this article are illustrative of instances where questions can be asked about



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whether the auditor has exercised sufficient professional scepticism. The intention is not to criticise auditors in general, because the truth is that in most of these instances there is a person/(s) on 'the other side of the table' – most often management or those charged with governance – who did not do 'honest business' and who deceived, concealed and/or misled many people, including the auditor. The intention is rather to raise awareness of cases like these and to learn from the mistakes of others so that auditors can ensure that the audit is conducted in accordance with professional standards, including obtaining sufficient appropriate audit evidence.

Regulators and standard-setters globally – such as the Independent Regulatory Board for Auditors (South Africa), Financial Reporting Council (United Kingdom), Public Company Accounting Oversight Board (United States of America), International Federation of Accountants, Australian Securities and Investments Commission, Auditing and Assurance Standards Board (Australia) – are concerned that professional scepticism is not judiciously applied in audits of financial statements.

For example, a number of significant findings in the IRBA Public Inspections Report 2017³ relate to a possible lack of professional scepticism demonstrated in applying professional judgement; determining materiality for the audit; evaluating accounting estimates; and during the identification and assessment of risks, including fraud risks.

In addition, the publication *An analysis of alleged auditor deficiencies in SEC fraud investigations: 1998–2010*⁴ confirms this with their findings of the three most common auditor failings:

- Failure to assess and respond to fraud risks
- Lack of competence and diligence
- Lack of professional scepticism

After frauds have been discovered, some auditors tend to blame the client, which works against them in trying to explain that a proper audit was performed. The following are examples of cases in point:

- In the 1992 PharMor fraud, the auditors claimed that 'we are watchdogs and not bloodhounds'

and the TV presenter agreed but said, 'the watchdog was asleep'.⁵

- In the 2006 Adelphia fraud, the auditors claimed, 'we were deceived by management' but the SEC spokesperson said: '[The auditors] were not deceived – they didn't just miss red flags – they pulled the flag over their head and then claimed they couldn't see!'⁶
- In the 2013 \$54 million City of Dixon fraud, when the audit partner was questioned about his role, this is how the dialogue went:⁷

Q: Do you know what the concept of scepticism is?

A: No

Q: Ever heard of that?

A: Yes

Q: Have you heard that in the context of the practice of accounting?

A: Not that I can recall

Needless to say, the City of Dixon auditors were described as 'the dog that didn't bark', found negligent and had to repay \$40 million in audit fees.

Has anything changed since all these examples of frauds hit the headlines?

Let us take the more recent example of Carillion, which was the second biggest construction company in the United Kingdom. The company was liquidated in January 2018 and when, during the enquiry, the panel asked the audit partner whether Carillion owed £200 million or it was owed the £200 million, the partner said, 'I don't know'. The minister of parliament then said: 'I wouldn't hire you to do an audit of the contents of my fridge ...'⁸

WHO IS RESPONSIBLE FOR FRAUD PREVENTION AND DETECTION?

First we must ask if it is the auditor's responsibility to detect fraud, so let us look at a brief history of the responsibility:

- *1900–1920s:* Fraud detection was a *primary objective* of the audit.
- *1920s–1960s:* Fraud detection was considered a 'responsibility not assumed'.

- *1960s–1980s:* Auditor acknowledged responsibility for detecting fraud that would normally be uncovered by an examination *performed in accordance with United States Generally Accepted Auditing Standards*.
- *Post-1980s:* Materiality and audit risk are the key. SAS No 82,⁹ SAS No 99¹⁰ and ISA 240¹¹ state the auditor must identify and assess the risks of material misstatement of the financial statements due to fraud, obtain audit evidence, and respond appropriately.¹²

Auditors' duties to detect and report fraud have become more firmly established but do not seem to be taken seriously enough by either auditors or management in many cases.

When I was in the forensic department at one of the Big Four firms, part of my job was to educate clients and my colleagues on fraud risk management. I would approach audit partners just before I heard their audits were about to begin and ask them if their audit staff could detect fraud (not because the auditor has primary responsibility in this regard, but in the context of the auditor's work effort in accordance with the requirements of ISA 240). The answer was usually 'no'. I would then suggest one of our forensic auditors be part of their audit team so that there could be a transfer of skills to the partner's staff and to add value to the audit in fulfilling the auditor's responsibilities in terms of ISA 240. The partner would usually say something like, 'Good idea, but who is going to pay for your forensic person's time? It is not coming off my audit budget and the client will not pay, so no thanks.'

I would then chat to some of the audit staff and ask them similar questions around the detection of fraud as I did the audit partner and generally the answer was 'no'. I asked why not, and the answers ranged from 'it's not our job' to 'I trust my client'.

As mentioned earlier, we do not want to place all the blame on auditors as we tend to get the same answers from management in some companies – 'it is not my job to be the policeman', 'I trust my staff', 'we do not have fraud', etc.

