Barriers to Fraud Risk Assessments in The Public Sector: The Deviations of SAS No.99

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Abstract. Fraud may never be fully prevented, but the detection responsibilities of auditors will continue to increase with growing public dissatisfaction of auditing results. As stated in the Statement of Auditing Standards (SAS) 99, Fraud Risk Assessment (FRA) must be performed by auditors in each audit assignment at the planning phase. On the other hand, determining the fraud risk factors has become the main issue faced by auditors due to budget and time limitations. As the impact, the auditor's competence level is not aligned with the expected results of the FRA implementation. The auditor should have a very good justification for any deviation from SAS No.99 so that it can reduce their responsibilities in finding the fraud. Hence, there is a prospect gap between auditors' role and SAS No.99 in identifying the occurrence of fraud in the business sector and the public sector. In this paper, we critically examine the constraints in implementing the FRA in the public sector audit. In this paper, we critically examine constraints in implementing FRA in public sector audits. We argue that the implementation of FRA failed so that it cannot reduce fraud in the public sector.

Keywords: fraud, fraud risk assessment, SAS 99, public sector, fraud detection, auditors' abilities

1. Introduction

Fraud has been a problematic issue in all sectors all over the world because fraud has a negative impact on the quality of life (Whitehill, 2017). Based on Certified Fraud Examiners (CFE) surveys, the typical organization has lost 5% of sales because of fraud occurrence in a given year (Association of Certified Fraud Examiners, 2016). The Cressey Fraud Triangle generally stated that during the occurrence of fraud, there will be three conditions happened such as management and employee will be under pressured, ineffectiveness of the internal control, and recognizing fraud capability (R. Kassem & Higson, 2012). When fraud prevention has failed, the methodology for detecting fraud is very important. (Bolton et al., 2002). A key aspect of detecting fraud is the establishment of an audit plan designed to carry out audit

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procedures related to fraud detection and material misstatement. (Dorminey, Scott Fleming, Kranacher, & Riley, 2012).

Both the public sector and the business sector are not immune to fraud that will cause financial losses to the organization (Holmes, Strawser, & Welch, 2000). The public sector is a part of the economy that is bound by the state and some sectors are given subsidies by the state to provide services or goods to the public (De Vries, Bekkers, & Tummers, 2016). Based on the definition, the scope of public sectors and private sectors are different whereby the public sector is referred to services that are provided by government and also state-owned organizations. Meanwhile, private sectors are good and services that are provided by non-governmental organizations and non-governmental associations (Almquist, Grossi, van Helden, & Reichard, 2013). To assess accountability in public sector organizations must be audited by external auditors (De Vries et al., 2016). Public sector auditing is very important in order to provide the information and to conduct the independent evaluation that consists of the following assessments: the realization of conducting and managing government policies and the activities or procedures to handle the public governance (ISSAI 100, 2013). The difference methods might apply by auditors to produce the reliable services and to act with veracity (Date, 2012).

The auditor's responsibility will become wider when SAS no. 99 is fully implemented because they must carry out the FRA and plan an audit procedure to detect fraud. The auditors have to determine the fraud that is related to the audit process and remain updated till the audit process completed. There are three requirement processes done by the auditor as written in SAS No.99 which are: (1) gather the necessary data to determine the visible deficiency risk due to fraud, (2) measure the risk of fraud based on the entity's assessment and managing the operations, and (3) provide an act on fraud risk assessment results. In SAS No. 99, auditors also need to gather and consider fraud risk assessment information in the past (Ramos, 2003). The responsibilities of public sector auditors are also the same in relation to the implementation of this FRA as required in SAS no 99. During the audit process, the auditor must be able to do the investigation and perform certain procedures to determine the fraud risks that are aligned with the audit objectives. They also have to be critical in determining the fraud occurrence possibility (ISSAI 100, 2013).

