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Audit Tests and Their Impact on Fraud Detection-Case of Albania

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Abstract

For an auditor having the responsibility for the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing, and has been one of the most frequently debated areas amongst auditors, politicians, media, regulators and the public (Gay et al 1997). The primary objective of financial reporting is to provide high-quality information to financial statement users. Regarding to this, we have taken into consideration an important element, such as the audit report which provides reasonable assurance to present and potential capital providers and other stakeholders when making investments, credit decisions, and allocating resources that may enhance overall capital market efficiency. The audit engagement in Albania is based on International Auditing Standards. We have attempted to study and identify the role of audit tests, performed by auditors during the audit process, in detecting material misstatements in the financial statements, in order to obtain a more qualitative financial reporting. Through the literature study regarding the impact of audit procedures undertaken in the auditor's opinion and the evidence gathered by the questionnaire addressed to auditors in Albania, it is possible to carry out our research questions about the subject field. In conclusion, we will express our opinion about the possible suggestions that should be followed during the selection of the adequate audit test to be performed, in order to ensure the most qualitative financial reporting in Albania.

Keywords: financial reporting, audit, accounting, audit tests.

Introduction

The primary objective of financial reporting is to provide high-quality information to financial statement users. Regarding to this, we have taken into consideration an important element, such as the audit report which provides reasonable assurance to present and potential capital providers and other stakeholders when making investments, credit decisions, and allocating resources that may enhance overall capital market efficiency. Through this paper we would like to study the relationship that may exist between the audit tests performed during an audit engagement and fraud detection.

This paper also aims to ascertain: “Auditors responsibility is fraud detection or expressing an opinion whether the financial statements are prepared, in all material aspects, in accordance with an applicable financial reporting framework? For an auditor having the responsibility for the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing, and has been one of the most frequently debated areas amongst auditors, politicians, media, regulators and the public (Gay et al 1997). The studies conducted found the existence of an audit expectation gap between auditors and financial report users with respect to the actual duties of auditors.

This debate has been especially highlighted by the collapse of both small and big corporations across the globe, but also with the latest phenomena in our country, such as the theft of the Bank of Albania or the second tier banks.

Methodology

In this paper data was collected from both the primary and secondary sources. Primary data used in this study were obtained through the administration of structured questionnaires which addresses both open and closed-ended questions to the respective certified accountants. Secondary data was gathered using foreign literature, research and scientific work of foreign and Albanian authors. Data obtained from the questionnaires was processed through editing and coding and then entering the data into a computer for analysis using descriptive statistics with the help of Statistical Package for Social Sciences (SPSS).

Through descriptive and analyzing statistical analysis are tested the below hypothesis:

First Hypothesis: The type of audit test elected affects the detection of fraud.

H1: The type of audit test elected affects the detection of fraud.

H0: The type of audit test elected does not affect the detection of fraud.

Second Hypothesis: Fraud detection is auditor's responsibility.

The second hypothesis is tested by means of a questionnaire to identify how the auditors in our country perceive this frequently discussed issue. Questionnaires were handed to 150 auditors and audit firms according to the public register of the Institute of Certified Public Accountants and only 37% of the target group responded. The audit sampling selection was done randomly without following a structured technique, avoiding any conscious or predictable judgment.

The questionnaire is organized in three sections aiming to satisfy the objectives set out in this paper.

In the first section, are asked questions about the general characteristics of the sample like age, years of practicing the profession, training in the field of audit, etc.

Second section includes questions regarding to audit procedures, type of tests applied, and the impact of the extent of tests in fraud detection.

Third section contains questions which aim to identify auditor's responsibility in detecting and reporting fraud, as well as, the impact that would have fraud detection on financial statements users.

Literature review

Porter (1997) reviews the historical development of the auditors' duty to detect and report fraud over the centuries. Her study shows that there is an evaluation of auditing practices and shift in auditing paradigm through a number of stages.

Porter study reveals that the primary objective of an audit in the pre-1920's phase was to uncover fraud. However, by the 1930's, the primary objective of an audit had changed to verification of accounts. This is most likely due to the increase in size and volume of companies' transactions which in turn made it unlikely that auditors could examine all transactions.

