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FRAUD MANAGEMENT AUDIT AND THE EVOLUTION OF FINANCIAL MARKETS UNDER THESE CIRCUMSTANCES

Florin BOGHEAN[1*], Carmen BOGHEAN[1]
[1] „Ștefan cel Mare" University, 13 Universitatii Street, 720229, Suceava, Romania,
e-mail: florinb@seap.usv.ro, carmenb@seap.usv.ro

Abstract
Financial management could not be conducted without information in general and without financial and accounting information in particular. Economic, financial, accounting and market information is essential for understanding and applying the management objectives. Financial decisions rely upon the association between the regulatory economic policies implemented on a macroeconomic level and the individual financial decisions made on a microeconomic level. The responsibilities of external auditors, internal auditors and government auditors often require the investigation of suspected fraud. SAS 99 and SAS 110 require auditors to use the information obtained during the planning and performance of the audit to identify risks that may result in a material misstatement due to fraud. In addition, auditors need to be aware of the various types of frauds, their signs and the need to follow up to determine whether a suspicion is justified.

Key words: audit, fraud, stakeholders, financial information

JEL classification: G32

I. Introduction

For centuries, the main objective of the audit procedures has been to identify fraud and errors. Throughout the past century, audit professionals have shifted their focus

* *Corresponding author*: *Florin BOGHEAN, e-mail: florin@seap.usv.ro*

from detecting fraud and error to assessing the extent to which financial statements meet the objective of true and fair view. However, a survey conducted among the users of the audited financial statements has revealed that many of them still believe that fraud detection is the main purpose of the audit procedures. It seems that this attitude among users is caused by their tendency to extend insignificant frauds to the financial statements as a whole. Among other things, the survey conducted by the Institute of Chartered Accountants of Scotland also reveals that the public understands audit proceedings mainly as providing the assurance that:

- no frauds have been committed, and
- the company hasn't broken any legal provisions.

Moreover, the public believes that auditors should inform third parties if they find that the management of the audited company engages in fraud or other illegal acts.

Financial statement may be materially misstated as result of errors or fraud. While accounting errors are unintentional, fraud consists of knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood and act on it and, thus, suffer a loss or damage. This definition encompasses all means by which people can lie, cheat, steal and dupe other people. Management fraud is deliberate fraud committed by management that affects investors and creditors by materially misleading information. Since management fraud usually takes the form of misleading financial statements, management fraud is sometime referrers to as fraudulent financial reporting. The national Commissions on Fraudulent Financial Reporting defined (1987) fraudulent financial reporting as intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements.

Auditing standards define errors as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Errors may involve mistakes in gathering or processing data, unreasonable accounting estimates arising from oversight or misinterpretation of facts, or mistakes in the application of the current accounting principles. Fraud, as the term is used in AICPA AU 240 (PCAOB316), relates to intentional acts that cause a misstatement of the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets (also referred to as "defalcation") (Whittington O. Ray, 2012).

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II. Psychology of the events that may lead to fraud

Fraud can occur as a consequence of events such as (Horomnea Emil, 2009):

- manipulating and altering accounting records or documents (altering them in order to misrepresent or conceal the truth);
- altering or stealing assets;
- inappropriate allocation of assets, that may lead to the deterioration of the financial reporting of the audited company, with direct consequences on the consistency of its activities;
- eliminating or omitting the effects of certain transactions from records or documents, or recording fictitious transactions with the purpose of enhancing the financial statements;
- intentional misapplication of the accounting policies related to the presentation of financial statements that would mislead their users.

Apart from fraud and errors, the US audit standards also include the inappropriate and intentional acts or deeds performed by managers and third parties, either alone or/and with the assistance of prospective customers; these illegal acts, include the following (Arens et al, 2012):

- illegal commercial/financial transactions or operations;
- inadequate, incomplete or significantly delayed recording of transactions or supporting documentation;
- payments from the treasury of the organization for: unidentified objectives, unspecified services; consultancy provided by employees, offices or affiliated subsidiaries or companies from different industry branches; excessive commissions or fees, as compared to the current fees paid for similar services.

