

HOW DO INDEPENDENT AUDITORS DETECT FRAUDULENT FINANCIAL STATEMENTS? (Participatory Observation in Public Accounting Firm “X”)

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ABSTRACT

Independent auditors have audit risk making them unable to detect material misstatements, especially those caused by fraud. This is because fraud may involve sophisticated, organized, and carefully designed scheme to be covered from the auditors. In addition, the audit risk could also be influenced by the negligence of the auditors, such as the audit that is not according to auditing standard, having no professional skepticism, and the inadequacy of training and audit experience. The objective of the research is to analyze whether the independent auditors perform a good audit planning and have a professional skepticism and audit experience to be able to detect fraudulent financial statement in the company in order to obtain a reasonable assurance. This research uses qualitative approach using participatory observation on 1 object, Public Accounting Firm (KAP) “X”, the only big four-audit firm that has a branch office in Surabaya. The research findings indicate that the audit team performs good audit planning, has professional skepticism and audit experience, can detect fraudulent financial statements.

INTRODUCTION

Lately, fraud has increasingly attracted the attention of the public. The company management should be responsible for preventing and detecting fraud. In the Public Accountants Professional Standards (SPAP) SA 240 (2013, 1) states that:

“It is important for management, under the supervision of the parties responsible for governance, to emphasize on the fraud deterrence which can reduce the chance of fraud and the fraud deterrence which can persuade individuals not to commit fraud because it is likely to be detected and punished.”

Independent auditors have audit risk making them unable to detect material misstatements, especially those caused by fraud. The risk of undetected material misstatements resulted from fraud is higher than the risk of undetected material misstatements resulted from error (IAPI, 2013, 2). This is because fraud may involve sophisticated, organized and carefully designed scheme to be covered from auditors. In addition, the audit risk is also influenced by the negligence of auditor (Albrecht and Hopes, 2014, 15). The negligence includes the audit that is not according to auditing standard, having no professional skepticism, and the inadequacy of training and audit experience.

In the International Standard on Auditing (ISA) 240 states that the independent auditors are responsible for planning and implementing the audit to obtain reasonable assurance whether the financial statements do not contain material misstatements caused by either error or fraud (2014, 161). Independent auditors should plan the audit as well as possible so that it can respond to the audit risks and achieve high quality of audit. Popova (2008, 36) states that if the auditor concludes that there is a risk of material misstatement in the financial statements, including the risk of fraud, this can make auditors more conservative in assessing the risk and extending the procedures that have been planned.

In the audit planning, the independent auditors will also evaluate the company's internal control. The research result of Krambia-Kapardis (2002, 272) shows that 76% of companies, whose management is

involved in fraudulent financial statements, have ineffective internal controls. Statement on Auditing Standards (SAS) No. 99 issued by the American Institute of Certified Public Accountants (AICPA) in 2002 indicates that the audit team should discuss the potential for material misstatements in financial statements caused by fraud before and during the planning and auditing (Ramos, 2003, 28). Kranacher (2012, 80) says that the discussion needs to be done with employees who do not belong to the company's key management, so that the auditors get a different perspective from the parties related to the financial reporting.

SPAP SA 240 states that the auditors are responsible for maintaining professional skepticism throughout the audit, considering the potential for carelessness in control by management, assessing the risks of material misstatement due to fraud, and designing procedures to detect such misstatement (2013, 3). SAS No. 99 also emphasizes the auditor's skepticism and responsibility to consider explicitly the possibility of fraud in any audit process. Independent auditors must have professional skepticism and improve their competence to detect fraud and its indicators, and understand the motivation and rationalization of the fraud, such as when detecting the weaknesses of the company's internal control (Kranacher and Stern, 2004, 67).

Audit experience has a major effect on the performance of independent auditors in detecting fraudulent financial statements. Kaplan (1995, 33) mentions that senior

auditors are more conservative in assessing the risk of material misstatement in the financial statements than auditor manager. This research is reinforced by Fairchild (2008, 52) describing the game theory in the audit process. Auditing or fraud detection game is a game between the auditor and the company manager (client). Initially, a company manager who has no ethics will tend to commit fraud because he feels that the fraud cannot be detected (*'get away with it'*). At that time a new auditor, who is just starting the career, will tend to dislike the fraud committed by the management and he will try to detect such fraud. Over time, the auditor will have a lot of audit experience because he understands the business and management of the company, and his ability to detect fraud increases. However, at the same time he would be sympathetic to the management, then he would close his eyes (*'turn a blind eye'*) on the fraud occurring.