Extensive studies have been conducted in many countries into the perception of financial report users of auditors' responsibilities in fraud prevention and detection for example Low (1980) in Singapore; Humphrey et al (1993) in the UK; Monroe and Woodliff (1994) in Australia; Epstein and Geiger (1994) in the USA; Leung and Chau, (2001) in Hong Kong; Fadzly and Ahmad (2004) in Malaysia; Dixon et al (2006) in Egypt. These studies found that many financial report users believe that the detection of irregularities is a primary audit objective and that the auditors have a responsibility for detecting all irregularities.

The auditor could not be expected to uncover all fraud committed within the company, since the auditor was not an insurer or guarantor, but was expected to conduct the audit with reasonable skill and care in the circumstances (Carmichael, 2004). This is a misconception and shows the existence of an audit expectation gap between auditors and financial report users with respect to the actual duties of auditors.

In order to verify the adequacy of the financial statements and the company's internal controls, one performs a series of audit procedures.

According to Boynton et al (2002, p. 209) audit procedures are methods or techniques the auditor uses to assess and collect material, sufficient and competent evidence. Auditing is concerned with the verification of accounting data and with determining the accuracy and reliability of accounting statement, it means looking for sufficient evidence to satisfy oneself as auditor that the accounts show a true and fair view (MILLICHAMP, p. 225 1996).

Santi (1988, p. 88) defines compliance test as tests of the set of procedures and audits designed to confirm whether the critical functions of internal control, which the auditor will depend on subsequent phases of the audit are being implemented effectively.

A research conducted in Albania by Luçi E., Dako,E. (2016) concluded that control tests contribute to the prevention and detection of fraud in the organization.

According Imoniana (2001, pg. 163) substantive tests are audit procedures designed to obtain reasonable and competent corroborative evidence of validity and ownership of the accounting treatment of transactions and balances and evidence to detect material misstatement in the financial statements. Beuren and Cunha (2006, p.69) complements that the substantive procedures in audit are used to establish the reasonableness or otherwise of transactions and account recorded balances. Substantive testing is inversely related to the tests of controls. The higher the confidence found in internal controls, the lower the extent and depth in the application of substantive testing. Moreover, the greater the application of substantive tests, when the auditor found weakness in internal controls.

Although studies on how the type of test applied affects the detection of fraud can be at low levels, we can say that among them is a study conducted by Imoniana, J. Antunes, MT, Mattos, S. & Pereira, A. (2011), who identify that the level of risk and possible errors that each account may contain as a result of fraud, are the main factors that influence the choice of audit substantive audit procedures.

Empirical investigations of Carter and Stover (1991), Latham and Jacobs, (2000) identified two fundamental variables, managerial ownership and the debt limit, which affect the extent of fraud in financial statements.

Fraudulent financial reporting can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management but pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting.

Regarding to ACFE report (2016) Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing. Carcello & Palmrose (1994) focused on examining measures of financial difficulties in terms of weak financial conditions and weak financial performance as motivational mechanisms. The conclusions reached by this research, argue that motivations to commit fraud in the financial statements increases when firm encounter financial difficulties.

ISA and audit tests

4.1 The understanding of audit tests

ISA 330 "The auditor's responses to assessed risks" (ISA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA 315 in an audit of financial statements. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In order to express an appropriate opinion auditors obtain evidence from tests of controls and substantive procedures.

4.1.1 Tests of Controls

ISA 330 "The auditor's responses to assessed risks" defines test of control as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control, regarding to this the auditor shall:

Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

How the controls were applied at relevant times during the period under audit;

The consistency with which they were applied; and

By whom or by what means they were applied.

Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

4.1.2 Substantive procedures

Substantive procedures referred to ISA 330 “The auditor’s responses to assessed risks” are defined as an audit procedure designed to detect material misstatements at the assertion level.

