Summary of Academic Research on
Identification, Assessment, and Response to Fraud Risks

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This report summarizes findings from academic research related to auditors' identification, assessment, and response to fraud risks. Research findings along with key takeaways are presented for each of these areas. The report is based on a review of research published in highly regarded academic journals between 2017 and August 2022, as well as unpublished working papers available on the Social Science Research Network (SSRN).[1]

Identification of Fraud Risks

Several recent studies have investigated the ways in which auditors identify fraud risk factors for the purpose of subsequently assessing fraud risk. Given the important role fraud brainstorming plays in the identification of fraud risks, many of these studies examine auditor performance during brainstorming sessions. Dennis and Johnstone (2018) gained access to actual fraud brainstorming sessions and demonstrate how prompting audit partner leadership can lead to new fraud risks being identified. The prompt instructed partners to convey both general prompts (e.g., emphasize fraud brainstorming as a training opportunity) and targeted prompts (e.g., discuss any relevant personal experience on engagements involving fraud) during the brainstorming session. The study also finds that the leadership prompts increase the total number of fraud risks discussed by the audit engagement team and that audit seniors' risk assessments are more likely to be enhanced by the partner prompts than more experienced audit managers.

[1] This report is based on research published in the following journals: *Accounting Horizons*, *Accounting, Organizations & Society*, *Auditing: A Journal of Practice & Theory*, *Behavioral Research in Accounting*, *Contemporary Accounting Research*, *Journal of Accounting and Economics*, *Journal of Accounting and Public Policy*, *Journal of Accounting Research*, *Journal of Accounting, Auditing & Finance*, *Journal of Finance*, *Journal of Financial Economics*, *Review of Accounting Studies*, *Review of Financial Studies*, and *The Accounting Review*. Our review of the academic literature also included a search of SSRN (www.ssrn.com) for relevant research because the website is frequently used to disseminate unpublished working papers.

Janssen, Hardies, Vanstraelen, and Zehms (2020) use data from actual audit engagements to demonstrate that the professional skepticism of the audit partner can drive fraud brainstorming quality. In particular, the research team observed a higher attendance rate and contribution of specialists, more extensive discussion, longer preparation, and longer brainstorming sessions for engagements led by partners with high trait skepticism and high moral courage. The study does not find a significant relationship between partners with a high presumptive doubt trait and brainstorming quality.[2]

Other studies related to fraud brainstorming involve controlled laboratory experiments where the participants are practicing auditors who complete case studies by providing their fraud-related judgments and actions for a hypothetical audit client. Harding and Trotman (2017) examine how partner communication of the likelihood of fraud during brainstorming sessions can impact the extent to which their audit managers and seniors consider potential fraud risk factors. Specifically, the study illustrates that auditors are more apt to consider fraud risk factors as potential risks when the partner expresses management's view that there is a low likelihood of fraud (vs. the partner expressing their own view that fraud risk is low or alternatively offering no view at all). Chen, Trotman, and Zhang (2022) focus on the technology used during brainstorming sessions. The researchers employ two different forms of an electronic brainstorming platform: a structured brainstorming platform and a non-structured brainstorming platform. In the non-structured brainstorming platform condition, inputs of all audit team

[2] The authors use various scale measurements to assess trait skepticism, moral courage, and presumptive doubt. First, participants' trait skepticism is determined using the Hurtt Professional Skepticism Scale (Hurtt 2010), which includes measures of a questioning mindset, suspension of judgment, the likelihood of searching for knowledge, interpersonal understanding, autonomy, and self-esteem. Moral courage, meanwhile, is measured using the Professional Moral Courage Scale (Sekerka, Bagozzi and, Charnigo 2009), which includes assessments of participants' moral agency, moral goals and endurance of threats, with an overall objective of determining participants' willingness to take skeptical action. Finally, presumptive doubt is measured using Rotter's Interpersonal Trust Scale (Rotter 1967), which measures one's expectation that written or verbal representations made by others are reliable.

members are shown chronologically on a computer screen. In the structured brainstorming platform condition, idea inputs are shown by categories/topics rather than in chronological sequence. While the psychology literature suggests potential benefits from the structured brainstorming platform, the study observes that a structured brainstorming platform does not improve auditor performance (either the quantity or quality of fraud hypotheses generated). In particular, the structured technology inhibited the performance of audit managers (vs. seniors).

