

# **INTERNAL AUDITORS' PERCEPTIONS OF THE EFFECTIVENESS OF RED FLAGS TO DETECT FRAUDULENT FINANCIAL REPORTING**

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## **Abstract**

The purpose of this study is to investigate the level of effectiveness of 42 red flags for detecting fraudulent financial reporting as perceived by 82 internal auditors. According to Practice Advisory 1210.A2-2.2: Responsibility for Fraud Detection (IIA, 2004), "internal auditors have a responsibility to exercise 'due professional care'...with respect to fraud detection. The Professional Practices Framework (IIA, 2005) expects internal auditors to deter, detect, investigate and report fraud. While Statement of Auditing Standard (SAS) No. 99 requires external auditors to use red flags in financial statement audits, internal auditors also use them in conducting operational, compliance and financial statement audits. Of the 42 red flags, we found 15 were rated as more effective, 14 were considered effective, and 13 were perceived to be ineffective as indicators that fraud might be present. SAS No. 99 further categorizes these red flags into three groups—"opportunities," "incentives and pressures," and "attitudes and rationalizations." The results also

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show that internal auditors consistently rated red flags categorized as “opportunity” and “attitudes and rationalizations” as more effective in detecting fraudulent financial reporting activity than red flags labeled “incentives and pressures.”

## INTRODUCTION

What has happened to the fraud detection process in auditing? Were red flags present and not seen when Enron and WorldCom failed? While external auditors apparently failed, how did the internal auditors also miss those obvious signs that something was wrong? Is it possible that these flags were present, but auditor’s perceptions negated the importance of these red flags?

The Institute of Internal Auditors (IIA) put forth the Statement on Internal Auditing Standards (SIAS) No. 3 (IIA, 1985) which summarizes the expectations of internal auditors concerning the deterrence, prevention, detection, and reporting of fraud. It states that “internal auditors should have sufficient knowledge of fraud to be able to identify indicators (red flags) that fraud might have been committed.” Statement on Auditing Standards (SAS) No. 82, *The Consideration of Fraud in a Financial Statement Audit* (AICPA, 1997) identified 25 red flags (risk factors) that auditors should pay attention to as indicators that fraudulent activity is very possible. Both SAS Nos. 82 and 99 emphasize that indicators (i.e. red flags) are an important part of the audit process to detect possible fraud. In 2002, SAS No. 99, *The Consideration of Fraud in a Financial Statement Audit* (superseded SAS No. 82) raised expectations to a new level, described by one online accounting organization as changing hats from “I believe management” to “I don’t believe management.” SAS No. 99 requires external auditors to use 42 red flags in financial statement audits to detect fraudulent financial reporting. Any auditor who fails to recognize red flags will most likely be held negligent (Accounting Malpractice.Com, 2004). The auditor’s responsibility to detect fraud has increased over time as evidenced by SAS No.

82 which superseded SAS No. 53 and SAS No. 99 which in turn superseded SAS No. 82.

Internal auditors assist external auditors in conducting financial statement audits. Statement of Auditing Standard No. 65 (AICPA, 2003) states the competence and objectivity requirements for internal auditors to assist external auditors in performing financial statement audits. In addition, internal auditors also conduct their own financial audits of different areas of the accounting system. Internal auditors have as much professional interest in using red flags to detect fraud as external auditors do. The Practice Advisory 1210.A2-2.2: Responsibility for Fraud Detection (IIA, 2004) states the internal auditors' responsibility to detect fraud as follows:

...internal auditors have a responsibility to exercise "due professional care"...with respect to fraud detection. Internal auditors should have sufficient knowledge of fraud to identify the indicators (red flags) that fraud may have been committed, be alert to opportunities that could allow fraud, evaluate the need for additional investigation, and notify the appropriate authorities.

Realizing the mandatory use of red flags during the financial statement audit process, other questions remain that might negate the importance of some red flags or increase the significance of others. Do internal auditors rely more heavily on certain red flags and ignore others or are they equally weighted? Do all auditors perceive the same relative weight for these red flags or does a wide divergence exist among auditing professionals? The purpose of this research study is to examine the relative fraud-detecting effectiveness of these 42 red flags as perceived by internal auditors.

## **PRIOR RESEARCH**

While there is an abundance of research concerning red flags in audit situations, there are only a few which specifically address the effectiveness of red flags. Albrecht and Romney (1986) validated the significance of red flags as a predictor of management fraud as determined by audit partners. The results showed that only one-third of the red flags were significant predictors of fraud, and most tended to be personal characteristics of management rather than company-specific variables. Heiman-Hoffman and Morgan (1996) asked external auditors of a (then) Big Six international public accounting firm to rank the thirty most important warning signs of possible fraud. The auditors tended to rate management attitudes as the most important red flags compared to any organization's situational factors in the organization. The most important red flag perceived by the respondents was client dishonesty.

