Investigating the Black-box of External Audit Practice: The Paradox of Auditors’ Failure in Detecting and Reporting Fraud

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Investigating the Black box of External Audit Practice: The Paradox of Auditors' Failure in Detecting and Reporting Fraud

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Abstract

**Purpose:** The study aims to explore the reasons behind external auditors’ failure to detect and report fraud

**Design/methodology/approach:** Semi-structured interviews were conducted with twenty-four experienced Big 4 auditors

**Findings:** The present study reveals power issues within audit firms and how some dishonest audit partners deal with auditors’ concerns at the higher echelons. It also shows how auditors are pressured and intimidated by audit clients when fraud-related issues are raised. Further, it sheds light on ethical, governance, and regulatory issues inhibiting auditors’ ability to detect or report fraud.

**Originality:** This is the first study exploring external auditors’ views on their failure to detect and report fraud and how the conflict of interests operates in the audit practice.

**Research Implications:** This study advances the audit literature by adding practice-based evidence on why external auditors fail to discover fraud.

**Practical Implications:** The results draw policymakers’ attention to the issues that inhibit external auditors’ ability to discover fraud in practice which could help policymakers develop effective interventions. Additionally, it provides several recommendations which could aid policymakers and audit firms in designing effective audit reforms to resolve the fraud detection deficit.

**Keywords:** Conflict of interests; Fraud; Fraud detection; External auditors
1. **Introduction**

The external audit is a crucial governance mechanism introduced to enhance organisations’ financial reporting quality by providing reasonable assurance that the financial reports are free from material misstatements due to fraud or error (ICAEW, 2005). Therefore, if done adequately, external audits could deter fraudulent behaviour and protect shareholders' interests (Cohen et al., 2010; Dezoort & Harrison, 2018; Guragai & Hutchison, 2019; Li et al., 2020). However, external auditors have a long history of failure to detect fraud (Sikka, 2009; 2015a), casting doubt over the value of external audits as a governance mechanism (Thomas & Pickard, 2021). The public trust in auditors' judgments plays an essential role in accepting audit functions as value-added services, which lend credibility to published financial statements (FRC, 2016a). Therefore, it is crucial to understand the main causes of audit failure concerning fraud and devise preventive measures accordingly (Firth et al., 2005).

Still, the reason behind auditors’ failure has been well explored in the audit literature. In particular, the current debates are predominately based on personal viewpoints or secondary data rather than empirical evidence. Very few studies used experiments to explore the link between audit tenure and auditors’ ability to detect fraud (e.g., (Singer & Zhang, 2017; Carcello & Nagy, 2004; Patterson et al., 2019). However, their results were inconsistent and not informed by external auditors’ views and practices. Additionally, they failed to provide deeper insights into the issue, perhaps due to the limitations of experiments as a research method. Experiments cannot measure phenomena related to a human's intentions, attitudes, and thoughts because these concepts may not be observed or measured without evidence. In some situations, the respondents may choose random answers rather than genuine responses, or they
could not be allowed to have the flexibility to give answers which are more relevant to their cases (Pham, 2018).

The current study fills these literature gaps by interviewing twenty-four experienced external auditors to explore their experiences in fraud detection and why auditors may fail to detect and report fraud. The study reveals power issues within audit firms and how some dishonest audit partners deal with auditors’ concerns at the higher echelons. It also shows how auditors are pressured and intimidated by audit clients when fraud-related issues are raised. The study sheds light on ethical, governance, and regulatory issues inhibiting auditors' ability to detect and report material misstatements due to fraud. The findings have implications for policy, practice, and future research, later discussed.

This study's main contribution lies in its novelty, being the first to provide evidence from the audit field on the reasons for auditors’ failure to detect and report fraud. By doing so, it advances the audit literature by adding practice-based evidence. It also responds to future research calls for more practically-orientated research that does not hesitate to open the 'black box' of audit practice (Maroum and Atkins, 2014). It also provides recommendations to aid audit firms and policymakers in designing effective audit reforms. Knowing the issues auditors face in audit practice and how they could be addressed could guide audit regulators and firms on where to focus their interventions and enforcement efforts. The study's findings are timely and essential given that the Financial Reporting Council in the UK identified fraud risk as a priority area in all future audit inspections (see News 1 Financial Reporting Council (frc.org.uk)). Hence, the findings could alert the FRC to audit regulatory and practice issues requiring interventions to mitigate fraud risk.
2. Systematic Literature Review (SLR) – Insights and Gaps

2.1. SLR Methodology

A systematic literature review was conducted to explore prior studies’ findings on the reasons behind external auditors’ failure to detect material fraud. More than two decades of peer-reviewed academic journal articles from 2000 to 2022 were systematically reviewed using multiple search engines and databases for relevant papers. This includes JSTOR, Wiley Online Library, SCOPUS, EBSCOhost Business Source Premier, ProQuest, Elsevier ScienceDirect, Emerald Insight, Springer Standard Collection, Sage Journals Management, Allen Press American Accounting Association, IEEE Open Access Journals, and Conferences, and Taylor & Francis Open Access.

The following screening criteria were applied to ensure further the quality and relevance of the selected publications: (1) Only full-text academic peer-reviewed articles were included in the analysis. (2) Only articles with an empirical or theoretical focus on the reasons for auditors’ failure in fraud risk assessment or fraud detection were included. (3) Only peer-reviewed academic articles written in English were considered in this paper. (4) Following the approach of Moll & Yigitbasioglu (2019), the review was not limited to a journal list. Still, attention was paid to papers published in leading accounting journals cited in the Association of Business Schools Academic Journal Guide 2021.

