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An Examination of Actual Fraud Cases With a Focus on the Auditor's Responsibility

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Abstract :

The purpose of this paper is to contribute to an understanding of the intricate relationship between audit regulation and developments in audit practice in relation to the fraud issue. The extent and exact nature of the responsibilities of the auditor to detect fraud in relation to audit engagements has been widely discussed over the years. In this paper we classify actual cases, where the responsibilities of auditors have been established by the court system and/or by the auditors own professional organizations in Denmark. The dataset includes all publicized cases raised against Danish auditors within the time period 1909-2006. The information provided in the cases provides a basis for identifying the actual responsibilities pertaining to fraud during the audit. The overall finding of the historical analysis is that the responsibilities of the auditor in relation to fraud should be interpreted not as a group of its own, but in line with the development of what constitutes a good audit in general.

Keywords:

Fraud, auditor responsibility, intentional misstatements, misappropriation, fraudulent reporting, embezzlement.

1. Introduction

The purpose of this paper is to contribute to an understanding of the intricate relationship between audit regulation and developments in audit practice for the purpose of understanding current responsibilities of the auditor in relation to fraud. The contribution of this paper involves insight into an audit market with a historical tradition for mandatory audits of not only listed companies, but all limited liability companies. The institutional setup has allowed insight into fraud cases, where the auditor's responsibility has been questioned for a time period which reaches back to the start of the audit profession in the beginning of the last century.

One current interpretation of the auditor's responsibilities in relation to fraud can be found in the revised audit statement on the auditor's report ISA 700. The auditor's responsibility is described as part of the audit report, i.e. the following illustration is provided in ISA 700, section 60:

> *"Auditor's Responsibility:*
>
> Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are **free from material misstatement**.
>
> An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, **whether due to fraud or error**. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circum-

stances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control (emphasis added by authors)". [1]

From the viewpoint of the users of financial statements this is often read as "it is the auditor's responsibility that the financial statements are free from (material) misstatements whether due to fraud or error". Yet, in the vision paper provided by the CEOs of the six international audit networks the problem is clearly recognized: "Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud", (Vision paper, November 2006, p.12). We aim to diminish this confusion by examining the relationship between audit regulation and developments in audit practice in relation to the fraud issue.

In this paper we examine and classify cases, where the responsibilities of auditors have been established by the court system and/or by the auditors´ own professional organizations. The information provided in the actual cases provides a basis for identifying the actual responsibility to recognize potential fraud situations during the audit and the responsibilities to react upon such knowledge. While the contribution of court systems in accounting studies been identified as being very important, it is also a relative ignored source of information for research purposes (Mills and Young, p. 244). The examination is also interesting in a time perspective, because many of the cases predate the recent promulgations national and international standard setters (i.e. IFAC). The promulgations have increased the awareness toward the auditor responsibility of identifying and reporting on (potential) fraud matters.

The overall finding of the historical analysis is that the responsibilities of the auditor in relation to fraud should be interpreted in line with the development of what constitutes a good audit. In the responsum, tribunal and court cases the criticism against the auditor has been based on shortcomings of the audits

[1] Effective for auditor's reports dated on or after December 31, 2006.

either in the form of inappropriate/insufficient audit tasks or related to failures of communication. The auditor is never reprimanded or punished for not detecting frauds as such, but criticism is raised whenever audits have been found to be below standard. The development in sanctions and civil liabilities confirms that the court system is now considering fraud as a normal, although unusual, business scenario towards which the auditor has proactive responsibilities when planning and conducting the audit.

In the next section, we provide the motivation for the study and discuss prior literature on fraud issues. In section 3, the background for interpreting the historical account is provided in two subsections. The first subsection describes the Danish legal and collegiate system as a background for the development of the audit regulation and for understanding fraud cases. The second subsection describes the methodology applied in attaining, classifying and analysing the actual fraud cases. The historical account for the changes in the auditor's responsibilities in relation to fraud is provided in the three subsections of section 4. The paper is concluded in section 5.

2. Motivation and literature review

In this section we provide the motivation for the paper and discuss previous literature on fraud. The extent and exact nature of the responsibilities of the auditor to detect fraud in relation to audit engagements has been widely discussed over the years. An illustration is provided by the continuous update of pertinent audit standards in the US, i.e., SAS 53 (AICPA 1988), 82 (AICPA 1997) and 99 (AICPA 2002). The auditor's responsibility in relation to fraud is an issue that has gained even more attention in recent years. This is due not least to the collapse of Enron and other corporate scandals, which have contributed heavily to a decrease in the trust in auditors by users of financial statements and the public in general. As early as 1996, the Commission of the European Communities pointed out in the green paper on the role, the position, and the liability of the statutory auditor within the European Union that the public expects the auditor to have a role in protecting the interests of shareholders, creditors, and other stakeholders by providing assurance regarding the existence of fraud (EU Commission, 1996). The Commission also pointed out that this expectation is contributing to the so-called expectation gap between auditors and users of financial statements.

The expectation gap related to fraud has proved hard to close, see Nieschwietz, Schultz and Zimbelman (2000, 192). We contend that this is probably related to the fine distinction between the auditor's responsibility to "detect" or "react" to financial misstatements. From the auditor's point of view the assurance service provided is based on a less than full examination of the evidential matter, hence the potential observations of fraudulent behaviour hinge on the materiality level for the particular engagement. This problem has been examined by Braun (2000) by looking at the effect of time pressure as explaining the auditor's main focus on the regular audit acts as opposed to attention towards less frequent fraudulent behaviour. In addition, an assessment of high fraud risk is not necessarily the same as fraud being committed. Due to confidentiality issues, the auditor is especially placed in a precarious situation when faced with a suspicion of fraud committed by management or those charged with governance, see Bloomfield (1997) on strategic dependence, and Newman, Patterson and Smith (2001) on the dynamic interaction between auditor and auditee. From the users point of view the distinction between detecting fraud and reacting to observed fraud is obscured by the lack of understanding of the role of an auditor. Difference in expectations has been observed in terms of the perceived level of assurance for fraud detection with higher levels expected by users than by auditors, e.g., Goldwasser (2005), Epstein and Geiger (1994).

The increased attention to fraud issues applies not only to regulators but also to academics. Thus the auditor's responsibility in relation to fraud and hence the auditor's detection of fraud is an issue that has been – and still is – attracting an increasing amount of research. Nieschwietz, Schultz, and Zimbelman (2000) provide a comprehensive review of the empirical research. They state that their review is warranted primarily because policy makers, academics, government officials, and practising auditors have debated the auditor's responsibility for detecting fraud for several decades (Nieschwietz, Schultz, and Zimbelman, 2000, p. 190).

Pany and Whittington (2001), starting from the recommendations from the Panel on Audit Effectiveness, provide insight into a number of auditing standard issues. They state that research on fraud has generally found that auditors differ in judgments about the amount of fraud risk signalled by different red flag indicators, i.e. fraud risk factors that more sophisticated decision models are found to improve auditors' ability to distinguish the risk of fraud, and that auditors modify overall audit plans and audit programmes in response to assessments of fraud risk in different ways (Pany and Whittington,2001, pp. 404-405). Similar conclusions can be drawn from the review of prior studies by Nieschwietz, Schultz, and Zimbelman (2000), and from more recent studies, e.g. post-SAS 82 studies in the US by Knapp and Knapp (2001), Glover et al. (2003), Lynford and Bedard (2003), and Mock and Turner (2005).

Fraser and Lin (2004, pp. 166-168) outline the academic discussion and prior research of the potential impact of audit standards on actual auditor behaviour. In a two country experimental set up involving UK and Canada they find that auditors do take the detailed prescription of standards into account, when considering their responsibilities for the detection of clients´ illegal acts, Fraser and Lin (2004, p. 178). In line with the critical viewpoint of the potential impact of audit standards Wilks and Zimbelman (2004) uses a game theory perspective to develop recommendations for improving current audit standards. They propose that due to the strategic nature of fraud, audit policymakers should replace standards that inhibit auditors' strategic reasoning (e.g., emphasis on lists of fraud cues) with standards that encourage strategic reasoning (e.g., persuade auditors to consider how management might manipulate their perceptions of fraud cues), Wilks and Zimbelman (2004, p. 182).

Part of the studies on fraud has dealt with the issue from the viewpoint of audit failures. This literature primary concerns litigation and enforcement activities of supervisory bodies such as SEC in the United States, e.g., Bonner, Palmrose and Young (1998), Rollins and Bremser (1997), Campbell and Parker (1992). In an analysis of 415 SEC releases from 1972 to 1989 Campbell and Parker (1992) identified several important issues in relation to fraud. The large majority of cases in which the SEC associated the auditor with fraud (recklessness) involved smaller audit firms, whereas the large majority of cases of management fraud involved large audit firms, see Campbell and Parker (1992, 308-309). Similarly, Rollins and Bremser (1997) examined 309 SEC releases from 1982 to 1991. One of their findings was an inverse relationship between the relative number of cases where auditors were disciplined and the audit firm size. In effect, Big Six firms were disciplined less often than national and local firms in relation to accounting violations by clients, Rollins and Bremser (1997, p. 198). Finally, the litigation risk has been tied in to the SEC releases in the study by Bonner, Palmrose and Young (1998). The study provides a very useful taxonomy of 12 general categories of fraud. The taxonomy is based on prior academic and practice related literature combined with categories applied in actual SEC releases. They found that auditors are more likely to be sued over more frequently occurring frauds (such as premature revenue recognition) and fictitious transactions frauds (such as fictitious revenues). From the 261 companies examined in this study (SEC releases from the period 1982 to 1995), 42% have no litigation, 38% have auditor litigation and 20% have other litigation, Bonner, Palmrose and Young (1998, p. 513). One implication suggested by Bonner, Palmrose and Young (1998, 527) is that "litigation alone is not sufficient for deterrence of fraudulent financial reporting", i.e., leaving a non-neglectable role for audit regulation.

Regulation through audit standards has proved to provide useful "common knowledge" in the communities of academics and practice alike. Hence, for the purpose of this study the ISA 240 (revised) is used as the present benchmark for a historical examination of the auditors' responsibility in relation to fraud. ISA 240 (revised) refines the concept of fraud by introducing a number of important distinctions. First, fraud may be divided into management fraud and employee fraud. Management fraud is defined as fraud involving one or more members of the management or those charged with governance, whereas employee fraud is defined as fraud involving only employees. It is emphasized that, in either case, there may be collusion with third parties outside the company. Second, fraud may be divided into fraudulent financial reporting and misappropriation of assets. These are the two overall types of fraud that are relevant to the auditor's considerations. Fraudulent financial reporting is defined as intentional misstatements or omissions of amounts or disclosures in financial statements intended to deceive users of financial statements. Misappropriation of assets, on the other hand, is defined as theft of a company's assets.[2] [3] Compared to the distinction between management fraud and employee fraud, cases of fraudulent financial reporting are often, but not exclusively, management frauds, whereas cases with misappropriations of assets are often, but not exclusively, employee frauds. Finally, ISA 240 (revised) summarizes what popularly has been termed "the fraud triangle", namely involving three interrelated elements: (1) incentives or pressures to commit fraud, (2) perceived opportunity to do so, and (3) some rationalization of the act on behalf of the perpetrator. The distinctions identified from ISA 240 (revised) are used as a way to classify actual fraud cases in a historical perspective, thus providing potential descriptive characteristics on type of fraud perpetrator, type of fraud, and concrete elements in accordance with the fraud triangle.

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[2] As examples of misappropriation of assets, the standard mentions (1) embezzling receipts, (2) stealing physical or intellectual property, (3) causing an entity to pay for goods and services not received, or (4) using an entity's assets for personal use. It is emphasized that, in order to conceal the fact that assets are missing, misappropriation of assets is often accompanied by false or misleading records or documents.

[3] It is important not to confuse the term 'theft' used in this definition with the legal term 'theft' which is a more narrow term than misappropriation of assets.

