
STANDING ADVISORY GROUP MEETING

THE AUDITOR'S APPROACH TO DETECTING FINANCIAL STATEMENT FRAUD

NOVEMBER 20–21, 2014

Introduction

As previously discussed with the Standing Advisory Group ("SAG"), Public Company Accounting Oversight Board ("PCAOB" or "Board") staff is conducting outreach and analyzing available evidence, research, and data regarding the auditor's approach to detecting material misstatement of financial statements due to fraud.¹ The purpose of the outreach and analysis is to study the economic consequences of fraud and the effectiveness of audits in detecting fraud, as well as to explore actionable ideas for the Board's consideration, including potential mechanisms to improve the effectiveness of audits in detecting financial statement fraud.

To date, the staff has studied scores of research papers in fields such as auditing, economics, and other social and behavioral sciences. For example, economic and trend data informs the staff's consideration of the cost of fraud to investors, the effects of fraud on capital formation, and the potential need for standard setting.

¹ See the appendix to the November 15–16, 2012, SAG briefing paper "Consideration of Outreach and Research Regarding the Auditor's Approach to Detecting Fraud" for a discussion of the auditor's responsibilities under PCAOB standards regarding the consideration of fraud in an audit, available at http://pcaobus.org/News/Events/Documents/11152012_SAGMeeting/2012_11_15_%20SAG_BP_%20Fraud.pdf.

This paper was developed by the staff of the Office of the Chief Auditor as of November 14, 2014, to foster discussion among the members of the SAG. It is not a statement of the Board, nor does it necessarily reflect the views of the Board or staff.

The staff also is conducting broad outreach through a combination of discussions with the SAG and other knowledgeable people.² For instance, the staff has reached out to more than 100 professionals, including financial statement auditors, internal auditors, financial analysts, fraud investigators, law enforcement officials, criminologists, sociologists, behavioral economists, legal scholars, hedge fund investors, economists, auditing researchers, and current and former regulators. This outreach and research has addressed, among other things, lessons that might be learned from other disciplines that detect fraud and whether those lessons might be applied to audits. The staff also is reviewing past financial statement fraud cases—including those in which auditors detected the fraud and those in which auditors did not detect the fraud—to understand potential lessons to be learned from those cases.

During its outreach, the staff has heard repeatedly about: (1) the effect of attitudes and behaviors on the aptitude for fraud detection; (2) approaches and methods used by other disciplines to detect fraud that might be applied by financial statement auditors; and (3) the knowledge and skills needed for effective fraud detection. The results of this outreach have led the staff to seek further advice from the SAG on the potential implications of these matters for financial statement audits. At the November 20–21, 2014, meeting, three panels will discuss auditor behavioral factors, lessons learned from other disciplines, and knowledge and skills for detecting financial statement fraud. Specifically, the panels will discuss the following:³

1. Auditor behavioral factors: Topics to be discussed include cognitive biases that may affect auditors' abilities to detect financial statement fraud, incentives and disincentives related to detecting financial statement fraud, and the mindset of other professionals who detect fraud compared to the mindset of the independent auditor in a financial statement audit.

The panel will consist of:

- An academic who has performed research regarding auditor cognitive biases;

² Recent discussions with the SAG regarding financial statement fraud occurred at the November 13–14, 2013, and the November 15–16, 2012, SAG meetings. See the SAG meeting archives at http://pcaobus.org/News/Events/Pages/11132013_SAG.aspx and http://pcaobus.org/News/Events/Pages/11152012_SAGMeeting.aspx.

³ For additional background information, the attached appendix presents a sample of academic papers that discuss these topics.

- A forensic accountant who conducts accounting- and financial-disclosure-related investigations on behalf of audit and special committees of boards of directors; and
 - An attorney who has investigated financial fraud both as a regulator and on behalf of special committees of boards of directors.
2. Lessons learned from other disciplines: Topics to be discussed include approaches and methods used by other professionals who detect fraud (including how those professionals use technology to detect fraud) and how an enhanced focus on fraud can affect the independent auditor's approach in a financial statement audit.

The panel will consist of:

- A forensic accountant who conducts corporate investigations involving potential accounting irregularities on behalf of audit committees, special committees, and management;
 - An investment analyst who performs financial statement analysis to detect anomalies that might indicate financial statement fraud; and
 - An independent auditor with expertise in using technology to detect fraud.
3. Knowledge and skills: Topics to be discussed include the knowledge and skills that independent auditors need to detect financial statement fraud and the relevant education and training that accountants currently receive.

The panel will consist of:

- An academic who has researched the effectiveness of risk assessment in a fraud setting as well as the root causes of instances in which auditors failed to detect financial statement fraud; and
- An academic who has conducted research on the effectiveness of forensic training on the ability to detect financial statement fraud.

The panelists will make brief remarks, and then SAG members will ask questions and provide their views, including on the matters discussed by the panelists. The staff is seeking SAG members' views on the following matters:

- The various ways and extent to which auditor mindset, attitudes, and cognitive biases have an impact on audit effectiveness, and what implications this might have on PCAOB standard setting;
- The extent to which the approaches or methods used by other disciplines to detect fraud might be applied in financial statement audits;
- The extent to which PCAOB standards could encourage the use of technology and other methods in fraud detection;
- The extent to which the PCAOB might address knowledge and skills relevant to fraud detection in its standards on auditors' technical competencies and firm training; and
- Approaches that the PCAOB could take through its various oversight programs to enhance the effectiveness of auditors and financial statement audits in the detection of material misstatements due to fraud.

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of brokers and dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

APPENDIX

SAMPLE LIST OF ACADEMIC PAPERS

This appendix presents a sample of some academic papers that generally address the topics of auditor behavior regarding fraud detection, lessons from other disciplines and knowledge and skills regarding fraud detection.

1. Gregory M. Trompeter, Tina D. Carpenter, Naman Desai, Keith L. Jones, and Richard A. Riley, Jr., *A Synthesis of Fraud-Related Research* 32 *Auditing: A Journal of Practice & Theory* 287, 287–321 (2013).
2. Chris E. Hogan, Zabihollah Rezaee, Richard A. Riley, Jr., and Uma K. Velury, *Financial Statement Fraud: Insights from the Academic Literature* 27 *Auditing: A Journal of Practice & Theory* 231, 231–252 (2008).
3. Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation* 95 *Northwestern University Law Review* 133, 133–220 (2000).
4. Alexander Dyck, Adair Morse, and Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 *The Journal of Finance* 2213, 2213–2253 (2010).
5. Tina Carpenter, Cindy Durtschi, and Lisa Milici Gaynor, *The Incremental Benefits of a Forensic Accounting Course on Skepticism and Fraud-Related Judgments* 26 *Issues in Accounting Education* 1, 1–21 (2011).
6. Jacqueline S. Hammersley, *A Review and Model of Auditor Judgments in Fraud-Related Planning Tasks*, 30 *Auditing: A Journal of Practice & Theory* 101, 101–128 (2011).
7. Stephen Asare and Arnie Wright, *The Effectiveness of Alternative Risk Assessment and Program Planning Tools in a Fraud Setting*, 2 *Contemporary Accounting Research* 325, 325–352 (2004).