CONSIDERATIONS CONCERNING THE FINANCIAL AUDITORS' RESPONSIBILITY TO DETECT THE FRAUDS COMMITED UPON AN ENTITY'S PROPERTY

Marioara AVRAM, Professor, PhD.
Veronel AVRAM, Professor, PhD.
University of Craiova

Key words: responsibility, audit, fraud, standards.

Abstract: During the audit process of the financial situations, the auditor has a great responsibility in detecting the significant falsifications of the information due to fraud. The International Federation of Accountants (IFAC), the representative international structure of the accounting profession has elaborated the International Audit Standard 240 "The Auditor's responsibility to analyze the fraud in an audit of financial situations" which establishes the regulations and offers the recommendations concerning the procedures that must be applied by the auditor in order to detect the significant falsifications consequent to fraud which influences the fidelity of the information presented in the financial situation. The auditor can identify a falsification in the financial situations and in this case he must analysis if such a falsification can indicate a fraud and when such a clue exists, the auditor must analyze the implications of falsification in relation with other audit aspects, especially those related to the credibility of the leadership's declarations. The auditor's responsibilities are different in each country and the obligation to confidentiality can be evaded in certain situations through a legal status, law or court order. In some countries, the auditor is compelled to report the emergence of frauds to the authorities when the leadership and the management of the entity do not take corrective measures.

1. Introduction

The International Audit Standards (ISA) 240 "The Auditor's responsibility to analyze the fraud in an audit of financial situation", elaborated by IFAC through its structure IASAB and assimilated by the professional structure from our country, the Romanian Financial Auditors Room, is put in practice by the financial auditors when they audit the annual financial situations of the economical entities.

This standard establishes the regulations and offers recommendations which are applied by professional accountants during the audit process.

2. Fraud and error

ISA 240 makes the distinction between fraud and error and defines two types of fraud relevant for the auditor:

- Falsifications that are caused by the misrepresentation of the assets;
- Falsifications that are caused by the fraudulent financial reporting, meaning the basic action that has provoked a falsification of the financial situations was done intentionally or/and unintentionally.

The concept of error means a falsification of the financial situations made unintentionally, including the omission of an amount of money or a presentation, as follows:

- An incorrect accounting estimation as a consequence of the misinterpretation of the facts;
- A mistake that has appeared during the data research and processing from the financial situations;
- A mistake in applying the accounting policies regarding evaluation, recognition, amortization and depreciation of the entity's assets.

Fraud is a deliberated action done by one or more persons from the society's leadership, employees or third parts, action which involves the use of false pretence in order to obtain an illegal or unjust advantage.

Fraud is an action initiated by one or more persons and can be determined by one of the following events:

1. falsification of documents and records;
2. actives' misappropriation or theft;
3. wrongful assignment of some actives , with influences on the continuity of the entity's activity;
4. elimination or partial registration of a transition's results in order to make the financial statements look better;
5. misapplication of accounting policies so to embezzle the entity's assets and performance etc.

Fraud is determined by the intent to deceive, the desire to obtain undeserved advantages as a consequence of shortcomings' existence in the functioning of an entity after some unproductive controls.

The auditor will be concerned with the fraudulent actions leading to a significant falsification of financial situations. The fraud involving persons from the leadership level is known under the name "managerial fraud" and the one involving only entity's employees is named "fraud by employees' association".

The deliberated falsifications are classified in two categories:

1. Falsifications emerging from the financial reporting;
2. Falsifications emerging from the assets' dilapidation.

The fraudulent financial reporting represents falsifications or omissions of the information from the financial situations made intentionally with the aim to misinform and mislead the persons using the financial situations (shareholders, clients, providers, employees, banks etc.).

The fraudulent financial reporting can be done through the next methods:

- Manipulation, falsification, and modification of the accounting entries or of the vouchers on which the financial situations are based;
- Misinterpretation or the deliberated omission of events, transactions or other important information from the financial situations;
- The bad application with intention of the accounting policies.

The fraudulent financial reporting can be due to the manipulation of the incomes by the entity's leadership to cheat the persons using the financial situations over the performance and profitability of the economical entity.

For example:

- underestimation of costs and over evaluation of incomes will lead to the registration of a higher profit to be given to the shareholders;
- underestimation of assets and over evaluation of debts will lead to the establishment of a higher net active;
- overestimation of the shares' value on the stocks' market.

The dilapidation of assets means the theft of an entity's assets and it is most often done by the employees. Dilapidation can be done through different methods:

- Fraudulent receipts – accumulation of the frauds in debt accounts or the orientation of the receipts toward personal accounts;
- Theft of tangible and intangible assets;
- Payments for goods and services undelivered yet;
- The use of the society's assets in personal interest.

The dilapidation is accompanied by false records or documents with the aim of covering up the missing assets.

