

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

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DECREASED LIKELIHOOD OF DETECTING FRAUD**

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.

## **DEFRAUDING THE PUBLIC INTEREST: A CRITICAL EXAMINATION OF REENGINEERED AUDIT PROCESSES' AND FRAUD DETECTION**

*“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 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 U.S. 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 balances.<sup>1</sup>

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* indicates that fraud discovery by external auditor review amounted to only 4% of discovered frauds—down from 5%

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<sup>1</sup> Similar statements regarding emphasis on controls can be found in Winograd, et al. (2000) regarding PricewaterhouseCoopers and in KPMG (1997).

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 presentation is divided into five additional sections. The next section presents the results of studies examining the source of financial statement frauds. This analysis is followed by a presentation of the profession’s stated responsibilities for fraud detection, and the profession’s perspective on the source of financial statement frauds. The following section presents a critical examination of the reengineering, continuous auditing, and analytical procedure initiatives of the public accounting profession and the potential effects of these initiatives on fraud detection. The final section provides some concluding comments and concerns over the likely increase in the expectations gap between auditors and users of financial statement audits.

## **SOURCE OF FINANCIAL STATEMENT FRAUDS**

The source of financial statement fraud can be an important consideration in the way an auditor might detect a material misstatement. Specifically, fraud created by higher level

management may be more difficult for the auditor to detect due to the lack of control system oversight of top management. In this section, we review the existing literature on the source of financial statement misstatements, and provide additional empirical evidence on the source of frauds for more recent time periods.

Beasley, Carcello and Hermanson (1999) studied frauds committed by 204 companies based on SEC fraud findings issued between 1987 and 1997.<sup>2</sup> The objectives of their study were to provide base measurements of the prevalence of fraud, and nature of the companies and the individuals within companies who were involved in fraudulent financial reporting. Their findings indicate that the CEO was involved in 72% of the frauds they examined.

This section presents a review of individuals responsible for recent financial statement frauds based on a study of accounting and auditing enforcement releases (AAERs) issued by the Securities Exchange Commission (SEC) in 1998 and 1999. The main focus of this section is to ascertain who was involved in committing the financial statement frauds. An AAER is only issued if the fraud was presented in published financial statements, indicating that the frauds reported were *not* detected by an auditor.<sup>3</sup>

The sample of AAERs used in this study begins in January, 1998, immediately after the sample used by Beasley, et al. (1999) ends. The AAERs examined range from number 1004 to number 1213, spanning a period from January 1, 1998 to December 31, 1999. Of these 210 AAERs, 139 involve accounting or auditing issues unrelated to a financial statement fraud,<sup>4</sup> or cover a financial statement fraud discussed in other AAERs.<sup>5</sup> As such, our analysis is based on 72

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<sup>2</sup> When the SEC discovers materially misstated financial statements, an accounting and auditing enforcement release (AAER) describing the fraud is issued. The SEC also documents the actions they have taken against the perpetrators of the fraud. Typical sanctions by the SEC include a censure and fine. The SEC may also refer the perpetrators to the US Attorney for potential criminal prosecution.

<sup>3</sup> Loebbecke et al. (1989) gathered information on frauds which were detected by auditors. Of the non-theft frauds discovered by the auditors in their sample, 64.8% involved the client's CEO.

<sup>4</sup> For example, AAER # 1074 relates to an allegation of lack of auditor independence.

<sup>5</sup> For example in the Livent case of early 1999, at least 5 AAERs were issued for the same fraud.

cases of financial statement misstatement which resulted in the issuance of at least 1 AAER.<sup>6</sup>

What is most noteworthy regarding the updated AAER information is that the number of frauds discovered appears to be growing. Beasley, et al. (1999) examined AAERs for a 10 year period (1987 to 1997), and found 204 unique instances of fraud, for an average of 20.4 frauds per year over the ten year period. In the current study, we examined two years of AAERs (1998 & 1999), and identified 72 unique instances of fraud, or 36.5 per year, on average. This finding suggests that the prevalence of fraud may be increasing

The position of the individual who was found responsible for the each of the financial statement frauds is summarized in Table 1. The table indicates that the most of the material frauds undetected by auditors arise from top management's actions. Over 70% of the frauds examined directly involved the top executive of the organization. For example, AAER # 1206 documents the fraudulent financial reporting perpetrated by The Cronos Group. In this case, the SEC noted that "Palatin [CEO and Board Chairman] controlled the company's disclosures and was the beneficiary of the transactions which the company misrepresented in its filings. Cronos systematically fired or demoted employees and directors who challenged or questioned that transactions or disclosures" (AAER # 1206, p. 2). An additional 14 of the 72 frauds (i.e., 19.4%) were the result of actions by a senior manager who was not the CEO. As such, over 90% of the frauds which the auditor failed to detect were perpetrated by senior management. Less than 10% of the frauds identified in the AAERs were the result of actions by individuals below the level of senior management. In these cases, divisional management was typically the perpetrator of the fraud.

