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The role of financial auditor in detecting and reporting fraud and error

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The role of financial auditor in detecting and reporting fraud and error

Abstract:

Responsibility for preventing and detecting fraud rest with management entities. Although the auditor is not and cannot be held responsible for preventing fraud and errors, in your work, he can have a positive role in preventing fraud and errors by deterring their occurrence.

The auditor should plan and perform the audit with an attitude of professional skepticism, recognizing that condition or events may be found that indicate that fraud or error may exist.

Based on the audit risk assessment, auditor should develop programs to audit procedures by which to obtain reasonable assurance that the financial statements in their entirety, all significant errors and fraud have been identified. It is expected that the auditor to implement procedures that will lead to the discovery of errors or fraud without significant impact on the financial statements can not be held responsible for undetected such irregularities.

The auditor should communicate with the management of his client. He should ask the management information concerning any significant fraud or error has been detected in order to detect key problems that could lead to certain activities, the implementation of audit procedures more than usual However the auditor faces the risk inevitable that some significant errors to be detected, even if the audit is planned and done properly

Keywords: fraud, error, tests, audit

1. Introduction

The incidence of financial fraud is increasing and has been a central feature in a number of financial scandals in recent years. This fact, together with the increasing sophistication of fraudsters, creates difficult problems for management and auditors.

Some who would argue that the detection of fraud and error should be the auditors' principal function. This prevailing attitude clearly gives rise to a public expectation which is neither shared nor fulfilled by the profession.

ISA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* provides guidance on the auditor's responsibility to consider fraud and error in an audit of financial statements.

2. Differences between fraud and error

In planning and performing audit procedures, as well as in assessing and reporting audit results, the auditors should consider the risk of significant misstatements in the financial statements, as a result of fraud or errors.

Misstatements in the financial statements can arise from either fraud or errors.

The term *error* refers to an involuntary misstatement occurred in financial statements, including the omission of an amount or disclosure, such as:

- an error occurred in the collection or processing of data on which the financial statements are based on;
- an incorrect accounting estimate occurred due to overlooking or misinterpretation of facts;

- an error in applying accounting policies related to data assessment, recognition, classification, disclosure or description.

Errors may occur in connection with the recognition, assessment, disclosure or description of elements included in financial statements. The financial statements do not comply with the European Directives (in Romania – *Order of the Ministry of Public Finance no. 1752/2005 for approving accounting regulations in accordance with the European Directives*) if they contain material or immaterial errors made intentionally for getting to a certain presentation of a company's financial position, performance or cash-flow, and such an intentional misstatement of information disclosed in the synthesis documents leads to *fraud*.

Potential current period errors discovered in that period are corrected before approving the financial statements. Although the European Directives also state the possibility of correcting errors related to previous financial years, and discovered in the current financial year, by means of affecting the opening balances of the financial year in which the error was found, according to the Romanian legislation in force, errors shall be corrected in the financial year in which they were discovered.

The term *fraud* refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. Fraud may involve:

- manipulation, falsification or alteration of records or documents;
- inadequate allocation of assets;
- voidance or omission of transactions in records or documents;
- recording of transactions without substance;
- incorrect application of accounting policies.

In the analysis of bank financed projects, the Department for Institutional Integrity considers that following actions are cases of fraud:

- contractual irregularities and violations of procedures regarding public procurement;
- subsequent amendment of contractual terms existing as of the date of winning the auction;
- agreement between participants in an auction;
- product substitution;
- inadequate setting of prices and partnerships;
- incorrect calculation of costs and work provided;
- request for a bribe;
- acceptance of money and other gifts;
- incorrect use of funds or positions;
- theft and abuses;
- revenge;
- irrational use of bank funds.

From a legal point of view, according to the definition given by Mr. Alexandru Boroï in his *Dictionary of Criminal Law*, fraud is defined as cheat, misguidance, and delusion for profit purposes by inducing damage.

Mr. Mircea N. Costin, in his *Dictionary of Civil Law*, defines fraud as an intentional violation by the parties of the mandatory provisions of the legislation in force, often by using perfidious means, at the conclusion or execution of a legal act.

Although fraud is a broad legal concept, the auditor is concerned with fraud that causes a material misstatement in the financial statements. It is possible that the misstatement of financial statements should not be subject to fraud. The auditor does not make legal determinations of whether fraud has actually occurred or not.

