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PRACTITIONER SUMMARY

External Auditors and Corporate Corruption: Implications for External Audit Regulators

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SUMMARY: The purpose of the current study is to examine the responsibility of external auditors in relation to corporate corruption and to highlight the implications of this for external audit regulators. The current study is based on a critical review of prior academic literature as well as a thorough examination of both the International and American Auditing Standards relating to fraud and illegal acts. External auditors have a responsibility for assessing corruption risks but their role was not clearly defined by external audit regulators. The current study was the first to clarify the responsibility of external auditors with regards to corporate corruption, and to shed light on current limitations in the audit standards related to this area. The current study also offers recommendations to audit regulators, external auditors, audit firms, and researchers on such controversial area.

Keywords: corruption; external auditors; fraud risks; international audit standards; American audit standards.

INTRODUCTION

Corruption is a major threat facing corporations and countries all around the world. Corruption not only destroys lives and communities, but also undermines countries and institutions ([Transparency International 2012](#)). Combating corruption requires the efforts and collaboration of regulatory authorities, external auditors, investigators, and the governing board ([Institute of Internal Auditors \[IIA\] 2014](#)). However, this paper focuses only on the role of

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external auditors and the efforts of audit regulators in combating corruption. A thorough examination and review of audit standards as well as prior literature has revealed that the role of external auditors with regards to corporate corruption was neither given enough attention in the literature nor clearly defined in the audit standards.

The objectives of this paper are twofold. First, it aims to clarify the role of external auditors with regards to corporate corruption. Second, it aims to show the impact of corruption on financial statements and thus the audit profession by providing evidence from actual corruption cases and prior literature. This paper also offers recommendations to external auditors, audit regulators, and researchers on how to combat corruption.

The rest of the paper is organized as follows: the next section discusses the responsibilities of external auditors in relation to corporate corruption and identifies gaps in audit standards related to this area. This section also examines the impact of corruption on the financial statements by providing evidence from prior literature. The third section explains the impact that corporate corruption might have on the audit profession by providing evidence from actual corruption cases. The fourth section critically reviews prior literature into corruption and the role of external auditors. It also identifies gaps in prior literature related to this area. The fifth section provides the conclusion as well as recommendations to audit regulators, external auditors, and researchers on how to combat corruption. The final section suggests ideas for future studies that might help in combating corporate corruption.

LITERATURE REVIEW

Reviewing prior literature shows a stream of research into the impact of corruption on the economy, and the links between corruption and culture. For instance, [Lambsdorff \(2003\)](#) found that corruption is likely to reduce investments that will also bring about a lower GDP. [Picur and Riahi-Belkaoui \(2006\)](#) found that tax compliance internationally is positively related to the successful control of corruption. [Kimuyu \(2007\)](#) found that not only does corruption undermine firm growth but also it reduces the propensity to export. [Freckleton, Wright, and Craigwell \(2011\)](#) found that in the cases of the developing economies, lower levels of corruption enhance the impact that Foreign Direct Investment (FDI) has on economic growth. [Papaconstantinou, Tsagkanos, and Siriopoulos \(2013\)](#) found that corruption has a negative impact on economic growth. [Seleim and Bontis \(2009\)](#) explored the relationship between culture and corruption and the findings revealed that individual collective practices encourage corruption, and uncertainty avoidance increases levels of corruption. The authors defined uncertainty avoidance as “the extent to which a society relies on norms and procedures to cover events and situations in their daily lives” ([Seleim and Bontis 2009](#), 168). Characteristics of a society with high uncertainty avoidance include the use of formality in interacting with others, relying on formalized policies and procedures, taking moderate and carefully calculated risks, and showing strong resistance to change ([Grove 2005](#)).

Our review has also shown that only a few studies have examined the role of external auditors and/or the audit profession in combating corruption. Indeed, no study seen by the authors has actually examined the responsibilities of the external auditors in relation to corruption. For instance, [Uecker, Brief, and Kinney \(1981\)](#) investigated whether managers’ perceptions of external auditor serve as a deterrent to corporate irregularities. However, their results did not support this hypothesis. The authors suggested that external auditors are expected to make additional efforts to detect irregularities to change management perception. Some of the few relevant studies found were [Albrecht, Malagueno, Holland, and Sanders’ \(2012\)](#) investigation of whether the existence of a professional oversight body and specific education regulations were associated with a country’s