Financial auditors are dividing frauds depending on their nature such as:

- frauds referring to the financial statements' elaboration and presentation;
- frauds having for results the entity's operations, significant reduction of the activity, which determines the risk of continuity;
- frauds affecting the personnel policy(employees health, work safety etc.);
- frauds affecting the environment and its protection, which determines the risk of continuity for the activity.

It can be said that fraud determines the entity's managers and employees degree of honesty and trust.

The primary responsibility for the prevention and detection of frauds and errors belongs to the leadership as well as to the management of the society.

The accent falls on preventing frauds, and it can determine individuals to not commit fraud because of the possibility to be discovered and punished. The creation of a culture of the organization and ethical behavior is necessary in any society and it must be communicated and sustained by the persons in charge of leadership (surveillance, control, management).

The active surveillance of those in charge of the leadership means a continuity of the internal control, the analysis of the financial situations' safety, the efficiency and efficacy of operations, of the conformity with the legislation and regulations in use.

It is obvious in the present days that the fraud phenomeneon has reached globalization as well considering the number of high profile frauds that have kept the public attention lately, being discovered inside of some of the most prestigious multinational companies. The list is very long and includes cases such as ENRON in USA, Parmalat in Italy and Group Societé Génèrale in France. A study conducted in 2005 at the University Martin Luther from Hale, Germany, made on a sample of over 3600 international companies, has indicated the percent of each type of fraud, as shown in Table 1.

Table 1

Types of fraud

Nr.	Fraud type	%
1.	Delapidation	22
2.	Financial Statements Manipulation	19
3.	Corruption and Bribery	19
4.	Fals Pretences	15
5.	Falsification	9
6.	Money Laundering	7
7.	Others	9

Source: Nadir Ali, Considerations about the Internal Audit Role in the Prevention and Detection of Fraud, in Financial Audit Review, nr. 6/2007.

The study proves that only 26 % of frauds were identified by internal audit, while 34 % were discovered by chance.

3. The auditor's responsibilities

The auditors' main objective during his audit mission of financial situations, seen as a whole, is to obtain a reasonable assurance that the financial situations do not contain significant falsifications caused by frauds or errors. The auditor can not obtain an absolute assurance of the fact that the significant falsifications of the financial situations will be detected by using the audit tests because of the inefficacy of the internal control and the fact that the audit evidences he holds are more persuasive than conclusive.

In order to obtain a reasonable assurance, the auditor:

1. maintains an attitude of professional skepticism during the entire audit process;
2. analyses the possibility of the society eluding the controls ;
3. admits that it is possible the procedures used to detect errors or falsifications consequent to fraud are not adequate.

The professional skepticism is an attitude which involves an inquisitive mind and a critical evaluation of audit evidences. Preserving an attitude of professional skepticism imposes the permanent analysis of the reasonable character of the answers given by the leadership delegates during investigation as well as of the other information those persons have given.

When the audit process is done by a team, the team members must debate upon the possibility of the existence of a potential for significant falsifications of the financial situation consequent to fraud.

The debate is a very good occasion for the more experienced team members to share their knowledge about the manner and place in which significant falsifications of the financial situations consequent to fraud might emerge.

Discussion keeps up an inquisitive mind, without taking in account the convictions of some team members about the honesty and integrity of the society's leadership. The debate usually includes:

- ✓ Exchange of ideas between team members about the manner and place in which the emergence of significant falsifications of the financial situations consequent to fraud might emerge can be suspected, the entity's leadership can commit and hide fraudulent financial reports and the assets of the entity can be dilapidated;
- ✓ Analysis of the circumstances that can prove an incomes' manipulation;
- ✓ Analysis of the factors that might put pressure on the management or others to commit fraud;
- ✓ Analysis of the leadership's involvement in the surveillance of the employees with access to cash money or other assets that can be dilapidated;
- ✓ Analysis of unusual changes in the life of the leadership members or employees;
- ✓ Analysis of the types of situations that can indicate the possibility of a fraud;
- ✓ Analysis of the risk of leadership eluding controls.

International Audit Standard 240 "The Auditor's responsibility to analyze fraud in the audit of the financial statements " mentions:

- responsibility for preventing frauds and errors belongs to the entity's leadership, that have the obligation to implement and operate continuously through adequate systems of accountancy and internal control;

– the financial auditor, though "it can not be hold responsible for frauds and errors prevention", has the obligation to plan and make the audit so to obtain a reasonable assurance that the financial statements are not significantly embezzled consequent to recorded frauds and errors.

The manager's responsibility is at maximum in regard to the prevention or investigation of fraud, corruption, bribery, as well as establishing the necessary measures for the case in which alarm signals might appear from this point of view. For example:

– omissions or errors in the providers' and clients' identification data on the fiscal receipts;

– disagreements between the information on the receipt and on the order form;

– disrespect for the information privacy;

– close relationships between the persons in charge of supply and entity's providers, thus appearing the opportunity for taking bribe;

– a third person almost always winning the auctions for undertaking goods or services;

– using certain methods of payment or cash in the country as well as abroad etc.