In another study related to audit partner leadership during brainstorming sessions, Gissel and Johnstone (2017) have audit seniors and staff view videos of simulated brainstorming sessions where the partner's leadership is manipulated. The researchers subsequently measure the extent to which the seniors and staff share privately known, fraud-relevant information. The two versions of partner leadership are intended to invoke different levels of psychological safety in subordinates who can be intimidated by the prospects of actively participating in a brainstorming session. The researchers illustrate that, when the partner engenders a more supportive, non-threatening group dynamic along with a style that encourages idea sharing (versus an unsupportive, threatening environment that discourages idea sharing), seniors and staff are more apt to share relevant fraud risk factors with the engagement team. Using an experiment with graduate-level accounting students who formed audit teams, McAllister, Kadous, and Blay (2021) study the effects of trait professional skepticism on fraud brainstorming performance. The researchers find that groups with a minority of high trait skeptics identify more fraud risk factors than control groups with a majority of high trait skeptics (or groups with no high trait skeptics as well). The study illustrates that a minority of auditors who are more skeptical can effectively influence a less skeptical majority during a conversion process that may occur as part of a fraud brainstorming session. This conversion process can be more influential to group member skepticism than having a majority of high trait skeptics. Still, skepticism has been shown to come at a cost to auditors, especially when it does not identify a misstatement (Brazel, Jackson, Schaefer and Stewart 2016). Brazel, Leiby, and Schaefer (2022) perform several experiments in an attempt to identify cost-reduction mechanisms that may enhance auditors' skepticism and enhance fraud identification. However, findings show that, unless supervisors consistently reward appropriate skepticism with positive performance evaluations (regardless of whether a misstatement is ultimately identified), auditors are unlikely to pursue fraud red flags.

Outside the realm of fraud brainstorming, Majors and Bonner (2019) examine auditors' fraud risk identification during end-of-audit analytical procedures. Specifically, the study demonstrates that working under a completion goal ("just get it done") leads to poorer performance when identifying fraud risk factors versus a "refuse to accept" goal that fraud risks will go unidentified. The positive effect of "refuse to accept" (i.e., identification of fraud risk factors) is found to be stronger for auditors that identify more with the audit profession. Still, these auditors are less likely to raise a fraud risk concern to their superiors, as doing so would threaten their self-concept that their previously performed risk procedures were adequate.

Research also investigates auditor proficiency at detecting deception in client communications. Hobson, Mayew, Peecher, and Venkatachalam (2017) test whether instructing experienced auditors to attend to cognitive dissonance cues in CEO narratives enhances deception detection abilities.[3] Findings indicate that the instruction is effective, in that auditors who received the instruction provided more extensive descriptions of fraud red flags and were

[3] Consistent with the conventional understanding of cognitive dissonance as having conflicting beliefs, the authors define cognitive dissonance as "the negative, uncomfortable emotion a person feels when they are saying something that they know is not true. Those experiencing cognitive dissonance feel uncomfortable, uneasy, and bothered" (Hobson et al. 2017, 1144).

more likely to identify parts of CEO conference call speeches exhibiting negative, uncomfortable, or inconsistent responses to analyst questions. Fraud interview techniques have also been studied as a mechanism through which auditors might improve fraud identification. For example, Lauck, Perreault, Rakestraw, and Wainberg (2020) find that reminding auditees during fraud interviews about statutory whistleblower protections enhances the likelihood that auditees will report fraudulent activities. The authors also find that fraud reporting is more likely to occur in the afternoon, when auditees' self-regulation is depleted, making them less likely to resist impulses to keep fraud information to themselves. Further, results from Holderness (2018) suggest that conducting fraud interviews with two auditors might be better for fraud detection than using the traditional single auditor. Specifically, the presence of two auditors, as opposed to just one, prompts more deceptive clients to talk more and enhances feelings of nervousness, making them more likely to "leak" fraud-related information. In addition to multiple auditors, the presence of a continuing auditor can enhance fraud identification: Patterson, Smith, and Tiras (2019) find in a multi-period game setting that continuing auditors are able allocate effort more efficiently across periods and are therefore more likely to detect fraud and decrease audit risk. This suggests that audit firm tenure may influence the likelihood fraud identification.