In a study examining the efficacy of red flags, Pincus (1989) found that only half of the respondents indicated they used red flag questionnaires to assist in their fraud assessment. The other respondents, however, did not use such questionnaires since they did not believe that red flags were good indicators of fraud. Hackenbrack (1993) noted a wide range of the importance ratings of fraud risk factors. Differences in auditors' experiences between large and small clients account for much of the variability in the ratings of red flags. Those auditors assigned primarily to large client engagements placed more emphasis on factors relating to the opportunities of perpetrators to commit fraud. Apostolou and Hassell (1993) sampled 126 internal auditors regarding their perceptions of the importance of red flags that indicate the possible occurrence of management fraud. In their study, no significant difference existed among the auditors surveyed with respect to the importance of these red flags. Church et al. (2001) surveyed internal auditors regarding possible red flags under a variety of hypothetical income situations. The results indicate that auditors considered fraud to be more probable when red flags were discovered such as income surpassing expectations and managers'

bonuses based on earnings. Apostolou et al. (2001) questioned both internal and external auditors regarding the importance of twenty-five red flags as found in SAS No. 82. The highest rated indicators were management characteristics and influence over the control environment. However, no significant differences were noted between internal and external auditors regarding the weighting of importance.

### **METHODOLOGY**

This research study examines the level of effectiveness of 42 red flags in detecting fraudulent financial reporting. SAS No. 99 (AICPA) requires these 42 red flags to be used by external auditors in conducting financial statement audits. Often, the executive management of the client corporations negotiates with CPA firms to allow their internal auditors to assist the financial statement audits. Internal auditors participating in the audit process reduce the extremely high audit fees. SAS No. 65 (AICPA) states specific requirements that internal auditors must satisfy in order to assist external auditors in the financial statement audit. As a result, internal auditors are as interested as external auditors in knowing the level of fraud-detecting effectiveness of each red flag. In this study, a questionnaire was designed to measure the perceptions of internal auditors concerning the level of fraud-detecting effectiveness of 42 red flags.

The questionnaire utilizes a six-point Likert scale to measure the internal auditors' perceived level of fraud-detecting effectiveness of each red flag. As respondents, the internal auditors were asked to determine the fraud-detecting effectiveness of each red flag scale ranging from "not effective" to "extremely effective" on a six-point Likert scale. In addition, the questionnaire included demographic questions concerning the auditors' experience with red flags, job title, work experience, educational background, certifications, gender, race, and income.

The questionnaire was designed by the researchers and then sent to the Global Auditing Information Network (GAIN), which is affiliated with the Institute of Internal Auditors (IIA). This

questionnaire was placed on the GAIN's Flash Survey website. The GAIN organization sent email notifications to approximately 1,800 IIA-member internal auditors, who previously volunteered to participate in surveys listed on this site. These internal auditors answer numerous questionnaires listed on this GAIN website in exchange for the privilege of reviewing the results of each survey after completing the corresponding questionnaire. The questionnaire was available online for a period of approximately four months during which 88 internal auditors responded. A total of 82 usable questionnaires produced a 5 percent response rate, which is low. Due to the complexity of the questions in the survey instrument, our response rate was typical for this type of research. Numerous auditing professionals in a small pilot study commented on the difficulty in ranking the red flags. After the data collection period ended, the IIA sent the database to the researchers for analysis.

## **RESULTS**

### **Background Information about Internal Auditors**

Many of the respondents indicated they had strong professional backgrounds in internal auditing and extensive experience with red flags. Out of the 82 respondent internal auditors, 99 percent were exposed to red flags, 85 percent had used red flags often, and 82 percent had detected fraud. Among the 82 organizations employing these internal auditors, 62 percent had detected fraud, and 61 percent considered red flags effective in detecting fraud. To improve their understanding of red flags, 20 percent received in-house job training on red flags, and 61 percent attended conferences on red flags with an average of 30 CPE hours accumulated each year. Approximately, 80 percent of the respondents are either internal auditing managers/directors or vice presidents over internal auditing. Regarding certifications, 40 percent of the respondents are Certified Internal Auditors (CIAs), and 58 percent are Certified Public Accountants (CPAs).

On average, these respondents earn an \$110,000 annual salary and have 15 years of internal auditing experience and 4 years of external auditing experience. At the bachelor degree level, 58 percent majored in Accounting and 8 percent in other business majors. In addition, 34 percent of the respondents also graduated with Master of Business Administration and another 5 percent with a Master of Science in Accounting. Approximately, 79 percent of the respondents were Caucasians, and the remaining 21 percent represented other minority groups.

### **Data Analysis**

A total of 82 internal auditors in the United States assessed their perceived level of fraud-detecting effectiveness of each of the 42 red flags originating from SAS No. 99 (AICPA). In answering the questionnaire, the internal auditors selected from “not effective” (weighted with a value of 1) to “extremely effective” (weighted with a value of 6) on a 6-point Likert scale representing six different levels of fraud-detecting effectiveness for each red flag. In data analysis, an average rating from all 82 internal auditors was computed for each of the 42 red flags. An average of 1 indicates the red flag is not effective in detecting fraud, whereas an average of 6 indicates the red flag has the highest level of perceived effectiveness in detecting fraud. In Tables 1, 2 and 3, the averages for all 42 red flags ranged from the lowest value of 2.56 to the highest value of 4.97. Higher averages indicate that internal auditors perceived the red flags as more effective in detecting fraud.