perceived level of corruption. Their findings revealed that countries that have established an audit profession oversight body are perceived to be less corrupt. They also found that countries requiring practical experience, academic study, and a licensing examination in order to practice auditing are perceived to be less corrupt. [Kimbrow \(2002\)](#) argued that the probability of detecting corruption could increase by increasing accountability, transparency, independent oversight, audits, and information access. [Brown, Smith, White, and Zutter \(2013\)](#) investigated the relationship between political corruption and firm value. Their findings revealed that strong audit monitoring can mitigate the negative firm value effects of political corruption within the U.S. [Lamoreaux, Michas, and Schultz \(2015\)](#) investigated the role of accounting and audit quality in the allocation of international development aid loans provided by the World Bank. Their findings indicate that the amount of aid lent by the World Bank to a country is higher for countries with stronger accounting and audit quality. They also found that accounting and audit quality are associated with World Bank lending only in countries with relatively high level of corruption.

Although evidence from prior literature showed that sound external audits could help in combating corruption, there is still a huge gap of knowledge in this area especially when it comes to the responsibility of external auditors with regards to corporate corruption and how external auditors could actually assess and respond to corruption risks.

THE RESPONSIBILITIES OF EXTERNAL AUDITORS IN RELATION TO CORPORATE CORRUPTION

An examination of the audit standards revealed that although the efforts of audit regulators in combating fraud cannot be denied, little attention has been given to external auditors' responsibilities with regards to corporate corruption. For instance, in relation to fraud, the International Auditing and Assurance Standards Board (IAASB) issued the International Standard on Auditing (ISA) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* ([IAASB 2007](#)), and ISA 240, *The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements* ([IAASB 2009a](#)). The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued the Statement on Auditing Standards (SAS) 99 *Consideration of Fraud in a Financial Statement Audit* in 2002 ([ASB 2002](#)). The Public Company Accounting Oversight Board (PCAOB) also issued AU Section 316 *Consideration of Fraud in a Financial Statement Audit* ([PCAOB 2002](#)). However, none of these audit standards make a direct reference to external auditors' responsibilities with regards to corporate corruption that was only implicitly implied and in some instances seemingly ignored, assuming that corruption has no impact on the financial statements.

For instance, ISA 200 stated that "external auditors are responsible for detecting material misstatements whether due to errors or fraud" ([IAASB 2007](#), 3, para. 5). Given that corruption is a type of internal fraud ([Wells 2005](#)), external auditors are likely responsible for detecting material misstatements arising from it. However this was again ignored by ISA 240 ([IAASB 2009a](#)), and SAS 99 that require external auditors to assess and respond to fraud risks arising from only two types of internal fraud, "asset misappropriation and financial reporting fraud" ([ASB 2002](#)). ISA 240 justified this by stating that asset misappropriation and financial reporting fraud are more likely to have an impact on the financial statements ([IAASB 2009a](#), para. A1–A6). SAS 99 did not explain its rationale.

This indicates that both standards assume that corruption does not have an impact on the financial statements although evidence from prior literature seems to show otherwise. For instance, [Pacini, Swingen, and Rogers \(2002\)](#) stated that transparency in financial reporting is

impaired by bribery activities. Corrupt employees can cause employers to overpay for goods and services bought by a company in which the employees have a hidden interest. This form of corruption is called “conflict of interest.” These conflicts of interest can also lead to writing off sales through the use of discounts or allowances. Inadequate disclosure of conflicts of interest and related parties transactions could also have an impact on the financial statements and may mislead shareholders. Corrupt payments could be made by normal business checks. Disguised payments on the payer’s accounting records might appear as some sort of legitimate business expense such as consulting fees. Loans and credit card expenses could also be used as a form of bribe (ACFE 2012). Corruption could have an impact on the financial statements because of the procurement of high-value goods and services. In addition, most bribery involves disbursement of cash and the recording of that disbursement in the financial records (IIA 2014; Wells 2011). Other accounts that could be affected by corruption include petty cash, gifts, travel and entertainment payments, reimbursements, accounts receivable, donations, and sales contracts (IIA 2014). Payments of bribes recorded in the accounting records are more likely to be in the form of fictitious payables, false purchases, ghost employees, interest-free loans, fictitious bids, or overbilling (Vona 2008; Wells 2011). Cooper and Fargher (2011) considered that the concealment of bribes can take place through charging the company for services that were not performed, invoicing the company at an inflated rate, or in the form of loans, accounts receivable, or bonus payments to corporate officers. This results in misrepresentation of expenses and assets in the financial statements that could also be material. In FASB Statement 2, materiality was defined as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement” (FASB 1980, 10). As corruption is an illegal act, its concealment would be because knowledge of it would influence “the judgment of a reasonable person.” The knowledge of a corrupt act is probably more important than the absolute size of the transgression. Therefore, even a relatively small misstatement in the financial statements in order to hide a corrupt act may be considered to be material because it could be taken as an indication of the impairment of management’s integrity.