Archival research identifies characteristics of fraud firms that auditors might consider when identifying fraud risks. For example, Cao, Luo, and Zhang (2020) find that lower-than-normal investments in a firm's labor pool are associated with higher likelihood of subsequent restatements, accounting irregularities, and fraud-related lawsuits.[4] The authors suggest that auditors should consider abnormal labor employment changes as red flags and take them into

[4] The authors establish an expected investment in labor using year-over-year percentage changes in employee headcount. They then identify deviations from the expected levels of labor investments, and label them as "higher" or "lower" than normal labor pool investments.

account when assessing fraud risks. Additionally, Davidson (2022) finds that executives who are implicated in financial reporting frauds are significantly more likely to have equity incentives than their peers who do not commit fraud, suggesting that auditors might consider such compensation when determining fraud risk.

Lastly, fraud identification can be aided by recent developments in machine learning. For example, Bao, Ke, Li, Yu, and Zhang (2020) develop a fraud prediction model using raw accounting data, which purports to predict accounting fraud more effectively than the previously established financial ratio models. Additionally, Brown, Crowley, and Elliott (2020) execute a thematic, contextual analysis of 10-K disclosures that the authors believe is better able to predict financial misreporting than existing models. These results suggest that auditors may inform their fraud identification by studying disclosures and themes in annual report filings.

Key Takeaways:

- The expression of audit partner leadership, professional skepticism, and viewpoints (i.e., tone from the top) can impact the sharing of information and the identification of fraud risk factors during fraud brainstorming sessions.
- Before introducing technology into the fraud brainstorming sessions, there should be a careful consideration of any unintended effects (e.g., a reduction in creative thinking).
- The trait skepticism of individual auditors, including their self-esteem, autonomy, or likelihood of questioning inconsistencies, as well as the overall prevalence of high or low levels of skepticism on an audit team, can influence the team’s dynamics and the identification of fraud risk factors.
- When performing analytical procedures at the end of an audit, it is important that the auditor is motivated to identify any remaining unidentified fraud risk factors and not complete the procedures with a “check the box” mentality.
- Fraud identification in client communications might be enhanced using several mechanisms, including cognitive dissonance cue training, reminding auditees of whistleblower protections, and performing fraud interviews with two auditors.
- Reduced labor investments and heightened equity incentives for executives may indicate a heightened risk for fraud.

- Innovative machine learning tools, such as applying archivally-developed fraud prediction and applying 10-K linguistic analyses, may aid auditors in fraud identification.

Fraud Risk Assessment

Recent fraud studies have investigated auditors' use of analytical procedures. When assessing fraud risk, auditors use the results of preliminary analytical procedures to identify unusual or inconsistent patterns between expectations and recorded balances. Rose, Rose, Suh, and Thibodeau (2020) consider whether generating more or fewer explanations for unusual fluctuations improves audit quality. The authors conduct an experiment with 92 senior auditors and find that the generation of more explanations for account fluctuations can be counterproductive because a greater number of plausible explanations increases the perceived difficulty of the task, which leads to anchoring on client explanations. Brazel, Jones, and Lian (2022) consider which benchmarks for identifying unusual fluctuations are most effective when assessing fraud risk. The authors find that industry data, nonfinancial measures, and cash flows, which are less susceptible to management manipulation outperform both prior year balances and relations within the client's financial data when assessing fraud risk. Of all the benchmarks suggested by auditing standards, fluctuations away from industry averages have historically been the best indicator of fraud.