### **Degree of Fraud-Detecting Effectiveness of 42 Red Flags**

SAS No. 99 (AICPA) organized the 42 red flags into three groups: (1) *opportunity*, (2) *incentive or pressures*, and (3) *attitudes or rationalizations*. The level of effectiveness of the 42 red flags was analyzed in terms of these three groups. First, the 12 attitude/rationalization red flags shown in Table 3 with a 4.32 group average had the highest level of fraud-detecting effectiveness. Second, the 14 opportunity red flags shown in Table

2 with a 4.12 group average had the second highest level of fraud-detecting effectiveness. Third, the 16 incentive/pressure red flags shown in Table 1 with a 3.47 group average had the lowest level of fraud-detecting effectiveness.

### **Incentive or Pressure Red Flags**

*Incentive/pressure red flags* are associated with either excessive pressure originating from board directors, executive officers, investors, creditors, or analysts. These pressures may funnel down the organization's hierarchy to mid-level and lower level managers to achieve predetermined financial goals at any cost. Incentive/pressure red flags are also associated with a manager's compensation or performance evaluation depending on the achievement of predetermined financial goals. Apostolou et al. (2001) concluded the highest-rated fraud indicators were management characteristics and managers' influence over the control environment. In addition, incentive/pressure red flags may include events in industry, market and the national economy as well as in technology developments that impact company performance, financial position or cash flows.

In Table 1, the fraud-detecting effectiveness of 16 incentive/pressure red flags were classified into three groups: (1) 6 red flags considered as being "more effective," (2) 5 red flags as being "effective," and (3) 5 red flags as being "less effective."



**Table 1**  
**Degree of Effectiveness of**  
**Incentive or Pressure Red Flags**  
**(group average = 3.47)**

<b>More Effective</b>	<b>Mean</b>
Excessive pressure on operating management or personnel to meet financial targets (sales and profitability incentive goals) exerted by board of directors of chief executive officers	4.21
Significant portions of management's compensation, represented by bonuses and stock options, being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow	4.09
Rapid growth or unusual profitability, especially compared to that of other companies in the same industry	3.93
Unrealistic profitability or trend level expectations by management in overly optimistic press releases or annual report messages	3.93
Recurring negative cash flows from operations or an inability to generate cash flows while reporting earnings and earnings growth	3.75
Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards	3.69
<b>Effective</b>	
Unrealistic profitability or trend level expectations of investment analysts, institutional investors, significant creditors or other external parties in overly optimistic press releases or annual report messages	3.61
Management and/or board directors have personally guaranteed significant debts of the entity	3.59
Operating losses making imminent threat of bankruptcy or foreclosure, or hostile takeover.	3.44
Management and/or board directors holding significant financial interests in the entity	3.39
Marginal ability to meet exchange listing requirements or debt repayment	3.35
<b>Less Effective</b>	
High vulnerability to rapid changes in technology, product obsolescence, or interest rates	3.13
High degree of competition or market saturation, accompanied by declining margins	2.99
Significant declines in customer demand and increasing business failures in the industry or overall economy	2.96
Need to obtain additional debt or equity financing of major research and development or capital expenditures to stay competitive	2.85
New accounting, statutory, or regulatory requirements	2.56

**Six "More Effective" Incentive/Pressure Red Flags.** The board of directors and chief executive officers exerting high pressure on operating managers to achieve financial targets of sales or profits are perceived by a sample of 82 internal auditors as being highly indicative of fraudulent financial reporting. Operating managers dealing with this pressure may falsely overstate reported

revenue, when actual sales fall below the expected goals. Internal auditors, who are aware of the pressure to achieve financial goals, should recommend to the audit committee to reduce or eliminate the unobtainable financial goals.

The majority of management compensation is represented by bonuses and stock options that are contingent upon achieving aggressive targets for stock prices, operating results, financial position or cash flows. This type of managerial compensation package may motivate fraudulent financial reporting activity. Internal auditors should verify the actual performance results, before bonuses are paid and/or stock options can be exercised. In addition, the corporation should consider terminating managers who commit this type of fraud as well as criminally prosecute them. This verification process, along with termination and prosecution, can serve as a deterrent for most managers.

A company that experiences both rapid growth and unusually high profitability compared to other companies within the same industry is perceived by respondent internal auditors as being highly indicative of fraudulent financial reporting activity. If the growth rate and profitability level of a particular company significantly exceeds those of other companies within the industry, that particular company is either outperforming its competitors or falsely overstating revenues and profits. Internal auditors can conduct analytical procedures to compare the company's financial ratios with the industrial averages for the current period. If significant differences are discovered, they should investigate those specific areas. Also, internal auditors can verify sales where recorded sales figure exceeds the initial estimates of revenue.

Another factor that may contribute to fraud occurs when top executives publicly communicate unrealistically high profitability expectations in press releases or annual reports. When this occurs, they have given the impression to the general public and specifically to analysts and investors, that this company will generate high profitability for the current period. If actual profitability falls below the goal communicated by executive management and expected by analysts, management may

fraudulently inflate revenues and profits for the company to avoid stock price drops. In this case, the internal auditors should be extra vigilant to investigate and verify revenue and profits.