2. Literature Review

2.1 Statement on Audit Standard (SAS) 99

The audit objective in general is the auditor movement to ensure the financial statements fulfill the related framework for financial reporting. Meaning that, there is no room for errors which might cause by material error and fraud error (IFAC, 2016). The auditor should follow the following steps: determine the fraud risk factors and develop fraud detection procedures so that the audit purposes can be achieved. On the other hand, the audit might not able to determine fraudulent areas if the auditor cannot identify the fraud risk when the audit plan is drawn up and audit procedures are started (Schafer & Schafer, 2018). In fact, in the international audit standards, auditors have to identify fraud risk factors before the audit began. The American Institute of Certified Public Accountants (AICPA) Auditing Standards Board has delivered Statement on Auditing Standard (SAS) No. 99 "Consideration of Fraud in a Financial Statements Audit" (Sabala, 2011). Based on SAS No.99, the auditors are responsible to justify financial statements clear from the fraud errors during the audit process. Hence, the auditors should have clear planning to determine and control the fraud risk occurrence.

As stated in current audit standards and the official guidelines, the auditor is required to check the audited financial statements does not have any mistakes or fraud (Hogan, Rezaee, Riley, & Velury, 2008). There is a three-pronged framework that also known as the "fraud triangle". The fraud occurrence cases have happened because of many aspects such as under pressure, opportunity, and rationalization. The fraud triangle has been a powerful tool for Certified Public Accountants (CPA) who attempt to understand and manage fraud risk and have been officially adopted by the audit profession as part of Statement on Audit Standard (SAS) 99: Consideration (Wolfe & Dana, 2004). Adoption of the fraud triangle in SAS No. 99 is the obligation for the auditor to understand fraudulent behavior in the fraud risk assessment (Lokanan, 2015). In order to observe the pressure, opportunity, and rationalization, the auditor has to develop proxy variables for measurement purposes (Skousen & Wright, 2006). The auditors can be assisted to asses risk factors for fraud through some specific examples of management attitudes, organizational values, and personal characteristics (Johnson, Kuhn, Apostolou, & Hassell, 2013).

SAS 99 requires auditors to conduct FRA separately for each audit assignment where the auditor's ability to detect fraud is overseen by regulatory oversight (Brazel, Jones, & Zimbelman, 2009). Identifying fraud risk factors is an unstructured task that requires a fraud hypothesis, the implications of the hypothesis, an effective audit method for disclosing fraud as hypothesized (Hammersley, 2011). Identifying fraud risk factors becomes a critical issue due to budget constraints (Lin, Chiu, Huang, & Yen, 2015). The obligation of external auditors to detect material irregularities including fraud, has made auditors under pressure because they accept legal responsibility for detecting material fraud (Krambia-Kapardis, 2002). The Public Company Accounting Oversight Board (PCAOB) put the pressure on auditors on detecting high-risk fraud situations and react to those situations with a proper adjustment to planned audit procedures (Hammersley, 2011). SAS 99 mandates the improvement of documentation in certain audit areas, discussions among audit team members, including the obligation to brainstorm fraud risk factors for the entity and then establish audit procedures related to fraud detection (Marczewski & Akers, 2005).

Auditing standards provide an important foundation supporting audit quality. According to Statement on Auditing Standards (SAS) no. 99, to get this reasonable assurance, the auditors must keep a professionalism and skepticism and consider the potential for fraud in financial statements by conducting the fraud risk assessment (Abdullatif, 2013). Fraud risk assessment is defined as a process and activity to identify an organization’s internal and external fraud and overcome organizational vulnerability towards the fraud cases. Thus, the auditors have an important role to make and a plan and perform the audit so that free mistakes in financial statements can be obtained (ACFE, 2016). The purpose of fraud risk assessment is to identify possible fraud in the audited entity and suggest audit procedures to detect fraud (Institutions, 2013).

2.2 Fraud Risk Assessment

Fraud risk assessment is involved the management evaluation of the potential fraudulent schemes in the organization and corruption that might be done in internal or external of the organization. Thus, it can sustain the mitigation and monitoring of the efficiency of the internal controls which can protect mechanism. Fraud risk assessment is included three aspects which are:1) fraud risk identification; 2) inherent fraud risk assessment; 3) identification; (Cascarino, 2012).