[Please place Table 1 about here]

### **THE AUDITOR'S FRAUD DETECTION RESPONSIBILITY**

In the US, the accounting profession promulgated SAS # 82, which applies to audits after

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Each of the AAERs involved the actions of different participants in the fraud. In cases where multiple AAERs were issued for a single fraud, the fraud was included only once in our analysis.

<sup>6</sup> Our ratio of frauds to AAERs of 37.8% (95 frauds/251 AAERs) is similar to that of Bonner et al. (1998), who found 261 frauds in 674 AAERs examined (i.e., 38.7%).

1997. SAS # 82 makes explicit that the auditor “plan and perform the audit to obtain reasonable assurance about whether the financial statement are free of material misstatement, whether caused by error or *fraud*.” (AU 316.02, emphasis added). The use of the word fraud was a material change in the standards, the previous terminology being “irregularity.” The key question for auditor’s fraud detection responsibility is then what level of responsibility “reasonable assurance” implies. The term is defined in the standards by what it does *not* represent (AU 316.10, emphasis added):

An auditor *cannot obtain absolute assurance* that material misstatements in the financial statement will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement arising from fraud. Accordingly, ... the auditor is *only able to obtain reasonable assurance* that material misstatements in the financial statements, including misstatements resulting from fraud, are detected.

In effect, reasonable assurance is something less than 100% assurance of fraud detection. Because the process needed to detect fraud varies depending on the source of the fraud, the operationalization of reasonable assurance will affect the probability of detecting frauds involving senior management. In general, the manner in which the accounting profession has operationalized reasonable assurance suggests that top management fraud is not a significant concern of the profession.

While the U.S. profession acknowledged its *professional* fraud detection responsibility in SAS # 82 in the late 1990s, the profession’s *legal* responsibility to detect fraud diminished in the late 1990s due to legislative action. The auditor’s potential for legal loss resulting from failure to detect fraud was significantly limited by a 1995 securities law change. In this change, Schmitt (1998) notes the US congress “adopted a fairly narrow view of auditor’s duties” (A6) regarding fraud detection which made auditors ““huge winners”” (A6) by reducing their exposure to lawsuits for failure to detect fraud. As such, the potential legal incentives for auditors to detect fraud decreased in the late 1990s.

## THE PROFESSION'S PERSPECTIVE ON THE SOURCE OF FRAUD

SAS # 82 provided guidance on risk factors that may suggest the presence of both top management and lower level fraud. However, the emphasis indicated by various CPA firms and professional publications has been on lower level fraud. Sriram and Vollmers (1997) note that as early as 1933, the profession was focused on lower level employee fraud: "To avoid fraud, *management* was responsible for establishing and maintaining an adequate system of internal control" (p. 76, emphasis added). Recent examples of the profession's focus on lower level fraud are also common. For example, an article published in the *Journal of Accountancy* providing guidance on fraud detection provided an example of a lower level fraud created by a branch manager (Barnett et al. 1998). More recently, the same journal published Beek et al. (1999), which focused on how the auditor could work as a "sleuth" to help senior management catch lower level employee fraud. KPMG adopted a similar approach in their 1998 fraud report, which focused on frauds perpetrated by lower level employees. There is even a section of the report entitled "How to deter employee fraud." There is no similar section on how to deter top management fraud. The professional standards in the US indicate that (AU 316.02) : "...*management* is responsible for the prevention and detection of fraud" [emphasis added], once again indicating that the profession's perspective is that fraud is perpetrated by lower-level employees overseen by management, rather than by management themselves. In effect, the profession's operationalization of reasonable assurance of fraud detection seems to exclude responsibility for detecting senior management fraud.