The on-going cases of fraudulent financial statements provide evidence about the failure of an independent auditor in detecting fraud that causes material misstatement in the financial statement. The failure is caused by improper implementation of auditing standards, no attitude of professional skepticism, and inadequate training and audit experience. The existence of these problems leads to the formulation of the problem as follows:

“How do independent auditors perform audit planning, have professional skepticism and audit experience in order to be able to detect fraudulent financial statements?”

Based on the description above, this research focuses on “after performing the audit planning well and having professional skepticism and audit experience, will the independent auditors be able to detect fraud in the company to obtain a reasonable assurance.

This research is of interesting to discuss because the researchers examine one object, namely Public Accounting Firm (KAP) “X”. Public Accounting Firm (KAP) “X” is the only member of Big Four Accounting Firms that has office in Surabaya. The Big Four Accounting Firms have a better audit quality than non Big four Accounting Firms. This is because the Big Accounting Firms always protect their reputation to maintain public confidence. To maintain its reputation, a Public Accounting Firm is required to work more competently and independently in any audit procedures performed.

REVIEW OF RELATED LITERATURE

The Triggering Factors of Fraud

GONE theory, presented by Jack Boulogne, describes four factors that cause fraud. GONE is an abbreviation of four factors: *greed*, *opportunity*, *need* and *exposure*. *Greed* and *need* are the factors that are related to individual nature of the perpetrators of fraud (also called *individual factors*), while *opportunity* and *exposure* are the factors that are related to the organization as a victim of fraud (also called *common factor*).

1. Greed

This factor is associated with the desire to obtain as much as possible.

2. Opportunity

The opportunity to commit fraud depends on the position of the perpetrator to the object of fraud. The opportunity, which is sometimes big or small, to commit fraud always exists in every office. In general, the management of a company has a greater opportunity to commit fraud than the employees.

3. Need

This factor tends to be associated with the views / thoughts and needs of employee / management related to the assets owned by the company where he works. Besides, the pressure encountered in work can make an honest person have a motive to commit fraud.

4. Exposure

The exposure of fraud does not guarantee non-repetition of fraud committed by either the same perpetrators or other perpetrators. Therefore, any perpetrators of fraud should be penalized when the actions are found.

Good Audit Planning – Detailed Audit

Detailed audit planning begins with a specific risk assessment. Acceptable audit risk and inherent risk greatly affect the implementation of audit. Then, the higher the inherent risk to an account, the greater the evidence to be gathered by auditor in the audit of the account.

ISA 300 explains that the planning of the audit procedures is taking place during the audit process (2014, 260). The auditor's risk assessment procedure planning occurs at the beginning of audit process. However, the specific planning of nature, timing and extent

of audit procedures depends on the results of risk assessment procedures. If there is material misstatement identified during the audit process, the auditor should update the level of risk, audit materiality, and audit procedures.

The auditor should also pay attention to the risk of fraud when making audit planning. Popova (2008, 36) states that if the auditor concludes there is a risk of material misstatement in the financial statements, including the risk of fraud, this can make the auditor more conservative in assessing the risk and extending the procedure that has been planned.

In the audit planning, the independent auditors will also evaluate the company's internal control. The research results of Krambia-Kapardis(2002, 272) show that 76% of companies, whose management is involved in fraudulent financial statements, have ineffective internal controls. The results of this study show how important it is for the auditor to evaluate the company's internal controls and to test the depth control when finding ineffective internal control.

Statement on Auditing Standards (SAS) No. 99 requires that an independent auditor use the 42 red flags to find fraudulent financial statements. Price Waterhouse describes the red flags as: *"a potential symptoms existing within the company's business environment that would indicate a higher risk of an intentional misstatement of the financial statements"* (Majid, et al., 2001, 264).

In a detailed audit planning, the independent auditors will determine the level of audit materiality. The determination of materiality in testing requires professional judgment. FASB 2 in Arens et al. (2014, 270) defines materiality as:

“The amount of deletion or misstatement of financial information which, by taking into account the situation, causes the consideration of the wise man that relies on such information may be changed or affected by the deletion or the misstatement”.