The following keywords were used in the search: fraud AND auditors; fraud risk assessment AND auditors; fraud detection AND auditors; fraud prevention AND auditors; fraud, auditor, AND failure; fraud, auditor, AND issues; fraudulent financial reporting AND auditors.
To identify relevant studies, paper titles, keywords, abstracts, and primary texts were searched for these terms. When a relevant paper was identified, the reference list was examined to ensure that other vital contributions were not missed. Afterwards, the keywords were refined based on how the fraud was described in these articles to locate other relevant articles. In subsequent stages of analysis, the contents of relevant sources were read to ascertain the focus, scope, and, where relevant, the methodology. During these processes, specific articles were excluded from subsequent analysis. For example, they focused on fraud but were not connected with external auditors or covered internal auditors instead of external auditors. Or they did not include issues or failures of external auditors in detecting fraud or assessing fraud risk. At the end of the data collection and selection process, a final sample of 16 papers was collected for analysis.

2.2 SLR Insights and Gaps

The systematic review shows that research exploring the reasons behind auditors’ failure in detecting fraud is sparse and predominantly based on theoretical assumptions and personal viewpoints or secondary data lacking empirical evidence. A common theme in these theoretical papers discussed how regulatory issues inhibit auditors’ ability to detect or report fraud. For instance, Rodgers et al. (2009) conclude that auditors favour the reluctance to report fraud risk due to the current low litigation risk environment in the United States. Based on secondary data, mainly enforcement actions issued by the China Securities Regulatory Commission, Firth et al. (2005) found external auditors more likely to be sanctioned if they fail to detect and report revenue overstatements rather than asset-related misstatements indicating regulators’ unequal treatment of auditors’ responsibilities in detecting fraud.

Using secondary data, Beardsley et al. (2019) identify increased client misstatement rates among audit offices that increase focus on non-audit services in the presence of audit fee
pressure compared to audit offices that do not. Asare et al. (2015) argue that conflict of interest resulting from being paid by the client will discourage auditors from testing areas where they suspect fraud to please the client. Coffee (2019) discusses that the payment of audit fees by management and external auditors’ engagement in non-audit services are reasons for auditors’ reluctance to discover fraud and proposes to give shareholders more power to appoint and fire auditors based on their audit quality. Sikka (2015b) criticised the current auditing reforms, which, from his perspective, continue to be grounded in neoliberal ideology and are unlikely to address the fraud crisis for several reasons. In his words, these reasons include:

"Auditors remain dependent on company directors for their appointment, sale of consultancy services, and fees and cannot be independent. The industry is dominated by just four firms that command considerable financial and political resources to advance their interests. The audit files are not available to stakeholders, and thus inadequacies do not easily come to light though regulators may occasionally speak about them in a general way. Even when auditors are found guilty, the penalties are low."

Based on a theoretical model, Patterson and Smith (2003) argued that the concept of materiality provides a basis for auditors to ignore minor misstatements. Chong (2013) argues that requiring auditors to be aware of the possibility that fraud may exist is not enough to resolve the fraud detection deficit. The audit standards remind auditors of their duty of care serving a symbolic function, but auditors’ failure in fraud detection is due to differences in skill sets and task objectives between financial statement audits and fraud detections. Asare et al. (2015) point out that current audit standards provide several examples of incentives and opportunities but minimal guidance on integrating these multiple factors into a fraud risk assessment, which could inhibit auditors’ success in fraud risk assessment.
Other theoretical papers suggested that auditors’ failure to discover fraud pertains to the audit profession’s reluctance to accept responsibility for fraudulent financial reporting detection (Reinstein & McMillan, 2004). It may also be attributable to mistakes around the audit process, auditor inherent factors, institutional factors, and morality (Kleinman et al., 2020). Emphasising the significance of morality, Morales-Sánchez et al. (2020) discuss that promoting the ethical behaviours of auditors improves audit quality. They elucidated that the audit quality is improved because the ethical behaviour of the auditor is favoured to report the material misstatements and guarantee their independence, integrity, objectivity, professional secrecy, professional diligence, and responsibility.

Only very few studies provided empirical evidence through experiments; however, their results were not informed by the views of external auditors and were inconsistent. A common theme was also regulatory issues. For instance, Singer & Zhang (2017) indicate that longer audit firm tenure leads to less timely discovery and correction of misstatements. In contrast, Carcello & Nagy (2004) did not find evidence that fraudulent financial reporting is more likely given extended auditor tenure. Patterson et al. (2019) show that audit risk (the probability that fraud exists and goes undetected) is lower during audit tenure than with a change in auditors. Another study by Reffett (2010; 2011), also based on an experiment, showed that the current auditor liability system might incentivise auditors to avoid investigating fraud. In particular, the current US legal system is more likely to hold auditors liable for failing to detect fraud when the auditors investigated for the perpetrated fraud, relative to when the auditors did not investigate for the fraud.
To sum up, the audit literature has given little attention to the reasons behind auditors’ failure to discover fraud. This systematic review reveals that prior studies were mainly based on theoretical assumptions, personal views points, or secondary data. Besides, the results of the few empirical studies identified in this review were not informed by the views of external auditors. They were also based on experiments that cannot measure phenomena related to a human's intention, attitudes, and thoughts because these concepts may not be observed or measured without evidence. In some situations, the respondents may choose random answers rather than genuine responses, or they could not be allowed to have the flexibility to give answers which are more relevant to their cases (Pham, 2018). Semi-structured interviews are the best method for addressing “why and how” questions as they allow interviewees to provide their views through free-flowing discussions, resulting in rich insights (Bryman, 2012). The absence of interview-based studies in this area means that having a deeper understanding of the inhibitors to auditors' success in discovering fraud remains an underexplored issue. To fill these gaps, the present research draws on an inductive approach to explore this under-researched issue. It interviewed twenty-four experienced external auditors to explore why auditors may fail to discover fraud.