Studies involving enforcement activities of professional accountant bodies are, however, extremely rare although these bodies are engrained in most institutional systems as part of national Accounting Associations (Chartered Accountants in Australia, in Ireland, in UK etc.). In addition, litigation environments outside US seem to be less aggressive. However this is probably not only due to few committed and/or detected frauds. The relatively infrequent nature of fraud (a maybe even more scars detection of fraud) makes empirical examination of the area more difficult, Nieschwietz, Schultz and Zimbelman (2000). While the auditor's responsibility in relation to fraud may be relatively unchanged in principle, the always present situational circumstances seem to have clouted the ability to reach consensus on the actual responsibilities of the auditor. Hence, the intended examination of actual cases with analysis of the content and categorisation of shared properties becomes a highly relevant and data-rich setting in comparison.

The nature of auditing may be described as a practice-oriented endeavour. Hence, audit regulation has often been a codification of established good audit behaviour (Wilks & Zimbelman 2004) and "nudged along" by enforcement activities (Campbell and Parker 1992). It is in this context that the responsibility of the auditor to detect fraud has evolved over time. Peecher et. al. (2007, p. 464) suggests that auditing approaches evolve endogenously in response to changes in society's information needs, regulations, business organization's value creation-processes and available accounting and audit technologies. In a similar manner, it is our contention that the responsibilities manifested in audit regulation have functioned in a symbiotic relation with actual practice, courtroom rulings on litigation cases and disciplinary actions from professional and supervisory bodies subject to institutional differences in individual countries. Hence, the research question is raised as follows.

RQ: How has the auditor's responsibility in relation to fraud developed over time?

In order to shed light on this question we examine actual cases involving the auditors' responsibilities in relation to fraud raised within the institutional audit environment of Denmark. The contribution of this paper involves insight into an interesting audit market with a historical tradition for mandatory audits of not only listed companies, but all limited liability companies. The institutional setup has allowed insight into fraud cases, where the auditor's responsibility has been questioned for a time period which reaches back to the start of the audit profession in the beginning of the last century.

3. Examining fraud cases in Denmark

The purpose of this section is to provide a short overview of the Danish legal system and describe the methodology applied in attaining and classifying the attributes found in the actual fraud cases.

3.1. The Danish legal system

This section provides an overview of the Danish legal system, i.e., the Danish institutional environment regarding professional organizations, standard setters, and courts. The section only provides an overview of this institutional environment, i.e., a description of the institutional environment that is sufficient with regard to the analysis of fraud cases later in the paper. Thus the section does not provide an exhaustive description of the institutional environment.[4] An overview of the pertinent collegiate bodies and legal system is provided in figure 1.

[4] Holm and Warming-Rasmussen (2006) provide an overview of auditing in Denmark. Similarly, Christiansen (1993a) Christiansen (1993b), Elling (1993), and Hansen and Sørensen (2003) provide an overview of accounting in Denmark. This literature is all in English.

In Denmark, there are two types of auditors: State Authorized Public Accountants and Certified Public Accountants[5]. As a main rule, companies, i.e. limited liability companies, are always required to prepare their financial statements in accordance with the Danish Financial Statements Act. Also, as a main rule, companies that are required to prepare their financial statements in accordance with this Act are always required to have their financial statements audited by one or more auditors. Before April 1, 2006, this was not the main rule, but the only rule. Thus, before that date, companies that were required to prepare their financial statements in accordance with the Financial Statements Act were always required to have their financial statements audited by one or more auditors.[6] However, since that date, companies that are required to prepare their financial statements in accordance with the Financial Statements Act are not required to have their financial statements audited by one or more auditors, if they do not exceed certain limits.[7] Only State Authorized and Certified Public Accountants are allowed to carry out statutory auditing. Thus companies that are required to prepare their financial statements in accordance with the Financial Statements Act and have their financial statements audited by one or more auditors are required to have their financial statements audited by one or more State Authorized or Certified Public Accountants. Furthermore, state-owned or listed companies are required to have their financial statements audited by at least one State Authorized Public Accountant. For this and other reasons, State Authorized Public Accountants dominate the audit market in Denmark.

[5] The number of State Authorized Public Accountants is approximately 2000 and the number of Certified Public Accountants is approximately 3000. In comparison the entire Danish Population is approximately 5.4 million people..

[6] Before December 31, 2004, state-owned and listed companies or other types of enterprises were required to have their financial statements audited by two auditors, i.e., two auditors from two different audit firms, see §165, paragraph 6. This requirement has been abolished so that even state-owned and listed companies are now required to have their financial statements audited by one or more auditors.

[7] Specifically, companies that are required to prepare their financial statements in accordance with the rules in reporting class B are not required to have their financial statements audited by one or more auditors if they do not exceed two of the following limits as at the balance sheet date in two consecutive financial years: (1) a balance sheet total of DKK 1.5 mio., (2) revenue of DKK 3 mio., and (c) an average number of 12 full-time employees during the financial year.

Most State Authorized Public Accountants are members of the Institute of Certified Public Accountants (Foreningen af Statsautoriserede Revisorer – FSR).[8] This institute consists of a number of professional committees. Three of the most important of these committees are the Accounting Committee, the Auditing Committee, and the Responsum Committee.

<Insert "Figure 1. Fraud cases considered in the collegiate bodies and legal system" about here>

The responsibility of the **Accounting Committee** is to develop accounting standards. These standards are inspired by the international accounting standards (International Accounting Standards – IAS/International Financial Reporting Standards – IFRS) that are issued by the International Accounting Standards Board (IASB). The responsibility of the **Auditing Committee** is to develop auditing standards (revisionsstandarder – RS). These standards are based on the international auditing standards (International Standards on Auditing – ISA) that are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). In fact, the Danish standards are verbatim translations of the international standards except for any special provisions in the Danish legislation which are added to the international standards. Many of these provisions are found in the Financial Statements Acts. However, many of the provisions are also found in other acts, e.g. the Auditors and Companies Acts.

Finally, the responsibility of the **Responsum Committee** is to make expert opinions ("responsa") regarding "good auditor practice".[9] This concept of "good auditor practice" originates from the Danish Auditors Act. One of the central provisions in this Act provides that the auditor is "the public representative" or "the public watchdog" when performing audits or other types of engagements that are

[8] Similarly, most Certified Public Accountants are members of the Institute of Certified Public Accountants (Foreningen af Registrerede Revisorer – FRR).

[9] The Responsum Committee has the authority to make expert opinions regarding 'good auditor practice' whether the auditor involved is a member of FSR or not. FRR has its own Responsum Committee.

comprised by the Act. This provision also provides that the auditor must perform audits and other types of engagements that are comprised by the Act in accordance with “good auditor practice”. Thus the concept of “good auditor practice” originates from the Auditors Act. However, the concept is a general clause that is supplemented not only by this Act, but also by other acts and other types of regulation, e.g. the Danish auditing standards. This hierarchy of the auditor’s responsibility in relation to “good audit practice” is indicated in figure 2. Furthermore, the concept is also supplemented by responsa from the Responsum Committee, disciplinary decisions from the Disciplinary Tribunal and judgments from the courts in the regular court system, i.e. the third level in figure 2.

<Insert “Figure 2. The regulatory hierarchy of auditor’s responsibility for “good audit practice”” about here>.

Compared to the Disciplinary Tribunal and the courts, it is important to be aware of the fact that the Responsum Committee cannot impose any sanctions on an auditor. Thus only the Disciplinary Tribunal and the courts can impose sanctions on an auditor. Admittedly, the Responsum Committee makes experts opinions regarding “good auditor practice”, but it is up to the Disciplinary Tribunal and/or the courts to decide if any sanctions should be imposed on an auditor. Furthermore, neither the Disciplinary Tribunal nor the courts are obliged to request a responsum from the Responsum Committee when deciding whether to impose any sanctions on an auditor or not.

As identified in figure 1 there are three types of legal liability for auditors: (1) disciplinary liability, (2) civil liability (or liability to pay damages), and (3) criminal liability. Cases of disciplinary liability are handled by the **Disciplinary Tribunal** and from 1967 to 2002 by the **Accountants Tribunal** as a court of appeal. The Accountants Tribunal is now abolished and only the Disciplinary Tribunal constitutes the disciplinary system. Cases of civil or criminal liability, on the other hand, are handled by the courts in the regular court system. In Denmark, there are three levels of courts in the regular court system. The first level consists of a number of **District Courts**. Most cases start out at this level. The second level consists of two **High Courts**. Many cases, especially more serious ones, also start out at this level. Finally, the third level consists of a **Supreme Court**. The Supreme Court is only functioning as a court of appeal. Thus no cases start out at this level. As a main rule, it is only possible to appeal a judgment once, i.e. either from one of the District Courts to one of the two High Courts (if the case starts out at the first level) or from one of two High Courts to the Supreme Court (if the case starts out at the second level).

As previously mentioned only the Disciplinary Tribunal and the courts can impose sanctions on an auditor. The number of fraud cases considered in this paper has been classified in figure 1 in accordance with type of sanction. Disciplinary liability can result in different sanctions depending on the severity of the offence and other circumstances. These sanctions include a warning, a fine, or a suspension of the license to practice as an auditor. Similarly, criminal liability can result in different sanctions depending on the severity of the offence, the provision that is violated, and other circumstances.[10] These sanctions include a fine, an imprisonment or – similar to disciplinary liability – a suspension of the license to practice as an auditor. Civil liability cannot result in any sanctions as such. Rather, in cases of civil liability, the plaintiff seeks to claim damages from the defendant, i.e. the auditor. Thus civil liability assumes that the plaintiff has suffered an economic loss, e.g. because the auditor has been negligent in performing an audit or another type of engagement.

[10] Many of the criminal provisions – in particular the most ”serious” ones – are found in the Criminal Code. However, criminal provisions – in particular the less ”serious” ones – are also found in other acts, e.g., the Financial Statements Act (§164), the Auditors Act (§27) and the Companies Act (§§160-61).

3.2. Methodology and overview of the actual fraud cases

In this section we provide a description of the methodology applied in identifying and recognizing pertinent facts during the examination of the cases. The 83 fraud cases considered in this study are such cases where the responsibility of the auditor has been questioned. It includes all the cases which have been made publicly available within the time period from1909 to 2006. Due to the relationship between the institutions involved, the same case is sometimes handled more than once, i.e. the number of **unique fraud cases** considered in this paper is 72. It should be considered that the list of cases is not exhaustive in terms of fraud cases raised within the court system in Denmark and certainly not in terms of the number of criminal offences committed. In fact, many fraud cases do not lead to questions being raised as to the particular responsibilities of the auditor[11]. Due to the interest in examining the auditor's responsibility over time, only fraud cases involving the auditor are examined. An overview of the type of actual fraud cases considered is provided in the flowchart in figure 3. Here a distinction is made between responsum cases and tribunal or court cases.

<Insert "Figure 3. Flowchart of fraud cases considered" about here>

In total 53 fraud cases have been identified from the total set of 1250 responsum cases handled over time by the responsum committee. As a first step these cases were identified through a thorough word search using several different combinations of words like fraud, criminal act etc. As depicted by the flowchart some, but not all the fraud responsa, have been used by the tribunals or courts. As a next step the fraud responsa were examined in detail. It should be noted that any particular responsum typically addresses more than one issue pertaining to the responsibility of the auditor. Most of the issues

[11] In comparison the MARC "Classification and Analysis of Major European Business Studies" (2005) identified 21 of 60 business failures as involving the role of the auditor.

raised involve concrete scenarios which provide insight in relation to whether the auditor has conducted the mandated tasks in a manner which is in accordance with "good auditor practice". Whether the auditor has received critic from the responsum committee is also identified in the flowchart, i.e. 37 of the 53 cases in figure 3. Criticism raised in the responsum may lead to sanctions on the auditor, but it is not necessarily the outcome in the tribunal or court systems.