The calculation of audit materiality requires consideration of quantitative data and qualitative information (Graham, Lynford and William Messier 2006, 117). The auditors need to use professional judgment in considering the type of industry and business characteristics of the client in calculating audit materiality.

In detailed audit planning, the auditors will conduct preliminary analytical procedures. The auditor should perform analytical procedures when planning the nature, the timing and the extent of audit testing (AICPA, 1988 in Glover, et al., 2000, 27). Arens and Loebbecke explain that the significant fluctuations between the financial data, which is not audited in the current year, and the expectation indicate an increased risk of material error, and the auditors will focus on conducting the test that has been planned on the high-risk account (Glover, et al., 2000, 27). Analytical procedures should also involve analysis of the relationship between financial data and non-financial data (Tuannakota, 2014, 413). It is strengthened by the research of Grove and Basilico that uses financial ratio analysis and nonfinancial factors analysis in detecting

fraudulent financial statements (2008, 31).

SAS No. 99 issued by the American Institute of Certified Public Accountant (AICPA) in 2002 indicates that the audit team should discuss the potential for material misstatements in financial statements due to fraud before and during the planning and auditing (Ramos, 2003, 28). The internal discussions conducted by the audit team will make the entire audit team members understand the information concerning the company, how the fraud is carried out, and how the company's management conceals the fraud. In addition, the audit team should also discuss with the company's management to obtain useful information for the audit process.

Professional Skepticism

SPAP SA 200 (2013, 10) states that the auditors should plan and perform the audit with professional skepticism given that certain conditions may occur that cause the financial statements to contain material misstatements. IAASB (2014, 36) describes the professional skepticism as: *“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 evidence.”* The concept of professional skepticism reflected in the standard is inquiring attitude, being alert, and critical in carrying out the entire audit process.

All parts of the ISA stress that the auditors should have professional judgment, maintain professional skepticism during the audit planning, audit execution, and others such as identification and assessment of risk of material

misstatement whether caused by fraud or error, obtain sufficient and relevant audit evidence, and express an opinion on the financial statement based on conclusions derived from the audit evidence. The independent auditors should have professional skepticism, improve their competence to detect fraud and its indicators, understand the motivation and rationalization of the fraud, and detect the company's internal control weaknesses (Kranacher and Stern, 2004, 67).

SPAP SA 240 (2013, 17) mentions that the fraudulent financial reporting often involves control negligence by management, even though the control seems to operate effectively. Fraud can be done through the control negligence by management using several techniques, such as recording a fictitious journal, particularly towards the end of the accounting period; adjusting assumption incorrectly and changing the considerations that have been used to estimate account balances; eliminating, admitting first, or delaying recognition in the financial statements; hiding or not disclosing facts that may affect a number recorded in the financial statements; using a complex transaction which is arranged to present wrong financial position or performance; and changing records and provisions related to significant and unusual transactions.

In addition to improving audit quality and detecting fraud, professional skepticism also plays a role in preventing fraud. Research by Chen, et al., (2009, 1) states that the professional skepticism shown in the audit, in the form of giving the management critical questions to

expand testing, can reduce the tendency of management to commit fraud.

Although SPAP has defined professional skepticism, there are no definite guidelines concerning the application of professional skepticism. After studying various standards and researches relating to the professional skepticism, Hurtt (2010, 152) developed a professional skepticism model and charted the professional skepticism characteristics of a person. There are 6 characteristics: questioning mind, suspension of judgment, and search of knowledge, interpersonal understanding, autonomy, and self-esteem.

Audit Experience

The first common standards can be interpreted as requirements for the auditors to have a formal education in the field of auditing and accounting, sufficient experience in auditing practices for the job being done, and to follow the continuing professional education (Arens et al., 2014, 54). The above statement implies that audit experience has a major effect on the performance of the independent auditors in detecting fraudulent financial statements. Result of research by Moyes and Baker (2009, 40) states that: *“CPA firms Employing external auditors who have accumulated both more external auditing experience ... have a greater effectiveness in detecting fraud using red flags in audits than CPA firms whose external auditors have less external auditing experience.”* The result of this study is contrary to Kaplan (1995, 33) stating that senior auditor is more conservative in assessing the risk of material

misstatement in the financial statements than the auditor manager.