3. Methodology

Data Collection, Study Participants, and Sampling

Semi-structured interviews were conducted with twenty-four experienced Big 4 auditors between 2017 and 2018. Four interviews were conducted with audit partners, 11 with audit managers and nine with senior auditors. Big 4 auditors were chosen as research participants because auditors in Big 4 audit firms are considered highly knowledgeable and experienced compared to other audit firms (Fuerman, 2004; Eshleman & Guo, 2014; Chen et al., 2016; Jiang et al., 2018) despite the criticism that auditors currently face.
Given the nature of the research questions, the experience of auditors in auditing was a crucial factor. Therefore, auditors with at least five years of audit experience were asked to participate in the study. Respondents who have insufficient knowledge or experience may have deliberately guessed at the answer, a tendency known as an 'uninformed response,' which reduces data reliability (Saunders et al., 2009).

All study participants were located in Egypt at the interview time; however, they all have international audit experience and have worked in various countries, including the US, UK; Canada; Dubai; Qatar, Bahrain, and Saudi Arabia. It is important to note that participants' views about the current research issues reflected their practice and experience in all the countries they worked in and were not restricted to one particular context. This was confirmed with all participants through probe questions during the interviews.

Snowballing was used for sampling purposes. I started by approaching two personal contacts and audit partners at two Big 4 audit firms. Then, I asked them to seek the permission of other auditors interested in participating in the current study. In auditing, the snowballing approach can work well, even when researching firms, as the pool of experts in some areas is so tiny that they know their peers in other firms (Malsch & Salterio, 2016). Regarding sample size, I followed recommendations for qualitative research to continue interviewing until no new information is collected from additional interviews, a term called "saturation" (Teddlie & Tashakkori, 2009). Qualitative researchers have found that saturation occurs well before reaching the end of their sampling plan, which generally involves between 15 and 30 interviews (Guest et al., 2006; Malsch & Salterio, 2016).
Several measures were taken to ensure the trustworthiness of the data. A semi-structured interview script with open-ended questions was developed in consultation with four senior academics and five experienced auditors. The interview schedule has also gone through a risk assessment check in one of the Big 4 audit firms to clarify questions and participants' anonymity. Permission was sought to digitally record each interview, granted in each instance except for one. Notes were taken during the interviews to reduce errors and ensure reliability. To maintain credibility, a copy of the transcripts was sent to each interviewee, and they were asked to confirm they were happy with the recorded responses and if any changes were required.

The research addressed all relevant ethical issues, including anonymity, confidentiality, anxiety/stress to participants, and loss or damage to data. Consistent with protecting each interviewee's anonymity, Table 1 provides high-level descriptive data, including their code, rank, years of audit experience, and education. These codes are used as identifiers in quotations from interviews reported herein. These codes were also used instead of participants’ names to ensure anonymity. Raw interview data, including participants’ personal data, has been deleted to ensure confidentiality, as agreed with the participants. The University’s ethics committee thoroughly reviewed the research proposal and all interview documents before granting approvals, and ethical approvals were obtained before using any human participants in this study. A copy of the interview schedule, participants' information sheet, and consent form are available upon request.

(Insert Table 1 here)
The interviews lasted 50 minutes on average. Fourteen interviews were conducted via Skype, and ten were conducted via regular phone calls. The participants were first asked if they had ever encountered fraud during their audits. Then, they were encouraged to provide as many details as possible about their experiences in identifying fraud, if any. In particular, what actions have they taken, whether they have reported the fraud, and if not, why. Those who did not detect fraud were then asked to clarify the reasons. Afterwards, all participants were asked to discuss any inhibitors to their ability to detect and report fraud. Probe questions were used to clarify participants' responses and encourage them to share more details if needed.

Data Analysis

The data were analysed using thematic analysis, which involves identifying, analysing, and reporting patterns or themes within data (Saldana, 2016). Thematic analysis is one of the most popular qualitative analysis techniques and an appropriate method for understanding experiences, thoughts, views, or behaviours across a data set (Kiger & Varpio, 2020). There are two approaches to thematic analysis: Inductive and deductive. The inductive approach involves deriving meaning and creating themes from data without preconceptions, thus allowing themes to emerge from the data. A deductive approach involves using pre-existing coding informed by prior research (Varpio et al., 2019). Given the lack of interview studies in this research area, I followed the inductive approach, where themes are derived from the interview data.

The most widely-accepted framework for conducting thematic analysis involves a six-step process suggested by Braun and Clarke (2006): (1) Familiarisation with the research data, (2) generating initial codes, (3) searching for themes, (4) reviewing themes, (5) defining and naming themes, and (6) producing the report. Following Braun and Clarke’s six-step approach,
the thematic analysis process started with a thorough overview of all the data collected before analysing individual items, transcribing the interview audio, reading through the text and taking initial notes, and generally looking through the data to get familiar with it. Afterwards, initial codes were generated from the data set. In qualitative research, codes are labels assigned to a piece of text to identify and summarise concepts in the interview data related to the research aim and questions (Tracy, 2019). As a sole researcher, I have conducted the coding process to ensure a consistent approach. However, I asked an independent researcher, an expert in qualitative data, to review the coding process to ensure consistency and reliability (Cohen’s kappa 0.87).

Codes are vital as they are a foundation for themes. Qualitative researchers look for patterns or themes in the codes. Grouping the codes into themes serves as a way of summarising sections of the data in a way that helps answer the research question(s) (Kiger & Varpio, 2020). I worked through the data and the codes to identify themes and subthemes. Subthemes are subdivisions of themes that focus specifically on an aspect within the theme that is significant or relevant to your research question. All themes are then reviewed and defined to ensure their clarity and link to the current research issue. Three themes were identified in the current study representing the key inhibitors to external auditors’ success in detecting and reporting fraud: (i) Ethical issues, (ii) regulatory issues, and (iii) audit firms’ governance issues. Each one of these themes has subthemes.