An additional 30 fraud cases have been identified from the tribunal (19) and court systems (11). We have only considered public available cases, where questions are raised in relation to the responsibility of the auditor in fraud settings. The flowchart demonstrates that ten of the fraud cases have been considered as responsum cases before ending up as tribunal or court cases. The remaining 20 cases have been raised without obtaining the professional commentary from the responsum committee. Because the courts do need to arrive at an interpretation of the auditors' responsibilities, the responsum may be a useful instrument. An example of the importance of responsum is observed in one of the court cases. Here two of the three judges stated that the absence of a responsum pertaining to the specific area is precluding them from finding the auditor responsible in violating "good practice", court case 6 (1997, p. 1798).

Each of the 83 fraud cases has been examined in detail in order to be able to identify any patterns developing over time. In addition to the detailed information in the individual fraud cases, a data set has been constructed. The total data identifies 18 variables of classification and 15 descriptive variables. The classifications are tied to the case material in different ways. The main classifications used in this paper include:

a) Type of case document (responsum, tribunal, court)
b) Time of origin for case document (1909-1970, 1970-1996, 1996-2006)

c) Type of perpetrators (management, employee, management and employee in collusion, external party, internal and external party in collusion)

d) ISA 240 fraud classification (fraudulent reporting, misappropriation of assets, concealment/ combination of the two)

e) Criticism of auditor (yes/no)

f) Type of criticism (none, insufficient or inappropriate audit tasks, communication failures, both audit task and communication failures)

g) Type of liability (disciplinary, civil, criminal)

h) Type of sanction (none, warning, fine, liability amount, imprisonment, suspension)

When the 72 unique fraud cases are tabulated it is possible to discern relationships between type of frauds and type of perpetrators, see table 1. First, it may be observed that fraudulent reporting is a management deed (11 of 11 cases). Second, concealment of misappropriation of assets is involved in most of the cases (50 of 72), when the responsibility of the auditor is questioned. As identified in ISA 240 fraud often involves carefully organized schemes designed to conceal it.[12] Pure cases of misappropriation of assets are rare for obvious reasons – the perpetrator does not want to be caught. Third, concealment is chosen by both management and employees when placed in situations, where the opportunity arises. Fourth, only a few of the raised cases involve collusion by more parties (one with internal and one with external) or pure theft from an external party (here two situations with bankers). This suggests that most of the fraud cases raised in this context involve typical auditor situations.

<insert “Table 1. Fraud types and perpetrators (unique cases)” about here>

[12] As examples of such schemes, the standard mentions (1) forgery, (2) deliberate failure to record transactions, and (3) intentional misrepresentations being made to the auditor.

4. The auditor's responsibility in relation to fraud

This section provides an analysis of the auditor's responsibility in relation to fraud on the basis of the actual fraud cases and the relevant regulation. The analysis is divided into three time periods. The first time period is the period from the beginning of the previous century until around 1970. This period is without audit regulation pertaining to the auditor's responsibilities in relation to fraud. It is a relatively long period dominated by actual fraud cases rather than regulation. In the second time period from 1970 to 1996 the auditor's reactive responsibilities are recognized in the general audit standards. Thus the transition from the first to the second time period reflects a codification of actual fraud cases into regulation. In the final time period from 1996 to 2006 the responsibilities are characterised as proactive in both the legislation and in the specific audit standards pertaining to fraud. The transition from the second to the third period also reflects a codification of international auditing standards into Danish auditing standards. An overview of the audit regulation and number of fraud cases in each time period is recognised in figure 4. This figure provides a timeline as a basis for the historical account of the audit regulation and examination of actual fraud cases in the three time periods.

<insert "Figure 4. Timeline for audit regulation and fraud cases" about here.>

4.1. Audit regulation and fraud cases in the time period before 1970

The historical account for the responsibility of the auditor starts with a 60 year span without any fraud provisions in the audit regulation, see part I of the historical overview in figure 4. The first Auditors

Act was adopted as early as 1909. However, this Act did not contain any provisions that were relevant to the auditor's responsibility in relation to fraud. A new Auditors Act was adopted in 1930. Compared to the 1909 Act, this Act contained very few new provisions and none of these provisions were relevant to the auditor's responsibility in relation to fraud either. Furthermore, the 1930 Act was repealed as early as 1931, but the provisions from the Act were moved to a new Business Act and supplemented by an Executive Order on Auditors' Activities, Duties, and Responsibilities in 1933.[13] A new Auditors Act was not adopted until 1967.

However, frauds were committed, and the auditors were expected to play a certain role in relation to solving frauds. In 1930 a new criminal code was introduced, and the implications for the auditors were discussed in the following years. The Copenhagen law professor Stephan Hurwitz was invited to speak on the role of the auditor at an annual assembly of the State Authorized Public Accountants. The manuscript titled "On enrichment and financial statements crimes" was also published in the profession magazine for the Danish auditors "Revision & Regnskabsvæsen" (Hurwitz, 1935). The message of the presentation was that "intent" by a perpetrator is a crucial legal criterion in order to establish the particular form of crime. The same "objective act" might point to different conclusions such as embezzlement, property damage or no criminal act at all. Because criminal intent is an internal psychological attribute of the perpetrator, the external objective act observable by the auditor can only be circumstantial. Hence, the law professor cautions the auditors to be careful. Based on an examination of the books and accounts the auditors are not equipped to positively declare that fraud has occurred. Instead they should limit themselves to observe objective facts, i.e. that this or that has been found to be incorrect or missing and that this could be indicative of some criminal act (Hurwitz, 1935, p. 183).

[13] An executive order is similar to an act. The only difference is that an act is prepared and adopted by the Danish parliament whereas an executive order is prepared and issued by public officials. However, public officials are only entitled to prepare executive orders under the provisions of an act.

This particular interpretation can be rediscovered in the proclaimed criticism of the auditor in responsum case 29 (1935, p. 1, in translation):

> "However, in many cases it is natural that he [the auditor] obtains as much information as possible before he delivers his report; but sometimes it is even correct to raise criticism against the auditor if he seeks information directly from the person who has conducted fraud too early on, especially if the extent of the fraud is not fully clarified."

> "The auditor's task must always be to give an objective and impartial account of the circumstances that are mentioned in his report. Normally, he shall not pass judgment on the legal nature of the criticised actions."

Hence, the auditor was criticized in general terms. The message is that the auditor profession should refrain from making legal assessments on observed transgressions. The presumed fraud was tied to the sole accountant and suggested lack of appropriate bookkeeping and detainment of received payments. The same interpretation of the extent of the auditor's responsibility could be found in Sweden at the same time. At the 4th Scandinavian Auditor Congress in Stockholm the Swedish Authorised Auditor Sven Hagström made a very thorough description of the possible steps for the auditor in order to detect fraudulent reporting. The presentation was published in the Danish profession magazine Revision & Regnskabsvæsen (1936, pp. 1-18). On the issue of the auditor's responsibility in relation to fraud examinations, he suggested that if the examination should be used as a basis for a legal judgment, then the best course for the auditor would be to refrain from classifying identified errors from a legal standpoint (Hagström, 1936, p. 17). Thus, the inspiration for the cited decision in responsum case 29 is clear.

<Insert "Table 2. Number of Responsum cases (percentage with critic of auditor), perpetrators and time period" about here.>

This is one of only 21 responsum cases on fraud provided in the time span from 1909 to 1970. The typical fraud case involved an employee as the sole perpetrator (13 cases), while 7 cases involved management as sole perpetrator, see table 2. Only one case identifies a fraud scenario with collusion between manager and employer. Criticism of the auditors was proclaimed in 52 percent of the fraud cases. This is a considerably lower proportion than for the later time periods, see table 2 for comparative figures. It is noticeable that no criticism was raised in the two responsa (117 and 179) later associated with court cases handled in this first time period. Responsum case 179 (1953, p. 2, in translation) provides the following explanation which does elucidate the absence of criticism in a number of fraud cases:

> "The purpose of a normal audit of financial statements is to examine the accuracy of the financial statements. This includes that the auditor – depending on the type and organisation of the company – takes into consideration rather obvious possibilities for fraud. Only if the auditor comes across circumstances that must raise his suspicion he should extend his examination until he reaches an assurance about whether the suspicion is justified or unjustified. History shows that fraud transactions that have happened once will repeat themselves with increasing frequency, and therefore the auditor relies on the fact that sooner or later and with ordinary scepticism he will normally come across circumstances that will lead to detection."

The public can be confident that most perpetrators will eventually compile enough transgressions to be noticeable. Therefore it is only a matter of time before the auditor will detect frauds in the natural course of annual audits. In accordance with this assessment by the responsum committee the High Court acquitted the auditor (court case 2, 1955). In spite of the auditor's knowledge about the lack of separation of duties at the client, he was not sanctioned by the court to pay damages. This is somewhat in contrast to the other court case in this time period (court case 1, 1951). In this case separation of duties for the cash register and bookkeeping was also weak. The auditor was sanctioned to pay damages because of his lack of supervision with this particular business cycle. However, the claimed damages by the prosecutor were lowered, because the court found that the own supervisory responsibility by the business manager had not been maintained sufficiently. That is, the importance of own control or internal control is considered by the court system to be a pertinent requisite for the task performed by the auditor.

The reason for the importance of internal controls in relation to fraud prevention should be obvious. In an article of the time, one state authorized auditor (and lecturer at CopenhagenBusiness School) stated that (Jensen 1953, p. 188, in translation):

> "As is well known, the vast majority of the frauds committed consist of withholdings [of payments from debtors]. Therefore the auditors must be particularly aware of this fact and seek to prevent any possibilities for this type of fraud or detect it as soon as possible when it is committed."

This is in line with a focus on the relationship between lack of controls and fraud opportunities in this time period. Another article from the profession magazine "Revision & Regnskabsvæsen" looked at the pertinent question: "Can frauds be prevented through internal controls", Orreby, 1945. The article started with a message of a social conscious nature: (Orreby, 1945, pp. 255-256):

> "It is not only the cashier who assumes a responsibility, when he takes over the cash management. The company that hires the cashier also has a considerable responsibility, i.e. the responsibility for the cashier's moral. It is not right to expose a person to the temptations that are connected to the management of the cash of someone else without giving him or her the moral support of an effective control at the same time. The more difficult it is to have the cash at your disposal and the greater the risk that irregularities will be detected, the smaller are the temptations."

It is important not to tempt the person in charge of cash receipts and, as such, it is important to implement the necessary control system in a company. This involves separation of duties and automatic controls ingrained in the work processes of the different employees. The article goes on to suggest more mechanic systems related to the payments like the American "imprest system" (payments related to a fixed amount for which the cash clerk is responsible). More concrete controls are suggested in the articles as related to the cash receipts, but the principle is implied for the entire administrative system (Orreby, 1945, p. 258, in translation):

> "Of course, the internal control shall not only take into consideration the cash management, but you should aim at such an organisation that errors occurring in the accounting or the overall routine office work will be detected and corrected."

From a current perspective this is interesting, but what was the interpretation of internal controls at the time? Of course "separation of duties" and related controls were central. This would be in accordance with the reference to "internal checks" as distinctive from "the internal control system" made in the

KPMG´s publication "The 21st Century Public Company Audit" (Bell et al. 2005, p. 7). Before the 1992 COSO report the definition of internal control was hardly uniform (COSO, 1992). But even in the middle of the last century the definition extended to more than separation of duties. As an example, the Norwegian considerations on the auditors' responsibilities were presented in the Danish magazine Revision & Regnskabsvæsen – in modern auditing you distinguish between internal control and external auditing: (Sommerschild (1937, p. 185, in translation):

> "Following a modern understanding of auditing, it is the responsibility of the external auditor to form a justified opinion about whether the internal control is properly organised. The auditor must know its structure thoroughly and must continually and in an unpredictable manner ascertain that the control system is being followed. If the auditor comes to the opinion that both the system itself and its implementation is first class, many details can be left to the internal control."