Recent research has also considered audit committee characteristics and fraud risk. Wilbanks, Hermanson and Sharma (2017) examine audit committee oversight of fraudulent financial reporting and management integrity. The authors survey 134 audit committee members and find that audit committee members with personal connections to the CEO are less vigilant when assessing fraud risk and management integrity. Socially connected audit committees are reluctant to engage in observable monitoring actions that could jeopardize social ties to the CEO. However, audit committee members with professional ties to other independent directors, audit committee members with experience as controllers, and audit committees with female participants are more vigilant monitors. Brazel and Schmidt (2017) consider whether auditor and audit committee chairs constrain fraudulent reporting through monitoring the relation between nonfinancial and financial measures. Prior research has found that a large discrepancy between growth in nonfinancial measures (e.g., number of stores, product sold) and growth in financial measures (e.g., revenue) is a fraud red flag. The authors find that auditors with greater industry expertise and tenure and audit committee chairs with greater tenure are less likely to be associated with companies that exhibit large inconsistencies between their reported revenue growth and related nonfinancial measures (lower fraud risk).

Recent fraud research has examined whether consulting with forensic specialists or taking a forensic perspective can improve fraud risk assessments. Asare and Wright (2018) survey of 57 experienced auditors and find that when auditors consult with forensic specialists with a greater understanding of the client's business and engagement objectives, they make better risk assessments. Chui, Curtis and Pike (2022) consider whether priming auditors with a forensic perspective improves their fraud risk assessment and their subsequent audit plan. In an experiment with 113 experienced senior-level auditors, some participants were primed when they were asked to read a list of key forensic attributes and then asked to “think like a forensic specialist” when completing the audit task. Other participants were not similarly primed. The authors find that primed auditors assessed fraud risk higher than unprimed auditors in both high fraud-risk and low fraud-risk environments. Regarding risk response, the primed auditors proposed more audit-plan modifications as compared to the unprimed auditors in a high fraud-risk environment. The authors found the proposed modifications by the primed auditors were largely consistent with recommended responses from a panel of audit and forensic experts. In the low fraud-risk environment, audit-plan modifications are similar between groups, which demonstrates that primed auditors are still efficient in low-risk environments.

Recent studies have also evaluated the act of assessing fraud risk. Simon, Smith and Zimbelman (2018) consider whether decomposing fraud risk assessments into separate assessments of the likelihood and magnitude of risk leads to more effective risk assessments. In an experiment with 101 experienced auditors, the authors had some participants decompose their fraud risk assessment into likelihood and magnitude while the other participants took a holistic approach. The authors find that auditors that decomposed their fraud risk assessments assessed significantly lower fraud risk when fraud risk was high than auditors who took a holistic approach. In other words, auditors who decomposed their fraud risk assessments appeared to be less concerned when fraud risk was high than auditors who took a holistic approach. Hamilton and Smith (2021) examine auditors' perceptions of misstatements resulting from omission (e.g., failing to record an expense) rather than commission (e.g., recording a fictitious sale). In two experiments using 58 corporate managers and 215 auditors, the authors find that given the choice, managers choose to commit fraud by omitting a transaction as opposed to falsifying a transaction. This is important because auditors judge a misstatement as less likely to be intentional and are less likely to follow up (e.g., gather additional evidence) when a manager commits a misstatement of omission versus a misstatement of commission.

Two other recent articles on fraud risk assessment address CFO and auditor narcissism and cultural differences in auditors' compliance with firm policy on fraud risk assessment procedures. Johnson, Lowe and Reckers (2021) conduct a quasi-experiment with 118 auditors and find that auditors interpret verbal and nonverbal expressions of high CFO narcissism as indicative of increased fraud risk. Although, verbal cues of narcissism had greater influence on auditors than nonverbal cues. With respect to auditor narcissism, more narcissistic auditors generally underestimated client risk relative to less narcissistic auditors. In addition, morally disengaged auditors (i.e., auditors who tended to disassociate the risk of fraud from its moral and ethical implications) assessed lower fraud risk for clients with narcissistic CFOs, which suggests an auditor's propensity to morally disengage reduces professional skepticism. Bik and Hooghiemstra (2018) use proprietary data from a Big 4 firm's internal quality reviews involving 1,152 audit engagement from 29 countries to assess the impact of cross-national cultural differences on auditors' compliance with firm policy related to fraud risk assessment procedures. The authors find that auditors' compliance with firm methodology is associated with three cross-national cultural differences – specifically, collectivism, religiosity, and societal trust. Collectivism is defined as the extent to which individuals express pride and loyalty toward the group they are a part of, and are socially expected to give preference to the group rather than to themselves. Religiosity is defined as the degree to which individuals in a society adhere to religious values, beliefs, and practices. Societal trust is defined as the degree to which there is a willingness to rely on another party. The authors suggest that audit firms should develop country-specific guidance rather than having one, international fraud methodology.

