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Detecting Fraud in Financial Statements: The Use of Digital Analysis as an Analytical Review Procedure

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The advent of SAS No. 82 and SAS No. 99 has strongly encouraged auditors to plan their audits with fraud in mind. Accounting literature has suggested that digital analysis could be used as an analytical review procedure to assist in the planning stage of an audit as per SAS No. 56. However, previous literature has used digital analysis at the disaggregated account level and has failed to identify sources for fraudulent financial data. This study advances the concept of using aggregated financial data from a fraudulent company to determine the effectiveness of using digital analysis.

INTRODUCTION

For years, auditors have searched for a "magic bullet" to be used to identify troubled companies at the beginning of the audit. The implications of SAS No. 82 and SAS No. 99 have intensified this search for an ideal analytical review procedure. Nigrini (1999a, 1999b) and Nigrini and Mittermeir (1997) suggest that digital analysis might be this "magic bullet" for auditors. Their studies determine that digital analysis is useful in analyzing disaggregated account data while searching for fraudulent activities.

Other researchers have also suggested digital analysis as an analytical review procedure. Busta and Weinberg (1998) use simulated data to test whether digital analysis can detect manipulated data. They indicate a need for replication using real financial data that has been manipulated and cite an inability to find real fraudulent data.

This study examines the appropriateness of digital analysis as an analytical review procedure to determine the possibility of financial statement fraud using aggregated data. This aggregated data is obtained from a real company whose CEO has been convicted of financial statement fraud. Our findings lead us to conclude that digital analysis would not have