The responsibility of the auditor is separate from the supervisory responsibilities of the company. The nature of the responsibilities can be indicated by looking at the selected responsum fraud cases 172 and 394. In Responsum case 172 (1952) the auditor was found free from criticism "even though" he waited half a year to follow up on his initial suspicion of fraud by an employee. The message is that it is not the auditor's main task to detect fraud or even – as indicated in this situation – to react immediately upon fraud suspicions. In the later Responsum case 394 (1968, p. 2, in translation) involving an employee's detainment of payments from debtors the responsum committee explained that:

> "It is usual for state authorised public accountants to review the company's administrative procedures within the accounting areas at regular intervals. If

> the auditor finds any circumstances that give cause for criticism during such a review, the auditor should draw the management's attention to that fact."

This explanation summarizes the principle nature of the auditor's responsibility as interpreted by the responsum committee. In this period the auditors were not only left to their own interpretation of good auditor behaviour. As demonstrated above frequent translations of articles from profession magazines in other countries were also published, especially from the neighbours of Sweden, Norway and Germany. The international development in the audit profession was followed with keen interest. One of the articles of particular interest for the present purpose was entitled "Why do trusted persons commit fraud?" (Revision & Regnskabsvæsen, 1951/52). This was a translation of an article in The Journal of Accountancy by professor in Sociology Donald R. Cressey. He suggested a scientific approach toward identifying a set of conditions for fraudulent behaviour. Cressey had collected empirical data through interviews with the entire population of fraudulent criminals imprisoned in the Illinois state penitentiary in Joliet (USA). His "theoretical formula" is presented as (Cressey, 1951, pp. 577-578):

> "Trusted persons become trust violators when: (1) they conceive of themselves as having a financial problem which is non-sharable, (2) have the knowledge or awareness that this problem can be secretly resolved by violation of the position of financial trust and (3) are able to apply to their own conduct in that situation a verbalization which enables them to adjust their conceptions of themselves as trusted person with their conceptions of themselves as users of the entrusted funds or property."

In the context of the current focus on the fraud triangle the three main reasons listed in this article is quite interesting. They translate directly into the three elements of incentives, opportunity and rationalization. Thus Cressey is accredited the sociological observations behind the fraud triangle as described in ISA 240 and related fraud literature. So, on one hand it is interesting to identify the origin of these fundamental observations. On the other hand it could be relevant to ask the question: "what's new in ISA 240"?

As previously mentioned, a new Auditors Act was adopted in 1967, see part I of the historical overview in figure 4. This Act did not contain any provisions that were relevant to the auditor's responsibility in relation to fraud either. However, the Act established the disciplinary system that is now an integral part of the institutional environment. Specifically, the Act established the first Accountants Tribunal. However, the functioning of this tribunal was changed in 1993, and the tribunal was ultimately abolished in 2002.[14] In 1970, another Auditors Act was adopted. This Act established the two-tier system of State Authorized and Certified Public Accountants that is still in effect. The activities of State Authorized Public Accountants were regulated in the 1967 Act, whereas the activities of Certified Public Accountants were regulated in the 1970 Act. However, aside from the educational requirements for becoming a State Authorized or Certified Public Accountants, there were few differences between the provisions in the 1967 and 1970 Acts.

A common basis for the following time periods is established in this section. In summary, it is not the auditor's main responsibility to detect fraud. If (when) the auditor does detect fraud, he should notify the company. This could lead to an extended role of helping to detect the causes behind suspicious behaviour. The distinction between the auditors and the criminal investigators´ responsibilities in relation to fraud can be made from a legal standpoint. In addition, a distinction must be made between internal control and the auditors' control.

[14] The Accountants Tribunal that was operative from 1967 to 1993 is often labelled 'the old Accountants Tribunal' whereas the tribunal that was operative from 1993 to 2002 is often labelled 'the new Accountants Tribunal'.

4.2. Audit regulation and fraud cases in the time period 1970-1996

The second time period from 1970 to 1996 introduces regulation that deals specifically with the auditor's responsibility in relation to fraud. The transition from the first to the second time period reflects a codification of good audit practice into regulation, see part II of the historical overview in figure 4. The work of the responsum committee led to a few auditing guidelines in the period from 1970 to 1973. These precursory guidelines were not as authoritative as the subsequent standards, i.e. the first Danish auditing standard was issued by the Auditing Committee in 1978. This standard – RV 1 (1978) – deals with the fundamental principles for audits of financial statements.[15]

However, one of the precursory guidelines – RV (1970) – is relevant to the auditor's responsibility in relation to fraud. The guideline deals with the fundamental principles for audit of financial statements. The auditor's responsibility in relation to fraud is mentioned in the section of the standard that deals with the limitation of the auditor's and the management's responsibility. Specifically, the auditor's responsibility in relation to fraud is described in the following way in the standard (sections 30-32, in translation):

> "During his audit, the auditor is aware of the fact that fraud may occur, because fraud and similar irregularities can have a material effect on the financial statements and hence his report. However, the audit is not intended to detect fraud."

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[15] Also, the standards were not numbered.

> "In his planning, the auditor must take into consideration that fraud is not the usual but the unusual case. Furthermore, the means and the circumstances that can be used for, or be a cause of, fraud are so multifarious that a systematic avoidance of all the possibilities would cause a workload and hence costs of impossible size. Thus the auditor must rely on the fact that an audit that is planned with the purpose of checking the financial statements, combined with ordinary due care, very often will lead to detection if fraud occurs, e.g. because the prior experience suggests that such irregularities will repeat itself with increasingly greater frequency. However, fraud is best prevented by well-functioning internal control."

> "If the auditor comes across any circumstances that raise his suspicion that fraud is occurring he expands his examinations. He reports his findings to the competent management and at the same time makes it clear if the circumstance is so material that it can have an effect on his report on the financial statements. Finally, it is agreed whether the management or the auditor is going to handle the further examinations. Whether the auditor can rely completely on the management's examinations and be content with only being informed about the result hereof or not will depend on to what extent it is possible that any irregularities may have an effect on the financial statements."

This standard was an important inspiration in the development of RV 1 (1978). Thus there is a high degree of conformity between the two standards which has been superseded by RV 1 (1993). Like RV 1 (1978), this standards deals with the fundamental principles for audits of financial statements. Furthermore, like both RV (1970) and RV 1 (1978), the auditor's responsibility in relation to fraud is mentioned in the section of the standard that deals with the limitation of duties and responsibilities between the management and the auditor. Specifically, the auditor's responsibility in relation to fraud is described in the following way in the standard (section 2.7-2.8, in translation):

> "The auditor must plan and perform the audit with a view to being able to decide if the financial statements contain material errors and mistakes.
> An audit planned and performed in accordance with good auditing practice does not provide absolute assurance that any material error and mistake in the financial statements is detected."

> "Errors and mistakes in the financial statements can be unintentional or intentional. For example, intentional errors can be the result of fraud or other irregularities. Intentional errors and mistakes are usually attempted to be concealed or disguised and hence there is an increased risk that the auditor do not detect these errors and mistakes. Thus an audit planned and performed in accordance with good auditing practice cannot prevent that such material errors and mistakes remain undetected."

These standards, i.e. RV (1970), RV 1 (1978), and RV 1 (1993), all reflect a reactive approach to the auditor's responsibility in relation to fraud. Thus the standards do not focus on the auditor's responsibility for proactively detecting fraud during an audit. Instead the standards focus on the auditor's responsibility for reacting on fraud in the – presumable rare – case that the auditor accidentally comes across a case of fraud during an audit. RV (1970) requires the auditor to be aware of the fact that fraud may occur, because fraud and similar irregularities can have a material effect on the financial statements and hence the auditor's report. However, it is emphasized that an audit is not intended to detect fraud. Similarly, RV 1 (1978) requires the auditor to be aware of the fact that fraud and other irregularities may occur, because such circumstances can be important, when evaluating the financial statements. However, once again it is emphasized that an audit is not intended to prevent or detect fraud or other irregularities. Finally, it is emphasized in RV 1 (1993) that an audit planned and performed in accordance with "good auditing practice" cannot prevent that intentional errors and mistakes remain undetected.

In this time period the 1967 and 1970 Acts were changed several times. None of these changes were relevant to the auditor's responsibility in relation to fraud. However, some of the changes are worth mentioning anyway. For example, in 1988, the 8th directive was implemented in Danish legislation. Furthermore, in 1993, the disciplinary system was changed.

The codification of the auditor's responsibility in relation to fraud coincides with an increasing number of actual fraud cases. We have identified 21 responsum cases, 7 tribunal cases and 2 court cases in the time period from 1970 to 1996. In most responsum cases raised in this period the auditor was criticized, i.e. the responsum committee expressed criticism in 86% of the cases as compared to 52% for the previous period, see table 2.

The criticism is tied to the newly codified responsibilities to react upon the suspicion of fraud. As such the auditor could receive criticism for failure to perform necessary tasks catered to the concrete circumstances of the audit and/or for failure to communicate in an appropriate fashion with those charged with governance. In seven of the 18 responsum cases with criticism, the responsum committee pointed to pure audit failures in the form of insufficient or inappropriately conducted tasks. In the remaining 11 responsum cases communication failures were part of the audit failures (this break up is not shown in table). Examples of audit failures could be drawn from Responsum cases 741 and 910.

In Responsum case 741 (1981), the auditor was criticised on a number of points. The frauds were made possible as a result of shortcomings in the administrative procedures for which reason the auditor should have performed supplemental audit work such as comparisons, reconciliations and analysis of differences between the budget and the financial statements which could have contributed to an earlier detection. In Responsum case 910 (1987), the auditor was criticised on a number of points. Among other things, the auditor should have audited the balance sheet item accounts receivable and performed a review of sales invoices around the balance sheet date. Also, the auditor should have performed unannounced cash audits for the use of an assessment of the administrative procedures and the internal control. Furthermore, the auditor should have compared the registrations in the bookkeeping records with statements of accounts from banks.

In these fraud cases, the concrete circumstances of the audit were considered and used in order to assess potential shortcomings of the audit. In a number of the fraud cases the responsum committee also reflects on the difficulties involved in detecting fraud. In this time period the audits are not considered as audit failures in their entirety. Instead (usually a few) shortcomings are noticed and commented by the responsum committee. This evidently reflects the regulatory requirement that it is not the auditor's main task to detect fraud.

Communication failures in light of frauds are typically tied to the auditor's responsibility to notify those charged with governance about inadequate internal controls. Examples can be drawn from responsum case 661 and 868.

In responsum case 661 (1979), the auditor was only criticised on a few points. Among other things, the auditor clearly should have explained the shortcomings in the internal control to those charged with governance and the management and given advice with a view to provision of good internal control. The responsum committee explains that it would be reasonable that the auditor in the audit protocol had explained the possibilities for fraud (responsum case 661, 1979, p. 3). In a reply, the audit firm argues that such "philosophical" considerations are beyond normal audit practice. The responsum committee retorts that it will not enter into a discussion, but argues that their assessment is related to the specific case. Similar in responsum case 868 (1986) where the auditor was only criticised on a few points. Among other things, the auditor should have extended his audit and criticised the invoicing system and the uncertainty about the financial reporting in the audit protocol.

The communication failures are tied to the official communications between the auditor and the client. It should be noted that few Danish companies, including public companies, have established audit committees. This may be so for a number of reasons. First, due to the separation of supervisory and executive activities, audit committees are hardly as necessary in countries using a two-tier management structure as they presumable are in countries using a unified management structure. Second, most Danish companies are small or medium-sized. Furthermore, due to the Danish two-tier management structure, boards of directors of Danish companies are generally small, even in public companies. Third, traditionally, the auditor has communicated with the board of directors through long form reports, which are termed audit protocols.[16] The audit protocol must be presented on every meeting of the board of directors. Moreover, entries in the audit protocol must be acknowledged by all members of the board, who must sign all entries.

Furthermore, there is a special provision in the Executive Order on Auditors' Statements mentioned above. If the auditor has a justifiable assumption that one or more members of the management or

[16] The contents of the audit protocol are regulated in the Auditors Act, in the Executive Order on Auditor's Statements, and RS 210, 260 and 265. RSs 210 and 260 correspond to ISA 210 and 260. RS 265, on the other hand, is a special Danish auditing standard that deals exclusively with the auditor's communication of audit matters with those charged with governance through the audit protocol. Thus there are some overlap between this standard and RSs 210 and 260.

those charged with governance may be held legally liable due to circumstances related to the company, the auditor must modify the auditor's report by adding an emphasis of matter paragraph. The provision comprises both criminal liability and civil liability.