This focus by the profession on lower level fraud reveals the accounting profession's cultural affinity with the members of upper management. The profession's perception of lower level employees as the source of potential problems is made clear in a recent monograph on the changing audit process, in which it is indicated that to avoid distributing misleading financial statements "Organizations, therefore, will continue to invest significant resources (in control structures) to guard against such risk" (KPMG 1997). If one is thinking only of lower level employee fraud, this position is reasonable. However, one must recognize that "organizations" do



not think separately and distinctly from senior management.<sup>7</sup> This statement would therefore imply that senior managers spend considerable resources ensuring that they themselves are adequately controlled. There is little evidence to support such a conclusion.<sup>8</sup>

The profession's cultural affinity with senior management can be seen in the Cendant fraud which was discovered in 1998. In this case, senior management overstated annual revenues by more than \$300 million to create an appearance of constant growth. An individual involved in the Cendant audit (which failed to detect the misstatement) was quoted as saying, "We never thought [senior management of Cendant] were the type that would do [that] sort of thing" (MacDonald 1998). So much for professional skepticism!

### **REENGINEERING THE EXPECTATIONS GAP**

This section of the paper will focus on three major initiatives of the auditing profession which have recently taken place or are proposed to take place soon. These initiatives will be reviewed in light of their ability to deal with the type of fraud which has been found to be most prevalent (i.e., fraud involving top management). The first two topics to be addressed in this section are the reengineering of the audit and the move to "continuous auditing," both of which place greater emphasis on internal control systems. Second, the increased use of analytical review in reengineered audits is discussed.

#### **The Audit as Control System Assurance**

One of the key changes in audit processes being proposed by advocates of both reengineered audit processes and of continuous auditing is enhanced reliance on control systems. Such an emphasis, however, ignores the limitations of internal control systems. The design and implementation of internal control systems have always carried the *caveat* that the benefit of additional internal control procedures should justify the costs. However, the typical cost curve for internal control system implementation is an exponential function (see Figure 1). The nature of this cost-benefit function is that with a small investment, significant gains in systems reliability are

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<sup>7</sup> The professional standards recognize this in their discussion of the tone at the top as an important component of an entity's control structure.

<sup>8</sup> For example, the Financial Executives Institute issued a statement indicating their opposition to proposals put forward by the Blue Ribbon Panel on the Effectiveness of Corporate Audit Committees. These proposals were designed to strengthen corporate governance and oversight of top management by the Audit Committee (Petersen, 1999).

made initially. This initial rapid gain is generally recognized to evolve from the implementation of low cost procedures such as segregation of functions which divides the responsibilities of employees and essentially eliminates the risk of fraud without the occurrence of collusion. Hence, the lower level employees are easily controlled at a relatively low cost.

[Please Insert Figure 1 about here]

The exponential nature of the curve, however, recognizes that after a certain point it becomes very difficult to improve systems reliability without incurring significant additional costs. The primary driver of this change in cost curve is the shifting from controlling employees whose functions are easily segregated to a focus on higher level managers whose functions are less easily segregated without sacrificing certain organizational efficiencies. At this point, most organizations choose not to incur the large incremental costs that would be necessary to enforce control. While cost is one factor for this decision, the other driving factor is the perspective that such accomplished individuals as senior management are more committed and more trustworthy—hence, not of concern in the organizational control system.

In addition, in any control system, there is always the possibility of management override of the system (SAS # 78, ¶ 16). An override involves a manager going outside the system to accomplish some objective. While the objective may be appropriate, senior managers can also work around the system to perpetrate fraud in a way that even the most carefully designed system will be unable to detect.<sup>9</sup> Due to the inherent limitations of control, a fraud perpetrated by a CEO will not be detected by the client's internal control system.

The potential barriers which might prevent a fraud from reaching a company's financial statements are presented in Figure 2. As the figure indicates, there are many barriers to a lower level fraud reaching the financial statements. A well designed internal control system may serve to prevent or detect lower level fraud. Similarly, top management has the oversight responsibility and authority to detect lower level employee fraud. Finally, if the fraud has eluded both the control system and top management, the auditor may uncover the lower level fraud if it is material. For fraud created by top management, however, the internal control system will be ineffective in detection due to both the cost/benefit and management override discussed above. Also, top management will not be looking for fraud created by themselves. As such, the detection of top

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<sup>9</sup> For example, at the 2000 Continuous Auditing and Reporting Symposium, one of the participants presented software that was designed to perform continuous auditing on the client's system. When the presenter was queried about who controlled the software on the client's system, the presenter noted that the client could turn the software off since it was running on the client's system. In such a case, management could easily conceal a fraud they created by turning off the auditor's software at the appropriate times.

management fraud is left solely to the audit committee<sup>10</sup> and the auditor. Thus, auditors have a particularly important role in detecting top management fraud because the auditor is virtually the *only* mechanism in place to detect top management (especially CEO) fraud.