This study is reinforced by Fairchild (2008, 52) describing the game theory in the audit process. Auditing or fraud detection game is a game between the auditor and the company manager (client). Initially, a company manager who has no ethics will tend to commit fraud because he feels that the fraud cannot be detected (*'get away with it'*). At that time a new auditor, who is just running the career, will tend to dislike the fraud committed by management and he will try to detect such fraud. Over time, the auditor will have a lot of audit experience because he understands the business and management of the company, and his ability to detect fraud increases. However, at the same time he would be sympathetic to the management, so that he would close his eyes (*'turn a blind eye'*) on the fraud occurring.

From the description above, it can be concluded that to make the independent auditors able to detect fraudulent financial statements requires good audit planning, professional skepticism, and audit experience. If the theory of audit planning is good and the ways to improve the professional skepticism and audit experience have been done, the independent auditors will be able to detect fraudulent financial statements.

RESEARCH METHOD

Research Approach

In order to be able to detect fraudulent financial statements, the independent auditors require in-depth analysis. The first thing to be

examined is how the audit planning is done, and then whether the independent auditors have professional skepticism and audit experience.

To find out how the audit planning is done and whether the independent auditors have professional skepticism and audit experience, this study applies a qualitative approach using participatory observation method (Palsson, 2007; Keiding, 2010).

The type of data in this study is qualitative data. The qualitative data used is in descriptive form, such as spoken and written expressions from observations, conversations, or written material (documents and literature). Based on the data sources used, this study uses primary data and secondary data. The use of primary data in this study is obtained directly from the object, ie the Public Accounting Firm (KAP) 'X', while secondary data is obtained from existing sources such as books and journals.

Data Collection Procedures

The data collection methods used to support this study are:

1. In depth Interviews, by way of providing question and answer face to face between the interviewer and the informant, with or without the use of interview guidelines, where the interviewer and the informant are involved in the social life in such a relatively long time (Bungin, 2007, 111).
2. Participatory Observation, where the observer is really involved in the everyday object of observation, directly lives together, feels and be in life activity of the object of observation, so that the observer

really dives into the life of the object of observation (Bungin, 2007, 119).

3. Documentary Method, which becomes the complement of interviews and participatory observation methods.

Data Analysis Techniques

The techniques used in data analysis are qualitative data analysis techniques, by:

1. Examining all data of the audit planning process, professional skepticism and experience of the audit team that have been accumulated. This process is done descriptively, where the description of the condition during the study is conducted as objectively as possible.
2. Focusing more on the research being conducted. Data selection is done by choosing only important data and reducing unimportant data.
3. Analyzing the data that has been selected, then comparing with the audit planning that should be done and professional skepticism as well as the audit experience that should be owned, in accordance with SPAP and supporting auditing theories.
4. After knowing the detail of the problems and causation of the problems, the review is then made based on the analysis of solution to resolve the problem by making recommendations for improvement of audit planning process that should be done and professional skepticism and audit experience that should be owned, if necessary

RESEARCH ANALYSIS

AND DISCUSSION

Audit Planning – Detailed Audit Planning

1. Understanding the client's business process

Based on documentation, the audit team has understood the client's business processes, the wheat flour industry development in Indonesia and other wheat flour producers that become the client's business competitors. Related to laws that have direct impact on the client's business processes, the audit team requests a written statement signed by the Director of the company that the company does not have cases related to the laws / regulations applicable in Indonesia as well as to the government or other institutions.

Through the documentation of Audit Strategies Memorandum, the audit team also understands the sources of funding and ownership structure of the company, as well as its relationships with related parties. In the Audit Strategies Memorandum, the audit team also performs analytical procedures to analyze the significant fluctuations between the financial data of the previous year and the current year, where the analytical procedure involves the analysis of the relationship between financial data and non-financial data. This indicates that the analytical procedure has been performed in accordance with theories, Grove and Basilico (2008, 31). Then, at the time of audit planning, the audit team will ask the client some information related to the use of information technology in the company's business processes to determine whether it needs help of a team information technology experts in the audit process.