The auditor's responsibility to communicate with those charged with governance is an ongoing process. In the responsum case 1007 (1993, p. 3, in translation) the committee noted that:

> "If the management – after the auditor has pointed to weaknesses in the internal control – does not take precautions to eliminate the weaknesses, the auditor must point to the weaknesses again. However, it is assumed that the auditor – during his audit of the items concerned – has used such a combination of audit procedures that he has reached a reasonable assurance about the accuracy of the financial statements. Otherwise, this should be reflected in the audit report."

Hence, in relation to absent or weak internal controls, the auditor has the responsibility to notify those charged with governance, to <u>repeat</u> the message if it is an unsolved problem, and to plan the audit choosing audit tasks which duly reflect the weaknesses. In this fraud case – where the cash clerk was later convicted for embezzlement – the responsum committee also addressed the question of when the auditor should react. The responsum committee responds confirming on the following direct question in Responsum case 1007 (1993, in translation):

> "Should an auditor – when a suspicion about irregularities arises – react without hesitation in order to dismiss or confirm the suspicion"?.

This is a clear change from the previous time period, where Responsum case 172 (1952) case was cited for not criticizing the auditor for half a year´s delay.

As opposed to the criticism raised by the responsum committee, real sanctions against auditors in fraud cases are restricted to the tribunal cases and court cases, see figure 1. In the period from 1970 to 1996 we have identified nine such cases, see table 3 for an overview. Here it is noticeable that fraud cases where the auditor's responsibility is questioned almost exclusively are tied to management frauds, that is, cases with fraudulent reporting or misappropriation of assets with concealment through the book-keeping.

<Insert "Table 3. Fraud cases and auditor sanctions in the time period 1970-1996" about here>

Whether the auditor has a special responsibility to detect fraud has been considered explicitly by the Accountants Tribunal in three cases involving fraudulent reporting (Tribunal cases 2, 3 and 5). In tribunal case 5 (1994) the auditor was acquitted. In this fraud case, the perpetrator was the CEO who had been found guilty and penalised with one and a half years´ imprisonment by the court system. The tribunal explains that the auditor had had special reasons to be aware of the possibility of fraud, but his opportunity to detect the fraud had been limited, and therefore should be considered free from sanctions. Tribunal case 5 (1994, 3, in translation):

> "In the opinion of the tribunal these circumstances should have given the defendant a cause for special scepticism.
>
> However, if there is no basis for determining that the defendant by a further examination, including a questioning of the company's manager, would have

> been able to detect the falsifications, and if the information about the expansion of the company in 1985 can have made the defendant's lack of observation that there was something unusual understandable, the tribunal does not find that it is possible to determine with the necessary assurance that the defendant has acted in a way that should be sanctioned according to the Auditors Act §19, now §18a, as far as this item of complaint is concerned.
> As a consequence, the defendant must be acquitted from all the complaints."

In contrast, the auditor was sanctioned with a fine of the amount of DKK25,000 which constitutes half of the maximum fine of the time[17] (tribunal case 3, 1990, p. 4, in translation):

> "The tribunal agrees with the defendant that it has not rested upon him as an audit responsibility to detect illegal acts which have been concealed from him, but the tribunal finds that the defendant has the responsibility that the external audit has not exercised adequate care with regard to the building loans whose balances to an uncertain extent must be presumed to have indicated that advance loans had been taken without it being ensured that the corresponding guarantees issued by the bank were recorded."

This instance of fraudulent reporting was one of the highly public fraud cases involving the financial crash of a smaller bank (6. juli banken). The Danish Commerce and Companies Agency had brought the case before the Accountants Tribunal to elicit an expert opinion on the auditors' responsibilities including the potential liability. Here the Accountants Tribunal explicitly states that the auditor does not

[17] The national currency "Danish Kroner" is abbreviated DKK. The current exchange rate is approximately 7.50 DKK to 1 Euro.

have a special responsibility to detect the fraud. The sanction awarded the auditor is for inadequate awareness in relation to particular loans. That is, a shortcoming in the audit conducted but not an overall audit failure. A very similar reasoning can be found in tribunal case 2 (1989). This was a case of fraudulent reporting for the purpose of obtaining illegal export grants from the government. The auditor in this case received criticism by the Responsum Committee (responsum case 886, 1986) and was sanctioned with a warning by the Accountants Tribunal (tribunal case 2, 1989). Hence, there the shortcoming was considered minor in comparison with the audit of the bank mentioned above.

Sanctions against the auditor were also awarded in the one fraud case in table 3 involving misappropriation of assets by an employee. The High Court found that the auditor ought to have uncovered a year-long embezzlement scheme by a bookkeeper (Court case 4, 1995). However, this does not suggest a change in the auditor's responsibilities. By his admission this was an audit failure in relation to payments to suppliers. Sufficient audit acts would in these particular circumstances have lead to the detection of more outgoing payments than appropriate. Therefore the High Court found the auditor liable to cover the defrauded amount of DKK483,457.

A couple of the cases in this time period addressed the auditor's responsibility to consider such discretions by management or those charged with governance in which they might be held legally liable. This could, for example, be related to illegal loans obtained by this group of people. In tribunal case 1 (1976) the auditor was sanctioned a fine of DKK2,000 by the Accountants Tribunal for not disclosing the information related to inappropriate withdrawal by a manager. In the consideration of these fraud cases the criminal acts have all been classified as concealments by management. Near the end of time period the fine to the auditor, for not disclosing an illegal loan, was DKK10,000 (tribunal case 6, 1994). In the following time period from 1996 to 2006 this type of offence was the sole reason for awarding sanctions against the auditor no less than seven times (i.e. the tribunal cases 8 through 12, 15 and 17).

Two of the responsum cases in this time period stand out in terms of size, namely responsum cases 1028 (1991) and 1044 (1995). Both are related to fraud cases with considerable public interest and subsequent legal scrutiny of the fraudulent reporting pertaining to these cases. Responsum case 1028 (1991) was raised to obtain an expert opinion for the use in a criminal case raised at the district court (here referred to as court case 3 (1994)). The case involved C&G Banken which had filed for suspension of payments on October 28th 1987 and later been declared bankrupt. Three different themes were raised in the responsum case, namely (1) Audit of the foreign branch in C&G Banken, (2) Audit of guaranties, and (3) Review of a prospect for new share capital dated July 28th 1987. Here the auditors received criticism related to the first two. The audit of the foreign branch involved insufficient audit acts for an area of the bank with poor internal controls. The audit of the guarantee obligations was also insufficient and the size of the amounts could involve a material risk for the company. Hence, the area should have been mentioned in the audit reports for 1985 and 1986. In the district court (court case 3 (1994), the criminal liability sanction against the auditors was 20 daily fines of the amount of DKK2,000 for each of the four auditors involved. Although it was the first time auditors were sentenced to daily fines for breach of the criminal code for gross negligence in their auditing, the verdict still must be regarded as relatively mild, considering the magnitude of their faults, and the impact that these faults had on the sequence of the events.

Responsum case 1044 (1995) involved the major corporate fraud scandal in newer history involving the Nordic Feather Company. The fraudulent reporting was initiated by the charismatic and dominant leader of the listed company who held a combined position as Head of the board and CEO. In 1990 the company was declared bankrupt – at that time the leader had committed suicide. The bankrupt estate was met with claims for more than 2 billion DKK. The trust in the auditor profession became a public issue. It was difficult for the public to understand how the company could receive unqualified audit opinions for a number of years, also after the auditors had been aware of major problems, including the apparent signalling effect by auditor resignations. This responsum case was raised upon request of the public prosecutor in 1994. The purpose was to elicit an expert opinion on good audit practice as well as good accounting practice for the use in criminal prosecution initiated at the District Court. The responsum committee responded with harsh criticism of the accounting practices involving numerous accounts of inflated assets and other accounting discretions. On no less than ten of 14 specific issues raised the auditors were criticized for not issuing qualified audit opinions. In these instances as well as the remaining four issues the auditors were criticized for insufficient audit acts and/or lack of audit documentation.

The fraud case continued for several years in the court systems ending with a High Court decision against management and auditors (court case 7, 1998). Members of management were sentenced to several years of imprisonment for gross fraud against investors and creditors. As indicated in table 4 in the next section, two of the three auditors involved were found criminal liable and sanctioned with fines. In the related case, the Supreme Court ruled in favour of two resigning auditors (court case 10, 2004). The two auditors had been appointed in 1987 and resigned in 1988 without auditing the company. The Supreme Court finally acquitted the two resigning auditors for civil liability towards the shareholders.

The public and political interest in this case brought a number of regulatory changes which are directly attributable to this fraud. This type of reaction to fraud scandals has been observed many times, e.g. the recent regulatory changes in the wake of the Enron scandal. As indicated in figure 4, the audit law was changed in 1994 and the executive order concerning the auditors report was changed in 1996. The company act also implemented certain restrictions in 1996. Among the changes – branded in the public as “lex Nordic Feather” – is a band against a combined position as Chairman of board and CEO (as had been the case in Nordic Feather, but in very few other companies) and the requirement that all board members should sign the audit protocol (at board meetings the leader in Nordic Feather had been reported to only read aloud passages from the audit protocol which he found relevant).

In summary the time period from 1970 to 1996 was dominated by codification of "good audit practice". Hence, the auditors' reactive responsibilities in relation to fraud were introduced in the general audit standards. The period had a number of serious fraud cases in terms of high public and political awareness, but it is noticeable that the sanctions against auditors were not toughened beyond the proportional size of the cases.

4.3. Audit regulation and fraud cases in the time period 1996-2006

This section provides a description of the relevant audit regulation in the period from around 1996 until today. In this period the proactive approach to the auditor's responsibility to detect fraud was introduced in the audit regulation in Denmark, i.e. starting by an Executive Order on Auditors' Statements issued in 1996. One of the provisions in this Executive Order provides that the auditor, when planning and performing the audit, to a certain extent must be aware of circumstances that are indicative of fraud and other irregularities and that are of importance to the users of financial statements.[18] Furthermore, the provision was the first provision in the legislation that deals specifically with the auditor's responsibility in relation to fraud.

[18] Specifically, the provision provides the following: 'In connection with this [i.e., when planning and performing the audit], the auditor to a certain extent must be aware of circumstances that are indicative of fraud and other irregularities and that are of importance to the users of financial statements'.

This provision predates RV 21 (1999) by a few years. RV 21 was inspired by the American SAS 82 (1997) and is the first Danish auditing standard that deals exclusively with the auditor's responsibility in this area. RV 21 also reflects the more proactive approach to the auditor's responsibility in relation to fraud. Thus this standard focuses on the auditor's responsibility for proactively detecting fraud during an audit – not just the auditor's responsibility for reacting on fraud in the – presumably rare – case that the auditor accidentally comes across a case of fraud during an audit.

In the United States, the auditor's responsibility in relation to fraud is regulated in the Statement on Auditing Standard (SAS) 99 from 2002. ISA 240 (revised 2004) and SAS 99 were prepared by the joint efforts of the IAASB and the Auditing Standards Board (ASB). Therefore there are only differences in terminology, but no material differences between the two standards. However, due to different traditions of the structure and layout of auditing standards between the IAASB and the ASB, the standards are not directly comparable.[19]

As indicated in the overview in figure 4, RV 21 (1999) was succeeded by auditing standard (Revisions Standard – RS) 240 from 2003. This standard was effective for audits of financial statements for periods beginning on or after July 1, 2003. The purpose of the standard was to provide guidance on the auditor's responsibility to consider fraud and error in an audit of financial statements. Danish auditing standards are now based on the International Standards on Auditing (ISAs) that are issued by the International Auditing and Assurance Standards Board (IAASB). The international standards are translated section by section and only any special regulations in the Danish legislation are added. Thus most of the Danish standards and the international standards are directly comparable. RS 240 was based on the corresponding ISA 240 from 2001. The overall value of Danish auditing standards as a source of regulation is that the auditor must perform audits in accordance with the standards.