However, there are many cases when errors have the same consequences as frauds and, in these situations, auditors must ensure that it was something other than fraud. Errors can be caused by:

- the mathematical or financial errors occurring in the accounting calculations, measurements or records;
- the omission or misinterpretation of events that have a significant influence on financial statements;

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- the misapplication and unknowing use of accounting policies.

Nevertheless, not even audit procedures conducted according to standards do not guarantee the absence of material deviations in terms of financial information, as deviations often involve misrepresentation attempts that can not always be detected, despite adequate audit planning and compliance with auditing standards. After the identification of the infringement, the auditor discusses with the management of the organization and, if this discussion does not reveal the legal nature of the transaction, the entity legal advisor will also be consulted and, if necessary, subsequent additional procedures will be conducted.

III. Types of audits

Audits are often viewed as falling into three major categories: *(1) financial audits, (2) compliance audits, and (3) operational audits.* Additionally, the Sarbanes-Oxley Act requires an integrated audit for public companies (Whittington O. Ray, 2012).

Financial Audits. A financial audit is an audit of the financial accounting information of an entity. An audit of financial statements ordinarily covers the balance sheet and the related statements of income, retained earnings and cash flows. The goal is to determine whether these statements have been prepared in compliance with the generally accepted accounting principles. Financial statement audits are normally performed by certified public accountant firms; however, internal auditors often perform financial audits of departments or business segments. The users of audit reports consist of management, investors, bankers, creditors, financial analysts and government agencies.

Compliance audits. The performance of a compliance audit is dependent upon the existence of verifiable data and of recognized criteria or standards, such as established laws and regulations, or an organization's policies and procedures. A familiar example is the audit of an income tax return by an auditor of the internal Revenue Service (IRS).

Operational audits. An operational audit is a study of a specific unit of an organization with the purpose of measuring its performance. The operations of the reception department of a manufacturing company, for instance, may be evaluated in terms of its effectiveness, i.e. its success in meeting its stated goals and responsibilities. Performance is also judged in terms of efficiency, i.e. success in using the resources available to the department to its best advantage.

The auditors' responsibility for identifying client noncompliance with laws and regulations depends upon their nature. The Professional Standards identify two types of laws – those with a direct effect on the financial statements in terms of identifying the results in the need for accounting journal entries. Examples include laws that affect the accounting for transactions under government contracts and the accrual of income tax and pension costs. Other laws do not have direct effects in the determination of amounts and related disclosures, but compliance with them is required to stay in business laws, environmental laws and regulations, and antitrust laws.

IV. Considering the effects of frauds (ISA 240-fraud)

The misstatements occurring in the financial reporting may be the result of fraud or errors. Auditors must focus on the fraud that leads to significant misstatements in the financial reporting. There are two types of intentional misstatements that are relevant to the auditor:

- fraudulent financial reporting;
- misappropriation of assets.

1. Fraudulent financial reporting (intentional misrepresentations or omissions of amounts or disclosures):

- manipulation, falsification or alteration of the accounting records or of the supporting documentation;
- misstatements/omissions related to events or transactions;
- intentional misapplication of the accounting principles;
- recording fictitious journal entries to manipulate operating results or achieve other objectives;
- inappropriate adjustment of the assumptions and changing the judgments used to estimate accounts balances;
- concealing or not disclosing facts that could affect the amounts recorded in the financial statements;
- engaging in complex transactions that are meant to misrepresent the financial position or performance of the business entity;

2. The misappropriation of assets:

- wrongful collection of debts/diverted earnings;

- tangible assets theft or intellectual property theft;
- payments to fictitious suppliers, without the receipt of goods/services;
- using assets for personal gains;
- false entries to cover missing items.

Throughout the audit process, the auditor must inquire about and find the causes of the fraud as well as the factors that influence the fraud risk.

The causes of fraud and the factors that influence the risk of fraud related to fraudulent financial reporting are:

- *inefficient control environment;*
- *administering unrealistic earnings meant to mislead the users;*
- *incentives/bonuses for meeting unrealistic objectives related to profit, as well as internal and external pressures;*
- *opportunities,* related to the nature of the economic sector, as well as the operations of the entity in terms of transactions with third parties, important, unusual or very complex transactions, assets, liabilities, revenues and expenses based on significant estimates, resorting to middlemen;
- consistent personal financial obligations of the employees can cause the misappropriation of the assets belonging to the company;
- negative relationships between management and employees, or the prospects of discharge, changes, promotions or compensations that fail to meet expectations.