The distinguishing factor between fraud and error is whether the underlying that results in the misstatement of the financial statements is intentional or unintentional. Unlike error, fraud is intentional and generally implies deliberate concealment of facts. While the auditor may be able to identify potential opportunities for committing frauds, it is difficult, if not impossible, for the auditor to

determine whether misstatements, particularly in issues involving management judgements, such as accounting estimates and proper application of accounting policies, are caused by fraud.

According to International Standard on Auditing 240 (hereinafter called ISA 240) (redrafted) *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* (effective for audits of financial statements for periods beginning with 15 December 2008 or later), the term fraud is defined as „an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage“.

In planning the audit activities, the auditor shall make inquiries of management to determine whether the material misstatements are due to fraud or errors. The auditor is interested both in management's assessments of the risk that the financial statements may be misstated due to fraud and the systems for identifying and responding to the risk of fraud, as well as in the accounting and internal control systems implemented to prevent and identify errors. Issues to be discussed as part of these inquiries include:

- existence of sites, business segments, types of transactions, balances of accounts or categories of financial statements with higher risks for errors, or for which that may exist factors for fraud risk, as well as how these problems are addressed by management;
- the internal audit function of a company and whether the internal audit has identified fraud or any significant gaps in the internal control, system;
- how management communicates to the employees its views on responsible business practices and ethical behaviour, for example through policies or ethical codes of conduct.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable certification. Thus, in an audit engagement, the auditor does not guarantee that material misstatements, arising from either fraud or errors, will be identified. Given the inherent limitations of an audit engagement, the risk of not identifying a material misstatement caused by fraud is higher than the risk of not identifying a material misstatement caused by errors, because fraud implies sophisticated and carefully organised actions, aimed to conceal them, such as deliberate omission of transactions or inaccurate statements provided intentionally to the auditor. The audit procedures that are effective for identifying an error may be ineffective for identifying fraud.

3. Detecting fraud and errors by auditors. Case studies

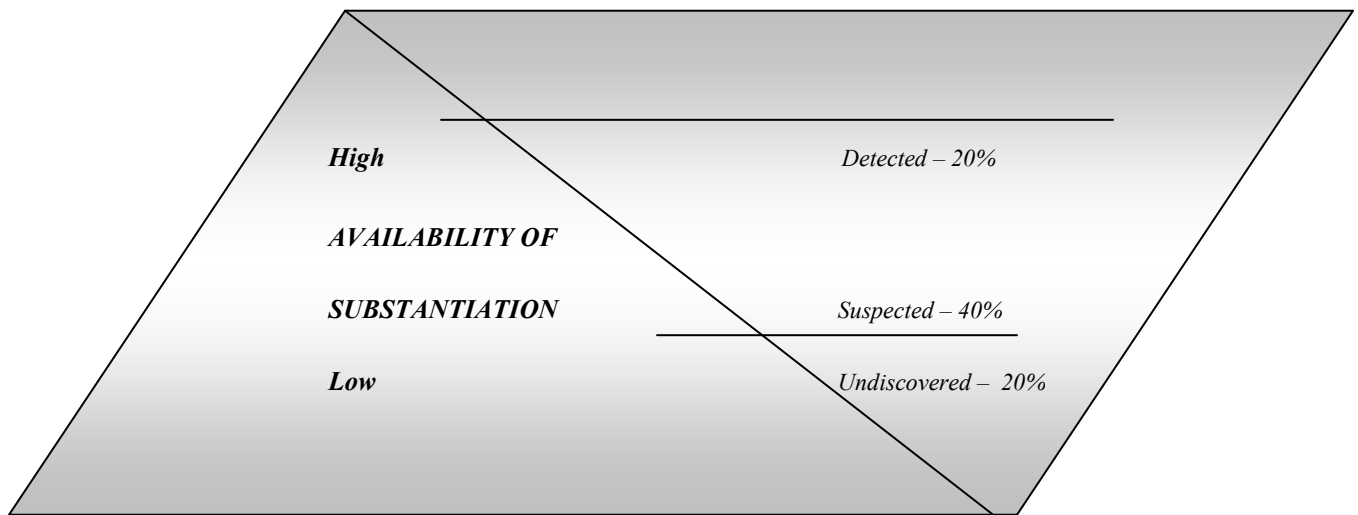
3.1. Detecting Fraud and Errors by Auditors

Already in the planning stage of the audit, the auditor should assess the risk of errors or fraud that can generate a material impact on the financial statements. Thus, based on the audit risk assessment, the auditor should develop audit procedures for identifying all material errors and fraud misstating the financial statements. Usually, if the auditor suspects the existence of fraud or errors with material impact, he expands the scope of auditing procedures, until he is convinced that the misstatement has been either corrected, or properly disclosed in the audited financial statements.