[19] In comparison, ISA 240 (revised 2004) consists of 112 sections and 3 appendices, whereas SAS No. 99 consists of (only) 84 sections and 1 appendix (and 1 exhibit on management antifraud programs and controls).

The purpose of the revised standard (ISA 240 (2004)/RS 240 (2006)) is (1) to provide guidance on the auditor's responsibility to consider fraud in an audit of financial statements and (2) to expand on how the regulations in ISA 315 and ISA 330 are to be applied in relation to the risks of material misstatements resulting from fraud. The audit risk standards comprise the risk of material misstatements in the financial statements whether caused by fraud or error. ISA 240 (revised 2004), on the other hand, comprises only the risk of material misstatements resulting from fraud. Thus this standard can be viewed as an elaborated interpretation of the general audit risk standards with regard to the risk of fraud.

In the first section of ISA 240 (revised), it is emphasized that the guidance provided in the standard is intended to be integrated into the overall audit process. Thus the auditor's work in relation to fraud must be an integral part of all audits. However, the standard does not change the auditor's overall responsibility in relation to fraud. Thus, again it is provided that the auditor's responsibility is to provide reasonable assurance that the financial statements taken as a whole are from material misstatements whether caused by fraud or error. On the other hand, on the concrete level, the standard implies a number of changes related to the fulfilling of this responsibility throughout the audit process.

As mentioned, the Danish Auditors Act was changed fundamentally in 2003. One of the important changes was that provisions were introduced, which impose an obligation on auditors of notification of management fraud.[20] The conditions of this obligation are (1) that one or more members of the management or those charged with governance are committing or previously have committed fraud related to the company and (2) that the auditor has a justifiable assumption that the fraud is concerned with a substantial amount or in other ways is of gross significance. On these conditions the auditor must notify each member of the management and those charged with governance. If the management and

[20] These provisions originate from a report from the so-called Brydensholt Commission (1999).

those charged with governance have not taken action on the fraud and documented this action within a period of two weeks, the auditor must notify the public prosecutor. In Denmark, there is a special department of the public prosecutor that deals exclusively with financial crime and fraud. If the auditor assesses that a notification of the management and those charged with governance is unsuited to prevent any further fraud – for example if the majority of the members of the management know about or are involved in the fraud – the auditor must notify the public prosecutor immediately.

This obligation of notification of management fraud constitutes an important limitation to the auditor's otherwise far-reaching professional secrecy. For example, ISA 240 (revised) provides that the auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud (or error) to a party outside the company. However, it is recognized that the auditor's professional secrecy may be overridden by the law or courts of law. It is also emphasized that the auditor must consider seeking legal advice before reporting to a party outside the company, in this case the public prosecutor. These general provisions reflect the fact that the auditor's professional secrecy and the exceptions to this secrecy are weighted differently in different countries. In Denmark, the auditor's professional secrecy is rather comprehensive, but there are a number of exceptions. The obligation of notification of management fraud reflects one of the more notable exceptions.

However, it is important to bear in mind that the obligation comprises only management fraud, not employee fraud. As mentioned, management fraud is defined as fraud involving one or more members of the management or those charged with governance, whereas employee fraud is defined as fraud involving only employees.

The fact that the auditor has a certain responsibility in relation to fraud is emphasized by a provision in the 2004 Executive Order on Auditors' Statements. Here it is provided that the auditor, throughout the audit process and to a certain extent, must be aware of circumstances that are indicative of fraud or other irregularities that are of importance to users of financial statements. However, the level of assurance that is required by the provision in the Executive Order is lower than the reasonable assurance that was introduced by RV 21 (1999) and that is now required by ISA 240 (revised). Thus the provision in the Executive Order is now of little significance.

The empirical findings available for the period 1996 to 2006 are based on an increased number of fraud cases relative to the time span. In eight of the 11 responsum cases criticism was raised by the responsum committee, see table 3 for a comparison with previous time periods. This is the first period with specific regulatory requirements for the auditor's responsibilities in relation to fraud. The earliest reference to the new RV21 (1999) is found in responsum case 1181 (2001, p. 2, in translation):

> "In Auditing Guideline 21 [RV 21] it is stated that if the auditor during his audit detects any transactions that could give reason for a presumption that there was a risk of fraudulent acts, the audit must be extended to clarify this. It is noted that this guideline is effective from 1999, but according to the committee the guideline conforms to the guidelines for good audit practice in the period concerned."

It should be noted that here the responsum committee is considering a possible reaction to fraud detection that is very similar to earlier references to RV1 related to the overall and not specific responsibility of the auditor. In the majority of the fraud cases, the responsum committee actually refers to RV1 and not RV21. In this sense, the criticism raised in this time period does not seem to change dramatically. This also raises the question about what should be covered by a normal audit. The responsum cases deal with this in various ways. In responsum case 1151 (2000, p. 1, in translation) the auditor under scrutiny argues along the lines found in the past:

> "It is noted that the auditor in the audit protocol dated on March 11 1991 has stated that "it is not the main purpose of the audit to detect frauds and irregularities" and that "If any inaccuracies are detected during the audit, the audit will be extended to clarify this."

The responsum committee counters with criticism based on the new proactive responsibilities, i.e. identifying an audit plan failure (responsum case 1151, 2000, p. 1, in translation):

> "In the specific case it is the committee's opinion that the present audit plans are adequate for an overall planning of the audit, but that the audit plan should have included a review of the internal control in the company, as far as salaries are concerned. This would have revealed that the management had not established an appropriate control of the salaries paid out."

Hence, here the responsibility to plan for the possibility of fraud is considered in the specific context of auditing the payroll and personnel cycle. The potential shortcomings in the course of an audit are now more regularly tied to the responsibility for planning. Audit planning is no new invention, but now the wording of the responsum committee´s criticism is addressing this explicitly. In the latest fraud case available from the responsum committee, it also addresses the issue of an extension of the audit as a reaction upon fraud suspicion. Responsum case 1239 (2005, p. 1, in translation):

> ".. [I]t is the management that has the responsibility to establish administrative procedures and good internal control. It is the auditor's task to confirm this. However, it is the committee's opinion that the auditor should have checked that agreed initiatives with a view to strengthening the administrative procedures and the internal controls had been implemented. … [T]he fact that the auditor may not have complied with good auditing practice on certain points does not entail that the auditor loses the right to a fee for assistance with the detection of fraud."

It is noticeable that the extension of the audit to examine the particular circumstances indicated by fraud suspicions is not considered as part of the normal audit. The solving of the crime may be a task where the auditor is considered to have a natural advantage, but this is not necessarily a part of the audit task for which the auditor will receive the audit fee. This is a task beyond the financial audit.

An overall assessment of the responsum cases belonging to this time period is that no major changes have been identified. In spite of new regulation suggesting a more proactive role of the auditor in relation to fraud, it has been the same type of problems and the same type of case handling as in previous time periods.

What has changed dramatically is the increase in the number of fraud cases. Especially the number of tribunal cases has been considerable. In effect, there have been 12 fraud cases in the last decade as compared to seven in the initial 26 years of the lifetime of the tribunals. As indicated in table 4, seven of the 12 cases have lead to sanctions, because of the explicit requirement to communicate about illegal loans. Particulars on the remaining cases are shown in table 4. The five tribunal cases are worth examining in detail because of the clear indication of auditor responsibility.

<Insert Table 4. Fraud cases and auditor sanctions in the time period 1996-2006 about here. >

The two examples of fraudulent reporting by management have lead to higher fines to the auditors than previously seen, see tribunal cases 14 and 19. The size of the fine in tribunal case 14 (2001) was considerably higher than previously seen. Although high, a fine of DKK100,000 is still just one third of the fine maximum available at that time. Fines of that relative magnitude had been used before. The list of shortcomings related to the audit is considerable and includes elements related to audit planning, conduct, documentation and communication. It is suggested that many of the particular issues in the fraudulent reporting would be apparent, if the auditor had conducted the audit in accordance with "good audit practice". The fraudulent reporting includes examples of double counting of company cars, wrongful inclusion of property, overvaluation of assets, missing liabilities, etc. In the latest tribunal case the fines to the two auditors involved were even higher, i.e. disciplinary sanctions amounting to DKK. 150,000 and 140,000 respectively in tribunal case 19 (2006). Much similar to what is seen in the responsum cases of this time period, the tribunal court is considering the importance of audit planning with explicit references to RV1, RV14, RV17 and RV18, but not RV21. Planning the audit is seen as an indispensable prerequisite for an appropriate audit and therefore presumably also for any fraud detection by the part of the auditor. Similar remarks are made in tribunal case 16 (2005) which involves a pure case of employee concealment made possible by insufficient separation of duties. In this case the tribunal sanctions the auditor with a fine of DKK75,000 due to inappropriate audit planning (tribunal case 16, 2005, 3).

The size of the fines suggests different circumstances in each of the disciplinary cases. The two examples involving fraudulent reporting lead to relatively higher fines than the cases involving concealments, see table 4. It should be noted that the fine of DKK25,000 in tribunal case 13 relates to a fraud case involving criminal charges made against both management and the auditor. Part of the circumstances is outdated, while the part considered by the tribunal dates back to 1991 and 1992, where the maximum fine would have been DKK50,000. This is considered explicitly in the decision of the tribunal court. In comparison, the sanction of DKK10,000 in the employee concealment case found in tribunal case 18 (2006) should be considered as being considerably less harsh.

Finally, we consider the circumstances of the fraud cases from 1996 to 2006 as handled in the court system. All but one of the seven court cases in this period are related to management frauds. Court cases 7 and 10 have been mentioned in the previous section as they are related to the fraud case in the Nordic Feather company. The only court case involving criminal liability is the one involving the three auditors prosecuted in court case 7. The remaining fraud cases are civil liability cases raised on the part of stockholders or other plaintiffs assuming that they have suffered an economic loss, e.g. because the auditor has been negligent in performing an audit or another type of engagement. In court cases 6 and 10, the auditors were acquitted for neglect. The particular reasoning in court case 6 was shortly mentioned earlier. That is, the ruling in favour of the auditor due to the absence of a responsum explaining the particular responsibilities in relation to an audit of related companies within a group.

The size of the civil liability should not be seen as a measure for the severity of the sanction. The amount awarded in court cases 5, 8, 9 and 11 reflects the economic loss by the part of the plaintiffs due to neglect by the part of the auditors, see table 4. In each of the cases where civil liability is found a responsum has been used as part of the court ruling showing auditor neglect.

The criminal acts by management actually predate the new responsibilities of the auditors in court cases 5 and 8. In court case 5 (1997) management had issued fictitious invoices to their factoring service company. The auditor's responsibility had been expressed in the criticism raised in responsum case 938

(1989). The responsum committee found shortcomings in the audit as compared to an appropriate audit, e.g. lack of sampling tests controlling for the existence of real deliveries behind hypothecated invoices and lack of confirmation letters to debtors. In the premises of the court case it is assumed that the bank involved would have refused further use of the credit facilities if appropriate information on the circumstances of the company had been provided to them. The neglect by the auditor as compared to an appropriate audit was sufficient to find him liable in this fraud case. Court case 8 (1999) is a somewhat similar instance of fraudulent reporting. In accordance with responsum case 1049 (1995) the High Court found that the auditor involved had incurred civil liability and was sentenced to pay damage to the plaintiffs (i.e. to the factoring company in the amount of DKK922,108.08 and to the bank in the amount of DKK1,531,820.71. In the premises for the court decision it is stated that the auditor is not reproached for not detecting fictitious invoices as part of the management fraud scheme. However due to clear demonstrated shortcomings of the audit, the financial statements have portrayed a too positive picture of the actual financial circumstances. Due to the responsibility to provide an opinion as to the true and fair view of the financial statements, the auditor was found liable in relation to both plaintiffs.