When companies experience negative cash flows from operations and simultaneously report increasing annual profitability, the internal auditors surveyed indicated the probability of fraudulent financial reporting is high. Auditors expect reasonable annual net cash flows to be associated with average reported net income. In these situations, the internal auditor should contact the external auditor to coordinate an investigation of revenues and cash inflows from customers.

Adverse effects of reporting poor financial results on significant pending transactions such as business combinations and contract awards may strongly represent a situation for fraudulent financial reporting activity. Because business combinations are usually highly complex, these transactions represent ideal circumstances to commit fraudulent activities without detection. In such cases, internal auditors working with the external auditors should investigate the major aspects of these type complicated transactions.

**Five “Effective” Incentive/Pressure Red Flags.** Board directors and/or managers, who either (1) personally guaranteed significant amount of firm debt or (2) held a significant firm ownership interest, are perceived by a sample of 82 internal auditors as two indicators of potential fraudulent financial reporting activity. If the directors and/or managers are highly invested in corporations, they have a conflict of interest where they can make decisions to enhance their personal gain rather than to increase the financial wealth of the stockholders. The internal auditors should report to the audit committee their concern regarding directors/managers who exercise undue influence/control as owners or creditors.

External parties, such as investment analysts, institutional investors or significant creditors, that communicate overly optimistic press releases, may indicate potential fraud. Managers may feel extremely pressured to achieve or exceed specific

financial goals publicly announced by analysts. If actual performance falls below the analysts' forecast, fraudulent financial reporting may occur. Internal auditors should be watchful of all press releases from external parties and investigate specific situations, where key officers may be highly motivated to falsify financial statements.

Operating losses may be indicative of fraudulent financial reporting activity. Managers may falsify financial statements to conceal the imminent threat of bankruptcy, foreclosure or hostile takeover resulting from large operating losses occurring over a long period. In situations of operating losses associated with bankruptcy or hostile takeovers, the internal auditors should be professionally skeptical regarding the possible issuance of fraudulent financial statements and involve the external auditors in the investigation.

Marginal ability of corporations to meet exchange listing requirements may indicate fraudulent financial reporting as well. All national stock exchanges have listing requirements that corporations must satisfy in order to sell stock or issue bonds in such national stock exchange markets. Corporate inability to meet listing requirements or comply with GAAP may indicate fraud. One such listing requirement is that all publicly held corporations must maintain audit committees. Publicly held corporations are expected to comply with stock exchange listing requirements, Generally Accepted Accounting Principles (GAAP) and SEC financial reporting regulations. Noncompliance with listing requirements may indicate corporate management concealing some type of fraudulent financial reporting activity. Internal auditors should always insure that their corporate employers are meeting all the listing requirements.

**Five “Less Effective” Incentive/Pressure Red Flags.** Industries experiencing rapid changes in technology are perceived by a sample of 82 internal auditors as being slightly indicative that fraudulent financial reporting activity is occurring. Such rapid advancements in technology may create a very competitive market where it is necessary for firms in that industry to make large and

frequent capital investments into research and development (R&D) activities to maintain up-to-date technology in their firms. Such R & D expenditures greatly reduce reported net profits. As a result, managers may be motivated to falsify revenues and expenses to increase reported profits. Internal auditors should plan to investigate and verify revenue and expense accounts, when rapid changes in technology occur in their industry

Funds designated for research and development expenditures, which are provided from additional debt or equity financing and are necessary to maintain competitiveness, may represent a weak fraud indicator. If a company has inadequate cash inflows from operations to sustain R&D expenditures, management may attempt to falsify the financial statements to improve its financial position in order to qualify for additional debt/equity financing of R&D activities. When firms finance large R&D expenditures, the internal auditors should inquire with executive management regarding their justification for the debt/equity financing.

According to the internal auditors surveyed, there is only a slight indication of fraudulent financial reporting activity, when a mature industry approaches the point of market saturation. Firms in saturated markets may experience slower growth and even decline in customer demand for products and services that reduce revenues and profits. As a result, managers may falsely overstate revenues to report higher net incomes. When firms operate in saturated markets, internal auditors should investigate revenue accounts carefully.

Significant declines in customer demand for products and services may decrease revenues and profits. These demand declines are perceived by internal auditors as only a slight indication of fraudulent activity. Major reductions in customer demand can increase the number of business failures. In order to prevent corporate liquidation and bankruptcy, management may be tempted to falsify financial statements to prevent business failure. Internal auditors should plan to carefully investigate possible fraudulent financial statements, when major reductions in customer

demand negatively affect the corporate operating performance and financial position.