Corruption is also an illegal act that is prohibited by laws and regulations in countries around the world. For example, the Bribery Act (U.K. Legislature 2010) was introduced to update and enhance U.K. law. The U.S. Foreign Corrupt Practices Act (FCPA) prohibits U.S. persons and businesses from making payments to foreign government officials or politicians to influence business dealings (IIA 2014). The Organisation for Economic Co-operation and Development (OECD) has played a vital role through the development and adoption of the 1997 convention in addressing global concerns regarding bribery around the world (Pacini et al. 2002). Audit standards also explained the responsibility of external auditors with regards to illegal acts. For instance, ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (IAASB 2009b), and SAS 54, *Illegal Acts by Clients* (ASB 1989), required external auditors to take into consideration the applicable legal and regulatory framework in conducting the audit of financial statements. ISA 250 stated, “The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements” (IAASB 2009b, para. A8). SAS 54 stated:

The auditor’s responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud. The auditor considers laws

and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. (ASB 1989, AU §317.05)

However, both standards did not directly refer to corruption or the responsibilities of the external auditors with regards to corruption. In addition, SAS 54 did not mention whether corruption risks could have a direct or indirect impact on the financial statements (ASB 1989). It was not also clear how external auditors could decide on whether an illegal act has a direct or indirect impact on the financial statements. ISA 250 provided some examples of indicators for non-compliance with laws and regulations that external auditors need to consider (IAASB 2009b, para. A13) that were similar to examples of red flags of bribery cited by Wells (2005) in his book *Principles of Fraud Examination*—such as: “cases when low-bid awards are frequently followed by changed orders or amendments that significantly increase payments to the vendor,” “unusual or unexplained fluctuation in payables, expenses or disbursements,” “unusually high price contracts for goods or services purchased by the company,” and “improper or unauthorized payment for goods or services.” This indicates that the standard implicitly required external auditors to assess and respond to bribery and corruption risks as long as it has a material impact on the financial statements; however, this was not directly mentioned in the audit standards.

This lack of clarity about the responsibilities of external auditors with regards to corporate corruption could make external auditors overlook their responsibility for detecting material corruption that could have an impact on the financial statements since this was not explicitly required by audit standards. This might increase auditors' liability and litigation costs. It might also result in inconsistency in complying with the requirements of the audit standards for illegal acts. The consequences of this could be severe not only in terms of losing shareholders' confidence in the audit profession but also in the ability of audit firms to survive in the market as a result of damaged reputation. The next section shows the impact of corruption on the audit profession by providing evidence from actual corruption cases and prior literature.

THE IMPACT OF CORRUPTION ON THE AUDIT PROFESSION

The impact of corruption on reputational risk may be severe even when financial impact is minimal (IIA 2014). When corporations suddenly fail or if it is revealed that management or key employees are involved in fraudulent activities, the validity of the financial statements of these corporations is often called into question. Once financial manipulation is revealed, the external auditor also comes under scrutiny (Cooper and Fargher 2011). For instance, the recent investigations at FIFA have brought corruption and in particular bribery into the public spotlight:

The FIFA corruption scandal does not only involve charges that at least \$150 million in corrupt payments were made to FIFA officials, but is also centered on a sport that is followed by more than two billion fans around the world. Preparation and hosting of FIFA world cup tournaments lead to billions of dollars of infrastructure expenditures and can have a dramatic impact on local economies. The FIFA scandal does raise a particular issue for auditors. The fact that FIFA's external auditor, KPMG, issued a clean opinion on the organization's financial statements continues to raise questions about the value of the audit service. (Verver 2015, 1)

Browing (2015) said:

Despite longstanding suspicion of corruption, world soccer's governing body has received a clean bill of financial health for 16 consecutive years from KPMG. It is legitimate to raise

questions about the effectiveness of the audits, given that the risks were already widely rumored and the auditor issued a clean report all these years.