The two remaining fraud cases both provide examples of auditor's neglect in relation to sufficiently checking the internal control systems of the clients. Court case 9 (2003) involved a concealment fraud committed by an employee. The Supreme Court ruled in accordance with the criticism raised by the responsum committee in responsum case 1151 (2000). The premises of the ruling indicate that the auditor should have a) examined the internal controls which would have revealed that management had not established appropriate controls in relation to payment of salaries, and b) communicated the weaknesses of the internal controls to those charged with governance as well as describing appropriate measures to improve the control systems. The Supreme Court found that the auditor was liable to pay damages to the plaintiffs because the neglect could be directly associated with absence of preventive measures against this particular fraud. Hence, here the proactive role of the auditor in relation to fraud is extended considerably as compared to previous interpretations of fraud responsibilities.

Court case 11 has been classified as an example of misappropriation in stead of concealment. This is a somewhat arbitrary classification because the main problem here is the elaborate absence of bookkeeping in the company. A point of criticism of the auditor had been expressed by the responsum committee in responsum case 1213 (2003). The auditor should have made sure that the accounting system and internal controls were established and functioning in this investment company. The premises of the Supreme Court are clear, i.e. Court case 11 (2006, p. 17) refers directly to RV1 paragraph 6; Due to the lack of bookkeeping and financial reporting the auditor should have planed the audit in accordance with an assessment of the risk of errors as being relatively high. The lack of inspection constituted such an audit failure that the auditor and the audit firm were found liable to pay damages to the plaintiff in the amount of highest amount to date, namely DKK8 million.

In summary the time period 1996 to 2006 has been dominated by a codification of international standards to Danish standards with a focus on proactive responsibilities. The fraud cases have been numerous and lead to higher fines and civil liabilities.

5. Conclusion

The purpose of this paper has been to contribute to an understanding of the relationship between audit regulation and developments in audit practice in relation to the fraud issue. The contribution of this paper involves insight into an interesting audit market with a historical tradition for mandatory audits of not only listed companies, but all limited liability companies. The institutional setup has allowed insight into fraud cases, where the auditor's responsibility has been questioned for a time period which reaches back to the start of the audit profession in the beginning of the last century.

The dataset includes all publicized cases raised against Danish auditors within the time period of 1909 to 2006, i.e. 72 unique fraud cases in total. The overall finding is that the auditors' responsibilities are tied to what constitutes a good audit. In the first time period until 1970, the exact nature and extent of a good audit was not completely clear before it was interpreted by the responsum system. It was clear that it was not the auditor's main responsibility to detect fraud and the responsum cases of the time demonstrate that the auditor was criticised in fewer cases as compared to the later time periods. The responsibility to prevent fraud is clearly placed with management and this includes the responsibility to set up a system of internal controls.

The time period from 1970 to 1996 was dominated by codification of "good audit practice". Hence, the auditors' reactive responsibilities in relation to fraud were introduced in the general audit standards. The period had a number of serious fraud cases in terms of high public and political awareness, but it is noticeable that the sanctions against auditors were not toughened beyond the proportional size of the cases.

The time period 1996 to 2006 has been dominated by a codification of international standards to Danish standards with a focus on proactive responsibilities. The fraud cases have been numerous and lead to higher fines and civil liabilities. The responsibilities of the auditor in relation to fraud should thus be interpreted as the development of what constitutes a good audit. In the responsum, tribunal and court cases the criticism against the auditor has been based on shortcomings of the audits either in the form of inappropriate/insufficient audit tasks or related to failures of communication. The auditor is never reprimanded or punished for not detecting frauds as such, but criticism is raised whenever audits have been found to be of substandard. The increased number of specific audit standards, including standards on the responsibilities to consider fraud, constitutes a more detailed benchmark for good audits than ever seen before. The development in sanctions and civil liabilities confirms that the court system is now considering fraud as a normal, although unusual, business scenario toward which the auditor has proactive responsibilities when planning and conducting the audit.

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Figure 1. Fraud cases considered in the collegiate bodies and legal system

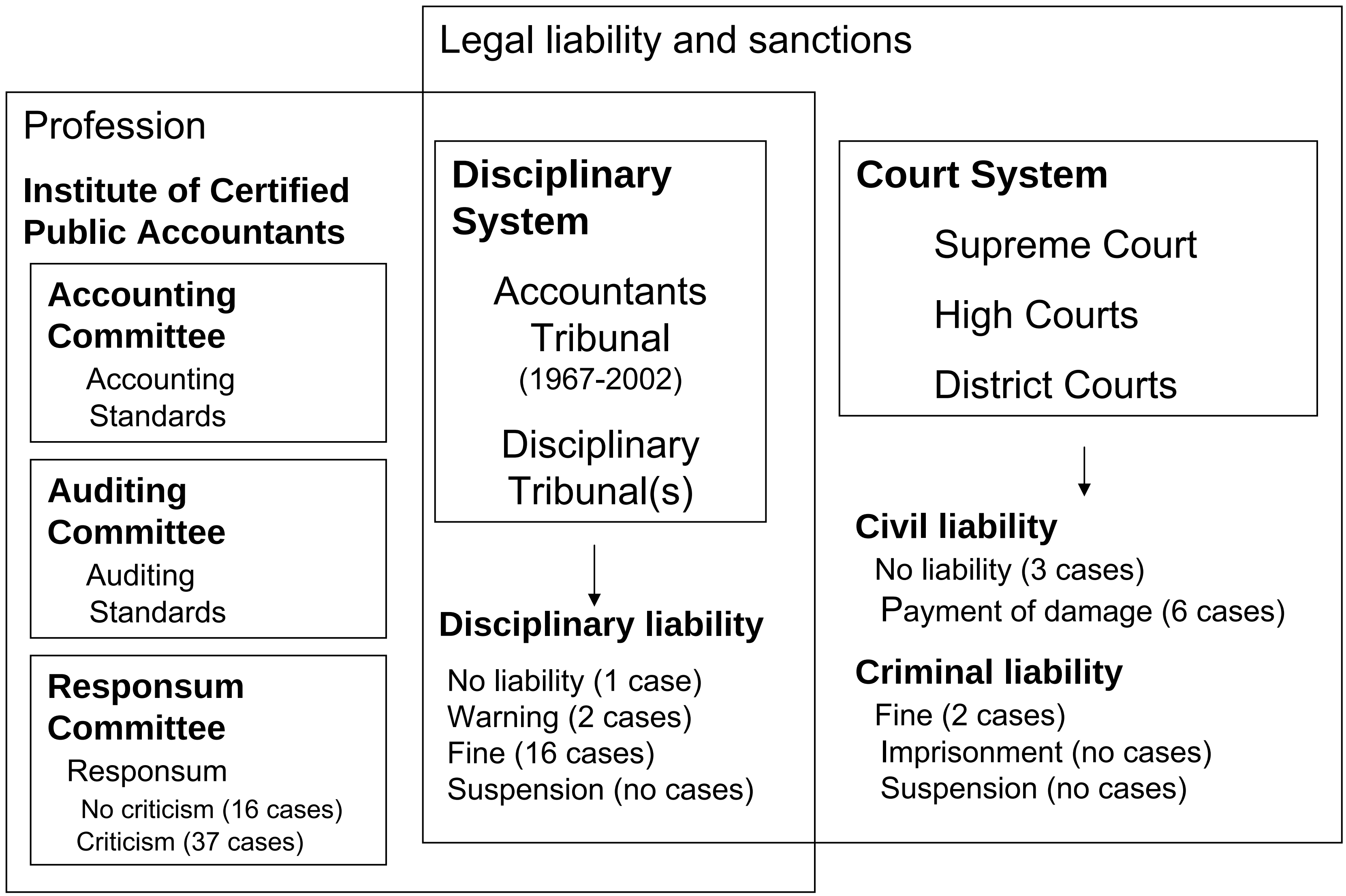

Figure 2. The regulatory hierarchy of auditor´s responsibility for “good audit practice”

