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# THE RELATIONSHIP BETWEEN THE AUDITORS EXPERIENCE AND FRAUD DETECTION: A CASE OF PRIVATE FIRMS WITHIN THIKA SUB COUNTY, KENYA

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## ABSTRACT

*The study was set out to assess the relationship between the auditors experience and fraud detection in private firms in Kenya. The study was conducted on selected private firms within Thika sub County, Kenya and the results generalized for all other private firms in Kenya. Data was collected by use of questionnaires distributed and collected by the researcher himself. This research was based on a descriptive survey and the study population was Thika Sub-County which had a population of 1896 firms. The population comprises of auditors auditing private firms'. The sample of 110 private organizations representing 5.8 per cent of the entire population had been selected from various private organizations as a representative of the whole population using stratified sampling procedure. More than 63% of the respondents had served for more than 10 years. This suggested that auditors need many years of auditing experience in order for them to perform audits effectively, with consistence and putting in mind the changing regulations and laid down procedures. Auditor's experience level had a significant effect on his/her ability to detect fraud. Targeted fraud awareness training for auditors is a critical component of a well-rounded program for preventing and detecting fraud.*

***Keywords:*** *Auditors, Experience and Fraud Detection.*

## 1. INTRODUCTION

Fraud, according to Adeniji (2004:354) and ICAN (2006:206), is an intentional act by one or more individuals among management, employees or third parties, which results in a misrepresentation of financial statements. Fraud can also be seen as the intentional misrepresentation, concealment, or omission of the truth for the purpose of deception/manipulation to the financial detriment of an individual or an organization which also includes embezzlement, theft or any attempt to steal or unlawfully obtain, misuse or harm the asset of the organization, (Adeduro, 1998 and, Bostley and Drover 1972). Fraud has increased considerably over the recent years and professionals believe this trend is likely to continue. The literature in the field on fraud detection has evolved over the years. Some authors have acknowledged that there are limitations in the way individual auditors make fraud judgments (Wilks and Zimbelman, 2004) and ultimately find it difficult to identify fraud (Kapardis, 2010; Carpenter, 2007; Knapp and Knapp, 2001; Pincus, 1989). However, during the period of 1980s, there have been developments concerning fraud which some have seen as marking significant extensions to auditor responsibilities (Humphrey, 1993). Although the auditors responsibility for detecting fraud has not changed from Statements Auditing Standards (SAS) No. 82, the amended standard provides more guidance on how the auditor should plan and perform the audit (including the use of analytical procedures) to identify the risks of material misstatements arising from errors or fraud (Albrecht, et al., 2009; Arens, et al., 2008).

Consequently, the Auditing Standards Board (ASB) in 1998 issued statement on auditing standards imposed greater responsibility on auditors to detect financial statement fraud. The ASB formed a task to reconsider auditors' responsibility for the detection of fraud and provides operational guidance to practitioners (Knapp and Knapp, 2001). Moreover, most accounting practitioners realize and acknowledge that auditors are often not positioned to detect the occurrence of fraud. Auditors lack the continuous presence necessary for the establishment and implementation of fraud prevention and deterrence programs. Unlike other crimes which may be witnessed, fraud, by its very nature, typically entails concealment by its perpetrators.

In Kenya, fraud and bribery is used mostly by companies to acquire and retain business. The private sector corruption is so rampant in transactions between business associates, including suppliers and much less when doing business with the government. Other studies have estimated that companies lose between seven and eight per cent of their revenues to corruption, translating to loss of millions of jobs every year (Ernst and Young, 2014). The area of fraud detection is particularly important from the investor's perspective. Generally, all investors want to protect their investments and want to be reassured that the assets of the company are correctly stated and safeguarded (Alleyne, 2005). It is also important that auditors are even more vigilant in the execution of their responsibilities by ensuring that due diligence and care is at the forefront of their agenda so that fraud can be detected and exposed. This is critically important, if auditors are to protect and preserve their professional reputation and integrity and avoid legal costs (Makkawi and Schick, 2003).