WHAT'S THE SOLUTION WITH REGARD TO PROFESSIONAL SCEPTICISM?

A common perception is that professional scepticism is either a characteristic that some people have while others do not, or it is a skill established through training.

I believe it is both. Audit firms should be hiring employees with enquiring minds who are not afraid to question management and then provide regular training, including interviewing skills, to detect deception. As a certified fraud examiner, one of the most useful courses I attended was a body language course that provided me with the skills to detect deception during conversations!

In my 20 years of forensic auditing I have found there are seven critical things that auditors should do differently and which will enhance their professional scepticism abilities:

- The way auditors audit tends to make them predictable. If, for example, I am responsible for the petty cash and I get told that the auditors will be arriving next week Monday do you think my petty cash will balance? Of course it will! Surely auditors want to obtain an accurate picture of how the organisation is operating, so a surprise audit would be the most reliable way to achieve this! Therefore, an element of unpredictability is crucial.
- Auditors get provided with a boardroom and they sit in there for two weeks examining the balance sheet, income statement and requesting samples of documents. In conjunction with this, auditors should also be walking around, talking to employees, observing what is being done, who is saying what and so on. That's how you will get a more truthful picture of the business, plus you will be provided with opportunities to chat to staff members and try to discern truth from deception.
- At one of our clients, the procurement manager said I should speak only with him as his staff do not know anything. My immediate desire was to chat to his

subordinates, so I waited until he was out and approached staff (in private) who said they were told not to talk to me, so I pressured them and said, 'time is money and I need answers now' and they would start answering me. The one employee said, 'This is not how I usually do my job, but my boss said that while you were here I should tell you that I always follow the standard operating procedures!'

- In addition to talking with management and employees, auditors are encouraged to contact a few vendors and clients to confirm transactions or agreements – remember, what management says is not audit evidence on its own.
- At one client we requested sample documents and a few hours later we had not received them, so I went looking for the person. I found him in his boss's office stamping documents that were unstamped, signing unsigned documents, and creating missing documents! So now I ask where documents, like invoices, are kept and then request the employee to take me there. When we arrive at the storeroom or strong room, I take out my list and say, please find these for me. I then see immediately if documents are missing or incomplete.
- Try and have a certified fraud examiner as part of the audit team, as this will bring a more critical eye to the audit process.
- Do not get too friendly with the client. This is difficult as the client hires the audit firm and the audit firm wants to retain the business but one of the fundamental principles to the IRBA Code of Professional Conduct is objectivity and independence. How independent and objective will the auditors be if they become friends with the client? Barry Minkow was a teenage millionaire and deceived two auditing firms, six banks and defrauded many investors. Yes, a teenager was able to deceive grown adults simply because the adults let profits cloud their judgement. As Barry Minkow said, 'I'm going to be nice to those auditors. I had them over for dinner.

I went to their houses for dinner. I wanted their wives to know me so if they had a go against me, they had to hear their wives say, "I think he's such a nice boy."¹³

In summary, an increased emphasis on professional scepticism and auditor training will assist in enhancing audit quality, including pertaining to the auditor's responsibilities relating to fraud in an audit of financial statements. However, the fate of any organisation or profession lies not in its rules and/or controls but in the organisational culture and tone at the top. It is the will and dedication of most people working in those organisations that will ensure a mindset that values professional scepticism, as a key audit criterion, over commercial considerations alone.

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NOTES

- 1 <http://www.pbs.org/wgbh/pages/frontline/programs/transcripts/1304.html>.
- 2 ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.
- 3 <https://www.irba.co.za/upload/Public%20Inspections%202017.PDF>.
- 4 *An Analysis of Alleged Auditor Deficiencies in SEC Fraud Investigations: 1998–2010*.
- 5 <http://www.pbs.org/wgbh/pages/frontline/programs/transcripts/1304.html>.
- 6 <http://www2.cfo.com/accounting-tax/2005/04/deloitte-statement-irks-sec/>.
- 7 <http://sip-trunking.tmcnet.com/news/2014/06/24/7892133.htm>.
- 8 <https://www.independent.co.uk/news/business/news/carillion-collapse-kpmg-deloitte-mps-worthless-accounts-business-committee-rachel-reeves-a8223626.html>.
- 9 Statement on Auditing Standards (SAS) No 82, Consideration of Fraud in a Financial Statement Audit.
- 10 SAS No 99, Consideration of Fraud in a Financial Statement Audit.
- 11 ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.
- 12 Brenda Porter and Catherine Gowthorpe, Audit expectation-performance gap in the United Kingdom in 1999 and comparison with the gap in New Zealand in 1989 and in 1999, The Institute of Chartered Accountants of Scotland.
- 13 <https://www.youtube.com/watch?v=p4Jk6r01oUQ>.