The number of new professional standards has greatly increased. The perception of the surveyed auditors is that this represents a weak fraud indicator. Among the professional organizations, the Financial Accounting Standard Board (FASB) issues Statements of Financial Accounting Standards (SFAS); the Auditing Standard Board (ASB) issues Statements of Auditing Standards (SAS); and the Institute of Internal Auditors (IIA) issues the Statements of Internal Auditing Standards (SIAS). From the federal government, the Securities and Exchange Commission (SEC) enacts numerous financial reporting regulations for publicly held corporations. From the U.S. Congress and Senate, the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB) that creates new statutory requirements for publicly held corporations. The PCAOB can amend, modify, repeal or reject ASB standards (U.S. Congress 2002). With this overwhelming number of professional standards, it is conceivable that accountants and auditors may misuse or not apply new standards in financial reporting due to not understanding of the new accounting and auditing standards. Professional development such as CPE conferences and classes are important today for accountants, external auditors and internal auditors to remain updated with all of the new standards.

### **Opportunity Red Flags**

*Opportunity red flags* indicate ideal situations in which people can commit fraud. One of the objectives of the board of directors and chief executive officers is to prevent these types of situations. In numerous cases, the perpetrators are not held accountable for their actions within the organization because they do not report directly to an effective executive management, audit committee, board of directors or any higher authority. However, when there is a clear line of delegated decision-making authority, assignment of responsibility and accountability for decisions and actions, it is more difficult for people to commit fraud. In addition, people are more likely to commit fraudulent activities in

environments with ineffective internal controls and ineffective accounting systems, especially when the audit committees have not implemented corrections for the reportable conditions recommended by external and internal auditors.

In Table 2, the fraud-detecting effectiveness of the 14 opportunity red flags are categorized into three groups: (1) 5 red flags considered as being “more effective,” (2) 5 red flags as being “effective,” and (3) 4 red flags as being “less effective.”

**Table 2**  
**Degree of Effectiveness of**  
**Opportunity Red Flags**  
**(group average = 4.12)**

<b>More Effective</b>	<b>Mean</b>
Formal or informal restrictions on the auditor that inappropriately limit his access to people or information or limit his ability to communicate effectively with the board of directors or the audit committee	4.95
Significant related-party transactions not in the ordinary course of business or with related entities are not audited or audited by another firm	4.74
Domination of management by a single person or small group in a nonowner-managed business without compensating controls	4.72
Ineffective accounting and information systems, including situations involving reportable conditions	4.47
Inadequate monitoring of significant internal controls	4.43
<b>Effective</b>	
Ineffective board of directors or audit committee oversight over the financial reporting process and internal control system	4.27
High turnover rates or employment of ineffective accounting, internal audit, or information technology staff	4.25
Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification	4.16
Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate	4.01
High turnover of chief executive officers or board directors	3.91
<b>Less Effective</b>	
Difficulty in determining the organization or individuals that have controlling interest in the entity	3.88
Overly complex organizational structure involving unusual legal entities or managerial lines of authority	3.70
A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or not arm's length transactions	3.35
Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist	2.95

#### **Five “More Effective” Opportunity Red Flags.**

Auditors with restricted access to key managers are prevented from receiving important information about possible fraudulent activities. Auditors, who cannot communicate effectively with the audit committee, are prevented from reporting fraudulent occurrences to the audit committee. Any restrictions on internal auditors to interview managers, examine records or communicate with the audit committee are perceived by internal auditors as highly indicative of fraudulent activity. These restrictions might prevent the internal auditors from collecting and analyzing enough evidence necessary to determine whether fraud exists. The internal auditing director should request a written contract known as a charter, which is authorized by the audit committee and describes the responsibilities and the independence of the internal auditors. The charter can eliminate interference by management with auditors and help maintain auditor’s independence and objectivity through audit engagements.

Significant related-party transactions that are not in the ordinary course of business are perceived by respondent internal auditors as strong indicators of fraudulent financial reporting. Since related parties act in their mutual interests to negotiate transactions that do not occur in marketplaces, one party can shift revenue or expenses to the other party through fraudulent or illegal transactions. Internal auditors should always investigate all significant related-party transactions with professional skepticism.

Company management dominated by a single person, without compensating controls, represents a strong possibility of fraudulent financial reporting activity. A dominating manager may operate in all incompatible functions: custody of assets, accounting system, authorization of transactions, operating responsibility, and information technology (Arens et al., 2003). According to GAAP, any manager should operate only in one of these incompatible areas to maintain proper segregation of duties that helps to detect and prevent fraud. Internal auditors should always maintain a skeptical attitude toward the chief executive officers who exert dominate control and operates in more than one of these



incompatible areas. Managers in high positions who use excessive influence or control to commit fraudulent activities create more difficult situations for auditors to detect. Internal auditors should report the problem of domineering managers to the audit committee.

Foreign Corrupt Practice Act of 1997 requires publicly held corporations to maintain both effective accounting systems and effective internal control structures. Ineffective accounting systems or ineffective internal controls create reportable conditions that represent strong fraud indicators as perceived by internal auditors. Reportable conditions are defined as important internal controls which auditors discover as being either missing or operationally ineffective. Ineffective accounting systems or ineffective internal controls increase the ease with which perpetrators can commit fraud. In these cases, internal auditors should encourage audit committees to implement missing internal controls or improve the effectiveness of existing controls.

