Auditor beware: management opts for omission rather than action in reporting fraud!

A manager who cheats on financial statements will try to hide his fraud. If the auditor discovers the associated misstatement, what does the manager say to avoid being labeled a fraudster? The most likely scenario is that the manager will present the deviation as a mistake that was made inadvertently. And it is not unlikely that the auditor will subsequently agree with this statement, with all its consequences. So be careful.

But how does a manager get the auditor to do so? The answer is so obvious that it has been underestimated for a long time: the manager prefers to omit rather than to make up a number.

Error story is better believed if presented as an "omission"
A manager's error statement is more plausible if a transaction was ignored (an omission), compared to the incorrect entry of a transaction (an action). The auditor is, therefore, more likely to see an omission as an unintentional error than as a fraud.

But, statistics would support the idea that mistakes are much more common than actual fraud. Are these statistics wrong?

Recent research by Erin Hamilton and Jason Smith calls into question this very question. They investigate whether omissions of transactions are a fraud method that has successfully stayed under the (auditor's) radar.

It is unusual that fraud explains deviations: but is that justified?
Existing research claims that most fraud comes about from actions, such as booking non-existent sales or booking sales early. Far fewer frauds, according to research, occur due to omission of transactions, for example the failure to record costs. This is evident from, among other things, the most recent COSO fraud report.

The question is whether this conclusion is accurate. An alternative explanation is that omissions have a greater chance of not being classified as fraud.

The literature in psychology also shows that individuals prefer not to show "morally wrong outcomes", rather than actively adapt these outcomes. An example from the literature is that actively poisoning someone is considered more negative than consciously withholding an antidote in the case of poisoning. While the intent is the same, active poisoning is seen as less ethical. Even if the consequences of inaction are more severe, it is sometimes seen as less bad.

It is not surprising that this strategy can be used by malicious parties in many situations. It is simply not easy for third parties to assess intentions if no action has taken place. The lack of action does not provide evidence.

Managers who want to commit fraud with financial reporting can of course make use of this phenomenon. Yet that has not been investigated before. Hamilton and Smith are changing that.

Let's explore this!

The starting point in Hamilton and Smith's research is that an omission (i.e. omission of an entry that should have been made) in the context of the annual accounts usually leads to an understatement, while an action usually leads to an overstatement. In doing so, they mainly focus on understating costs (by not booking them) and presenting the turnover too high.

Hamilton and Smith investigated managers' preferred method of fraud in manipulating external reporting. Subsequently, external auditors were asked how likely they think it is that a found deviation was deliberately caused by management.

The researchers, therefore, look both at the strategy that managers use to commit fraud and at the question whether that strategy is understood by the external auditor.

They conduct their research through a number of experiments. Based on a case study, 58 managers (with experience in the field of external reporting) are asked how they would steer profit: through a wrong entry of a transaction or by omitting a transaction. After that decision, the managers were asked how they would initiate this fraud, with the question again: are you doing this by adjusting or by omitting information in underlying documents?

108 auditing auditors were then asked to estimate how likely they deem the managers' fraud intent to find a misstatement due to an omission and a misstatement due to an adjusted transaction.

The results: managers prefer to omit over "cooking the books"

The results show that managers prefer to omit a cost item as opposed to incorrectly posting a turnover transaction. Even if they influence the underlying documents to achieve this outcome, they are more likely to opt for an omission than an adjustment. In short: "less is more".

The results also show that managers strategically choose omissions because they believe they come across as less deliberate to third parties, such as auditors. And they also think that omissions are less likely to be discovered at all.

Auditors rate a misstatement as less deliberate (in terms of fraud) when it concerns an omission compared to active forms of manipulation. Auditors then also decide to work less in the event of omissions.

These results suggest that the methods chosen by managers for fraudulent external reporting are also those that the auditors consider less likely to be fraudulent.

Since an omission can also occur with turnover and an active manipulation also with costs, a third experiment has been performed. This also shows that auditors are less skeptical about deviations associated with omissions (instead of adjustments).

Take-aways for practice and regulations

The study shows that auditors mistakenly label misstatements resulting from omissions as errors, when in fact they are frauds. This requires education and training that cultivates "awareness" for this underexposed fraud strategy and that creates a more skeptical attitude towards deviations as a result of omissions.

The study also provides a possible explanation for the finding that frauds are often classified as active manipulation of transactions ("most frauds involve the improper recording of revenues"). Perhaps many frauds due to omissions are incorrectly not recognized as such.

Referentie

This contribution is based on the article "Error or Fraud? The Effect of Omissions on Management's Fraud Strategies and Auditors "Evaluations of Identified Misstatements" by Erin L. Hamilton and Jason L. Smith (University of Nevada, Las Vegas). The article was published in The Accounting Review in January 2021, pp. 225–249.

What do the ISAs say about this?

Auditor's Responsibility and Evaluation Audit Information

Auditing standards require the auditor to look for material misstatements (ISA 240: 5). And in finding a misstatement, the auditor must determine whether there is an error or (possible) fraud (ISA 240: 35). In the event of possible fraud, the auditor must take further steps. Obviously, the decision as to whether a deviation is an error or a possible fraud has significant consequences for the continuation of the audit (ISA 240: 35-36).

Fraud Strategies

If an enterprise's management is intent on deliberately misrepresenting information in the financial statements, it may do so (for example) by misrepresenting matters or by deliberately omitting to record transactions (ISA 240: 6). The fraud can take place in the actual records or in the underlying documents (ISA 240: A3).