[Please place Figure 2 about here]

The move to reengineered audit procedures focusing on internal control systems exacerbates the difficulty of fraud detection, as the auditor succumbs to management's perspectives of trustworthiness. By focusing on the internal control system, the auditor adopts the stereotype that lower level employees are the only potential source of error and/or fraud.

This point becomes even clearer through examination of the fraud dichotomy put forth by the AICPA in SAS 82 (AICPA 1997). SAS 82 notes that two types of misstatements are relevant to the auditor's consideration of financial statement fraud: (1) misstatements arising from misappropriations of assets, and (2) misstatements arising from fraudulent financial reporting. Misstatements arising from misappropriations of assets involve the theft of client assets where the effect of the theft causes the financial statements to be misstated. Sources of such fraud include activities such as embezzling receipts, stealing assets, or causing an entity to pay for goods or services not received (SAS # 82). Sources of such frauds generally can occur throughout the organization, and these are the types of fraud most likely to be reduced via a strong internal control system.<sup>11</sup>

Misstatements arising from fraudulent financial reporting are intentional misstatements in financial statements with the intent to deceive financial statement users. Sources of such misstatements include manipulation or falsification of accounting records, misrepresentations or intentional omissions from the financial statements, and/or intentional misapplications of

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<sup>10</sup> Beasley (1996) and Beasley et al. (2000) suggest that fraudulent financial reporting may be less prevalent in firms with strong audit committees. These findings could result from audit committees "catching" top management fraud. Alternatively, the top management of companies who are unlikely to engage in fraud may be more willing to structure their boards with stronger audit committees. Given the polar opposite alternatives for interpretation, it is unclear whether audit committees are actually effective at fraud detection.

<sup>11</sup> For these types of controls, Waggoner (1990) notes that the average auditor in his study found only 59% of the instances in which the control system was not followed. This finding further suggests that an increased reliance on the auditor's control assessment as part of a reengineered audit may affect the probability of finding even non-management fraud, due to the auditor overrelying on the control system to find lower level employee fraud.

accounting principles. Such fraudulent activities seem beyond the scope (or motivation) of lower level employees. Rather, it would seem to be *within* the domain of top level management and *beyond* the domain of the internal control system.

### **Analytical Procedures as Conclusive Audit “Evidence”**

The key event that opened the floodgates of audit process reengineering appears to be the “great discovery” of 1988. As the AICPA issued the nine *expectations gap audit standards* among a great publicity push on how the profession was evolving to meet the expectations of users and the public interest, one broadly acclaimed change in the classification of analytical procedures actually triggered an apparent undermining of the public interest. The “great discovery” was the sudden realization that analytical procedures were capable of not only aiding in the planning of an audit, but also were *now* a valid substantive testing procedure. With the advent of analytical procedures as a valid substantive testing procedure, auditors could now fulfill their audit responsibilities through a combination of testing the internal control system and performing analytical procedures - while performing only very limited substantive testing.

The SEC has expressed concerns about this approach in a letter from the Chief Accountant of the SEC to the AICPA (Turner 1998, p. 10):

The recent combination of changes in the audit process and high profile financial frauds have raised questions about the efficacy of the audit process. For example, auditors have changed their audit procedures to use a risk assessment model that places increased reliance on analytical procedures, while decreasing the use of substantive audit procedures such as confirmations with debtors and detailed testing of transactions, account balances, and the activity in those accounts. This restructuring of the audit process has come at a time when the press has reported several frauds involving materially and in some cases hugely misstated financial statements that appear to have gone undetected by auditors.

This concern is supported by the results of Loebbecke et al.’s (1989) study. In a survey of 121 KPMG (then Peat Marwick) partners, 287 frauds had been detected by the audit partners in past engagements. Of the 287 discoveries, 61% were discovered via substantive tests of balances while only 19% were discovered through analytical tests of specific accounts. Yet, a recent monograph on reengineered auditing states: “KPI (key performance indicators (i.e., analytical tests)) ... can be

used as substantives tests to obtain evidential matter about particular assertions at the account balance or class of transactions level” (KPMG, 1997, p. 54).