Key Takeaways:

- When performing preliminary analytical procedures related to fraud risk assessment, generating more explanations for unusual fluctuations can be counterproductive.
- Of all the benchmarks suggested by auditing standards, fluctuations away from industry averages have historically been the best indicator of fraud.
- Audit committee members with personal connections to the CEO are less vigilant when assessing fraud risk and management integrity while audit committee members with professional ties to other independent directors, audit committee members with experience as controllers, and audit committees with female members are more vigilant monitors.

- Auditors with greater industry expertise and tenure and audit committee chairs with greater tenure are less likely to be associated with companies that exhibit large inconsistencies between their reported revenue growth and related nonfinancial measures (i.e., lower fraud risk).
- When auditors consult with forensic specialists' that possess a greater understanding of the client's business and engagement objectives, the audit team makes better risk assessments.
- Involving forensic specialists early in an audit engagement leads to improved teamwork and risk responsiveness.
- Decomposing fraud risk assessments into separate assessments of the likelihood and magnitude of risk leads to less effective risk assessments than taking a holistic approach.
- Given the choice, managers choose to commit fraud by omitting a transaction as opposed to falsifying a transaction, which is important because auditors judge a misstatement as less likely to be intentional and are less likely to follow up (e.g., gather additional evidence) when a manager omits a transaction versus falsifying a transaction.
- Auditors interpret verbal and nonverbal expressions of high CFO narcissism as indicative of increased fraud risk. Although, verbal cues of narcissism have greater influence on auditors than nonverbal cues.
- More narcissistic auditors generally underestimated fraud risk relative to less narcissistic auditors.

Response to Fraud Risk

Interactions with Client Management, Audit Teammates and Forensic Specialists

There is recent evidence that auditors' response to fraud can be improved by capitalizing on the audit team structure and the roles that auditors play in these teams (Holderness 2018, Bauer, Hillison, Peecher and Pomeroy (2020), as well as their consultation with forensic specialists (Asare and Wright 2018; Jenkins, Negangard and Oler 2018). Holderness (2018) examines the influence of client management deception on the skeptical judgments of individual auditors and two auditors working together and finds that the presence of two auditors, compared to a single auditor, induces management to exhibit more deceptive behavioral cues (i.e., conceal less) as management gets nervous in the presence of two auditors. Further, two auditors are more likely to successfully incorporate behavioral cues into subsequent judgments, suggesting the benefit of audit teammates when conducting client interviews, especially with a heightened risk of fraud.

Bauer et al. (2020) suggest that there is a benefit of auditors stepping out of their normal auditor role and into the role of providing informal advice to an audit teammate thus shifting their mindset to that of an advisor on the team. The results of their experiment suggest that the reason individual auditors fail to respond effectively to fraud risk is that they naturally apply an implemental mindset where they fail to recognize underlying fraud risk in a seeded fraud case. In contrast, those auditors who are primed to advise audit teammates use more deliberative mindsets and identify fraud audit procedures that are strongly linked to their own fraud risk assessments and that better align with experts' recommended fraud audit procedures for effectively addressing the seeded fraud cues.