The ineffective monitoring of significant internal controls by management may be highly indicative of a fraudulent occurrence. Effective operations of internal controls require constant supervision and monitoring to train employees to perform the internal control procedures correctly. Managers should monitor internal controls to verify that employees are performing these control procedures and that these controls are effective enough to detect and prevent fraud. Internal auditors should periodically perform walk-through inspections of the company's internal control system to confirm that managers are adequately monitoring internal controls.

**Five “Effective” Opportunity Red Flags.** High turnover rates may indicate problems within the organizations. A high turnover rate of board directors, audit committee members, and chief executive officers (CEOs) may indicate fraudulent financial reporting activity as perceived by a sample of 82 internal auditors. High turnover of directors and executive officers represents a lack of long-term strong leadership within the corporation. Executive officers and directors quitting frequently implies major problems

such as fraud, especially when directors leave due to pending lawsuits resulting from not performing their fiduciary duties. Internal auditors should always investigate the causes of high turnover of directors and CEOs, even more so when the turnover problem exists over a long period of time.

Also, a high turnover rate of staff, such as ineffective accountants, internal auditors and information technicians, may indicate fraudulent financial reporting activity. High turnover of these employees represents a continuous loss of key financial and technical expertise that is critical to the corporation's future success. Without these professionals, a corporation cannot effectively operate its accounting and information systems, which may negatively impact the financial reporting (disclosure) process. High turnover problems of key technical experts may indicate these professionals either committed fraud or have knowledge of fraudulent activities and leave the firm to protect their professional careers. Internal auditors should conduct audits in areas of suspected fraud when the firm sustains a continuous turnover of key managers and employees.

Ineffective board directors or audit committee members who neglect their fiduciary duties associated with the financial reporting and internal control systems may indicate potential fraudulent activities. Inadequate managerial oversight may create opportunities for perpetrators to commit fraud. Ineffective directors or audit committees may neglect reportable conditions. Internal auditors should always investigate accounting systems and internal controls, when the firm has ineffective board of directors or audit committee members for an extended period of time.

Assets, liabilities, revenues or expenses involving significant accounting estimates that are difficult to corroborate may represent fraud indicators as perceived by internal auditors. Conspiring accountants and/or managers may either overestimate or underestimate certain account balances to falsify financial statements. When a manager is writing off accounts receivable balances to falsely exempt his friends from paying their liabilities owed to the corporation, the accountant can overestimate bad debt

expense to conceal the crime. Internal auditors should analyze all the estimates made by the accountants to verify these accounting estimates are reasonable.

Significant bank accounts located in tax-haven jurisdictions that have no clear business justification or purpose may serve as fraud indicators. Corporations establishing bank accounts in foreign countries where these corporations do not conduct legitimate operations, imply the funds from such foreign bank accounts may be paid as kickbacks, bribes or indicate involvement in illegal acts. Internal auditors should analyze and determine the business purpose for all foreign bank accounts of their organizations.

**Four “Less Effective” Opportunity Red Flags.**

Difficulty in determining which individuals or organizations have controlling ownership interest in a specific corporation is perceived by the sample of 82 internal auditors as only slightly indicating potential fraudulent activity. When the names of the corporate owners are not clearly known and not made available as public information, the intentional concealing of stockholder names may imply possible illegal intent. If organizations are secretive and disclose inadequate information internally to employees and externally to the general public, the internal auditors should convince the audit committees to establish a new company policy to disclose more adequate information to all interested parties, both internal and external.

Overly complex organizational structures, that involve either unusual legal entities or unusual managerial lines of authority, may create the opportunity situations for perpetrators to commit fraudulent activities and are perceived by internal auditors as a weak fraud indicator. Clearly defined lines of decision-making authority, assignment of responsibility and individuals accountable for their decisions and actions are necessary to prevent fraud. Fraudulent financial reporting schemes can be easily concealed among the various subsidiaries owned by one parent or holding company. In addition, corporations without clearly defined lines of decision-making authority may provide opportunity for

managers to falsify financial statements. Internal auditors should analyze their organizational structures to verify that the lines of authority are clearly defined and confirm that all subsidiary companies, owned by the parent corporation, are conducting legitimate and legal operations.

A firm that has either a strong financial presence or the ability to dominate its industry may be able to dictate terms and conditions to suppliers and/or customers which are normally considered either inappropriate or not arm's length transactions. A good example is Microsoft that used its monopolistic position and influence against its competitors. As a result, the U.S. federal government and twenty state governments filed lawsuits against Microsoft. This strong financial presence or dominating ability is perceived by internal auditors as a weak fraud indicator. This monopolistic power over suppliers and customers reduces healthy competition in that particular industry. Internal auditors should investigate major complaints from suppliers and customers to confirm that the organization is not overexerting its influence or control illegally.

American companies that conduct significant operations across international borders are perceived by internal auditors as weak fraud indicators. Some corporate activities considered illegal or unethical in the United States may otherwise be legal and acceptable in foreign countries. Internal auditors should audit the activities of their corporate personnel operating in foreign countries to verify compliance with the Foreign Corrupt Act of 1977.

