

# Auditor Responsibility in the Context of Forward-Looking Judgments, Fraud Risk, and Evolving Stakeholder Expectations

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**Abstract.** This paper examines the changing scope of auditor responsibility in light of growing reliance on forward-looking estimates, fraud risk, and stakeholder expectations. It critiques the traditional Audit Risk Model, which assumes risks are quantifiable and independent, and shows how it fails to address uncertainties in areas such as expected credit losses, goodwill impairment, and fair value assessments. In response, newer frameworks like the Performance Materiality Model offer a more integrated approach by combining audit risk with accounting risk, better aligning with the complexities of modern audits. The discussion also highlights the audit expectation gap, which is the disparity between what the public expects auditors to do and what auditing standards require. Although stakeholders increasingly expect auditors to detect fraud and anticipate business failure, the auditor's formal role remains limited to providing reasonable assurance. Professional skepticism, though crucial, is often reduced to procedural compliance rather than being practiced as a code of conduct. The paper argues that reframing auditor responsibility requires both methodological and cultural shifts in how skepticism is exercised and communicated. Auditors must adopt more flexible risk assessment tools, actively apply skepticism, and clearly communicate their role to stakeholders. Bridging this gap is critical to maintaining public trust and the relevance of the audit profession.

**Keywords:** auditor responsibilities, audit risk model, fraud deduction, PMM model.

## 1. Introduction

### 1.1. Background

Auditing has long been seen as a cornerstone of financial accountability, with the auditor's primary tasks are providing assurance that historical financial statements are free from material misstatement. For instance, frameworks like the Audit Risk Model ( $AR = IR \times CR \times DR$ ) quantify the responsibility of auditing by conceptualizing audit risk as a product of inherent, control, and detection risks. This model reflects a backward-looking approach, focused on gathering evidence related to past transactions, the sufficiency of evidence, and the compliance with accounting standards. However, auditing has changed significantly over the past two decades. Financial reporting today includes more complex and judgment-driven elements such as fair value measurements, expected credit losses, and other accounting estimates that need to be evaluated prospectively. At the same time, recent years of corporate failures and financial scandals have drawn public attention to the deficiencies of auditors' roles in detecting fraud and predicting financial distress. These developments challenge the sufficiency of the traditional audit risk model and further raise questions about whether auditors are responsible for incorporating an assessment of future-oriented risks and management assumptions in addition to historical verification. To address these questions, researchers have critically examined the conceptual boundaries of auditor responsibility, particularly regarding forward-looking estimates, fraud detection, and stakeholder expectations.

### 1.2. Related research

The traditional Audit Risk Model (ARM), formalized as  $AR = IR \times CR \times DR$ , has long served as the cornerstone of audit planning. Its primary function is to determine the quantity and type of audit evidence required to reduce the likelihood of undetected material misstatement to an acceptably low

level. As Smieliauskas (2007) explains, the ARM is useful in evidence-gathering risk management, focusing on uncertainties auditors can control, such as detection and sampling error [1].

However, this model has been criticized for its inadequacy in dealing with forward-looking uncertainties, particularly those stemming from management's accounting estimates and judgments. The traditional ARM assumes that all misstatements can be known and corrected with sufficient evidence. Yet, as Smieliauskas argues, this overlooks the probabilistic nature of forecast-based accounting, where uncertainty is inherent and often cannot be eliminated by audit procedures alone [1]. He proposes expanding the model by distinguishing between "audit risk" (evidence-related) and "accounting risk" (forecast-related), which better reflects the reality of fair value measurements and other future-oriented disclosures. Moreover, the report of the Cohen Commission (1978) was one of the earliest critiques of ARM. It emphasized that financial statement uncertainty arises from business risks and accounting judgments, which are areas that belong more to management and standard setters than to auditors [2]. However, the responsibility for assessing and disclosing these uncertainties often falls on auditors implicitly, creating a gap between theoretical standards and practical expectations. By developing this conceptual foundation, Smieliauskas proposed a contemporary model named PMM model (probability of material misstatement). The model attempts to combine auditing and accounting uncertainty [1]. His discussions have been influential in the current debate on whether the auditor's role should extend to assessing the quality of financial reporting rather than rules-based compliance.