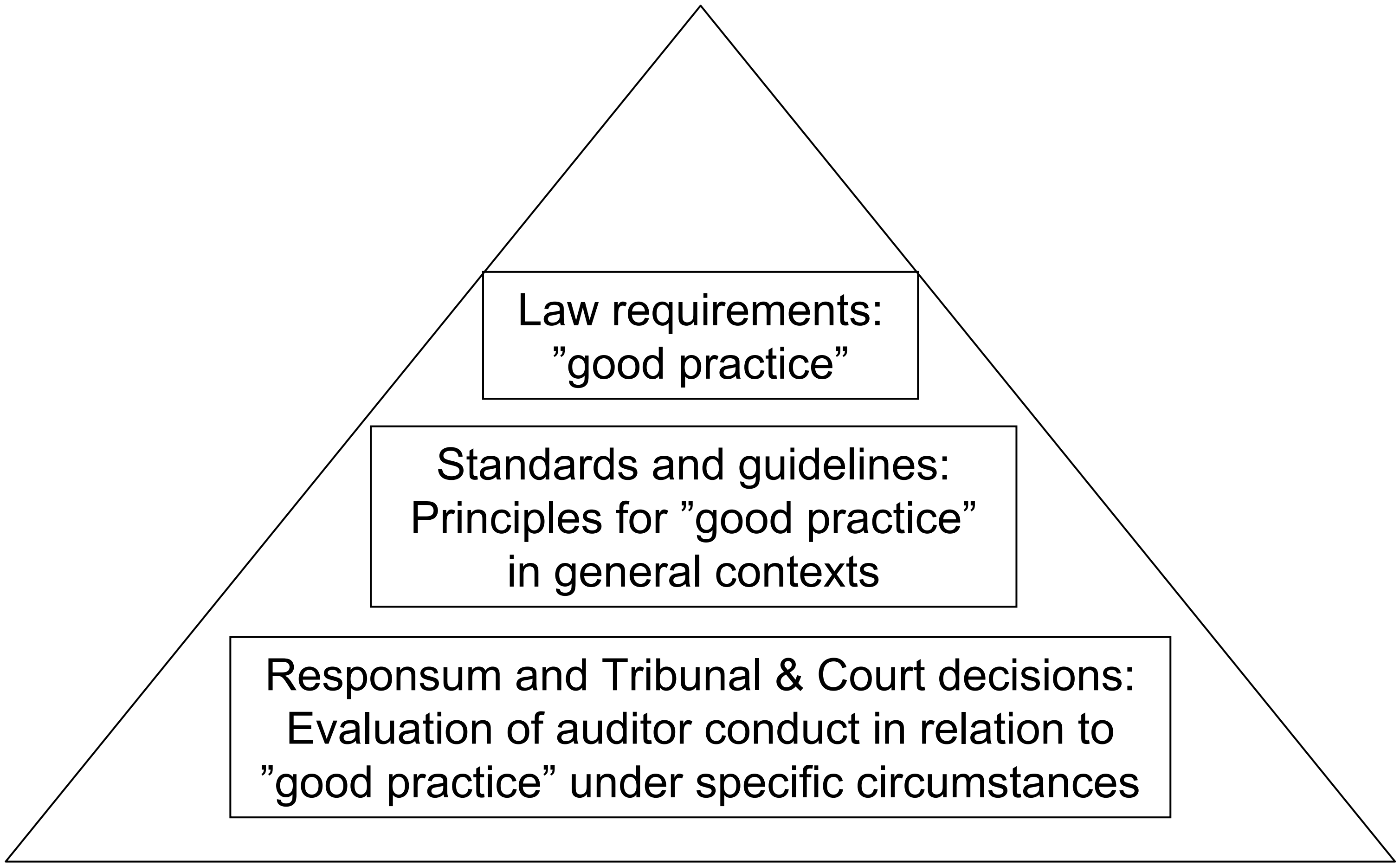

Figure 3. Flowchart of fraud cases considered

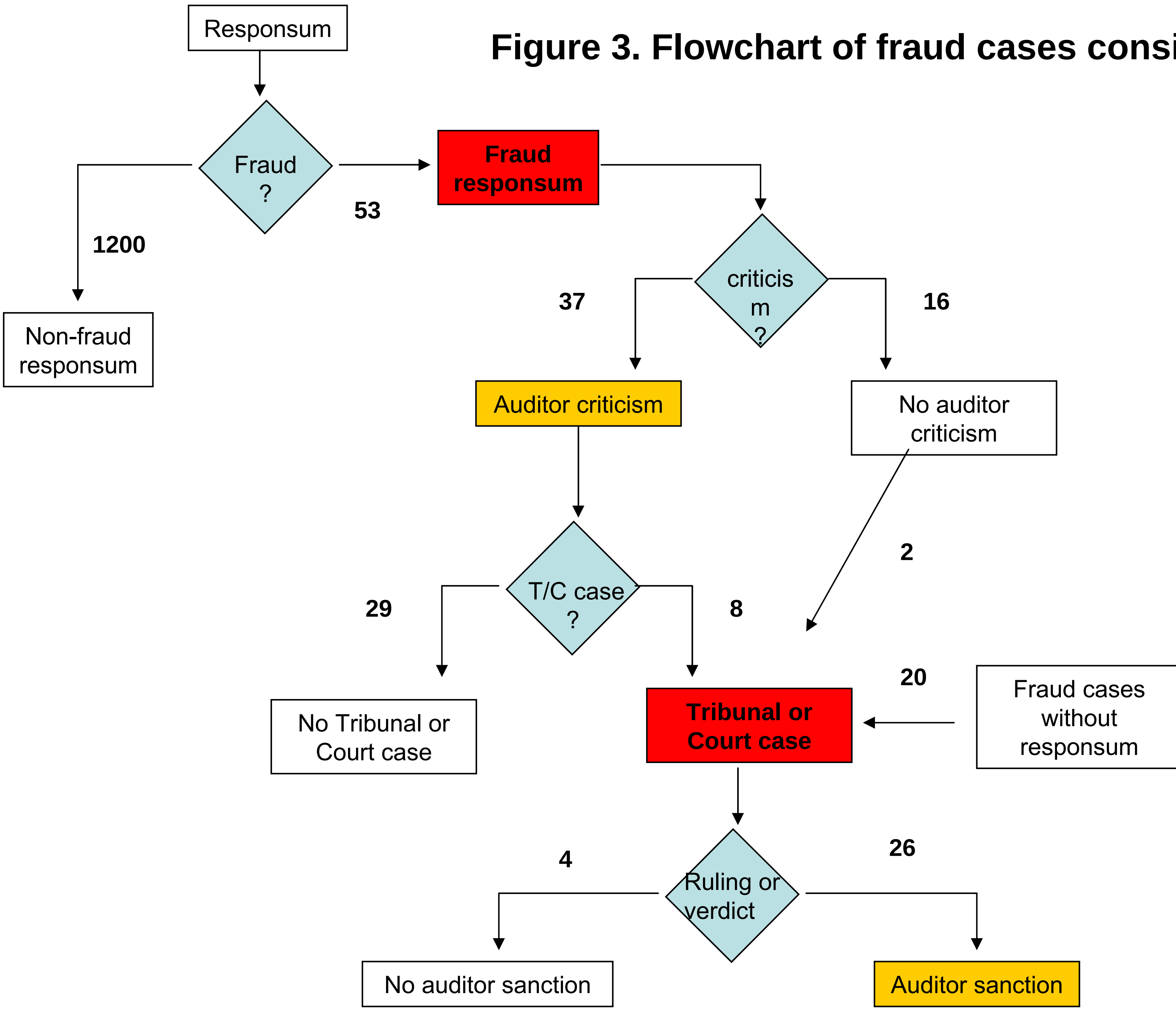

Figure 4. Timeline for audit regulation and fraud cases

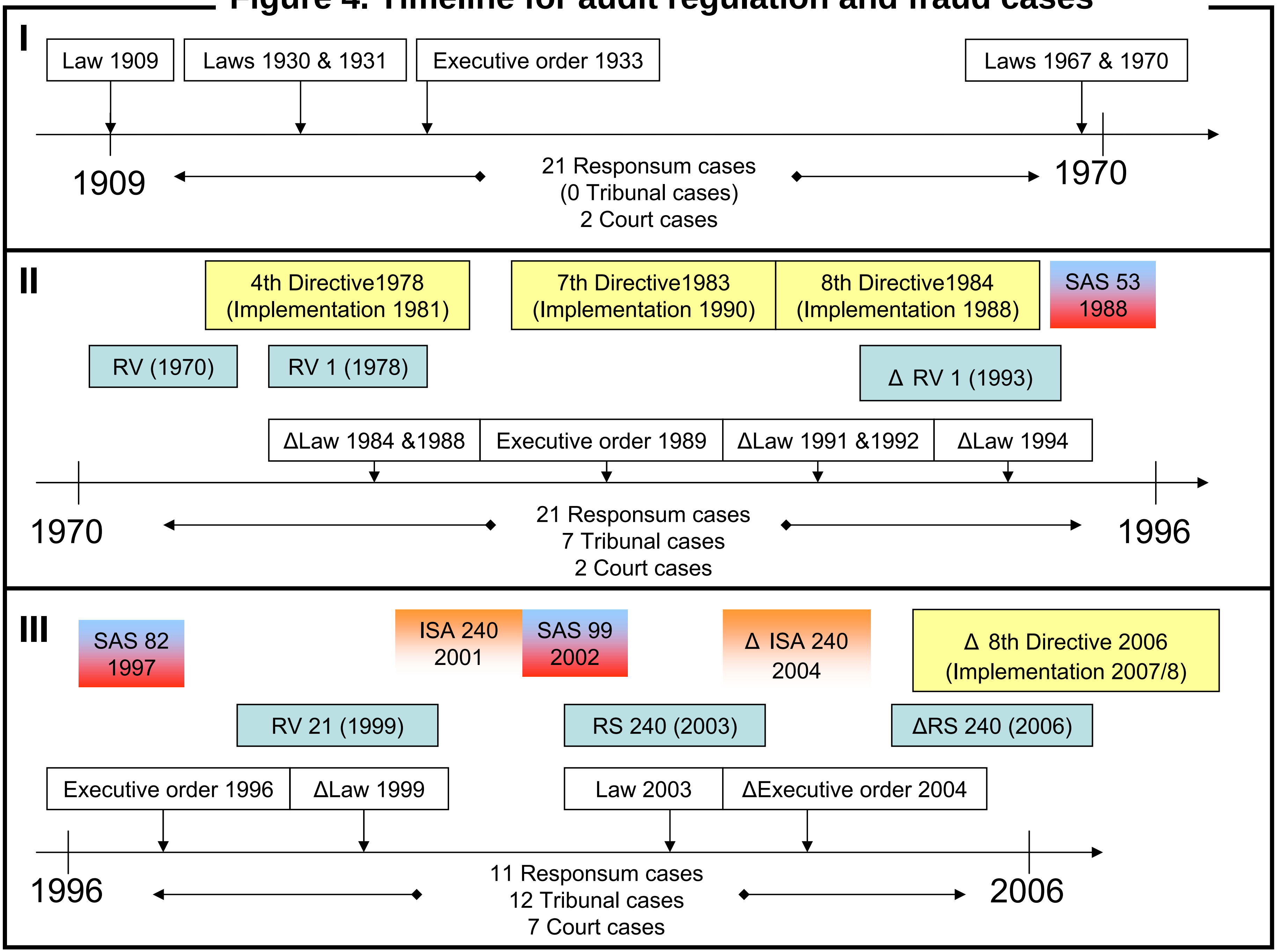

Table. 1 Fraud types and Perpetrators (unique cases)

	Management	Employees	External Party	Collusion	**Total**
Fraudulent Reporting	11				**11**
Misappropriation of Assets					
Pure cases	2	7	2		**11**
Cases with concealment	23	25		2	**50**
Total	**36**	**32**	**2**	**2**	**72**

Table 2. Number of Responsum Cases (Percentage with Criticism of Auditor), Perpetrators and Time Period

Perpetrators	Period I 1930-1970	Period II 1970-1996	Period III 1996-2006	**Total**
Management	7 (71%)	9 (89%)	4 (75%)	**20 (80%)**
Employee	13 (46%)	10 (90%)	7 (71%)	**30 (67%)**
Collusion	1 (0%)	0 (0%)	0 (0%)	**1 (0%)**
External	0 (0%)	2 (50%)	0 (0%)	**2 (50%)**
Total	**21 (52%)**	**21 (86%)**	**11 (73%)**	**53 (70%)**

Table 3. Sanctions against auditors in fraud cases 1970-1996

Case id	Type of Court/Tribunal	Fraud type	Perpetrator	Auditor Responsibility
Tribunal case 1 (1976)	Accountants Tribunal	Concealment	Management	Disciplinary sanction: fine (amount DKK. 2,000)
Tribunal case 2 (1989)	Accountants Tribunal	Fraudulent reporting	Management	Disciplinary sanction: warning
Tribunal case 3 (1990)	Accountants Tribunal	Fraudulent reporting	Management	Disciplinary sanction: fine (amount DKK. 25,000)
Tribunal case 4 (1993)	Accountants Tribunal	Concealment	Collusion	Disciplinary sanction: warning
Tribunal case 5 (1994)	Accountants Tribunal	Fraudulent reporting	Management	No disciplinary sanction
Tribunal case 6 (1994)	Disciplinary Tribunal	Concealment	Management	Disciplinary sanction: fine (amount DKK. 10,000)
Tribunal case 7 (1995)	Disciplinary Tribunal	Concealment	Management	Disciplinary sanction: fine (amount DKK. 10,000)
Court case 3 (1994)	District Court	Fraudulent reporting	Management	Criminal liability sanction (20 day-fines of amount DKK. 2,000 for each of the four auditors)
Court case 4 (1995)	High Court	Misappropriation	Employee	Civil liability sanction (amount DKK. 483,457)

Table 4. Sanctions against auditors in fraud cases 1996-2006 (without illegal loans)

Case id	Type of Court/Tribunal	Fraud type	Perpetrator	Auditor Responsibility
Tribunal case 13 (1999)	Disciplinary Tribunal	Concealement	Management	Disciplinary sanction: fine (amount DKK. 25.000)
Tribunal case 14 (2001)	Accountants Tribunal	Fraudulent Reporting	Management	Disciplinary sanction: fine (amount DKK. 100.000)
Tribunal case 16 (2005)	Disciplinary Tribunal	Concealement	Employee	Disciplinary sanction: fine (amount DKK. 75,000)
Tribunal case 18 (2006)	Disciplinary Tribunal	Concealement	Employee	Disciplinary sanction: fine (amount DKK. 10,000)
Tribunal case 19 (2006)	Disciplinary Tribunal	Fraudulent Reporting	Management	Disciplinary sanction: fines (amounts DKK. 150.000 and 140.000)
Court case 5 (1997)	Supreme Court	Fraudulent Reporting	Management	Civil liability sanction (amount DKK. 543,497)
Court case 6 (1997)	High Court	Concealement	Management	No civil liability
Court case 7 (1998)	High Court	Fraudulent Reporting	Management	Criminal liability sanction (auditor 1: 20 day-fines of amount DKK. 2,000, auditor 2: 10 day-fines of amount DKK. 2,000 and auditor 3: acquittal)
Court case 8 (1999)	High Court	Fraudulent Reporting	Management	Civil liability sanction (amounts DKK. 922,108.98 and 1,531,820.71)
Court case 9 (2003)	Supreme Court	Concealement	Employee	Civil liability sanction (amounts DKK. 374,584.64 and 43,750)
Court case 10 (2004)	Supreme Court	Fraudulent Reporting	Management	No civil liability
Court case 11 (2006)	Supreme Court	Misappropriation of assets	Management	Civil liability sanction (amount DKK. 8,000,000)

+7 illegal loans (tribunal cases 8,9,10,11,12,15,17)

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