In Brazil's Petrobras corruption scandal in 2015, in which 27 people were charged with corruption and money laundering, the company wrote off \$2 billion for bribery-related costs. The company's debt rose from \$25 billion to \$170 billion in 2014. The Petrobras CEO and five senior directors resigned after the corruption scandal. Third parties were hired as subcontractors to provide services to Petrobras with the cost of the work being inflated to hide the illegal payments made. Petrobras also faces a class-action lawsuit from shareholders who claim the company released false statements and misled investors about its assets. The company had to delay the release of audited financial statements because of uncertainty about the amount of write-offs for political corruption-related costs. Petrobras' auditing firm, PricewaterhouseCoopers (PwC), refused to sign off the accounts due to the corruption scandal and the lack of clarity on the accounts (Watts 2015). However, PwC was criticized for not examining the procurement processes carefully as part of the audit (Smith 2015).

In 2008, the Securities and Exchange Commission (SEC) charged Siemens with violations of the anti-bribery, books and records, and internal controls provisions of the Foreign Corrupt Practices Act (FCPA) (SEC 2008). Siemens has agreed to pay a \$450 million criminal fine to the U.S. Department of Justice and a fine of €395 million to the Office of the Prosecutor General in Munich, Germany. In the fall of 2003, Siemens' external auditor, KPMG, identified €4.12 million in cash that was taken to Nigeria by Communications Company (COM) employees and flagged the payments for review. However, no actions were taken by either the board of directors or the audit committee of Siemens. KPMG have also reported at least 250 suspicious payments made through Intercom to companies in foreign jurisdictions on behalf of COM and Siemens' Italian subsidiary. The audit report was provided to the board of directors of Intercom, as well as to certain members of Siemens' Corporate Compliance Office; however, they made no attempt to investigate these facts or explore whether they were related to other similar instances of wrongdoing (SEC 2008). However, there was no evidence about how KPMG reacted to this that indicates that external auditors still need guidance on how to respond to heightened corruption risks, especially when corrective actions are not taken by top management and auditor's comments are ignored.

In the Wal-Mart corruption case, a small shareholder group said the company's longtime auditor, Ernst & Young, knew about possible bribery in Mexico long before the company disclosed it to U.S. authorities. CtW Investment Group, which works with union pension funds that hold about 0.15 percent of Wal-Mart Stores Inc. stock, also said that Ernst & Young should have reported the suspected bribery to the SEC and should be investigated by the accounting oversight board, because the acts under investigation and how the investigation was handled could have affected the retailer's financial statements (Nassauer 2015).

The public expectations of the external auditors with regards to detecting corruption or at least being able to identify corruption risks indicate that external auditors and audit regulators should give more attention to corruption. This in turn requires audit regulators to clarify the role of external auditors with regards to corporate corruption and provide them with guidance on how to assess and respond to corruption risks. Khan (2006, 4) stated that "the public expectations are that the auditors should play an effective role in reducing, if not eliminating, corruption," and if external auditors cannot play a role in detecting corruption, they could at least identify areas where opportunities for corruption exist. Pacini et al. (2002, 2) argued that "auditors must satisfy growing expectations, not only in the more conventional areas in financial statements but also in relation to the existence of fraud and compliance with legal obligations. Auditors now face increased pressure

to plan and perform an audit to obtain reasonable assurance that material misstatements arising from fraudulent acts such as bribery are detected and reported.” Modugu, Ohonba, and Izedonmi (2012) mentioned that if external auditors are not competent, especially in bringing their skills to bear in a corrupt environment, then the whole audit process is of no value. Alabede (2012, 119) concluded that “the auditors are still holding to the principle, which views audit as watchdog not bloodhounds and not expected to detect fraud. Unfortunately, times have changed and public expectation of the role of the auditors has equally changed.” Adeyemi and Uadiale (2011) argued that unless the auditor’s role conforms to public expectation, the audit profession might risk social action of enforcement or penalty for nonconformity.

CONCLUSION AND RECOMMENDATIONS

This paper aimed to clarify the role of external auditors with regards to corporate corruption, showing the impact of corruption on the financial statements and the audit profession, and providing recommendations to external auditors, audit regulators, and researchers on how to combat corruption.