In contrast, Palmrose and Kinney (2018) maintain a compliance-oriented view that auditors are not responsible for ensuring that the underlying economics of the company are faithfully represented. Instead, they argue that the auditor's duty is limited to verifying GAAP compliance in all material respects [3]. Based on their analysis of SEC, PCAOB, and FASB guidance, there is no authoritative support for extending the auditor's responsibilities beyond GAAP compliance. They advise not to mix the roles of auditor and standard setter and warn that such an extension is conceptually unsound and impractical in the real-world auditing environment [3].

Responding to this, DeFond, Lennox, and Zhang (2018) offer a more broad view. They argue that auditing has evolved beyond mechanical compliance, and auditors are required to make professional judgment about the overall fair presentation of financial statements [4]. They argue that professional standards implicitly require auditors to assess the economic substance of accounting choices, especially in areas where discretion and estimates dominate [4]. This view reflects an evolving expectation that auditors must evaluate how faithfully accounting captures the firm's economic reality, not just whether it follows the rules.

The debate around audit scope is also reflected in fraud detection. DeZoort and Harrison (2016) use the Triangle Model of Responsibility to demonstrate that auditors' perceived responsibility varies depending on fraud type, auditor type, and accountability pressure [5]. They find that external auditors are most responsible for financial statement fraud, while internal auditors have a broader responsibility across fraud types. Importantly, they noticed that a stronger sense of responsibility leads to better fraud detection performance, particularly in brainstorming audit procedures.

Supporting this view, Drogalas et al. (2017) provide empirical evidence from listed companies in Greece, showing that internal audit effectiveness, training, and responsibility significantly improve fraud detection outcomes [6]. These findings highlight structural and organizational factors that shape fraud risk management beyond the individual auditor's technical skills.

Finally, Love (2012) clarifies how professional standards can navigate this situation. While GAAP does not require auditors to provide assurance that all fraud is detected, it does require auditors to maintain professional skepticism, especially when there are signs of management collusion. His comments bridged the expectation gap, emphasizing that while auditors are not obligated to investigate and anticipate all fraud, they are ethically and professionally obligated to question assumptions and reevaluate risks throughout the course of business [7].

Together, these studies illustrate the growing complexity of auditor responsibility, no longer limited to verifying past transactions, but increasingly shaped by forward-looking risk, public expectations, and ethical accountability.

## **2. Expanding the Audit Risk Model to Address Forward-Looking Judgments**

### **2.1. Conceptual Limitations of the Traditional Audit Risk Model**

The Audit Risk Model ( $AR = IR \times CR \times DR$ ) has long been a cornerstone of audit planning. It provides a framework for auditors to estimate the likelihood of undetected material misstatements and to tailor the nature, timing, and extent of audit procedures accordingly. However, this model is fundamentally backward-looking, and emphasizes verification of historical data rather than addressing the uncertainty that arises from management's forward-looking estimates. It is premised on the notion that sufficient audit evidence can be gathered to reduce risk to an acceptable level. In contrast, modern financial reporting increasingly involves forward-looking information, such as fair value measurements, expected credit losses, and impairment assessments. These areas require auditors to exercise professional judgment about the future, which is a type of uncertainty that cannot be resolved simply through additional audit evidence.

Another key conceptual drawback of the ARM is that it assumes that risk components are both independent and quantifiable. However, this is rarely the case in the practice. For example, inherent risk and control risk often overlap, particularly when poor controls increase susceptibility to material misstatements. Moreover, detection risk is influenced by these factors, making it difficult to treat the components as separate and multiplicative. This oversimplification can lead to overall audit risk miscalculation and inappropriate conclusions about the sufficiency of audit work.