Substantive procedures should be performed if tests of control determine that:

The controls are not operating effectively;

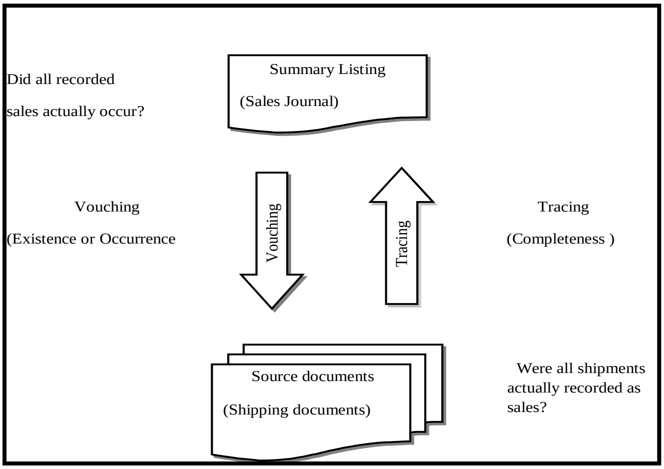
They do not exist; or

The auditor has determined that a substantive approach is more effective or efficient.

They enable the auditor to assess whether the transactions are bona fide and have been properly classified and recorded in the general ledger. The auditor’s approach in substantive tests of transactions is to inspect underlying documents, to trace the flow of transactions through the system. (Exhibit 4.1)

The direction of the trace determines the objective to be satisfied. Tracing from a source document to the accounting record provides evidence of completeness of the accounting records, that is, it detects errors of understatement. Tracing from the accounting record to the source document (commonly called vouching to the source document) provides evidence of occurrence, that is, it detects errors of overstatement. The extent of testing in a particular direction depends on the auditor’s judgment of the likelihood of error, but usually tests are made in both directions.

Exhibit 4.1 Transaction tracing) Source: Auditing & Assurance services, 2008)



There are two categories of substantive procedures:

Tests of details (of classes of transactions, account balances, and disclosures); and

Substantive analytical procedures.

An analytical procedure means the investigation and analysis of fluctuations and relationships to determine whether there are inconsistencies with other relevant information or deviations from predicted amounts. During this phase of the audit, we use analytical procedures as a substantive test to assist in corroborating balances. Since analytical procedures are generally at a higher level than tests of details, ASA 520 states that the extent of reliance on results from substantive analytical review procedures depends on the following:

Source of the information available. For example, information is ordinarily more reliable when it is obtained from independent sources outside the entity.

Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.

Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved.

Controls over the preparation of the information. For example, controls over the

There are a number of steps required to perform substantive analytical procedures in accordance with the Australian Auditing Standards which are shown below:

Identify relevant data.

Determine an expectation. A variety of sources can provide evidence for the audit team's expectations of the balance in a particular account. For example, comparison of current-year account balances to balances for one or more comparable periods (e.g., vertical and horizontal analyses) or comparison of the current-year account balances to anticipated results found in the company's budgets and forecasts

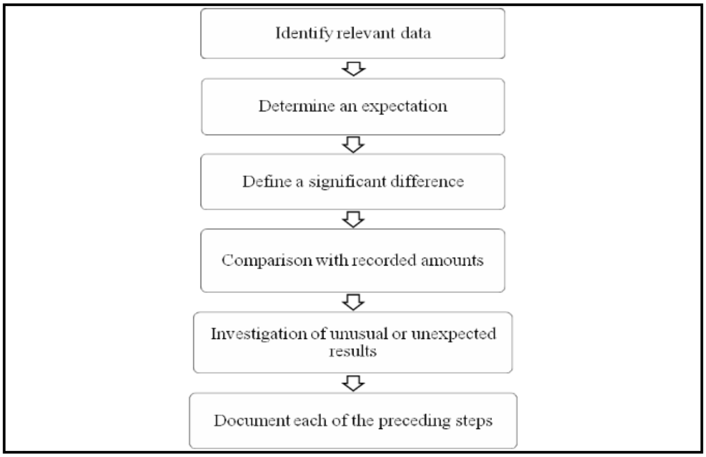
Define a significant difference. Basically, the question is, "What percentage (or dollar) difference from your expectation can still be considered reasonable?"

Comparison with recorded amounts. Many auditors start with comparative financial statements and calculate year-to-year changes in balance-sheet and income statement accounts (horizontal analysis). They next calculate common-size statements (vertical analysis) in which financial statement amounts are expressed as percentages of a base such as sales for the income-statement accounts or total assets for the balance-sheet accounts. These initial calculations provide a basis for describing the financial activities for the current year under audit.