To conduct a fraud risk assessment, the team audit must identify the risk of fraud risks simultaneously into the elements of the fraud triangle. Risks will be assessed based on professional judgment to categorize the risk according to the fraud triangle (Asare, Wright, & Zimbelman, 2015). Furthermore, the IFAC Audit Guide (2007) provides guidance related to the Fraud Risk Assessment Procedures include 1) audit team discussion, 2) identification of fraud risk factors, 3) assessment of fraud risk, 4) fraud risk register, 5) determination of significant risk, and 6) responding to significant risks (International Federation of Accountants, 2007). In the public sector, the International Organization of Supreme Audit Institutions (INTOSAI) have set the audit standard on International Standards of Supreme Audit Institutions (ISSAI) 1240 about the auditor's responsibilities relating to fraud in an audit of financial statements in the audit planning stage (Institutions, 2013).

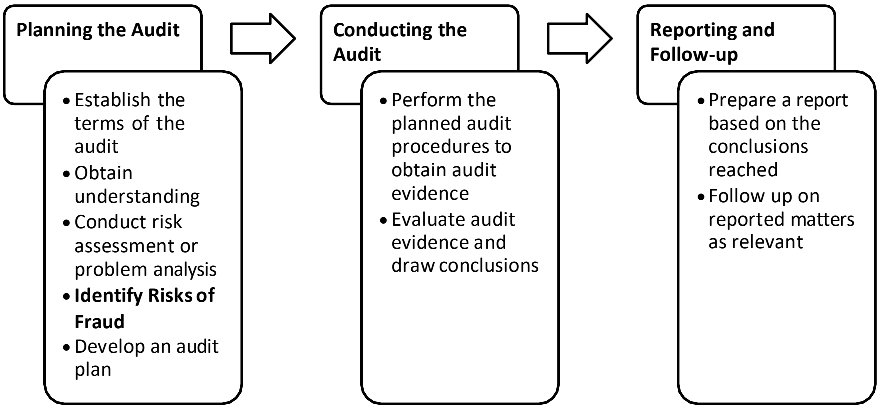

Figure. 1. Phase of Public Sector Auditing (Institutions, 2013)

Responsibility for fraud detection will support the realization of adequate audit procedures and minimize audit failure. The auditor should have a concern to identify fraud as it is required in the audit standards. The auditor might express the misjudgment due to the audit failure. The failure in the auditing can ensue because not implement the general auditing standards. In examining the application of standards, it has been revealed that although audit standards are compulsory, there is little attention and responsibility for external auditors to corporate corruption cases. (Rasha Kassem & Higson, 2016). The deadline for implementing an audit program under audit standards can reduce auditor performance and influence auditor dysfunctional behavior (Simanjuntak, 2008).

Audit planning is to decrease audit risks to an acceptably low level that consists of overall engagement audit strategy preparation and audit plan development. The engagement team involvement in the audit strategy will benefit from the experience and insight of the engagement partner and other key team members. It is also able to increase the efficiency and effectiveness of the planning activities (International Federation of Accountants (IFAC), 2013). Fraud risk assessment should be carried out by the auditor when preparing the audit plan (Institutions, 2013).

The risk assessment process for fraud comprises the following stages: 1) risk identification, 2) risk assessment, and 3) risk treatment (*Ethics and organization: The Fraud Risk Management practice in Istat*, 2017). Factors to consider when conducting FRA are assessing possibilities fraud based on previous data or similar fraud cases in other industries including the complexity of the relationship between the personnel involved in the process (Iit, n.d.). Auditing standards have suggested that auditors brainstorm during fraud risk assessments. Brainstorming has to emphasized to the auditors in order to enhance the fraud risk evaluations so that it can support the decision-making process instead of doing it individually (Nassir, Sanusi, Ghani, & Prabowo, 2016).