In addition, this model has a narrow focus on financial reporting risk, largely confined to the client's internal controls and transaction history. It does not explicitly account for broader external factors that can materially affect audit outcomes. For instance, macroeconomic conditions, market volatility, regulatory changes, and shifts in industry dynamics are all capable of impacting the risk of material misstatement but fall outside the scope of the ARM. The exclusion of these systemic and environmental risks creates a gap between the model's theoretical framework and the realities of the contemporary audit environment.

These conceptual limitations indicate that while the ARM remains useful for providing a basic risk assessment structure, it is increasingly inadequate as a standalone framework for modern auditing. As financial reporting evolves to include more subjective and forward-looking elements, auditors must adopt a more comprehensive approach that integrates judgment, estimation uncertainty, and external influences into risk assessments.

### **2.2. Practical Limitations of the Traditional Audit Risk Model**

While the conceptual limitations of the ARM highlight its theoretical gaps, these challenges become even more pronounced in practice, particularly in areas involving forward-looking information and model-based estimates. For example, the Expected Credit Loss model under IFRS 9 requires management to estimate credit losses based on future macroeconomic scenarios [8]. This process involves assumptions about economic trends or default probabilities, which are both inherently uncertain. Traditional audit techniques such as vouching transactions or recalculating balances cannot address these complexities. Auditors must instead critically evaluate the models, methodologies, and data inputs used by management, which is a task that is far removed from the historical focus of the ARM.

Similar difficulties emerge in goodwill impairment testing, governed by IAS 36, which requires management to estimate the recoverable amount of a cash-generating unit by predicting future cash flows and applying appropriate discount rates [9]. These estimates are inherently judgmental and may reflect bias. Auditors are required to assess the validity of these assumptions, which may be based on limited or unavailable external benchmarks. Standard audit procedures designed for verifying

historical transactions offer little guidance for these situations, making effective risk assessment challenging

Another practical shortcoming of the ARM is its limited guidance on how to adjust audit procedures based on assessed risk levels. While the model suggests that higher assessed risks should lead to more extensive audit testing, it does not specify how much additional work is required or how it should be targeted. This vagueness forces auditors to rely heavily on their judgment, which can result in audit inefficiencies or undetected risks.

### **2.3. Evolving Audit Standards Reflect a Shift Toward Forward-Looking Risk Assessment**

The limitations of the traditional Audit Risk Model have prompted standard setters to issue guidance that explicitly addresses forward-looking information and estimation uncertainty. In recent years, auditing standards have recognized that management's assumptions in prediction, rather than merely historical transactions, are increasingly essential to financial reporting.

A key development is the revision of ISA 540 (Auditing Accounting Estimates and Related Disclosures). This standard requires auditors to assess not only the reasonableness of accounting estimates but also the processes and controls used by management to develop them [10]. It emphasizes the need to evaluate the assumptions and data with forward-looking estimates. This represents a significant shift from traditional audit approaches, which primarily focused on verifying past events through corroborative evidence.

Similarly, ISA 570 (Going Concern) and ISA 315 (Identifying and Assessing Risks of Material Misstatement) highlight the importance of incorporating broader risk factors into audit planning. ISA 570 requires auditors to consider the appropriateness of management's use of the going concern basis of accounting and to evaluate whether there are material uncertainties that could cast doubt on the entity's ability to continue as a going concern [11]. ISA 315 reinforces the need to assess risks of material misstatement at both the financial statement and assertion levels, taking into account the complexity of the business environment and the susceptibility of certain areas to fraud or error [12].

These revisions reflect the recognition that forward-looking risks cannot be addressed solely through traditional audit techniques. They require a more judgment-based approach that includes assessing the integrity of management's assumptions and challenging subjective estimates. Moreover, they emphasize auditors' responsibility to maintain professional skepticism, especially in areas where there are biases or incentives affecting financial reporting.