Investigation of unusual or unexpected results. Auditors typically look for relationships that do not make sense as indicators of problems in the accounts and they use such indicators to plan further audit work. In the planning stage, analytical procedures are used to identify potential problem areas so that subsequent audit work can be designed to reduce the risk of missing something important. The application demonstrated can be described as attention directing: pointing out accounts that could contain errors and frauds. The insights derived from preliminary analytical procedures do not provide direct evidence about the numbers in the financial statements. Although the insights derived from preliminary analytical procedures provide only limited evidence about the numbers in the financial statements, they do help the audit team identify risks as an aid in planning the audit program.

Document each of the preceding steps.

Exhibit 4.2 Steps of performing substantive analytical procedures



Source: Authors

4.2 Relationship between tests

Tests of controls check the operating effectiveness of controls, while substantive tests of transactions are concerned with monetary misstatements. It often makes sense to design audit procedures to conduct both a test of controls and a substantive test of transactions simultaneously on the same document. All audit tests are dual-purpose tests. Whenever an error is discovered in a test, there is some evidence of a breakdown in controls and whenever no errors are discovered, there is indirect evidence that controls are operating. This is the reason that some auditors say the evaluation of controls is not final until the audit is completed. On the other hand, if controls are absent or not functioning, there will be no testing of controls and more extensive substantive testing will be necessary.

Data analysis

Data obtained from the questionnaires was processed through editing and coding and then entering the data into a computer for analysis using descriptive statistics with the help of Statistical Package for Social Sciences (SPSS) version 19, which offers extensive data handling capabilities and numerous statistical analysis procedures that analyses small to very large data statistics.

The hypothesis test was based on the use of the Chi-Square test, according to which a **p** value lower than $\alpha = 0.05$ indicates that the variables tested are dependent on and affect each other as well as in the descriptive and comparative analysis of the data collected by the questionnaires.

Before analyzing hypotheses and raised questions, a brief description of the target group characteristics is initially presented. From the collected data it was found that:

District Regarding to the graphic 5.1 (Annex) it is concluded that 58.9 per cent of the respondents are from Tirana, 10.7 per cent of them from Durrës and the rest of the respondents are from other districts like Fier, Berat, Vlorë, Elbasan.

Experience From the data collected and analyzed in the results that 51.8 per cent of the responders practice the audit profession for 4-10 years, for a period of 11-20 years practice the profession 32.1 per cent of the responders. From the sample of the elected auditor 10.7 per cent of them have 0-3 years of experience, while 5.4 per cent have over 20 years of experience in the profession.

Trainings. The responders were also asked about the duration of the trainings conducted on audit engagement (graphic 5.3, Annex) and results that 60.7 per cent of the responders frequent over 24 hours/year, 21.4 per cent frequet 17-24 hours/year and 10.7 per cent of them frequent 9-16 hours/year. The frequecy of trainings in auditing in the interval of 1-8 hours/year is done by 5.4 percent of the responders and only a small percentage of prej 1.8 per cent results that do not frequent organised trainings.

After brief description of target group characteristics, let's continue with the analysis of raised hypothesis.

First hypothesis: The type of audit test elected affects the detection of fraud.

Analyzing the evidence gathered relating with the impact of the type of audit test elected on fraud detection we concluded that 54.57 per cent of the respondents think that the type of the audit test does not affect on fraud detection and 46.42 per cent of them do think that fraud detection depends on the type of test applied.

Exhibit 5.1 The impact of audit tests on fraud detection

Nr. of question	Description of question	Measurement	Research method
Section 2/ Question 6	Which is the audit tests applied when conducting an audit?	Likert Rate with me 4 levels	Model Chi-Square Tests
Section 2/ Question 8	Do you think that audit tests applied affect fraud detection?	Yes / No	

H1: The type of audit test elected affects the fraud detection.

H0: The type of audit test elected does not affect the fraud detection.

Independence testing between these two variables shows that the variables are independent according to the Chi-Square test (p-value = 0.353> 0.05, → variables are independent, have no relation), which prove that the type of audit test elected does not affect on fraud detection.