The greatest difficulty in the effective application of analytical review procedures is in the interpretation of findings. The key idea is that the auditor should have formed an expectation about what the account balance/ratio, etc. *should be*. Without such a clear statement of expectations, the effectiveness of analytical review as an audit technique will be limited. The US auditing standards note that (AU 329.11) “The expected effectiveness...of an analytical procedure ...depends on ... the reliability of the data used to develop the expectation ... [and] the precision of the expectation.” The SEC indicates that in some instances, auditors have applied analytical review based on a default expectation that a balance which did not change was not an area of concern, without considering whether the balance *should* have changed (Turner, 1998):

It has been noted in some instances that analytics have been the only auditing procedure applied to significant liability accounts established for losses such as restructuring. For example, the staff has noted where balances were compared from one year to another, and as long as the balances did not change, the auditor noted no further work was considered necessary. Often such an audit procedure is inadequate in light of ongoing changes to the company’s business plans, strategies and industry conditions. Auditors need to understand what activity has occurred within the account balances, and in instances where no activity has occurred, question whether this is appropriate.

Much of the educational, academic and professional literature on analytical review, however, focuses on *fluctuations* in account balances being the main indicators of potential misstatements (e.g., Konrath, 1999; Anderson and Koonce 1998). The recent AICPA monograph on the use of analytical procedures (AICPA 1999) indicates the importance of developing expectations during the analytical review process: “In all cases, the effectiveness of analytical review procedures lies in developing expectations that can reasonably be expected to identify unexpected relationships” (p. 2). Yet a few pages later, the monograph indicates that when using two of the four analytical procedures discussed, the auditor would rely on “implicit expectations” (p. 8) when using these techniques.

A particular instance in which the faulty application of analytical procedures lead to the

auditor failing to adequately deal with a material misstatement is discussed in Accounting and Auditing Enforcement Releases (AAERs) # 1015 & # 1037 relating to the Perry Drug Company. In this case, Perry had overstated inventory by \$20 million, which resulted in an actual loss for the period being reported as a profit. Arthur Andersen was aware of the \$20 million discrepancy between the physical inventory and the recorded inventory, but agreed with the client's use of the overstated recorded inventory balance because analytical testing revealed no significant change from recent periods, even though Perry had changed the method used to compute inventory cost.

In other cases, the auditor is much more likely to be unaware of such discrepancies. However, the use of analytical procedures is almost always focused on the analysis of differences from the previous years—and not similarities as was the case with Perry Drug. At the root of this problem, similar to the focus on internal controls, is an inherent assumption that problems arise from the lower level employees whose fraudulent activities would result in changes to account balances. However, auditors rarely stop to consider that an upper level manager who falls to the temptations of fraud is most likely to attempt to cover up such a fraud by making the accounts look normal. Senior management is also more likely to have the broader authority necessary to manipulate different aspects of the financial statements to make them appear more “normal.” In other words, the senior manager is in a position to manipulate the financial statements to make them look similar to past years so that the auditors' analytical procedures present evidence supporting the contention that everything is fine since no discrepancies with prior year financial statements are detected.

**The Cendant fraud: An example of why control assessment and analytical review are not sufficient**

In a financial statement audit, there are three main ways in which fraudulent misstatements may be detected: (1) through the client's control system (2) through the auditor's effective use of analytical review and (3) through substantive testing of transactions and balances. The Cendant case was a widely publicized fraud in which the auditors failed to detect a material misstatement. The SEC subsequently issued an AAER (# 1272) documenting their findings. In the Cendant case, there were a large number of personnel involved, from top managers to divisional controllers. As

such, both collusion and top management override were present, indicating that a thorough audit review of the internal control system would not have detected the fraud because the fraud occurred outside the control system. In addition, the SEC documents that management was careful to ensure that there were no significant changes in financial statement ratios so that the auditor's suspicions would not be raised by analytical review. As such, analytical review would not likely be effective to detect a Cendant type fraud.

A wide variety of techniques were used by Cendant management to misstatement the financial statements, two of which are as follows. First the company failed to record decreases in cash that were the result of revenue transactions being canceled. By December 31, 1997, there was a \$100 million discrepancy between the cash on Cendant's books and the cash in Cendant's bank (AAER 1272, footnote 13).<sup>12</sup> An auditor could have detected such a misstatement most readily through substantive testing via a comparison of the book and bank records, use of bank confirmations, and/or through a thorough examination of Cendant's bank reconciliation. A second means of misstating the financial statements was for management to enter incorrect subsidiary financial information onto consolidation spreadsheets without explanation, and while maintaining the correct balances on the subsidiary's ledger accounts. As with the cash misstatement identified above, the prudent application of the substantive testing process of verifying that two client documents agreed could have lead to the discovery of the fraud. There were a number of other techniques used by Cendant, most of which would not have been detected using control assessment or analytical review, but which could have been discovered by an auditor carefully using basic substantive testing techniques and a healthy dose of professional skepticism. As such, increased reliance on control assessment and analytical review opens the possibility of more frauds being undetected by independent auditors, because of their focus on lower level employees, rather than top managers, as the source of material fraud.