### **Attitude or Rationalization Red Flags**

*Attitude or rationalization red flags* are associated with the reasoning and judgment of executive management concerning audit related issues. Heiman-Hoffman and Morgan (1996) concluded that the auditors tended to rate management attitudes as more important red flags compared to any organization situational factors. These red flags refer to situations in which perpetrators offer invalid reasons to justify committing fraud. Many of the 12

*attitude/rationalization red flags* directly involve issues between auditors and executive management.

In Table 3, the fraud-detecting effectiveness of 12 attitude/rationalization red flags are classified into three groups: (1) 4 red flags considered as being “more effective,” (2) 4 red flags as being “effective,” and (3) 4 red flags as being “less effective.”

**Table 3**  
**Degree of Effectiveness of**  
**Attitude or Rationalization Red Flags**  
**(group average = 4.32)**

<b>More Effective</b>	<b>Mean</b>
Significant, unusual, or highly complex transactions, especially occurring close to year end that pose difficult “substance over form” questions	4.97
Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work	4.92
Known history of violations of securities law, or claims against the entity, its senior management, or board members alleging fraud or violations of securities laws	4.82
Ineffective communication, implementation, support, or enforcement of the entity’s values or ethical standards by management or the communication of inappropriate values or ethical standards	4.52
<b>Effective</b>	
Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters	4.35
An interest by management employing inappropriate means to minimize reported earnings for tax-motivated reasons	4.30
Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality	4.22
Management failure to correct known reportable conditions in internal controls in a timely basis	4.17
<b>Less Effective</b>	
Non financial management’s excessive participation in the selection of accounting principles or the determination of significant estimates	4.09
A practice used by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts	4.08
Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor’s report	3.83
Excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend	3.72

**Four “More Effective” Attitude/Rationalization Red Flags.** Significant, unusual or highly complex transactions occurring close to year-end that pose difficult “substance over form” questions are perceived by our sample of 82 internal

auditors as being strong indicators of fraudulent financial reporting. Overly complex transactions, which are designed to take advantage of the loopholes in accounting rules and standards, create situations where fraud and other illegal activities can be hidden easily. Internal auditors should always investigate significant, unusual or highly complex transactions that occur close to year-end to discover potential fraudulent activities.

Management-domineering behavior over the internal auditors that reduces the scope of audit engagements impairs auditor independence and also decreases their ability to detect fraud. These scope restrictions do not allow the auditors to collect adequate evidence from all necessary areas of the accounting system. In fact, the respondent internal auditors perceived managerial-dominating behavior toward auditors to limit the scope of audit engagements as suspicious and highly indicative that fraudulent financial reporting activities are occurring. When managers are reducing their scope of the audit engagement, the internal auditors should investigate for any possible fraudulent activity committed by specific managers. They should inform the audit committee that certain managers are impairing their independence and possibly committing fraudulent activities. Furthermore, internal auditors should also recommend to the audit committee that they reprimand or replace the managers that have demonstrated domineering behavior toward the auditors.

Board directors and chief executive officers, who ignore security laws and allow their organizations to continuously violate them, may be a high indication of the occurrence of inside trading. Directors and chief executive officers who constantly violate federal law may have a tendency to falsify financial statements. A long history of security law violations by the publicly held corporation creates a very negative reputation to the general public. The internal auditor should convince the audit committee to change the organizational philosophy from non-compliance to compliance with security laws. If the audit committee remains non-responsive and inside trading continues, the internal auditor should

retire from the current employer to protect his/her professional career and certifications.

Ineffective communication of ethical standards as well as ineffective implementation and enforcement of ethical standards by corporate management are perceived by internal auditors as strong fraud indicators. In such organizations, the internal auditors should encourage the audit committee to adopt a new code of ethical standards or begin strict enforcement of the existing code of ethical standards. A code of ethical standards effectively communicated, implemented and enforced serves as a fraud deterrent for employees and managers. If the audit committee refuses to make a strong commitment to ethical standards throughout the organization, the internal auditors should consider other employment to maintain their professional careers.

**Four “Effective” Attitude/Rationalization Red Flags.**

Current and prior external auditors who disagree with the proper accounting, auditing or reporting issues may represent fraudulent financial reporting activities according to the internal auditors surveyed. As an example, an external auditor discovered fraudulent activities and wrote an unfavorable qualified audit opinion in the previous fiscal year. Later in the current fiscal year, the new external auditor did not discover any fraudulent activities and writes a favorable unqualified audit opinion. Internal auditors should always investigate disagreements between predecessor and current external auditors, since such disagreements between external auditors may point to potential fraudulent activities.

Management’s decision not to use Generally Accepted Accounting Principles (GAAP) for the purpose of minimizing reported profits and income tax liability may indicate fraudulent financial reporting activity, where management’s intent to reduce income tax using any means that are legal or illegal. Both external and internal auditors will logically challenge management’s use of a non-GAAP, unless management and the auditors can justify the use of such non-GAAP on the basis of a better measurement of either net assets or net income. Whenever corporate management selects any non-GAAP solely for the purpose of income tax

reduction, the internal auditors along with the external auditors should always investigate for the justification for using the non-GAAP.