To present the study’s results, the cases shared by external auditors in this study are first presented, and quotes are included to aid in the understanding of specific points of interpretation and demonstrate the prevalence of the themes following the previous qualitative research approach (Nowell et al., 2017; Eger, 2021). A unique identifier accompanies all quotes
to demonstrate that various participants represented the results. Afterwards, the prevalent themes are discussed to elucidate the main inhibitors to external auditors’ success in detecting and reporting material misstatements due to fraud. These themes were identified after carefully analysing the study participants’ cases.

4. Results and Discussion

As mentioned in the methods section, participants were first asked if they had managed to detect fraud during the ordinary course of the audit. Those that managed to detect fraud were then encouraged to share as much detail as possible about their experience. In particular, what actions have they taken, whether they have reported the fraud, and if not, why. Out of the 24 participants, 75% reported that they had managed to identify instances of fraudulent financial reporting during the ordinary course of the audit and shared twenty-two cases and the actions taken in each case. Those that did not manage to detect fraud (n=6, 25%) were then asked to clarify the reasons for this. Fraudulent financial reporting is the least common but costliest insider fraud type causing a median loss of $593000 to most victim organisations, as reported by the Association of Certified Fraud Examiners in its 2022 global fraud study (ACFE, 2022).

The analysis of the participants’ responses highlights three overarching themes elucidating the critical reasons for auditors’ failure in detecting and reporting fraud. These three themes include (i) Ethical issues, (ii) audit firms' governance issues and (iii) regulatory issues. Figure 1 illustrates these three themes and their related sub-themes. The cases that auditors share in this study also elucidate how the conflict of interests operates in audit practice, impacting auditors’ ability to detect and report fraud.

(Insert Figure 1 here)
Theme # 1 - Ethical Issues

The results show that most external auditors (n=16, 67%) faced undue pressure and threats from either dishonest audit clients or audit partners, mainly when fraud-related issues were raised. Unfortunately, in most cases, auditors submitted to these threats as they were conflicted by their desire to keep their jobs or receive audit fees. In other cases, they suffered severe audit scope limitations. One participant described their view:

Audit firms face a lot of pressure from management, which limits the audit scope, taking advantage of most audit firms' time and cost constraints. Management also threatens auditors by dismissing or not paying audit fees if they do not issue an unqualified audit opinion. External auditors always face the challenge of keeping the clients and, at the same time, following the requirements of the audit standards in maintaining high-quality audits (P4)

In another case, when the misstatement was material, the audit partner was forced to change the materiality level and issue a clean report:

In one case, the tax liability was manipulated. The matter was raised to the audit partner, who referred the matter to the board of directors, and an adjusting entry was required. The board of directors refused to prepare the adjusting entry, the audit partner was forced to increase the materiality threshold, and a clean report was issued due to fear of upsetting the client and losing the audit engagement (P7)

An audit manager reported that management’s pressure and intimidation are even more challenging for auditors when the Chief Executive Officer (CEO) of an audit client happened to be an ex-audit partner:

Auditors could be unlucky if an ex-audit partner happened to be the CEO of an audit client. In one case, this happened to me, and the CEO's rationalisation and intimidation were a real challenge. He always argued with me, and one day he rationalized an incorrect accounting treatment related to the research and development account. When we disagreed, he imposed restrictions on the audit scope, and I could not complete the inventory count. (P16)
This finding supports the results of Daoust and Malsch (2019) that auditees can actively influence staff auditors' professional judgment and scepticism, especially when the client is a former auditor.

In other cases (n=4), even when auditors uphold integrity and challenge management, the result is immediate audit firm dismissal, withdrawal from the audit engagement, or a disclaimer due to severe restrictions on audit scope imposed by dishonest management. The comments of some participants were:

The sales manager in a company created fictitious sales. This fraud was discovered by understanding the business and its industry by reviewing sales contracts. We also found missing proof of actual sale, alerting us to this issue. We raised the matter to the board of directors, who did not cooperate with us at all. We issued a qualified opinion, reported the matter to shareholders, and advised the board to contact a legal advisor. But unfortunately, we were immediately dismissed, and no legal actions were taken by either the board or the shareholders (P16)

A client was overstating revenues by creating fictitious accounts receivable. The amount was material, so we raised the matter to the board of directors, and an adjusting entry was required. However, the board of directors refused to cooperate and threatened to fire us. We did not submit to their threats and decided to collect more evidence before issuing a qualifying report. But the board limited our scope severely, and we ended up issuing a disclaimer (P11)

In one case, management committed improper asset valuation by overstating inventory. The auditor detected the scheme through inventory count. The issue was first discussed with management, who disagreed with doing the required changes. The matter was then referred to the audit committee and the board of directors, but no support was given. We had to withdraw from the engagement due to severe limitations and threats of dismissal (P3)

Dishonest management pressure on auditors to bend the rules was also evident in previous real fraud cases. Apostolou et al. (2001) find that Andresen auditors admit that Enron management often pressured them to accept their aggressive accounting practices and to search for lines of acceptability. Therefore, the current study’s results indicate that audit clients’ pressure on auditors to disregard high fraud risk is a persistent issue.
Other cases show how dishonest audit partners deal with auditors' concerns at the higher echelons. Some auditors (n=10) reported that audit partners collude with the audit clients to cover up misstatements, while in other cases, they turn a blind eye to misstatements due to fraud to avoid upsetting audit clients. Other audit partners would intimidate and threaten the audit team by dismissal should they consider fraud risk assessment in an audit assignment or actively try to look for fraud. The auditors submit to such threats due to fear of losing their jobs. The following quotes show the experience of several participants with dishonest audit partners:

*Sometimes collusion occurs between audit partners and clients, making it very difficult for senior auditors and audit managers to report a fraud case if it was detected during the normal audit course. We all have families to feed, and threats like these are challenging (P 22)*