Asare and Wright (2018) conduct a field survey that links auditors' consultation with forensic specialists to the quality of the audit work and audit team interactions. They find a positive association between forensic auditors' understanding of the clients' business and audit engagement objectives and effective teamwork and risk assessments. They also find a positive association between risk assessment and risk responsiveness. They document auditors' willingness to consult with forensic specialists because auditors believe they help to efficiently focus their work, which outweighs these specialists' cost. Based on a survey of auditors and forensic specialists, Jenkins et al. (2018) find that forensic specialists provide both guidance and direct assistance to audit teams across the audit in areas including fraud brainstorming, design of procedures to test for fraud, and review of results of fraud-related testing. In addition, forensic specialist involvement often resulted in incremental identification of material misstatements, financial reporting fraud, misappropriation of assets, and internal control deficiencies. The study's findings also suggest that auditors take comfort from forensic specialist involvement even when the specialist does not identify incremental audit findings.

Improving Auditors' Fraud Responses during Evidence Evaluation - Innovative Solutions

Several recent studies examine innovative solutions that auditors might employ in practice to more effectively respond to fraud risk (Brasel, Hatfield, Nickell and Parsons 2019; Brewster, Johann, Peecher, and Solomon 2021; Austin and Carpenter 2022; and Austin, Carpenter, Christ and Nielson 2022). Brewster et al. (2021) predict and find in an experiment that auditors can evaluate whether evidence is more or less indicative of fraud, but only when they possess stronger wise-thinking dispositions, a construct they define as a tendency of individuals to naturally engage in the balanced revision of doubts and beliefs by thinking openly and reflectively about evidence. Similarly, Brasel et al. (2019) document the benefits of trait skepticism, as they find that auditors were more likely to evaluate evidence more skeptically, resulting in a greater overall increase in skeptical judgments and actions (i.e., perform additional inquiries and other audit procedures), but only if they also exhibited higher levels of trait skepticism.

Austin et al. (2022) build on empowerment theory that suggests that employees who feel autonomy over their work can produce higher quality work. They investigate the efficacy of two-theory driven interventions that are designed to instill feelings of empowerment in auditors by providing supervisor support and autonomy for executing unplanned audit procedures. They predict and find that empowering auditors, where auditors feel like they can overcome constraints and feel supported to navigate their own work, can enhance their skepticism leading to more effective audit responses to unanticipated evidence suggestive of fraud, but they are not inefficient in the absence of such evidence. They provide experimental support for their theorized model finding auditors who feel more empowered in a case where fraud was seeded assess fraud risk higher, perform more audit work to search for fraud and, ultimately are successful in recommending more effective fraud audit procedures aimed at detecting the seeded fraud. Austin and Carpenter (2022) also provide experimental evidence of an innovative theory-driven intervention that incorporates game-like elements that improves auditors' response to fraud risk. They point out that audit firms recognize the challenges auditors face in detecting fraud, and currently communicate to auditors the importance of remaining alert for fraud and skeptical. However, they also suggest that regulators have suggested these communications from audit firms are insufficient. They predict and find that auditors receiving communication that simulates current practice, modeled after practice communication and a PCAOB speech, fail to effectively respond to fraud risk; however, auditors who are provided with communication that includes game-like elements, based on psychology theory that suggests that game-like elements pique curiosity associated with the task, as well as increase the challenge and enjoyment resulting in deeper cognitive processing, design effective fraud detection procedures. These studies provide promise for the future if auditors and audit teams can incorporate some of these innovative strategies.

Key Takeaways:

- Advising other auditors on the team, and engaging forensic specialists on the team, improves auditors' response to the risk of fraud and capitalizing on the use of teammates (i.e., using two auditors instead of just one in client inquiries about fraud) reduces clients' propensity to be deceptive.
- Wise-thinking disposition (i.e., a balanced view of evidence) and trait skepticism both contribute to auditors' effective linking of fraud risk and audit responses.
- Empowering auditors, where auditors feel like they can overcome constraints and feel supported to navigate their own work, helps improve auditors' effective response to evidence indicative of fraud without making them inefficient when fraud is not present.

- While auditors receiving audit firm communication that resembles practice fail to detect a seeded fraud, when innovative communication that contains game-like elements is provided, auditors' responses are effective at addressing heightened fraud risk.

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