Such information will be handed over to a team of information technology experts, for an assessment of whether the engagement requires the help of a team of information technology experts. Results of the assessment of the team of information technology experts on the client indicate that information technology is not complex, so it does not require the involvement of a team of information technology experts in gaining a preliminary understanding of the risks of material misstatement related to information technology. The results of this documentation conclude that the audit team has understood the client's business processes in accordance with the SPAP SA 315.

2. Internal control carried out in the company

Based on observations, the audit team has understood the integrity, ethical values, and behavior of the key management. In addition, the audit team also understands whether the management has the awareness of the importance of internal control and how his leadership style. In planning this meeting agenda, it is mentioned that there are personnel changes at the client's cost control. The results of these observations conclude that the audit team has understood the internal controls carried out in the company in accordance with SPAP SA 315.

3. Identifying the risk of fraud and audit response

At the time of identifying the risk of fraud, the audit team conducts observations and asks the management some information to assess

whether there is a misuse of internal control done by the management. In planning this meeting agenda, it is mentioned that there are personnel changes at the client's cost control. Based on observations, the audit team finds that the management has assigned less experienced staff (fresh graduate employee) in processing and recording inventory transactions and cost of goods sold. The audit team makes this as red flags that become a reference in performing substantive procedures. The audit team responds to the risk of fraud in the inventory transaction and cost of goods sold by expanding the scope of substantive procedures on the inventory transaction and cost of goods sold. This is in accordance with the results of research by Popova (2008, 36).

The results of audit on working papers of supplies found that there are material misstatements amounted to IRD 31 billion because there are supplies on the way that have not been recognized as supplies, whereas the supplies have been received and used in the production process. Based on the material misstatements, the company's management agrees that the misstatement be corrected by adjusting journal entries.

The results of observations and interviews conclude that the audit team has responded to the risk of fraud in accordance with the results of research by Popova (2008, 36) and SPAP SA 240

4. The level of audit materiality

Based on documentation, the audit team has determined the audit materiality using

professional judgment that involves the executive team of audit, including audit partner. The financial statements of period 2012 and period 2013 show that the client makes a profit, so the audit team uses profit before tax as the basis for measuring audit materiality. In addition, the client is a non-public company in the industry that is not strictly regulated by the government, has few shareholders, has no plan to be public company over the next 2-3 years, and has no debt traded. Based on these considerations, the audit team uses a higher percentage in counting the audit materiality.

During the audit process, the audit team will evaluate whether the materiality needs to be revised and how the impact of the revision on the audit procedures. The results of this observation conclude that the audit team has determined the level of audit materiality in accordance with the theory of Graham, Lynford and William Messier (2006, 117) and SPAP SA 320.

5. Determination of the accounts, disclosures, and assertions in the significant financial statements, as well as the significant class of transactions

Based on documentation, the audit team has determined the accounts, disclosures, and assertions in the significant financial statements based on an understanding of the client's business processes and internal controls, as well as the determination of audit materiality. The results of this documentation conclude that the audit team has determined the accounts, disclosures, and assertions in the significant financial statements.

Then, the audit team has determined the significant class of transactions. The audit team confirms this understanding by tracing transactions through the information system which is relevant to the financial reporting or called *walkthrough* from the process of initiation, recording, processing, and reporting such transactions to ensure that the documentation of the significant class of transactions has been accurate and to assess whether the audit team has identified all relevant *What Could Go Wrong (WCGW)*.

6. Internal controls in the classes of transactions and disclosures in the significant financial statements

Based on documentation, the audit team has designed the nature, timing and extent of testing of internal controls to obtain sufficient and appropriate audit evidence that the relevant internal control has been operating effectively as designed by the management. The results of these observations conclude that the audit team has understood the internal controls carried out in the company and has been in accordance with SPAP SA 315.

7. Assessment of Risk

Based on documentation, the audit team has assessed the audit risk that is acceptable to develop an audit strategy that is responsive to the risks of material misstatement. Based on the understanding and professional judgment, the audit team classifies inventory accounts and cost of goods sold as the high-risk accounts

This will impact the scope of testing becomes more widespread, with the hope that this audit strategy is responsive to the risks of material misstatement. The results of this observation conclude that the audit team has understood the risk assessment well.