Exhibit 5.2 Chi - Square Test “The relationship between the tests and fraud detection”

Source: Authors

Chi-Square Tests					
	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	.862a	1	.353		
Continuity Correction	.383	1	.536		
Likelihood Ratio	.873	1	.350		
Fisher's Exact Test				.537	.269
Linear-by-Linear Association	.846	1	.358		
N of Valid Cases	56				

Second hypothesis: *Fraud detection is auditor’s responsibility*

This hypothesis will be tested through the qualitative analysis of the questionnaire’s responses to identify how the auditors in Albania perceive this highly discussed topic.

Graphic 5.4 (Annex) shows that 21.4 per cent of the respondents strongly disagreed regarding to the auditor’s responsibility to uncover fraud and to report this to the appropriate authorities and 50 per cent are neutral to this statement.

In my opinion the responders who strongly disagreed should be in a greater percentage if we take in to consideration ISA 200 “Objective and general principles governing an audit of financial statements’, in which is defined that the objective of an audit of financial statement is to enable the auditor to express an opinion whether the financial statements are prepared, in all material aspects, in accordance with an applicable financial reporting framework. ISA 200 also requires an audit to be designed so that it provides reasonable assurance of detecting both material errors and fraud in the financial statements.

According to ISA 240 “The auditor’s responsibility to consider fraud in an audit of financial statements, the primary responsibility for the prevention and detection of fraud rests with both those charged with the governance of the entity and with the management of the entity. This standard requires the management and those charged with governance to place a strong emphasis on fraud prevention (to reduce opportunities for fraud), and fraud deterrence (to persuade individuals not to commit fraud by increasing the likelihood of detection and punishment).

Though it is not a statutory requirement for auditors to prevent and detect fraud, however, once fraud is detected auditors is required to report such fraudulent activities to the relevant authorities.

Overall, the results of the study are similar to previous studies by Chowdhury *et al* (2005); Epstein and Geiger (1994); Gloeck and De Jager (1993); Humphrey *et al* (1993); Leung and Chau (2001); Lin and Chen (2004) and Dixon *et al* (2006) that auditors have a responsibility for preventing, detecting and reporting fraud. The findings indicate that an expectation gap does exist between the respondents and the present statutory requirements of auditors with respect to fraud detection.

Should the auditor assess management’s style, to determine if the style might lead to fraudulent financial reporting? The results show 51.8 per cent of the respondents strongly agreed and a small percentage of 3.6 per cent strongly disagreed that auditors should assess the management style so as to determine if such style might lead to fraudulent financial reporting. Due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Conclusion and recommendation

Based on this paper, it is concluded that the type of audit tests applied does not affect the detection of fraud in the financial statements. Auditor’s responsibility is to express an opinion whether the financial statements are prepared, in all material aspects, in accordance with an applicable financial reporting framework. It is not auditor’s responsibility the prevention and detection of fraud. The primary responsibility for the prevention and detection of fraud rests with both those charged with the governance of the entity and with the management of the entity.

The management style should be assessed to determine if such style might lead to fraudulent financial reporting. Due to pressures to meet market expectations or a desire to maximize compensation based on performance, to cover financial difficulties management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. Furthermore, we recommend intensifying auditors training, especially for the exchange of experiences on audit procedures in detecting material misstatements.

More studies should be conducted, especially in identifying fraud cases in Albania, in order to increase the efficiency and the effectiveness of the audit engagement.

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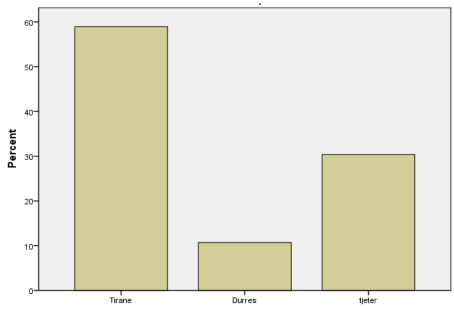
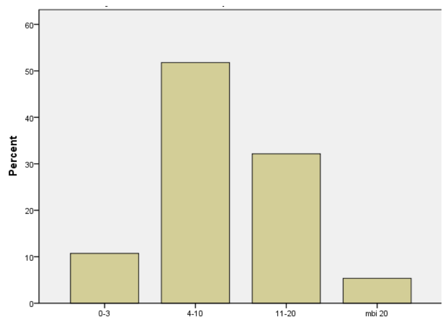
Annex

Graphic 5.1 Allocation by districts



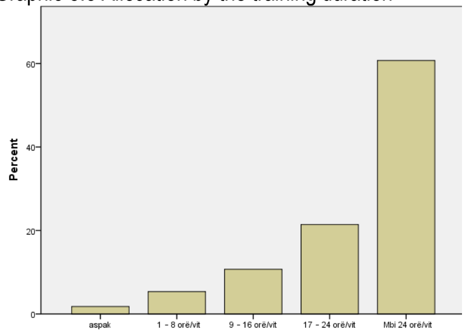
In which district do you practice your profession?