2.3 Public Sector Auditing Research in Previous Literature

There are many studies on auditing that concentrate on the FRA problem, but not much on the public sector audit. The effective method to reduce the auditors from diminish the audit quality is to align the accounting firms' ethical culture with professional values and also reduce the time pressure to avoid underreporting time (Svanberg & Öhman, 2016). Identifying a fraud is a complex task that necessary for auditors to understand the nature of fraud which includes how it can be done and how it can be hidden (R. Kassem & Higson, 2012). Auditors have seen an increase in their responsibility to detect fraud as a result of SAS No. 99, but many still fail to fully understand the recommendations they make for fraud detection and prevention (Sabala, 2011).

The assessment influence by the professional skepticism of the auditors that will greatly impact the risk of material misstatement. An experienced auditor is more skeptical to investigate the risk comparing to auditors who less experience. However, time pressure will give a negative impact on the assessment process. Hence, when the auditor working under high time budget pressure, their positive effect of professional skepticism on risk assessment is low comparing when they work under low time budget pressure conditions (Sayed Hussin, Iskandar, Saleh, & Jaffar, 2017). There is a significant influence between the experience, training, and auditor skepticism simultaneously on the detection of fraud (Hilmi, 2011). The audit procedures implementation to identify the fraud is influenced by specialization and independence of auditors (Sarwoko & Agoes, 2015).

The improvement of fraud risk assessment can be done by differentiate fraud risk assessment and errors in misrepresentations, Then, it is important also to share ideas on fraud risks and strategically thinking about the efforts that client management might make to conceal and hide fraud (Allen, Hermanson, Kozloski, & Ramsay, 2006). Auditors also require improving their sensitivity on fraud risk factors and effectively transform their audit plan to react to financial risk changing, or systematically allocate effective resources for all audits. These are to enhance fraud detection (Foster, 2018). The consideration auditor on fraud risk assessment will cause brainstorm and affect the number of audit procedures in detecting fraud (Chiu, Vasarhelyi, Alrefai, & Yan, 2018). In audit practicality, the auditors have a failure potential to detect fraud since the audit environment is very complex. Besides that, there a significant correlation between decreased audit quality and time pressure (Gundry & Liyanarachchi, 2007).

The components that might avoid auditor to implement the FRA and detecting fraud are as follows: 1) the auditor is unsuccessful to evaluate the management incentives of committing fraud effectively; 2) the auditor is unsuccessful in recognizing the chance for management to commit fraud and 3) the auditor does not have sufficient time to revise the audit activity. During fraud risk assessment, the auditors pay more attention to their perception of the management characteristics. It will cause a low fraud risk assessment when management considers having significant incentives and opportunities for fraud (Asare et al., 2015).

2.4 Agency Theory

The theory of agencies seeks to understand the problems that arose when one party, the agent, acts for another, the principal. The agent has many kinds of issues to deal with the directors, while the director has different issues to face the agents in order to ensure the action taken by the agents has corresponded with the standard preferences. Thus, the agency theory was developed to provide an understanding of the agency behaviors which includes two aspects. First, identify the problems and activities so that they can provide "acting for" (agent side) services. Second, the process of guiding and revising the agent actions (the main side) (Mitnick, 2014).

The theory of agencies also applies in the public sector, because citizens are in the position of the principal who has entrusted assets as agents to managers. The agency relationships of the public sectors are more complicated comparing to the private sectors. It is involved in so many factors. First, there is a correlation of the agent relationship with voters (as the principal) and politicians (as agents). However, voters are unable to perceive the legislator activities without make a payment. The advantage of any voter’s potential is too low to adjudicate the rational ignorance. Second, there is a relationship between the Government and Parliament among the agency. In parliamentary democratic government, the government has to provide the report of the budget and expenditures to Parliament. Thus, the audit has a significant role to avoid data from being subjective or manipulated by the government. Lastly, the third agency relationship that involves the government and civil servants. The issue is the conflicting interest between Bureaucrats chairmen and ministers. The Bureaucrats chairmen focus on having larger budgets for incentives, while ministers tend to eliminate leeway on budget. However, the bureaucrats have admittance to get more information (Hay & Cordery, 2018).