V. The responsibilities of those charged with governance and of management in terms of fraud detection

The main responsibility for the prevention and detection of fraud rests with both those charged with governance of the business entity and with management. The responsibilities of those charged with the governance of the entity consist in ensuring, with the oversight of the management structure, that the entity establishes and maintains internal control in order to provide reasonable assurance in terms of the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

The responsibilities of the management, with the oversight of those charged with the governance of the business entity, consist in establishing a control environment and

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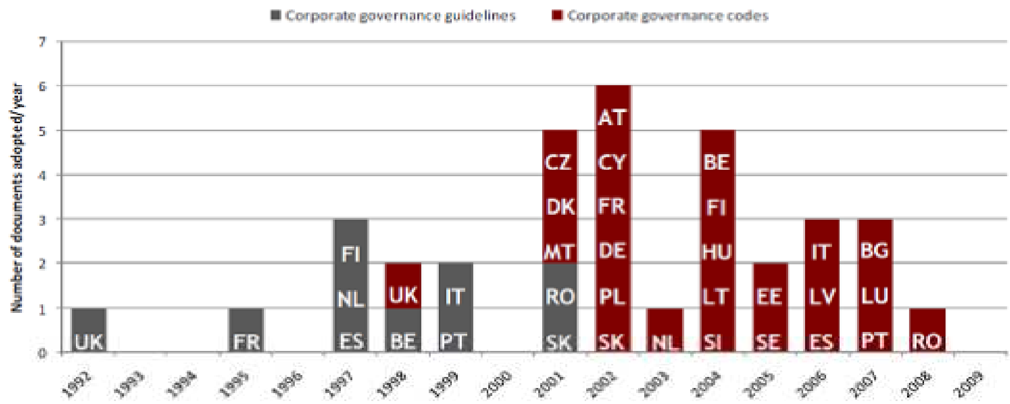
maintaining policies and procedures that would help meet the objective of ensuring, as far as possible, the orderly and efficient development of the activities performed by the business entity.

Therefore, the responsible parties that can provide the auditor with the information or the documents that would serve as evidence in identifying fraud are:

- governance – controlling risk monitoring systems, financial control and compliance with the law - attending meetings, reading minutes, requiring information;
- management – the way in which fraud risks are prevented, detected and assessed; management's reaction to fraud, including communication with the governance, the presence of a culture of honesty and ethical behavior;
- internal audit – auditors' opinion related to fraud risks, methods they apply;
- operating personnel that is not involved in the financial reporting process;
- employees in various management levels;
- employees involved in initiating, processing or recording transactions;
- ethical behavior manager or the person appointed to deal with fraud accusation.

The study conducted by the European Commission on the enforcement of corporate governance regulations reveals an upward trend in corporate governance codes on a European level.

Chart 1 **Evolution of corporate governance codes implemented in the EU**



Source: http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm

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Additionally, note that the member states of the EU *constantly revise their corporate governance codes, aligning them with the new recommendations of the European Commission.* However, there are still a number of corporate governance codes that need revision.

Corporate governance regulations provide a minimum set of information in the form of a comply-or-explain approach or a report included in the annual report that should be made available to the public on the company website.

Romanian companies present the information as a comply-or-explain statement, as opposed to German businesses that present a corporate governance report as part of the annual report.

VI. Evolution of the international capital flows during financial scandals

Ever since the ‘90s, AICPA (American Institute of Certified Public Accountants, 1993), mentions in the report of the Public Oversight Board that: *corporate governance in the United States does not work the way it should […] to blame are the many management committees that should make the system work in the appropriate direction … A more efficient corporate governance ultimately depends on a more consolidated role of the board of directors.* This caution has been disregarded by regulatory boards and management structures, while in the case of Enron, Global Crossing, Adelphia, and WorldCom *the main accusation of the US SEC commission was that the boards of directors and their administrative and audit committees in charge of financial reporting and audit failed to enforce proper monitoring.* Since *corporate governance principles* have been overlooked throughout the years, *a series of subsequent financial scandals* have highlighted the need to revise and develop new corporate governance codes, standards and regulations. We would like to mention some of the most famous financial failures from Great Britain, the US and Europe that have had a significant effect on the evolution of international corporate governance principles.