## **DISCUSSION AND CONCLUSIONS**

Among the recommendations of the National Commission on Fraudulent Financial Reporting (Treadway Commission—1987) was that generally accepted auditing standards should be changed to reflect the independent auditor's responsibility for the detection of fraudulent financial reporting. Under pressure from the business press, congressional hearings, and intense litigation; the accountancy profession responded to the Treadway Report with the issuance of the so-called "Expectation Gap Standards." These nine standards included addressing the auditor's

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<sup>12</sup> This discrepancy represented approximately 2/3 of Cendant's reported cash of \$149.5 million at December 31, 1997.

responsibility for detecting fraud and illegal acts (SAS Nos 53 and 54), improving the effectiveness of audits (SAS Nos. 55, 56, and 57), and the improvement of communications (SAS Nos. 58, 59, 60, and 61). Ironically, these are the very standards that have helped enable the development of the newly reengineered audit processes and the virtual abandonment of any responsibility for detecting fraudulent financial reporting.

This is not inconsistent with the concerns voiced by Byington and Sutton (1991) who viewed the expectation gap standards as an attempt to signal greater change to the profession's critics than in fact the profession intended to make. The Byington and Sutton (1991) study used a professional monopoly lens in viewing the historical pattern of standards releases by the profession and found that in times of deep criticism the profession showed a definite pattern of increased standards issuance in an apparent attempt to signal change. In each case, when the criticism abated the profession slowed the number of standards releases. The resulting impact of the "Expectations Gap Standards" a decade later appears to be a regressing in assumed professional responsibility rather than an attempt to bridge the gap and move towards meeting the expectations of financial statement users.

The "Expectation Gap Standards" included the "great discovery" where the profession suddenly realized that analytical procedures were not only acceptable and necessary for planning an audit, but that these same procedures could also replace substantive testing of account balances and underlying transactions. In a less obvious vein, this change also enhanced the feasibility of moving to a heavy internal control evaluation focus. It has long been the position of the accountancy profession that both internal control evaluation and substantive testing were necessary and required in an effective audit. However, increased internal control testing provides for less substantive testing if in fact the internal control system proves reliable during testing. This provides the justification for a process that is focused on internal control system evaluation and then uses analytical procedures as sufficient for meeting the reduced need for substantive testing procedures. Add to this the *de facto* decrease in responsibility for fraud assumed by the profession after the release of the "Expectations Gap Standards", and the natural evolution is today's reengineered audit process. In effect, there has been a decoupling of the activity of auditing



practice from the professional claim of audit effectiveness in accord with the Meyer and Rowan (1977) theory of institutionalized organizations.

As Shaked and Sutton (1981) note, the potential problem that exists with a professional monopoly (such as the accountancy profession) is the lack of incentives to provide a service at a level of quality that exceeds the minimum level that the market will accept. Hence, as Levitt (1998) suggests, the profession appears to be looking at methods for improving the efficiency of the audit process through reengineered audit processes without necessarily any concern for the enhancement, or even maintenance, of audit effectiveness.

While such an approach may succeed without any successful resistance given the positive economic environment, and a favorable political environment; the long run viability of such a strategy can be devastating to a profession. Martens and McEnroe (1992) note that by granting CPAs (and CAs) a professional monopoly whereby the profession can set its own rules; CPAs (and CAs) have been placed in a special position of public trust. The premium accounting professionals receive is a reward for trustworthy performance in their adjudicatory function. Habermas (1971) notes that adjudication processes retain their authority only as long as they command legitimacy with disputants. If accounting professionals lose the public's trust regarding their responsibilities for fraud detection, then they will lose the legitimacy of the disputants, and eventually destroy the effectiveness of the adjudications.

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**Table 1**  
**Summary of Individuals Involved in Financial Statement Frauds: 1998 & 1999**  
72 Frauds Disclosed in AAERs during the period

	<u>Number of frauds</u>	<u>Percentage of frauds</u>
<b>CEO, President or equivalent</b>	51	70.8%
<b>Other senior management</b>	14	19.4%
<b>Division management</b>	7	9.8%
<b>Total</b>	72	100%