2.5 The Signaling Theory

Signaling theory applied to understand the behavior of two parties (individuals and organizations), when they have admittance to different information. The sender focus on deciding the communication (providing signal) approach to deliver the information, while the receiver is required to find a way to interpret the signal. Signaling theory plays a vital role in most management literatures such as: strategic management, entrepreneurship, and managing human resources. Likewise, signaling theory has been implemented in the last decades which leads to unclear core principles as applied to organizational concerns (Connelly, Certo, Ireland, & Reutzel, 2011).

The feedback of the incentives provided by the bond market; the municipal governments have incentives to release more financial data. Signalization could be fully implemented in the government. It is useful for the government in order to convince the public through public expenditures or public assets. It can be used to make a decision based on that reliable information that can assist by a credible independent audit body (Hay & Cordery, 2018).

3. Discussion

Increased law enforcement, regulatory oversight, wider control, implementation of auditing standards related to fraud, and sophisticated monitoring technology are all appropriate steps and will contribute to preventing and detecting fraud (Wolfe & Dana, 2004). Auditors work under pressure because the time provided is limited with tight deadlines (Gundry & Liyanarachchi, 2007). In addition to time pressure, auditors have problems related to audit costs, competition, and good relations with the auditee that make auditors fail to detect fraud and reduce audit quality (Koroy, 2009). When the auditors are under the time pressure, the auditors will be focused more on the main task to gather the documentary evidence on misrepresentations of financial statements. They will have less attention to misstatement quality and the possibility of fraud occurrence (Allen et al., 2006). The risk of having the time and budget constraints, the auditors put the priority more on planning and audit procedures which consider as the primary task, while fraud risk assessment considers as a secondary task (Braun, 2000).

The results of the study have shown that the higher the time budget pressure felt by auditors in the implementation of audit procedures, the more the auditor's tendency to carry out dysfunctional actions in carrying out audit tasks (Simanjuntak, 2008). An audit work environment where there is pressure on the auditor can reduce audit quality (Norbarani, 2012). If the auditors have the ability to recognize the difference of fraud risks, it might impact the audit quality since the auditors might not concern on the signal mistakes evidence. The auditors will focus more on gather fraud risks between accounts whereby having difficulty in recognizing the potential for mistakes in low-fraud risk accounts. Besides that, the auditor also pays more attention to fraud risk on the manager target on low-risk accounts for assertive financial reporting deliberately. Thus, this will affect information related to the fraud (Mubako & O’Donnell, 2018).

Fraud issues have gradually become a problematic issue for the public and private sectors (Holmes et al., 2000). Fraud is increased due to the modern technology development and the global communication superhighways. As the impact, loss of billions of dollars to due fraud every year all over the world (Bolton et al., 2002). Today, companies are facing a perfect storm of internal, external, regulatory, and reputational fraud risk (Price Waterhouse Cooper's PwC, 2008). Graph1.4 shows the reported global economic crime and fraud in the world is on the rise.

In the public-sector audit environment, government and other public sector entities are accountable for tax-derived resource usage and other sources that use to provide services for citizens and other beneficiaries. These entities are also responsible for their management and performance and resource utilization for those who provide and citizens who use those resources. Public auditing is also to ensure the public sector entities and public servants perform their roles effectively. Hence, it can create an appropriate condition and strengthen the expectation (ISSAI 100, 2013). The auditors are responsible to identify and report the fraud occurrence. So, the auditors will see the report extensively for any misspelled financial (Halbouni, 2015). Auditors also need to conduct inquiries and procedures to detect and react to fraud risks that are associated with the audit goals. They have to be critical and alert for any occurrence fraud possibility during the entire audit process (ISSAI 100, 2013).