Fraud may occur because the responsibility for its prevention is not a normally assigned task, because dishonesty is accepted as inevitable, known cases go unpunished, and the disease spreads; because security is thought too expensive or covered by fidelity bonds. It may also persist when its prevention is not taken seriously and when dishonesty is accepted as something that cannot be avoided. Fraud exists when one or more of the following conditions exist: 1) misappropriation of assets, 2) overstatement of assets or understatement of liabilities to present more favorable financial position and/ or result of operation, 3) theft of assets through transactions with branches or subsidiaries of the parent company, and 4) lack of disclosure of significant information (Elder, et al., 2010). Moreover, the role of the auditor has not been well defined from inception. In the nineteenth century, auditors claimed fraud detection as an audit objective. Porter (1997) indicated that it was the auditor's responsibility to report to shareholders all dishonest acts which had occurred and which affected the propriety of the contents of the financial statements. However, the learned judge also argued that the auditor could not be expected to uncover all fraud committed within the company, since the auditor was not an insurer or guarantor, but was expected to conduct the audit with reasonable skill and care in the circumstances (Carmichael, 2004). As indicated by Vanasco (1998) during the 1930s, it became generally recognised that the principal audit objective was the verification of accounts. The profession took the position that fraud detection was management's responsibility since management had a responsibility to implement appropriate internal control systems to prevent fraud in their organisations. This was as a result of the increase in size and volume of companies' transactions that made it virtually impossible for the auditor to examine all transactions (Porter, 1997). Auditors used sampling and testing procedures, which offered only reasonable assurance of the contents of financial statements. In addition, auditors were unable to uncover fraud that involved unrecorded transactions, theft and other irregularities (Vanasco, 1998).

A study conducted by the Association of Certified Fraud Examiner suggests that an average company loses about six percent of its gross revenues to various forms of fraud (Joseph J., 1998). Most of these frauds are committed by employees or by outsiders in collusion with employees. Methods employed to embezzle funds are simple and yet are largely undetected by internal audits. Various authors have defined fraud differently depending on the scope and context of the organization associated with it. Fraud includes wide variety of acts, all characterized by the intent to deceive the victim or to obtain an unearned benefit. Fraud is a pervasive fact of life in the business world (Luowers, et al., 2011). An auditor's definition of fraud may be the following: The deliberate actions of a person or persons to mislead for the purpose of financial gain (Elder, et. al., 2010). Fraud is deliberate steps by one or more individuals to deceive or mislead with the objective of misappropriating assets of a business, distorting an organization's apparent financial performance or strength, or otherwise obtaining an unfair advantage (Hemrai, 2004). Where fraud is perpetrated by breaching security arrangements, organizations are reluctant to admit the commission of fraud. Auditors are committed to maintaining confidentiality as to their clients' affairs (Humphrey and Turley, 1993).

In light of the above discussion, fraud may be defined as intentional deception, cheating or stealing and can be committed against users such as investors, creditors, customers or government entities (Weirich and Reinstein, 2000). Statement on Auditing Standards (SAS) No. 82 identified two categories of fraud as fraudulent financial reporting and misappropriation of assets (Crawford, 2011). Fraudulent financial reporting (management fraud) is where management seeks to inflate reported profits or other assets by overstating assets and revenues or understating expenses and liabilities in order to embellish the financial statements. Misappropriation of assets (employee fraud) is where employees steal money or other property from their employers (Hemraj, 2004; Riahi-Belkaoui, 2000). Various fraud schemes could include embezzlement, theft of company property and kickbacks.

## 2. Statement of the Problem

Kenya's private sector has been listed among the worlds most corrupt. Business fraud and bribery in Kenya's private sector has been on the rise in the last two years (Ernst and Young, 2014). However, fraud still remains a severe issue at most levels of society. Despite market reforms, several business surveys reveal that business fraud is still widespread and that companies frequently encounter demands for bribes and informal payments in order to 'get things done' in Kenya. The use of agents to facilitate business operations and transactions in Kenya is widespread and poses a risk for companies, particularly at the market entry and business start-up stages. (Human Rights Report 2013). This scenario suggests a need for a study to investigate and recommend on the importance of auditors in detection of fraud. Thus the study therefore seeks to explore effects of auditors on fraud detection in private firms in Kenya.