*In most cases, when a fraud-related issue is communicated to an audit partner, no further actions are taken because of fear of losing the client. In most cases, the client is advised to modify the financial statements, and then a clean report is issued. A qualified opinion is only issued if the client refuses to modify the financial statements as requested by us, but this rarely happens given audit partners' tendency to please audit clients (P17)*

*A company CEO once committed asset valuation using low depreciation rates to record fewer depreciation expenses. It was discovered by reviewing the company's accounting policy for depreciation. The matter was raised to the senior audit partner, who assured me he would deal with it. However, the next day I discovered that I was removed from the engagement, and a clean report was issued (P15)*

*Sometimes the audit process is tailored to serve clients' needs rather than achieve the actual audit objective. Unfortunately, this is the reality of the situation. We are advised in our first starter training by Senior Audit Partners that audit is a business and that we have to keep clients happy, shall we wish to keep our jobs (P24)*

*I once discovered a material overstatement of revenues where management was involved. So, I reported the case to the audit partner, who assured me the issue would be dealt with. The next day, I realised that I had been removed from the audit engagement. When I confronted the audit partner, he said to me: "let us not complicate the matter. The manager said it is an error rather than fraud" (P20)*
Fighting fraud and unethical behaviour starts at the top of the organisation. The tone at the top reflects leaders' integrity and ethical culture within an organisation. If the tone set by top management upholds ethics and integrity, employees will be more inclined to follow those same ethical values. However, if top management seems unconcerned about ethics and fraud, employees will find it an opportunity to defraud the organisation (Kassem, 2022). The ethical issues presented in this section reveal that audit firms do not emphasise the tone at the top enough, which is evident from how some audit partners treated auditors who reported fraud. The results show that some audit partners are enablers of fraud rather than guardians of financial statements' credibility and suggest that unless the tone at the top in audit firms changes, auditors will be unwilling to report fraud and raise fraud-related issues. Therefore, the findings emphasise the significance of promoting ethical behaviour within audit firms to encourage auditors to report fraud and agree with Morales-Sánchez et al. (2020) that an auditor's ethical behaviour is necessary to report material misstatements.

**Theme # 2 – Audit Firms’ Governance Issues**

Effective audit firms’ governance is crucial in ensuring accountability. According to the FRC’s governance code, audit firms should establish policies and procedures for complying with applicable legal and regulatory requirements and international and national standards on auditing, quality control, and ethics, including auditor independence (FRC, 2016b). However, this study’s results reveal various audit firms’ governance issues inhibiting auditors’ ability to detect and report fraud. For instance, many participants (n=16, 67%) mentioned a lack of emphasis on fraud risk assessment and denial that fraud risk assessment is an integral part of the audit process. They reported that their audit firms do not consider fraud risk assessment a priority due to time and cost constraints. Consequently, with less emphasis on fraud risk assessment at the corporate level, it is hardly incorporated into audit methodologies:
The audit profession is not mature or sophisticated enough to deal with ethics or fraud in a highly professional way. We simply do not regard fraud risk assessment as part of our audits, as we do not have the time or capability to deal with fraud. (P1)

Fraud risk assessment is not one of the main concerns of external audits. Unless some conditions or circumstances make auditors believe financial reporting fraud risk is high, fraud risk assessments will not be considered (P4)

If discovered by chance, we might deal with fraud, but we will not really focus much on fraud risk assessment and fraud-related audit procedures. We do not have time for this (p11)

This finding supports Reinstein and McMillan's (2004) argument that auditors’ failure to discover fraud pertains to the audit profession’s reluctance to accept responsibility for fraudulent financial reporting detection.

Others referred to the lack of monitoring of the audit team’s compliance with the requirements of fraud-related standards (e.g., ISA 240; SAS 99):

In my company, we do not monitor the audit team's adherence to the requirements of ISA 240. Top management does not see fraud risk assessment as a priority. Fraud risk assessment, in general, could be very time-consuming and costly (P6)

Most participants (n=23) indicated that the lack of anti-fraud training is a critical inhibitor to auditors' success in detecting fraud. They reported that their audit firms ignore anti-fraud training and discourage auditors from pursuing fraud-related training or qualifications:

Management can cover up thefts and manipulate the figures of the financial statements in a way that might be beyond the auditors' ability to discover. We need training in fraud detection to be able to succeed in this (P20)

The lack of guidance in fraud risk assessment or in showing the importance of assessing fraud risks as part of the audit work in most audit firms creates inconsistencies in fraud risk assessment methodologies and makes it difficult for us to detect material fraud (P23)

Audit firms do not guide how to maintain professional scepticism or how to challenge management, and there is no emphasis on the discussion of the audit team about the susceptibility of the client's firm to fraud (P13)
One auditor shared their experience when attempting to reimburse the cost of external anti-fraud training, and as he described it:

When I graduated from the University ten years ago, I was very excited to start my job as an external auditor. Back then, we learned that fraud risk assessment is integral to the auditor's job. However, I was hit by reality when my audit manager refused to reimburse the cost of an external anti-fraud training I attended externally because he believed fraud risk assessment was not a concern in the audit. He even refused to recognize this training as part of my CPD (P9).

Eight participants added that they classify all manipulations as errors without question due to the lack of training on identifying fraud and differentiating it from error:

If fraud were discovered, we would generally be happy with requiring adjusting entries rather than reporting the matter to shareholders or advising the client to consult a lawyer because we are not trained to identify fraud from error (P15).

Audit firms’ reluctance to invest in anti-fraud education and training is a concern, and auditing is a profession built on knowledge and training (Marriott et al., 2011). Therefore, educating auditors and ensuring their competence should be a priority for audit firms.

Theme # 3 Regulatory Issues

The results uncover three key regulatory issues contributing to auditors’ failure to discover and report fraud, including (i) the payment of audit fees by management, (ii) the lack of legislation protecting auditors from the retaliation of dishonest audit clients, and (iii) insufficient guidance in the fraud audit standards (ISA 240; SAS 99).