8. Discussion of the audit team and the documentation of the audit strategy

Based on the observation, the entire audit team has discussed during the interim audit to plan an effective audit, determine the overall audit strategy, and develop a detailed audit planning. The results of these observations conclude that the audit team has conducted discussions in accordance with SAS no. 99.

Professional Skepticism

Based on observations, the entire audit team has had professional skepticism during the process of planning and conducting audits in accordance with SPAP SA 200. This can be evidenced by the response of the audit team when the management assigned less experienced staff (fresh graduate employee) in the processing and recording of inventory transactions and cost of goods sold. The audit team makes this as the red flags which are used as a reference in performing substantive procedures. Then, the audit team is critical in carrying out the entire audit process, primarily related to inventory and cost of goods sold. The results of the audit on the working papers of inventory found that there are material misstatements amounted to IDR 31 billion for because there supplies on the way there have not been recognized as the supplies, whereas

on the supplies have been received and used in the production process. The audit team is aware of this when testing the details of the balance on the paperwork of cost of goods sold prepared by the staff of cost control. This can be seen from the price / unit of raw materials under normal price. Base on the material misstatements, the company's management agrees that the misstatement be corrected by adjusting the journal entries. This proves that the audit team has professional skepticism in accordance with the SPAP SA 200.

To improve the professional skepticism, the auditorsof Public Accounting Firm get training through a web-based learning which provides cases in the real world and provides an assessment of the decisions taken by the auditors. This is in accordance with the research of Kranacher and Stern (2004, 67).

Audit experience

Based on observation, the audit manager has made the composition of audit team balanced and precise in terms of skills, experience and competence. This can be demonstrated on the budget plan and calculation.

In the audit, senior auditors are more conservative in assessing the risk of material misstatement in the financial statements than the auditor manager, because senior auditors are the audit team members who are directly involved in the audit process. This is consistent with the theory of Kaplan (1995, 33) and the theory of Fairchild (2008, 52). In addition, the audit partner is involved actively in supervising the whole process of auditing and audit quality

to ensure that the audit process has been going according to the audit planning and the audit team obtains reasonable assurance that the auditor's report issued on behalf of Public Accounting Firm (KAP) is right.

CONCLUSION AND SUGGESTION

Conclusion

The conclusion that can be drawn from the results of this study is as follows:

1. The audit team has done a detailed audit planning properly and in accordance with the SPAP, among others are understanding the client's business processes, understanding the internal controls carried out in the company, identifying the risk of fraud and how to address it, determining the audit materiality, specifying the accounts, disclosing and asserting in the significant financial statements, determining the class of significant transactions, understanding and testing the internal control, assessing the risks, and holding discussions with all members of the audit team.
2. All audit team members have had professional skepticism during the process of planning and conducting audits in accordance with SPAP SA 200.
3. The composition of the audit team has been balanced and appropriate in terms of skills, experience and competence. In the audit, senior auditors are more conservative in assessing the risk of material misstatement in the financial statements than the auditor manager, because senior auditors are the audit team members who are directly involved in the audit process.

4. In the audit planning, the audit team has had the professional skepticism and audit experience. The researchers can prove that the audit team can detect fraudulent financial statements by detecting the risk of fraud.

Suggestion

Based on the discussion above, the suggestions that can be put forward are as follows:

1. In conducting the audit, it is suggested that the audit team maintain professional skepticism, especially in interpersonal understanding, autonomy, and self-esteem in order to be able to improve the quality of audits, detect fraud, and prevent fraud
2. In conducting the audit of the financial statements, it is suggested that the auditors use sampling to obtain and evaluate audit evidence in drawing conclusions about the population that becomes the origin of the sample. In the sampling method, there is a risk of sampling, where the conclusion reached by the auditors to be different if the same audit procedure is applied to the entire population. In addition, the fraud sometimes involves sophisticated, organized and carefully designed schemes to be covered from the auditors. Although the auditors may be able to identify potential opportunities of fraud, it will be difficult for the auditors to identify all frauds occurring within the company. Because of the innate limitations of the audit, there is always inevitable risk that some material misstatements in the financial statements may not be detected, even though the

audit has been planned and executed well and the audit team has got professional skepticism and audit experience. Given the innate limitations of the audit, if it is found the risk of fraud, it is expected that the audit team communicate the findings to the forensic audit team under the management approval.

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