Our findings revealed that external auditors are likely responsible for detecting material misstatements arising from corruption that would have a material impact on the financial statements. However this was not directly and clearly stated in audit standards but rather implied. Audit standards also unjustifiably implied that corruption might not have an impact on the financial statements unlike other types of internal fraud such as asset misappropriation and financial reporting fraud. However, evidence from prior literature proved otherwise and showed how corruption could lead to misrepresentations in the financial statements. The findings also revealed that in the case of corruption scandals, external auditors are likely to come under scrutiny. This was evident in some of the recent corruption scandals when external auditors failed to discover corrupt practices by their audited clients throughout the years of the audit. The public expects external auditors to at least identify opportunities for corruption when they exist. Ignoring corruption will negatively impact the reputation of audit firms and will raise concerns about the value of external audits. The reason auditors should be worried about corruption is that a misstatement resulting from corruption may be more costly to the audit firm and probably the entire profession than a misstatement caused by other factors such as in the case of error. The FIFA example speaks to this. Many people questioned the value of audits because of the clean opinions that FIFA received each year. Although most of the public outrage may result from a misunderstanding of auditor responsibilities and auditing standards, that misunderstanding may result in higher settlement costs for audit firms.

Our findings also revealed a gap in prior literature in the area of corruption, mainly the responsibility of external auditors with regards to corporate corruption and how external auditors could actually assess and respond to corruption risks.

Hence, the current paper provides the following recommendations to audit regulators, external auditors, and researchers on how to combat corruption:

- Audit regulators should clarify the role of external auditors with regards to corruption. This requires audit standards to clearly state that “external auditors are responsible for detecting material misstatements due to corruption and that they are required to assess and respond to corruption risks.”
- Audit standards need to explain that corruption is not only a type of internal fraud that could have a material impact on the financial statements but also an illegal act. Audit regulators

should provide guidance to external auditors on how to assess and respond to corruption risk. Examples of misstatements due to corruption and illegal acts that could have a material impact on the financial statements should also be provided.

- External auditors still need guidance on how to react to cases when management or those charged with governance repeatedly ignore irregularities or weaknesses in the internal control system. Repeated mistakes or no efforts by management to take timely corrective actions might not only be an indication of weak monitoring but also an intention to commit fraud.
- External auditors need to understand the nature of corruption, the categories of corruption, and how each could be committed. This is more likely to help them identify possible opportunities for corruption. They also need to understand the scope of their responsibility in relation to corruption and the risk of ignoring it.
- External auditors need to be aware of high-risk accounts that could indicate a high risk of opportunity for corruption such as procurements, loans, petty cash, cost of services, accounts receivable, loans, credit card expenses, and disclosures in the financial statements, especially those related to related-party transactions.
- External auditors also need to be aware of weaknesses in internal control that could increase the opportunity for corruption. For example, lack of adequate segregation of duties especially in areas like procurement or at the board level. A lot of power in the hand of one person could increase the risk of that person abusing this power by engaging in corrupt practices for his or her own benefit. Also tone at the top could have a huge impact on an organization's culture. If top management made it clear that bribery and corruption will not be tolerated, then corruption risk might be reduced. Thus a detailed assessment of management's commitment to integrity and ethical values, management's philosophy and operating style, and board of director's participation in the entity's activities could help external auditors assess the risk of corruption.
- Reviewing existing laws, regulations, and rules including the bidding process as well as interviewing key personnel might help external auditors identify any opportunities for corruption.

Researchers have also an important role to play in combating corruption. They can help by conducting research that could help develop appropriate training materials for external auditors to help them understand the nature of corruption and how it could be committed including money laundering techniques used by corrupt individuals, and how external auditors could assess and respond to corruption risks. The next section provides some ideas for future research into this area.

FUTURE STUDIES

Future studies should explore audit techniques that might help external auditors assess and respond to corruption risks. One useful area might be the use of red flags in assessing opportunities for corruption. Prior literature explored the effectiveness of red flags in assessing risks arising from asset misappropriation and financial reporting fraud but no study actually examined the effectiveness of red flags in assessing corruption risks. Weaknesses in the internal control system could also help external auditors in identifying areas where opportunities for corruption exist. Thus future research could look into how the COSO internal control framework might help external auditors identify opportunities for corruption.

Future research should also examine public expectations of external auditors in relation to detecting corruption. Research highlighting the impact of corruption on financial statements and its implications for external auditors is also needed. A starting point could be an analysis of corruption cases to date to explore the types of corruption committed, how each was committed and detected, what was the impact on the financial statements, and what were the implications for external auditors and the perpetrators.

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