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Effectiveness of Red Flag: Indian Auditors' Perception

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Abstract

Red flags are the warning signal against occurrence of any act of wrongdoing. Early identification of red flags helps to avoid or minimize fraud losses. Thus, the present study aims to investigate auditors'perception towards the effectiveness of red flags in identifying corporate fraud. To achieve the objective of the study, data has been collected from Indian auditors through a questionnaire. The findings of the study confirm that auditors perceive rationalization as the most influencing category which was followed by opportunity and pressure.

Keywords: Red Flag; Assets Misappropriation; Indian Auditor; Perception

Introduction

Fraud has become an industry in current scenario. Fraud is different from mistake as fraud is intentional act to deceit others whereas mistake is act of ignorance. Fraud is an act to gain personal advantage by causing loss to other. Fraud take place within organization then it is treated as corporate fraud. Corporate fraud is of two types, one is financial statement fraud and another is assets misappropriation. Financial statement fraud is generally committed by managers of the company by altering the financial statements of the company which depicts wrong profits and financial position o f the company. Assets misappropriation is committed by employees of the organzation in form of theft or embezzlement.

Fraud is omni presence. Every organization is impacted by one or more kind of fraud irrespective of its size, location and nature. Worldwide existence of fraud causes both monetary as well as non-monetary losses. Association of Certified Fraud Examiners (ACFE) conducted a survey in 2018 and found that a fraud causes median loss of $130000 to a firm. Satyam scam (2009) in Indian history shook investors' confidence very badly. After the occurrence of scam investors became reluctant to invest in share market. PwC found in its study in 2016 that workforce of the organization was responsible for more than half of fraud cases which was in

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support of the finding of ACFE (2018). No fraud occurs in one day. It takes long time to get fraud revealed. As per study by ACFE (2016), a fraud case takes eighteen months to come into existence. Therefore, red flags have their own importance. If red flags have been given proper attention timely, fraud could have been identified as an early stage. Therefore, the present study aims to identify auditors' perception regarding effectiveness of red flags in Indian context.

Literature Review

Red flag is one of the hot issue of research among research community. Verious studies have focused over the concept of red flags like *(*Apostolou&Hassell, 1993), (Wolfe &Hermanson, 2004), (Rezaee& Riley, 2010), Kassem&Hegazy, (2010); Chong, (2011) etc. Different theories over the red flag are fraud triangle, fraud diamond and fraud pentagon. In most of the research study, fraud triangle is the mostly used theory. It categorizes rd flags in three categories, namely, pressure, opportunity and rationalization.

Pressure involves a situation that creates stress to commit fraudulent act.Increased personal debt (Haugen and Selin, 1999), distressed business (Dellaportas, 2013), significant third party transaction and compalex transactions (Wilks& Zimbelman, 2002) were found as significant red flags in previous studies.

Opportunity is availed due to organizational environment and leakage in it. Different factor that were found significant are lack of internal control (Moyeset al., 2006), ineffective supervision (Razaee and Riley, 2010) and poor physical control (Mohamed &Jomitin, 2014) were found as significant factor in previous studies.

Rationalization is the ability to rationalize in right way to an act of wrongdoing. Main red flags in this category are lack of integrity, poor moral values, overwork (Haugen & Selin, 1999).

Research Methodology

The present study is primary in nature. Data has been collected using questionnaire from Indian auditors working in audit firms with one years of experience. Questionnaire got filled using drop off method. Data was collected from 300 auditors out of which 35 questionnaire were found incomplete. Hence, final sample involves 265 auditors which were used for data analysis (Table 1).

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Table 1: Statistics for Questionnaire Collection

Survey method	Sent	Received	Response rate	Usable
Drop off method	350	300	85.71	265

Source: Research Analysis

Table 2 depicts demographic profile of the respondents. Of the total 265 respondents, 83.02 percent were male and 16.98 percent were female auditors. Majority of the respondents were working in partnership firms. Further, 67.92 percent respondents in total have experience of less than five years.

Table 2: Demographic Profile

Demographic profile	Frequency (460)	Percentage (%)
Gender		
Male	220	83.02
Female	45	16.98
Audit firm		
Partnership	190	71.70
Sole proprietorship	60	22.64
LLP	15	05.66
Experience (in years)		
Less than 5	180	67.92
5-15	50	18.87
More than 15	35	13.21

Source: Research Analysis

Analysis and Discussion

Respondents were asked to state their effectiveness on five point scale anging from most effective (5) to most ineffective (1).

Table 3 depicts auditors' perception in effectiveness of red flags. In category of pressure, management has personally guarantee significant debt of firm was found as most significant factor with mean value of 4.24 which was followed by continue industry change leading to business failure (mean 3.75). Under opportunity category significant third party transaction was found as the most effective factor with mean value of 4.25 and subjective judgement about

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financial item was found as the second effective variable. In rationalosation category, no cooperation during audit was perceived as most effective factor (mean value of 3.86).

Table 3: Effectiveness of Red Flags

Red flag	Item mean (SD)	T-statistic
Pressure		
Management has personally guaranteed significant debt of firm	4.24(0.93)	**132.5**
Profitability of organization relative to its industry is inadequate.	3.64(0.94)	
Continue industry change leading business failure	3.75(0.85)	
High debt dependence	3.40(0.92)	
Bankruptcy threat	3.50(0.95)	
Opportunity		
Long term continuation on same position	3.47(0.20)	**125.5**
Complex structure of organization	3.53(0.87)	
Subjective judgment about financial items	3.85(0.92)	
Significant related party transactions at present	4.25(0.67)	
Rationalization		
Dishonest or unethical management	3.82(0.92)	114.2
No cooperation during auditing	3.86(0.95)	
Tax saving reason	3.75(0.85)	

* All t-value are found to be significant at one per cent level.

Source: Research Analysis

Conclusion

The present study aims to analyze auditors' perception toward effectiveness of red flag. Significant third party transaction and management personally guarantee was found as the most influencing factors. The present study would be of immense importance to regulators, researchers and financial communities. Auditors perform brain storming sessions during audit. They must pay attention over red flags so that red flags can be identified on time and fraud can be detected. Future research studies may focus effectiveness of red flags in industry specific such as banking. Moreover perception of accountants, managers and other stakeholders may be perceived to study effectiveness of red flag.

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