

## **Can Auditors Detect Fraud: A Review of the Research Evidence**

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For years, it has been argued that one of the most effective ways to detect fraud is to use the “red flag” approach which involves identifying indicators of fraud and following up on them to determine whether they represent fraud or are the result of other factors. The fraud standards for both external (GAAS) and internal audits require that auditors use the red flag approach in detecting fraud. Because of the sparsity of and difficulty in gathering data on actual frauds, and because of the inconsistent information that is available about frauds that have occurred, there has not been many studies that have tested whether or not the red flag approach actually works or is effective in detecting fraud. The purpose of this paper is to review the fraud detection aspects of current auditing standards and the empirical and other research that has been conducted on fraud detection. A call for additional fraud detection research is also provided.

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Auditors have not always been required to search for fraud in their audits. However, when they have been required to do so, the approach suggested in both the external and internal auditing literature has been to focus on red flags as the primary method of detection. The red flag theory of fraud detection goes as follows: Every fraud involves three elements: (1) theft act, (2) concealment, and (3) conversion. The theft act involves taking assets such as cash, inventory, or even information. Theft acts can occur manually, electronically, or in other ways. Concealment involves the steps taken by the perpetrator to hide the fraud from others. Concealment can involve altering financial records, miscounting cash or other assets, or destroying evidence. Conversion involves benefiting from the stolen goods. Usually stolen assets are sold for cash and the cash is spent. If the asset taken is cash, conversion is simply the spending of the stolen funds. If the fraud involves misstatement of financial statements, the theft act often involves overstating assets and revenues or understating expenses and liabilities, concealment involves manipulating the accounting records to support the over- or understatements and conversion involves having a higher net income or stock price that results in larger bonuses, increased stock options or prices, or an ability to meet restrictive or other covenants. Because all frauds involve concealment, they are rarely observed.