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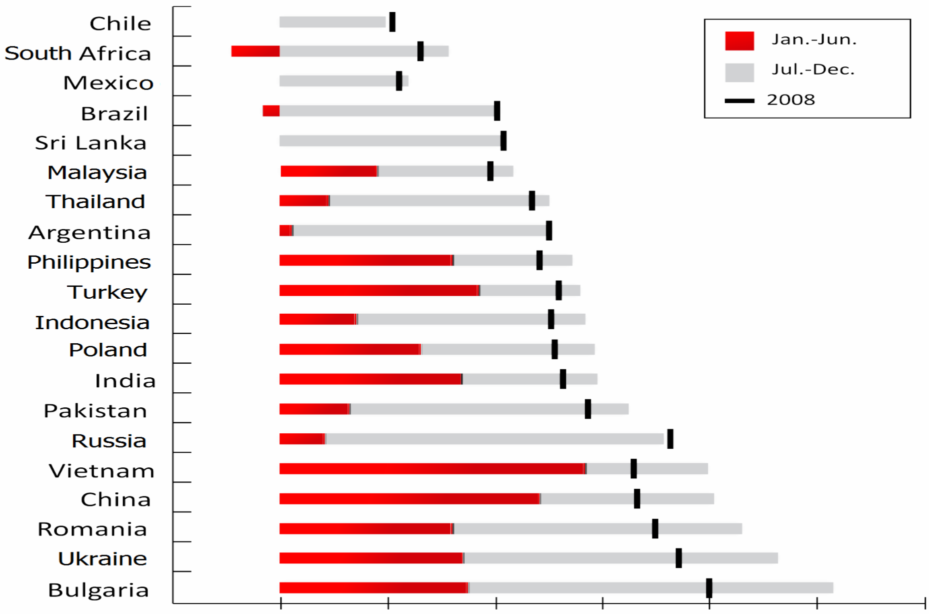
Chart 2 **Decline of capital markets in developing countries**



Source: analysis based on the information provided in the World Bank Report, 2009

The above chart shows that the capital markets in Brazil, China, India and Russia have recorded the most severe declines of 2008. Russia was the worst player of the four, with a 72.5% decline of the national currency (World Bank Report, 2009).

The severe fall of stock prices has resulted in considerable losses for most central banks, thus causing national currency markets to go into severe recession. The markets of the other three countries have lost more than half of their value – Brazil has declined by 40%, India by 52% and China by 66%. The severity of the recession during the second half of 2008 was more acutely felt by Brazil and Russia than by China and India, thus showing that the sudden fall of commodity prices has affected the former two countries more than the latter. Even highly efficient emerging markets such as Chile, Mexico and South Africa have suffered losses in 2008, which amounted to more than 20%.

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VII. Conclusions

Audit procedures cannot offer the complete assurance that the financial statements do not contain any significant errors or frauds. The errors may occur either as a consequence of the incorrect processing of the financial information or due to the employment of a wrong judgment in selecting and applying the accounting standards. There is also the risk that the auditor may not be able to identify them, regardless of the rigorous methods used by the auditor while applying the audit standards. The INTOSAI standards provide that "*while conducting regular (financial) audits, compliance with the current laws and regulations must also be tested. The auditor must devise the audit stages and procedures in such a way as to provide the reasonable assurance that he had detected the errors and the frauds that may have a direct and concrete effect on the amounts presented in the financial statements or on the auditor's report. Additionally, the auditor must be aware of the possibility that the illegal acts may have an indirect and concrete effect on the financial statements or on the auditor's report*".

We can devise ten coordinating principles for efficient corporate governance:

- Control of the business assumed by the shareholders
- Reliable and complete public reporting;
- Avoidance of power concentration to top management levels
- Even structure of the board of directors
- Strong and motivated board of directors
- One independent element in the management structure;
- Effective monitoring of the management structures by the board of directors;
- Competency and commitment
- Risk control and assessment
- A thorough audit process.

However, the extensive research conducted on the behavior of public and private investors on developing markets have revealed that 80% of investors are willing to pay an additional sum for the shares of those companies that have an efficient corporate governance system.

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