### **2.4. Integrating Forward-Looking Risks into Modern Audit Methodologies**

In response to the conceptual and practical limitations of the traditional Audit Risk Model, and the evolving expectations codified in standards like ISA 540 and ISA 570, the audit profession has begun to adopt more comprehensive methods that integrate forward-looking risks. These approaches reflect a shift from purely compliance-driven methods to a more holistic evaluation of business risks, estimation uncertainties, and external environmental factors.

One prominent development is the adoption of the Performance Materiality Model (PMM), which reconsiders materiality thresholds based on an entity's specific risk profile. PMM builds on the traditional concept of materiality but integrates both quantitative benchmarks and qualitative risk factors, such as complexity, management bias, and estimation uncertainty. It provides a more dynamic framework that allows auditors to tailor their tolerance for misstatement in response to heightened risks in forward-looking areas.

One of the key contributions of this model is its integration of both audit risk and accounting risk, the latter referring to the uncertainty inherent in financial reporting estimates. Rather than assuming that all material misstatements arise from audit failure, the PMM acknowledges that even well-executed audits may not eliminate estimation-based errors. The model is expressed as  $PMM = AudR + (1 - AudR) \times AccR$ , highlighting that material misstatements may occur even if the auditor perfectly detects and addresses all auditable risks, due to the unavoidable uncertainty in accounting judgments. For example, in cases where AudR is zero, material misstatements can still occur due to inherent

accounting risks. By incorporating accounting risk directly into risk assessment, the PMM offers a more comprehensive view of financial statement reliability and enhances auditors' ability to evaluate and disclose risks associated with management estimates.

### **3. Repositioning Auditor Responsibility in Response to Fraud Risk and Stakeholder Expectations**

#### **3.1. The Expanding Public Expectation of Auditor Responsibility**

Over the past two decades, the scope of what stakeholders expect from auditors has steadily widened. High-profile corporate failures, such as Enron, Wirecard, Carillion, and Luckin Coffee, have reinforced the view that auditors should have identified red flags earlier, prevented collapse, or issued stronger warnings to financial statement users. However, these expectations often go beyond the formal responsibilities defined in auditing standards, leading to what is widely called the “audit expectation gap”.

This gap reflects the difference between the public's perception of auditors as “watchdogs” responsible for detecting fraud, and the actual professional duties. The actual role of the auditor is generally to provide reasonable assurance that financial statements are free from material misstatement, whether due to error or fraud. According to ISA 240, auditors are not responsible for preventing fraud or ensuring the future success of the audited entity [13]. Their role is limited to planning and performing the audit to detect material misstatements based on available evidence at the time of the audit.

However, this technical boundary is poorly understood outside the audit profession. Users of financial statements, such as investors and the general public, often assume that an “unqualified” audit opinion implies a full approval of the entity's financial health and behavior. This misinterpretation is amplified during periods of economic distress or scandal, when stakeholders seek accountability and auditors become the focus of criticism. Moreover, the growing complexity of financial reporting and the increasing use of forward-looking estimates expand what stakeholders believe auditors should cover. For example, auditors are now more expected to challenge management assumptions used in valuation models, and to assess the viability of business strategies, and even predict solvency risks. These expectations go beyond what the traditional audit framework is designed to deliver, placing auditors in an awkward position.

As the gap between perceived and actual responsibility continues to grow, auditors face increasing reputational and legal risks. This has led to a new debate on whether auditors should redefine their role in fraud detection.

#### **3.2. Professional Skepticism**

The widening expectation gap discussed above has placed increasing pressure on auditors not only to detect fraud and assess future risks, but also to exercise deeper professional judgment. Professional skepticism is a foundational audit concept, intended to ensure that auditors maintain a questioning attitude and critically assess audit evidence, especially in areas involving management judgment and risk of fraud. However, in practice, skepticism tends to be viewed as a set of procedural checklists rather than a behavioral mindset. This may undermine the essence of skepticism, which is to develop an alertness to inconsistencies, bias, and misrepresentation.