Foreign Corrupt Practice Act (as federal law) requires effective internal controls implemented and maintained by all publicly held corporations. Any failure of management to correct known reportable conditions in a timely manner may be a fraud indicator as perceived by internal auditors. Reportable conditions represent significantly weak or missing key internal controls that are detected by auditors, which allow perpetrators to commit fraudulent activities more easily. Internal auditors recommend to the audit committee either the implementation of missing key internal controls or the improvement in operating effectiveness of existing weak internal controls. Delays in correcting reportable conditions may be due to management fraud. As a follow-up procedure, internal auditors should recommend to the audit committee the importance of correcting the reportable conditions to prevent and detect future fraud.

Management's recurring attempts to justify the marginal or inappropriate accounting methods on the grounds of materiality may indicate fraudulent activity. Using the materiality principle, a large dollar-amount transaction considered as being material compared to a basis such as net income is required to be recorded correctly in compliance with GAAP. Small dollar-amount transactions, on the other hand, may be recorded in another convenient manner without regard to GAAP compliance. Managers may abuse the materiality principle by selecting a basis represented by a larger dollar amount. In using this manipulation, the dollar amount of transaction in question will be viewed as relatively smaller when compared to the larger dollar amount of the selected basis. In this way, the transaction in question will be determined as not material. As a result, management can record the transaction fraudulently without concern for GAAP compliance. Internal auditors should always review how management and the accountants use the materiality principle in recording questionable transactions.



**Four “Less Effective” Attitude/Rationalization Red Flags.** Non-financial management’s excessive participation in the selection of accounting methods or GAAP may only slightly indicate fraudulent financial reporting activity as perceived by the sample of 82 internal auditors. A non-GAAP procedure is considered an error, unless it can be justified as a better measurement of net income or net assets. Sometimes, management may require the use of a non-GAAP for the purpose of falsely overstating revenue. Internal auditors along with the external auditors should negotiate with non-financial management to adopt a GAAP to replace the non-GAAP. If non-financial management refuses, both internal and external auditors can write audit reports to the audit committee. Both audit opinions from internal and external auditors should convince the audit committee to direct non-financial management to adopt the appropriate GAAP.

A management practice of accepting aggressive and unrealistic forecasts determined originally by financial analysts may only slightly indicate fraudulent financial reporting activity. Forecasts which are difficult to achieve may force management to overstate revenues and profitability. Internal auditors should vigorously investigate revenue and expenses to determine if their balances are reasonable in amount when management has been subjected to aggressive and unrealistic forecasts from analysts.

Unreasonable demands from the board of directors, such as time constraints to complete audits or to issue the auditor’s report, are perceived by internal auditors as being weak in indicating fraud. Scope restrictions in financial statement audits by external auditors may lead to qualified opinion or disclaimer of opinion as well as auditor withdrawal. The directors’ intention is to prevent the auditors from detecting fraudulent financial reporting activity by not allowing enough time to discover fraud. The internal auditors should state in their reports to the audit committee, that auditors have inadequate time to collect and analyze enough evidence to determine if fraudulent financial reporting activities are occurring. If the audit committee does not eliminate the unreasonable time constraints, the internal auditors should consider

other employment in order to protect their professional careers and certifications.

Management's excessive interest in increasing the corporation's profits and stock price trends are perceived by the internal auditors as being a weak fraud indicator. Management may be motivated to falsely overstate revenues in order to increase profitability and stock market prices. When internal auditors suspect management is falsely overstating revenue to increase profitability and stock prices, internal auditors should investigate revenue accounts to determine if their balances represent reasonable amounts.

### **SUMMARY**

In financial statement audits, Statement of Auditing Standard No. 99 requires external auditors to use 42 red flags to detect fraudulent financial reporting activities. As internal auditors generally assist the external auditors in conducting the financial statement audits, the SAS No. 99 red flags are important to the internal auditors as well. In fact, internal auditors use these red flags also in performing other operational and financial audits over specific areas of the accounting system.

In summary, not all red flags appear to be equal in their fraud-detecting effectiveness as perceived by internal auditors. SAS No. 99 categorizes the 42 red flags into three groups: Incentive/Pressure, Opportunity, and Attitude/Rationalization. Based on the averages of the responses from the 82 internal auditors surveyed, the Attitude/Rationalization red flags is slightly more effective in detecting fraudulent financial reporting activities than the Opportunity red flags, which are also moderately more effective in detecting fraud than the Incentive/Pressure red flags.

Our results confirm the findings of prior studies that auditors perceived some red flags as more effective than others and these differences need to be recognized by the auditing profession. The findings of this study can assist internal auditors in financial statement audits as well as financial audits of specific areas of the accounting system. Internal auditors should know which red flags

are more effective in detecting fraud, so they can use these more effective red flags on a regular basis to collect stronger evidence to support writing better audit reports. In contrast, internal auditors should also know which red flags are less effective in detecting fraud, so they only use these less effective red flags infrequently as the basis for writing audit reports. Inexperienced auditors may receive more benefits from this study's findings in their analysis and weighing of various red flags used in audit engagements.

Future research is suggested to investigate these red flag perceptions among internal and external auditors as well as experienced and inexperienced auditors in order to better prepare the audit professionals to detect fraudulent financial reporting activities.

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