ISA 240 (redrafted) provides that the auditor's objectives in identifying fraud are the following:

- ✓ to identify and assess the risks of material misstatement of the financial statements due to fraud;
- ✓ to obtain sufficient appropriate audit evidence about the assessed risks of material misstatements due to fraud, through designing and implementing appropriate responses; and
- ✓ to respond appropriately to identified or suspected fraud.

Despite his efforts, the auditor is subject to the inherent risk that some material errors in the financial statements may not be identified, even if the audit is properly planned and performed. In the business world, the percentage of identifying fraud is small considering the legislation in force and the modern means for preventing and finding it. In order to summarise the possibility of identifying fraud by the auditor, we present the following scheme:



According to ISA 240 (redrafted), the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the company and management. It is important that those charged with governance and management place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour, which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the company's performance and profitability.

The auditor is not and can not be held responsible for fraud and errors, but through his work he can play a positive role in preventing fraud and errors, by deterring their occurrence. The fraud character of an operation can be established only in court, so that, since the auditor has no responsibility to prove fraud from a legal point of view, his concerns are directed rather towards actions suspicious of fraud, than proven fraud.

The conditions and events that increase the risk of fraud or errors refer primarily to the gaps in the functioning of accounting and internal control systems or to inconsistencies of internal controls. Besides these, we can add the following:

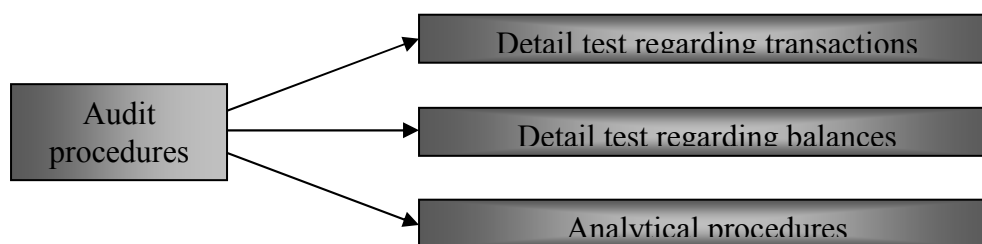
- *Questionable integrity or competence of management.* Ultimately, such a situation may lead to the auditor's withdrawal from the engagement; clues indicating such a situation may be:
 - a person or a group of persons dominate the audited company's management and the shareholders have no effective control over them;
 - a continuous failure in the internal control system or in the correction of the main weaknesses of the internal control structure;
 - frequent changes in the structure of key personnel within the financial department or frequent changes of company lawyers and auditors.
- *The existence of unusual pressure in the company or on its management,* such as:
 - a significant decrease in profits, to the extent that the assessment of management performance and, implicitly, its revenues are related to profit evolutions;
 - adopting of an aggressive expansion policy, which generates a severe working capital deficiency;
 - production of goods or services, which require an accelerated investment rate;
 - the personnel in the accounting department has to prepare the financial statements in an unusually short time.

- *The existence of unusual transactions*, which may generate fraud or errors due to the fact that they are either not caught in the internal control system, or they are so complex that, inevitably, are inappropriately understood or accounted for. Examples of such transactions:
 - unusual transactions that take place during the closure of the financial year, with a material impact on profits;
 - unusually high payments for certain services, such as those provided by consultants, lawyers, agents.
- *Difficulties in obtaining sufficient and appropriate audit evidence* – the audited company's management or other categories of employees refuse the collaboration or intentionally misinform the auditor. Such difficulties arise where the auditor finds:
 - inadequate accounting records, with omissions, too high adjustments, etc;
 - insufficient or inappropriate justifying documents;
 - an unusually high number of differences between accounting records and confirmations from third parties;
 - audit evidence is not correlated;
 - unusual and irrational changes of operation ratios.
- *Factors specific to computerised information systems that refer to events and conditions described above:*
 - inability to extract information from computer files due to lack of documents regarding the contents of records or programmes;
 - a large number of programme changes that are not documented, approved or tested;
 - an inappropriate report between computer transactions and databases, on one hand, and financial accounts, on the other hand.

Detecting errors and fraud by the auditor can be achieved through a combination of control tests and procedures.

Control tests are those tests performed for obtaining audit evidence about how the accounting and internal audit systems are designed and operated.