According to ISA 200, “auditors need to perform audits with professional skepticism, recognizing the possibility of a material misstatement regardless of past experience with the entity [14]. Similarly, ISA 240 emphasizes that professional skepticism is required when considering the risk of fraud [13]. Both standards clarify that skepticism is not just about completing required steps but about maintaining auditors' independent and inquisitive disposition.

In practice, skepticism is often reduced to documentation and procedural formality. Auditors may note that they have considered fraud risks, but fail to document the process and key inquiries. This

leads to a tension between form and substance, that is, compliance is met, but skeptical judgment is not truly exercised. This issue is particularly significant in forward-looking areas such as fair value or going concern, where management bias is often hidden and objective evidence is limited.

Furthermore, behavioral and contextual factors also influence skepticism. Time pressure, firm culture, and long-standing client relationships can dull an auditor's questioning mindset. As a result, material misstatements arising from optimistic judgment may go undetected, even in audits that appear reasonable.

Therefore, in a landscape of growing complexity and rising expectations, addressing this issue requires a shift in mindset. Skepticism should be reinforced not as a checklist, but as a mindset, encouraging auditors to challenge assumptions and think critically.

### 3.3. The Limits of Fraud Detection and Forecasting in the Audit Role

As discussed in the previous section, professional skepticism is essential when auditors confront areas of uncertainty and judgment. However, even when auditors strictly adhere to the principle of professional skepticism, there are practical limitations to its application. The scope of auditors' work is limited by clearly defined mandates, while society's expectations that they detect fraud or foresee corporate collapse often exceed standard requirements or realistic possibilities.

Auditing standards, particularly ISA 240, make clear that the auditor's responsibility is to obtain reasonable assurance that the financial statements are free from material misstatement [13]. Yet fraud often involves concealment and collusion, making it inherently difficult to detect. Auditors are not investigators, and they are not expected to guarantee fraud prevention. Their role is to assess fraud risk, perform appropriate procedures, and remain professionally skeptical — but within the boundaries of evidence and access provided during the engagement.

Similarly, under ISA 570, auditors evaluate management's going concern assessment, but they do not predict long-term viability [11]. They review assumptions and forecasts, but they are not accountable for future business outcomes. Nevertheless, unqualified opinions are frequently misunderstood by users as signals of corporate soundness.

These disconnects reinforce the audit expectation gap. When companies fail, auditors are blamed for not raising red flags, even if no standards have been violated. While expanding the audit scope could address some concerns, this requires fundamental changes in methodology, training, and regulatory oversight. Until then, clarifying the auditor's role remains essential to maintaining the public.

## 4. Conclusion

As the complexity of financial reporting increases, auditors are being asked to do more than verify historical transactions. They must now assess forward-looking estimates, challenge subjective judgments, and respond to rising public demands for fraud detection and early warnings of corporate failure. These developments expose the limitations of the Audit Risk Model, which was designed for a more static and objective reporting environment.

New methodologies, such as the Performance Materiality Model, offer more comprehensive approaches by incorporating accounting risk and estimation uncertainty. These approaches reflect the need to move beyond mechanical models toward risk assessments grounded in professional judgment. However, their effectiveness depends not only on technical design but also on the auditor's mindset and professional skepticism.

At the same time, the profession must confront the widening gap between what stakeholders expect and what auditors are required to deliver. While requirements of expanded auditor responsibility are understandable, they often overlook the practical and regulatory constraints auditors face. Maintaining professional skepticism, clarifying audit boundaries, and enhancing communication with users of financial statements are essential to realigning expectations with reality.

Last but not the least, in today's environment, reframing auditors' role means more than just expanding scope. It requires reinforcing core principles, adapting creative methods to reflect forward-looking risk, and building public trust through transparency and integrity.

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