From the participants’ perspectives, management’s payment of audit fees is a crucial inhibitor to auditors’ ability to detect and report fraud because it creates a conflict of interest dilemma that could impair auditors’ independence. This finding supports the arguments of prior studies that the payment of audit fees by management is a reason for auditors’ failure to discover fraud (Asare et al., 2015; Sikka, 2015b; Coffee, 2019).
The participants added that it is very challenging for auditors to do what is expected concerning fraud when no laws protect auditors from dishonest audit clients’ retaliation. Admittedly, we cannot expect auditors to be bloodhounds without adequate regulations and mechanisms ensuring auditors’ independence and protecting auditors from the intimidation of dishonest audit clients. As some participants put it:

*Everywhere I practised auditing, there was a tendency towards pleasing and keeping audit clients, and the external auditors’ lack of independence is a concern. Sometimes, there are huge discrepancies between a public auditor's report and the audit report from other private audit firms for the same company. I think the issue of the audit fees and the fact that auditors are still paid by management is the main reason for auditors' reluctance to detect fraud and comply with the requirements of audit standards (P11)*

*Sometimes collusion occurs between audit partners and clients, making it very difficult for senior auditors and audit managers to report a fraud case if detected during the regular audit. The payment of Audit fees by audit clients is the main reason for this and not just the integrity of audit partners. We all care about keeping our jobs, so if at least the audit fees were paid by an independent professional body or regulator, we would have no reason to fear management's threats (P24)*

Some participants shared their concerns about the lack of legislation protecting auditors from the retaliation of dishonest audit clients, which prevents honest auditors from discharging their duties:

*Auditors could easily be intimidated and threatened by management. There are no legislations or effective mechanisms anywhere in the world protecting auditors' rights, shall they detect and report fraud. So, honestly, I do not think it is fair to expect too much of auditors with very little support (P4)*

*Auditors' independence and integrity will remain a big issue because of the lack of legislation protecting our rights and holding audit clients accountable when they fire us shall fraud be detected and reported. Imposing sanctions on auditors will not change the fact that they are still concerned about losing their jobs, especially with the lack of laws protecting auditors' rights (P15)*
The results reveal that insufficient guidance in the current fraud audit standards (SAS 99; ISA 240) is another crucial regulatory issue impacting auditors’ success in detecting fraud reported by more than half of the participants (54%, n=13). Although the participants generally agreed that ISA 240 and SAS 99 help detail auditors’ responsibility for fraud detection, they believe that the standard has several limitations and did not help enhance their ability to detect fraud. These limitations are summarised in table 2 below.

(Insert Table 2 here)

As noted in table 2, one limitation is that the standards show what auditors should do to assess fraud risks but not how to do it (n=11). In particular, the auditors explained that ISA 240 and SAS 99 require auditors to consider fraud risk factors such as motives, opportunity, rationalization of fraud, and management integrity. However, they did not guide on incorporating them into the audit process. In short, for these auditors, both standards are more theoretical rather than practical guides. As one participant put it:

*I am well aware of SAS 99 and ISA 240 and could definitely say that both standards lack practical applications and examples. They show what we should do to assess fraud risks but do not show how we could do it (P3)*

The study’s findings agree with Asare et al. (2015)’s conclusion that current audit standards provide several examples of incentives and opportunities but minimal guidance on integrating these multiple factors into a fraud risk assessment, which could inhibit auditors’ success in fraud risk assessment.

The participants added that the audit standards are missing essential guidance concerning proving management’s intent to deceive, which is a differentiating factor between fraud and error (Wells 2011). They further highlighted that their inability to prove intent prevents them from reporting fraud and holding management accountable for their manipulations. The
auditors could not prove intent in three other cases; thus, the misstatements were classified as errors rather than fraud. The auditors explained that management often denies that misstatements result from fraud when confronted. In such cases, the auditors require management to adjust entries to correct misstatements. Unfortunately, the audit standards do not guide auditors to prove the intent to deceive, nor do audit firms. The intent to deceive differentiates fraud from error. Hence, failure to guide auditors prevents them from holding corrupt audit clients accountable. As put by some auditors:

Management's ability to rationalise fraudulent acts as errors or unintentional mistakes and intentions is challenging for auditors to prove or assess, especially with no professional training or guidance in this area. Management can cover up thefts and manipulate the figures of the financial statements in a way that might be beyond the auditors' ability to discover. Unless we have proper guidance on fraud, particularly how to prove the intent to deceive and audit management motives, we will never detect fraud. This guidance must be provided in audit standards, our primary benchmark. Let us also be frank; audit firms do not have time to provide such guidance (P2)

I once discovered a case of concealed liability involving the CFO, but unfortunately, I could not prove management's intent to deceive. Therefore, the case was classified as an error rather than a fraud. The proof of intent to deceive is complicated, especially with the lack of professional guidance in this area. ISA 240 and SAS 99 do not mention any examples of how auditors could detect management's intent to deceive (P3)

I have encountered a case where management was involved in an overstatement of fixed assets. Management was challenged, and an adjusting entry was recommended. However, the case was classified as a lack of knowledge rather than fraud. An unqualified report with an explanatory paragraph was issued, and no further actions were taken. Unfortunately, this is down to the fact that we cannot prove such practices are intentional or not (P21)

Moreover, as pointed out by ten auditors, both standards lack examples of management's inquiry about fraud-related matters that could help external auditors be more sceptical. The standards also lack guidance on maintaining professional scepticism and conducting brainstorming sessions effectively. The auditors believe that the audit standards are benchmarks for auditors and that depending on audit firms to provide fraud-related guidance
is unrealistic and risky; most audit firms do not consider fraud risk assessment a priority. As
some of them put it:

Fraud audit standards such as SAS 99 and ISA 240 are too general and vague, which opens the door for more inconsistencies among audit firms in their fraud risk assessment methodologies. If the standards do not tell us exactly what we are supposed to do and how then we should not be blamed (P1)

More emphasis and guidance are still needed on professional scepticism, management’s motivation behind fraud and its impact on the financial statements, and the audit team’s discussion about the client’s firm’s susceptibility to fraud. Such guidance is indeed missing in both audit standards (P5)

We are less likely to detect fraud because we need practical examples and guidance on assessing and responding to fraud risks that are currently lacking in the audit standards. Depending on audit firms to provide that guidance is risky as most of them do not consider fraud risk assessment an essential part of the audit (P20)

Not all auditors have the necessary skills to understand fraud’s nature, identify fraud risk factors and respond to it as required by ISA240 or SAS99. So, we need sufficient guidance in the audit standards. To be frank, guidance in audit standards is our only way to understand the nature of fraud, given the lack of guidance in our audit firms (P8)

The audit standards are considered benchmarks and the main determinants of auditors’ liability. With the absence of anti-fraud education and training in some audit firms, audit standards could be the only way to enhance auditors' skills in fraud detection. Auditors and investors know compliance with auditing standards by comparing actual auditor efforts to precise standards. This comparison will be difficult if audit standards are not precise and lack essential guidance (Simunic et al., 2015). So, the current study argues that there is a need for comprehensive, clear, and precise fraud guidance in the audit standards for the auditors to comply with. A lack of know-how in fraud risk assessment will force auditors to overlook fraud risk assessment. Unclear guidance in audit standards will also lead to audit firms’ inconsistencies in fraud risk assessments.
The results also show that most auditors in the reported cases (54%, n=13) chose not to report fraud to shareholders, regardless of materiality levels, simply because management cooperated with them in making the required adjustments. One of them said, “To meet bank debt covenants, a family-owned business's finance manager misclassified liabilities from short-term to long-term. A reclassification entry was required, and management was cooperative, so no further actions were taken” (P9).

This raises the question of whether it is enough for auditors to request adjustments in the financial statements when misstatements are identified and whether the audit standards' requirements concerning reporting misstatements are clear enough. Fraud-related audit standards (ISA 240; SAS 99) require external auditors to communicate any fraud-related matters to management and those charged with governance on a timely basis. The standards also added that if external auditors suspect that management or those charged with governance might be involved in fraud, auditors should determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Therefore, both audit standards left this matter to auditors' professional judgment and failed to provide enough guidance to ensure a consistent approach to reporting fraud.

Materiality judgment also seems to discourage auditors from reporting fraud. In two cases reported by participants in this study, they said that the amount of misstatement was immaterial, and thus no actions were taken to report the fraud. This finding may imply auditors’ misunderstanding about their responsibility for fraud concerning materiality judgment. ISA 240 advised that judgments about materiality involve qualitative and quantitative considerations. In the case of fraud, the qualitative aspects of materiality should prevail even if it is less than the quantitative materiality thresholds, especially if top management is involved.
in fraud. Another possible interpretation is that auditors may use materiality as a justification for not reporting fraud, which aligns with the conclusion of Patterson and Smith (2003).

5. Implications, Limitations, and Recommendations

The study findings have implications for research, audit practice, and policymakers. From a research perspective, this is the first study to provide evidence from the audit field on the inhibitors to auditors’ ability to discover and report fraud. The views and experiences of external auditors did not inform the results of prior studies in this area. Therefore, this study advances the audit literature by providing new practice-based evidence. The study identifies various ethical, governance, and regulatory issues contributing to the fraud detection issue.

It also suggests new directions for fraud research to open up academic debates in the area of fraud detection in the audit literature. In particular, it recommends that future research explore how auditors could assess management integrity, motivations to commit fraud, and management’s ability to rationalise fraud. Auditors in this study reported professional guidance in these areas is missing in the fraud audit standards and not provided by audit firms. Another concern auditors raise is their inability to prove management’s intent to deceive, which is a critical factor in differentiating between fraud and error. Hence, proving the intent to deceive is another area that needs future research attention. One limitation of this study is that it did not explore the impact of client size on auditors’ ability to detect and report fraud. Therefore, this area should also be considered by future studies.
From an audit practice perspective, this study identified various governance issues that audit firms should consider to improve audit quality and avoid reputational damage and penalties due to failure to detect fraud. In particular, (i) power issues within audit firms and how auditors' concerns are dealt with at the higher echelons by corrupt audit partners, (ii) attempts to ignore the requirements of the audit standards concerning fraud risk assessment, and (iii) less emphasis on anti-fraud education. Hence, the findings imply the need for audit firm governance reform, emphasising the tone at the top, anti-fraud education, and monitoring to ensure leaders are not abusing their power and that the audit standards’ requirements are fulfilled. Setting the right tone at the top requires leaders to set an ethical example of how their employees should behave in the workplace and provide a safe mechanism for reporting fraud and unethical behaviour (Kassem, 2022). Hence, this study recommends that audit firms aspire to monitor their organisations' ethical climate. They should also encourage auditors to report fraud risk when identified in audit client’s organisations.

Audit firms should emphasise the importance of fraud risk assessment and promote an anti-fraud culture. They should also provide anti-fraud training where auditors should learn that they are guardians of financial statements' credibility and not management's advisors. Auditors should also be advised to uphold ethics and integrity despite management's and superiors' pressure and threats. While this could seem complicated due to the fear of losing audit clients or jobs, the argument should be that if auditors' lost their independence and integrity, the public would lose faith in the value of and need for an external audit, which is a more significant threat to the audit profession's existence. Professional bodies should also incorporate ethics and anti-fraud education in the curriculum of professional audit qualifications. This aligns with the suggestion of Sir Donald Brydon in the 2019 Report of the Independent Review into the Quality and Effectiveness of Audit in the UK that training in both forensic accounting and fraud
awareness be part of the formal qualification and continuous learning process to practice as a financial statements auditor (Independent Review into the Quality and Effectiveness of Audit (publishing.service.gov.uk)).