The audit procedures are those tests performed in order to obtain audit evidence regarding detection of errors with material impact on the financial statements.



Detail tests on transactions allow the auditor to assess how transactions are recorded, by means of analysing credit or debit accounts.

Detail tests on balances are aimed to collect rather evidence of accounts balances, than of individual transactions that led to those balances. The auditor checks the total amount of debt to a supplier, by requesting a written confirmation from the supplier, and not by checking the final balance of the respective supplier account.

The analytical procedures are those procedures that analyse various accounting correlations in order to identify the trends of the analysed elements.

Also, the auditor may obtain audit evidence by applying certain alternative procedures, such as inspection, observation, examination of documents and records, investigation and calculation.

An inspection consists in examining records, documents or tangible assets.

Observation consists in pursuing a process or a procedure performed by other persons, such as, for example, observation by the auditor of stocktaking performed by the company's personnel or observation of control procedures application that do not generate audit evidence.

Examination of documents and records received or issued by the audited company presumes reading of documents, tracking their circuit, their comparison and reconciliation. The auditor may examine minutes of the Board of Directors in order to understand the policies implemented by the audited company regarding funding. Also, by tracking the circuit of documents, the auditor checks how invoices issued to clients or those received from suppliers are recorded in accounting.

Investigation consists in obtaining information by addressing written or oral questions to people inside or outside the company that can provide to the auditor information that he could not obtain by applying of control tests and procedures. Investigations and procedures for obtaining audit evidence are more effective when combined with confirmations, usually requested from third parties.

The calculation consists in checking the arithmetic accuracy of amounts included in source documents, accounting records or financial statements.

In conducting his work, the auditor may often face situations of fraud. The detection of these situations depends also on the threshold established by the auditor. There is a risk of not detecting fraud, which does not imply auditor's responsibility as it falls to those who have committed fraud. However, this does not allow the auditor to treat fraud with indifference, as he is the one to issue a reasonable opinion on the fairness of the information included in the financial statements.

3.2. Case Studies

1. Company SC X SA decides to build three buildings that will serve as storage for finished products, of which the company will have to cover the high demand. The company announces a bid for obtaining price offers from constructors, provided that the offer is global for the three buildings, but specifying individual costs for each of them.

The four bids are listed below:

-Euro-

	<i>Building I</i>	<i>Building II</i>	<i>Building III</i>
Company A	700,000	150,000	150,000
Company B	500,000	300,000	300,000
Company C	400,000	400,000	400,000

It is clear that the first offer is the best, with costs of only EUR 1,000,000. Of course, company X will chose this option. Company A accepts the engagement and begins construction, and finalises it quickly and qualitatively. A member of the Board of Directors informs management about works performed, therewith suggesting reconsidering the necessity of buildings II and III, because there are market signs that actual demand will not meet forecasts. After analysing this issue, the Board decides cancellation of buildings II and III. The auditor knows for sure that the member who suggested cancelling buildings II and III and Company A are plotters, as the contractor is winning at least EUR 200,000 in comparison to the other offers.

2. In an audit engagement is selected a payment transaction, which pays the value of repairs to a water tank. The repairs were aimed to restore the tank's internal insulation against rust and exterior painting. After examining all documents (services contract, invoice, payment order and work reception), all signs indicate that maintenance services were carried out properly and at minimum costs. The auditors note with satisfaction that there has been no fraud. Actually, the auditors did not examine in a factual manner how works were executed, by taking a worker/technician/engineer from another department, getting him into the tank and asking for a detailed description of findings. Thus, they did not observe that the tank was not treated with an insulating layer, being rusty inside. In this case, fraud was caused by the conspiracy of those who signed the reception document.

3. An internal auditor selects from the multitude of services payments a transaction that pays for cleaning rolls at the company's headquarters. The company that cleaned them offers a discount of 2% if the invoice is paid within 10 days, what has happened. In terms of quality, helped by another employee, the auditor concludes that the rolls have been cleaned properly. By examining the document for providing the work, the purchase order, the reception document and the invoice, the auditor considers that the transaction does not contain elements of fraud. By further examining the actual contract, the auditor finds that there has been negotiated a discount of 10% compared to the last minimum price published by the services provider. However, the invoice is issued for the full price. This error of omitting to apply the discount was used in a repetitive manner, which shows that this is not a simple mistake, but fraud.