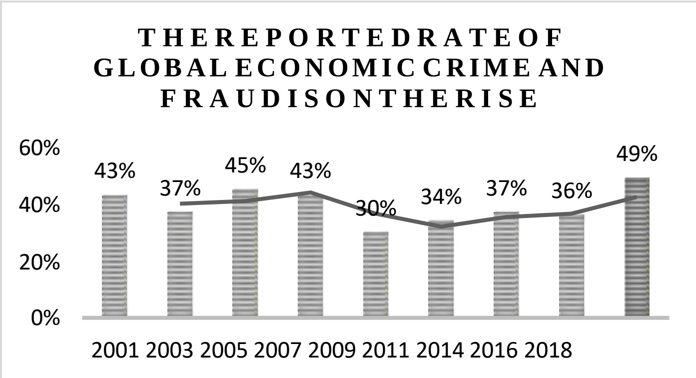

Figure 2. The Reported Rate of Global Economic Crime and Fraud

The purposes of a public sector financial audit are not only related to the material aspects to have the financial statement that is produced according to the applicable financial reporting framework (i.e. the ISAs scope). These also relate to audit and reporting responsibilities since there might be additional targets from the audit mandate including legislation, regulation, ministerial directives, government policy requirements, or legislative resolutions. These additional targets also align with general public expectations for the auditors to detect any non-compliance with authorities, including budgets and accountability frameworks, and/or reporting on internal control effectiveness. Hence, auditors should pay attention to those responsibilities and consider the fraud risks during planning and performing the audit (Ifac.Org, 2009).

Based on the audit standards, during the audit planning phase, the auditors have to able to determine the fraud risks and prepare the audit procedures to analyze the identified risk (Reffett, 2010). The responsibility for fraud detection by carrying out FRA will support the realization of adequate audit standards and minimize audit failures (Minaryanti & Ridwan, 2015). The shortcoming in the fraud risk assessment process is considered to play a significant role in the failures of audit (Asare et al., 2015). On the other hand, the outcome of the risk assessment depends on the strategic behavior interpretation of the risk evaluations. The risk assessment of errors will be high compared to the fraud risk assessment (Foster, 2018).

Fraud risk assessment involves the management to evaluate the potential fraudulent schemes in the organization. It also includes internal and external corruption assessment. The purpose is to monitor and control mitigation efficiency so that mechanisms can be protected. Fraud risk assessment comprises the following actions: 1) identify fraud risk; 2) inherent fraud risk assessment; 3) identify the structures of internal control to control mitigation risk 4) An adequacy evaluation on control structure 5) identification of critical control mechanisms within those structures, 6) testing and evaluation of the effectiveness of these critical control components (Cascarino, 2012).

4. Conclusion and Recommendation

Based on the literature review above the fraud risk assessment issues in auditing have been identified. Thus, it also explains why FRA takes into account. In another discussion, it was explained that there was time and budget pressure so that the implementation of the FRA could not be optimal even though it was required by auditing standards (SAS No. 99). The deadline for implementing an audit program in accordance with audit standards can reduce auditor performance and influence auditor dysfunctional behavior. Agency theory and signaling theory are very important in explaining fraud risk assessment in audits, and this is more complicated in the public sector. The big issue in identifying the risk factors is due to budget limitation. For future research, the researchers might focus on providing solutions to the implementation of FRA limitations.

The external auditors put under pressure due to their role to identify material irregularities including fraud to identify material irregularities. In examining the application of standards, it has been revealed that although audit standards are compulsory, there is little attention and responsibility for external auditors to corporate corruption cases. As stated in SAS No.99, the auditor is required to assess the fraud risk that includes in audit procedure as part of the fraud detection process. The auditors face difficulties to implement the FRA due to time pressure, budget constraints, and capacity shortages.

In further research, an in-depth study of the auditor's concern in implementing the FRA should be carried out. The constraints of implementing the FRA, namely time pressure, budget constraints, and human resource capabilities, are serious problems in meeting auditing standards (SAS No. 99). Thus, further research should be able to find out why and how the FRA is conducted.

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