*From a policy perspective,* this study uncovers that management's payment of audit fees significantly threatens auditors’ independence and willingness to detect and report fraud. Hence, the study urges regulators to shift audit fees payment from the audit client to an independent professional body to enhance auditors' independence. This study also shows that some audit partners collude with managers to cover up misstatements for fear of losing audit engagements and sometimes intimidate and threaten auditors who raise fraud-related issues. Therefore, this study suggests that regulators (e.g. FRC in the UK or SEC in the UK) establish an anonymous and secure whistle-blowing line to encourage honest auditors to report any intimidation threats or pressure, either from audit clients or audit partners to enable fraud and violate the audit standards. Seifert et al. (2010) conclude that whistle-blowing policies and mechanisms with higher levels of justice were perceived to increase an employee's likelihood of reporting fraud.

Further, the results reveal that audit firms do not (i) provide nor encourage anti-fraud training, (ii) consider fraud risk assessment a priority due to time and cost constraints, and (iii) regard fraud risk assessment as an integral part of the audit. Consequently, with less emphasis on fraud risk assessment at the corporate level, it is hardly incorporated into audit methodologies. This indicates the need for regulatory monitoring, emphasising effective audit firms’ governance with more emphasis on their tone at the top and commitment to integrity and ethics and their fraud risk assessment methodologies. Besides, auditors must be reminded that fraud risk assessment is integral to the audit. This study reports that auditors use time and cost constraints as excuses for ignoring fraud risk assessment.
Moreover, the limitations in the audit standards reported by auditors in this study imply the need for revisiting current audit standards (SAS 99; ISA 240). The FRC (2016a) asserts that it is essential that regulators set standards and follow up by seeing how they are put into practice and asking the auditors whether they are working and then revising them. This study provides a list of issues with current fraud audit standards informed by the views of experienced external auditors. Therefore, the findings could draw policymakers’ attention to the changes required in these standards.

Finally, adequate legal actions should also be taken against audit clients or firms that threaten, intimidate, or obstruct auditors’ work. Besides, audit firms or audit partners who fail to detect fraud or promote anti-fraud culture should be severely penalised by audit regulators. The penalty should be not only a financial fine but also a loss of license to practice or prosecution for conspiring with audit clients to cover up fraud. As Hess (2019, p. 151) noted, “*A common argument in favor of corporate criminal liability is that prosecution for violating the criminal law sends a stronger message to the market and non-market actors than a civil liability*”.

6. CONCLUSION

This study explores the reasons behind external auditors’ failure to detect and report fraud. The results are based on the views of twenty-four experienced Big 4 auditors collected via semi-structured interviews. The study highlights power issues within audit firms and how auditors' concerns are dealt with at the higher echelons by audit partners. The results also reveal how auditors are pressured and intimidated by audit clients when fraud risk is highlighted. The study identifies several ethical, governance, and regulatory issues as inhibitors to auditors’ ability to detect or report fraud. It provides various recommendations to enhance auditors’ ability to counter fraud.
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Figure 1 Why auditors fail to detect and report fraud – A thematic analysis
### Tables

#### Table 1 Participants' Demographics

<table>
<thead>
<tr>
<th>Participant Code</th>
<th>Position</th>
<th>Audit Experience</th>
<th>Professional qualifications</th>
<th>International experience</th>
<th>Big 4 Audit Firm</th>
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<tbody>
<tr>
<td>P1</td>
<td>Audit Partner</td>
<td>13 years</td>
<td>FCA(^1); CFE(^2); ESAA</td>
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<td>Firm A</td>
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<td>P2</td>
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<tr>
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<td>Egypt; US; Qatar</td>
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<tr>
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<td>Egypt; US; Dubai; Kuwait</td>
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<tr>
<td>P9</td>
<td>Senior Auditor</td>
<td>6 years</td>
<td>ACA; CFE; ESAA</td>
<td>Egypt; UK; US</td>
<td>Firm D</td>
</tr>
</tbody>
</table>

\(^1\) FCA: Fellow Chartered Accountant, Institute of Chartered Accountants in England and Wales (ICAEW)

\(^2\) CFE: Certified Fraud Examiners, the Association of Certified Fraud Examiners (ACFE), US

\(^3\) ACA: Associate Chartered Accountant, ICAEW

\(^4\) CPA: Certified Public Accountant, AICPA, US

\(^5\) ESAA: Fellow of the Egyptian Society of Accountants and Auditors
<table>
<thead>
<tr>
<th>ID</th>
<th>Position</th>
<th>Years</th>
<th>Qualifications</th>
<th>Countries</th>
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<td>P16</td>
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Table 2 Limitations in fraud audit standards (SAS 99; ISA240)

<table>
<thead>
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<th>Limitation</th>
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<tr>
<td>No guidance on assessing fraud risk factors such as motives, opportunity,</td>
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<tr>
<td>and management integrity</td>
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<tr>
<td>No guidance on how the different types of fraud are committed and</td>
</tr>
<tr>
<td>concealed</td>
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<td>No examples of management's inquiry about fraud-related matters that</td>
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<tr>
<td>could help external auditors to be more sceptical</td>
</tr>
<tr>
<td>No guidance on how to prove management's intent to commit fraud;</td>
</tr>
<tr>
<td>No guidance on collusion in fraud cases</td>
</tr>
<tr>
<td>Insufficient guidance on maintaining professional scepticism and</td>
</tr>
<tr>
<td>conducting brainstorming sessions</td>
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<tr>
<td>Insufficient guidance on conducting brainstorming sessions and discussing</td>
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<td>the client's susceptibility to fraud</td>
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