## 3. Literature Review

Audit Experience is the knowledge or mastery of an accounting work gained through involvement in or exposure to it. Auditor's expert is an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner3 or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: ISA 620 Para. A1–A3). Management's expert is an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Auditing requires a team with experience and expertise, to obtain and assess sufficient appropriate audit evidence and apply appropriate professional skepticism. Increasing use of judgments and estimates in financial reporting standards are leading to junior staff increasingly needing to assess and evaluate estimates as well as undertake re-calculations or re-performance procedures. The expertise and skills required of more junior staff is therefore changing. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: ISA 620 Para. A4–A9)

The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9–13 ISA 620 will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: ISA 620 Para. A10) (a) The nature of the matter to which that expert's work relates; (b) The risks of material misstatement in the matter to which that expert's work relates; (c) The significance of that expert's work in the context of the audit; (d) The auditor's knowledge of and experience with previous work performed by that expert; and (e) Whether that expert is subject to the auditor's. Fraud detection may require forensic auditors/accountants' who has expatriate experience. Forensic accounting is the specialty area of the accountancy profession which describes engagements that result from actual or anticipated disputes or litigation."Forensic" means "suitable for use in a court of law," and it is to that standard and potential outcome that forensic accountants generally have to work (Crumbleyet al.2005).

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. The job of forensic accountants is to catch the perpetrators of the estimated $600 billion theft and fraud occurring in the US companies per year. This includes tracing money laundering and identity theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorce cases

(Weygandt et al. 2008,). Forensic accounting has been pivotal in the corporate agenda after the financial reporting problems which took place in some companies around the world (see, for example, Enron, Tyco, and WorldCom, just to mention a few). These scandals resulted in the loss of public trust and huge amounts of money. In order to avoid fraud and theft, and to restore the badly needed public confidence, several companies took the step to improve the infrastructure of their internal control and accounting systems drastically.

## 4. Research Methodology

In this study data was collected from both the primary and secondary sources. Primary data was collected by the use of structured questionnaires which addresses both open and closed-ended questions and administered to the respective staff of auditors of private firms. They were dropped off at the respondent's office then picked later after they had been filled. To increase the response rate a follow-up by the phone followed. Secondary data was gathered in JKUAT main library from manuals, text write up and other reference materials including: texts, finance journals, magazines and internet sites. The study used both qualitative and quantitative data. Descriptive statistics was applied to analyze both qualitative and quantitative data. Data obtained from the questionnaires was processed through editing and coding and then entering the data into a computer for analysis using descriptive statistics with the help of Statistical Package for Social Sciences (SPSS) version 21.0,which offers extensive data handling capabilities and numerous statistical analysis procedures that analyses small to very large data statistics (Bell, 2007). Qualitative data was analyzed using content analysis. The study used Pearson's correlations to determine the relationship between the performance and the study factor variables.

## 5. Findings

**Table 1 Number of years of auditing and accounting experience**

| No of years of auditing and accounting experience | Frequency | Percentage |
|---|---|---|
| Below 5 | 5 | 14 |
| 6-10 | 8 | 23 |
| 11-15 | 10 | 29 |
| Above 16 years | 12 | 34 |
| Total | 35 | 100 |

The respondents showed that they had served as either accountants or auditors. More than 63% of the respondents have served for more than 10 years. This suggests that auditors need many years of auditing experience in order for them to perform audits effectively, with consistence and putting in mind the changing regulations and laid down procedures. The corporations are therefore able to save on labor costs such as disruption of the work force owing to unplanned reductions that result in employees leaving (Beardwell et al, 2004). As a qualification it indicates that effective auditing is dependent on the experience of internal auditors. Kenya's private firms, therefore, have more experienced internal auditors i.e. more than (63%) and thus it has positive implications on the efficiency of internal auditors.