4. Reporting fraud and errors

In the audit engagement, if the auditor gets wind of fraud or error, whose potential effect on the financial statements may be immaterial or material, he must communicate his findings to management as soon as possible. However, when communicating fraud or errors, the auditor should take into account the credibility of management statements. If the auditor suspects involvement of the company's personnel in committing fraud, he should take into account the position of the involved personnel in the company's organisational structure. It is preferable to report fraud at hierarchically superior levels to that of persons to whom the involved persons are subordinated. Where there is doubt on people who have final responsibility with respect to the company's management as a whole, normally the auditor would call on legal advice to determine the procedures to be followed. Normally, the auditor's obligation to maintain confidentiality forbids him to report fraud or errors to third parties. However, under certain circumstances, by statute, law or court decision it may be decided to disclaim confidentiality. In such circumstances, the auditor may call on legal advice, taking into account the auditor's responsibility against public interest.

In case of detection of fraud, if the company fails to take measures to remedy fraud that the auditor considers necessary in these circumstances, the auditor may withdraw from the engagement, even if fraud is not material to the financial statements.

The auditor must assess whether the problems on which fraud or errors are based on have been properly reflected or corrected in the financial statements, taking into account the possible impact of such issue on his report. Thus, we can highlight two different situations:

- a) where the auditor concludes that fraud or error has a material impact on the financial statements and it was not properly reflected or corrected in the accounts, the auditor should express a qualified or a contrary opinion,
- b) where the company hinders the auditor from obtaining proper and sufficient audit evidence to assess the possibility of occurrence of fraud or errors that would significantly influence the financial statements, then, the auditor should express a qualified opinion or even declare his impossibility of expressing an opinion on the financial statements due to limitation of audit scope.

For companies listed on capital markets, Romanian legislation¹ requires the auditor to report fraud issues to the National Securities Commission (CNVM).

Within 30 days, the auditor must prepare additional reports on operations indicated by shareholders holding at least 5% of the total voting rights. If managers and auditors fail to comply with their requests within the prescribed period or the report does not include reporting information, the shareholders may address themselves to the territorial court where the company has its headquarters for appointing another financial auditor. Within 10 days, the auditors are pledged to

¹ Law no. 297/2004 on capital markets

report any fact or act in connection with the activity of the listed companies, which they have become aware of in the exercise of their particular duties and which:

- a) represent a significant violation of laws governing the licensing and functioning of the audited company;
- b) are likely to affect the audited company as an on-going concern;
- c) may lead to a qualified audit opinion, to the impossibility of expressing an opinion or to a contrary opinion.

Upon written request from CNVM, the auditors are pledged to submit to this institution:

- a) any report or document that was made available to the audited company;
- b) a statement indicating the reasons for the termination of the audit contract, regardless of their nature;
- c) any report or document containing the findings that were brought to the attention of the audited company.

Fulfilment in good faith by the auditor of the obligation to inform CNVM, does not represent a breach of his obligation to professional secrecy, and it will not imply the auditor's responsibility.

Referring to fraud detection in financial audit engagements, ISA 240 provides: „If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (a) determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirements for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is permitted; and
- (c) if the auditor withdraws:
 - (i) discuss with the appropriate level of management and those charged with governance about the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) determine whether there is a professional or legal requirement to report to the persons or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Due to the nature of fraud and the difficulties faced by auditors in identifying material misstatements arising from fraud in the financial statements, it is important that the auditor obtains a written representation from management to acknowledge that following had been brought to the auditor's attention:

- (a) the results of management assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- (b) management knowledge of fraud or suspected fraud affecting the company.

5. Conclusion

ISA 240 The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements makes it clear that the responsibility for the prevention and detection of fraud and error rest with management, through the implementation and continued operation of adequate accounting and internal control systems. Such systems reduce but do not eliminate the possibility of fraud and error.

In contrast, the auditor is not and cannot be held responsible for the prevention of fraud and error. The fact that an annual audit is carried out may, however, act as deterrent. The auditor must therefore seek sufficient appropriate audit evidence that any fraud or error which may be material to the financial statements have not occurred. If it has occurred, the auditor must ensure that the effect of fraud is properly reflected in the financial statements or the error is corrected.

Because of the inherent limitations of an audit, there is an unavoidable risk that material misstatements in the financial statements, resulting from fraud or (to a lesser extent) error, may not be detected. Where such a misstatement is detected after the audit, the auditor will only have failed to adhere to basic principle and procedures if it is found that the audit procedures undertaken were not adequate in the given circumstances.

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