Graphic 5.2 Allocation by years of practising the profession



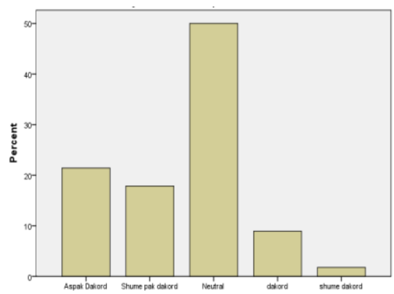
For how many years have you been practising audtiors experiece?

Graphic 5.3 Allocation by the training duration



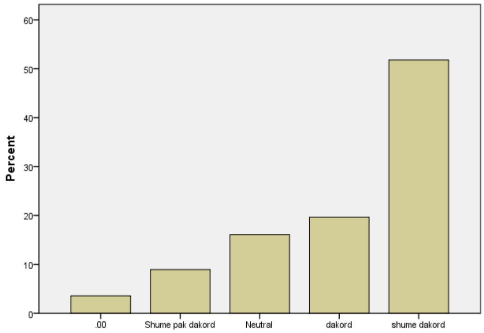
What is the duration of trainings conducted on auditing?

Graphic 5.4 Auditor's responsibility on fraud detection



Do you feel that it is auditor's responsibility to detect fraud?

Graphic 5.5 The relationship between fraud and management's style



Should the auditor assess management's style, to determine if the style might lead to fraudulent financial reporting?

Questionnaire

Section 1

How old are you?
25- 30
31-40
40-50
Over 50

For how many years have you been practicing auditor's profession?
0-3 years
4-10 years
11-20 years
Over 20 years

In which district do you practice your profession?
Tiranë
Durrës
Other

What is the duration of audit trainings conducted on auditing?
None
1 – 8 hour/year
9 – 16 hour/year
17 – 24 hour/year
Over 24 hour/year
Other

What is the duration of trainings conducted on fraud detection in financial statements?
None
1 – 8 hour/year
9 – 16 hour/year
17 – 24 hour/year
Over 24 hour/year
Other

Section 2

What is the average number of audit's engagement performed per year?
None
1 – 5
6 – 10
Over 10

Which are the audit tests you apply in an audit engagement?
Controls Tests
Test of details
Substantive analytical procedure
Other

Which sample selection method do you apply to your audits?
Random selection (Statistical Method)
Systematic selection (Statistical Method)
Monetary unit sampling (Statistical Method)
Haphazard selection (Non statistical Method)
Block selection (Non statistical Method)
Other

Do you think that the type of audit tests elected affects on fraud detection?
Yes
No

For each of the question below express your opinion from 1 (Strongly disagree) to 5 (strongly)

	1 Strongly diagree	2 Very little Agree	3 Neutral	4 Agree	5 Strongly agree
Should the auditor assess internal controls used by the company to prevent or detect the theft of assets?					
Should the auditor assess the role of the internal auditors?					
Should the auditor work to uncover all related party transactions?					
Should the auditor evaluate whether there is "substantial doubt" about a company's ability to continue as a going concern?					
Should the auditor assess management's style, to determine if the style might lead to fraudulent financial reporting?					
Should the auditor ensure that the management conveys the findings of the audit to the board of directors or audit committee, (whichever is applicable)?					

Section 3. For each of the question below express your opinion from 1 (Strongly disagree) to 5 (strongly)

	1 Strongly disagree	**2 Very little Agree**	**3 Neutral**	**4 Agree**	**5 Strongly agree**
Do you think that the discovery of fraudulent activity would have a negative impact on users?					
Do you feel that it is the responsibility of the auditor to uncover fraud and to report this to the appropriate authorities?					