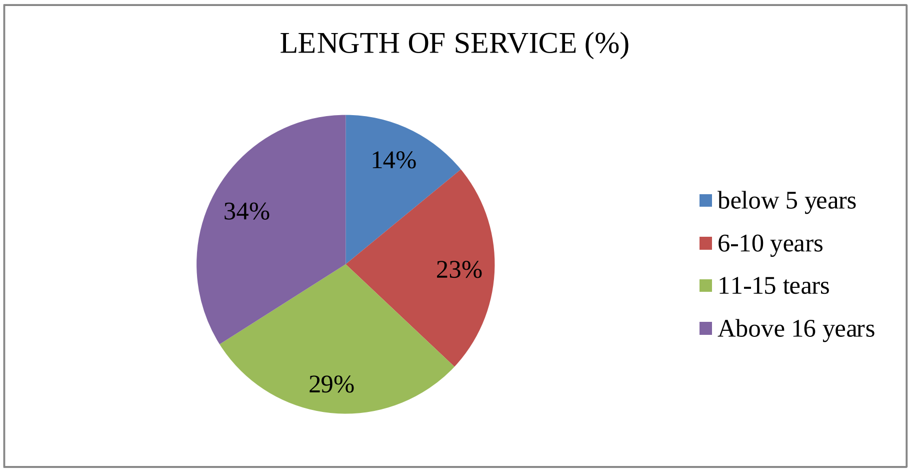


**Figure 1 Number of years of auditing and accounting experience**

**Table 2 Past experiences in fraud detection and fraud training**

| **Items** | | **Subjects** | |
|---|---|---|---|
| | | **number** | **%** |
| **Fraud** | Yes | **39** | **48.8** |
| | No | **41** | **51.3** |
| | Total | **80** | **100.0** |
| **Training** | Yes | **40** | **50.0** |
| | No | **40** | **50.0** |
| | Total | **80** | **100.0** |

The subjects were further asked whether they had ever worked on an audit client where fraudulent financial reporting of a material nature was detected. Table 4.7.1 shows that almost half, 39 (48.8%), of the subjects had experienced detecting fraud in the audit while the remaining 41 (51.3%) had not. Nieschwietz, Schultz and Zimbelman (2000) indicate that experiences with fraud in audit engagements are rare, so for any single auditor, repeated practice in detecting it is also rare. However, the subjects were also asked whether they had ever participated in a training session that specifically addressed fraud detection issues. As shown in Table 4.7.1, 40 (50.0%) of them had participated in such a training, while the remaining 40 (50.0%) had never participated.

**Table 3 Experience in fraud detection versus fraud training**

| | | **Experience in fraud detection** | | | | **Total** | |
|---|---|---|---|---|---|---|---|
| | | **Yes** | | **no** | | | |
| | | **No.** | **%** | **No.** | **%** | **No.** | **%** |
| **Fraud training** | **Yes** | 23 | 59.0 | 23 | 41.5 | 40 | 50.0 |
| | | | | | | | |
| | **No** | 16 | 41.0 | 23 | 58.5 | 40 | 50.0 |
| | | | | | | | |
| **Total** | | 39 | 100.0 | 23 | 100.0 | 80 | 100.0 |

Further analysis is made on the past experience in fraud detection and fraud training. The subject breakdown by these two variables is presented in Table 4.7.2. As demonstrated by Table 4.7.2, out of 39 subjects who had experienced detecting fraud, only 23 (59.0%) of them had participated in fraud training while the remaining 16 (41.0%) had never participated in such a training. The detection of fraud incidence may exist prior or after they had participated the fraud training. In either case, this study presumes that the fraud training attended by these subjects might have increased their awareness about the possibility of fraud occurring in the clients‟ accounts, or the training might have provided some guidance on how to proceed if fraud is suspected. On the other hand, out of those who had never detected fraud, 17 (41.5%) had participated in fraud training while the other 24 (58.5%) had never attended such training.

## 6. Conclusion and Recommendation

Auditor's experience level have a significant effect on his/her ability to detect fraud. The auditing and accounting regulators should expand the scope of the audit to satisfy the demand of market expectations. This can help to reduce the expectation gap problems. In fact, the gap always exists between auditors and users of audit. The desire is always beyond the responsibility and the ability of auditors. Responsibilities of the auditors is to ensure that the financial statements that there are no misstatements, and if any of the misstatements, the auditor must act under the guidance of the audit standards and law. The auditors are in difficult and unable to fully the meet of requirements. Therefore, the auditing regulators should expand the scope of audit.

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