The audit process, though developing in conformity with the legal and professional procedures and standards, does not absolve the auditor of the obligation to answer in front of the instance in one of the following situations:

6. when the leadership of a company pretends the auditors determined them to think that certain decisions were right and it was not fraud or error;
7. when persons, that have become shareholders later on, pretend that they have registered losses buying shares from the audited firm because of the financial audit report;
8. when third parts involved, taking into account the audit reports, declare they initiated business relationships with the audited firm;
9. when the company's new owners discover that the financial statement is not in conformity with the reality;
10. when a company's liquidator considers that the financial statement was not reflected in the accounts, so the audits provoked losses to the creditors.

In all the cases above, though the professional assurance exists, it might not be enough for covering the professional risks.

4. Audit procedures

In order to identify the risks of significant falsifications of the financial situations, the auditor or the audit team can apply the following procedures:

1. organizes meetings between the leadership and other persons from the society for the identification and treatment of the fraud risks;
2. analyzes if one or more factors of fraud risk are anticipated;
3. analyzes other information necessary for the identification of the risks of significant falsifications consequent to fraud.

a) to understand the environment of the society, including the environment of the internal control, the auditor questions the management about:

- the way in which the managements communicates to the employees its vision concerning the creation of culture of honesty and ethical behavior;
- the way in which the managements communicates to the leadership the aspects related to the identification fraud risks within the entity;

- procedures used by the management to identify the fraud risks, the accounts' balances or the transactions that are considered to be exposed to fraud risks;
- the risk evaluation done by the management of the society that financial situations can be falsified significantly consequent to a fraud.

The auditor must interview the management concerning its own evaluations of fraud risks, because it is responsible for the entity's internal control and for elaborating the financial situations. The auditors questions all the aspects related to the process of researching the unproved accusations of fraud, internal or external ones, affecting the society.

The auditor can also interview about the existence or suspicion of fraud:

- employees from different levels of authority;
- employees involved in the initiation, processing and recording uncommon and complex transactions;
- the judicial counselors within the entity;
- the person in charge of ethics, whether there is one.

The auditor also interviews the persons in charge of the society's leadership to determine if they have knowledge of real or suspected frauds.

b) to understand the entity's environment, including internal control, the auditor must analyze the presence of one or more factors of emergence for the fraud risk.

Because the fraud is usually hidden, it is very difficult to detect it, but due to the acknowledgement of the entity's environment, the auditor can identify events or conditions that indicate the existence of a stimulus or pressure to commit fraud.

These events or conditions to commit fraud are named "factors of fraud risk emergence", like:

- an ineffective control environment can bring out the occasion to commit fraud;
- granting important stimuli if certain unrealistic profit goals are achieved can create the premise to commit fraud;
- the necessity to fulfill the expectations of a third part to obtain supplementary capital infusion can create pressure to commit fraud.

The auditor must take into account the procedures applied for implementing an official ethical code.

When a small entity is concerned it is possible that a written ethical code do not exist but the entity has developed in time a culture pointing out the importance of integrity and ethical behavior through oral communications and the example the entity's management gives.

c) for the development of analytical procedures to understand the entity and its internal control, the auditor analyzes the unusual and unexpected that might indicate risks of significant falsification consequent to fraud.

The auditor develops certain expectations about plausible relationships which are reasonably expected to exist while applying analytical procedures.

The analytical procedures include the procedures concerning the incomes accounts aiming to the identification of unusual and unexpected relationships which can prove the existence of certain risks of significant falsification consequent to fraudulent financial reports (e.g. fictional sales).

d) for understanding the entity's environment, as well as its internal control, the auditor must analyze other information indicating risks of significant falsification consequent to fraud.

The information found by the auditor during the process of accepting and keeping of a client, as well as the experience gained during other audit missions, can be important for the identification of risks of significant falsification consequent to fraud.

The auditor uses the professional reasoning and analyzes the size of the possible falsifications of financial situations in order to identify and evaluate the risks of significant falsification consequent to fraud.

Suspicion of fraud or error must be present in the auditor's report, because the following situations can appear:

- fraud and error have a significant result on the financial statements, for which reason the financial auditors will express a cautious opinion or declare the impossibility of expressing an opinion because of the limits imposed by the audit;
- financial auditors can not evaluate the fraud or error's effect upon the financial statements, being prevented by the entity from obtaining the adequate and sufficient proofs necessary for the evaluation, in which case the financial auditors will express a cautious opinion or declare the impossibility of expressing an opinion because of the limits imposed by the audit.

The auditor can identify a falsification in the financial situations and in this case he must analysis if such a falsification can indicate a fraud and when such a clue exists, the auditor must analyze the implications of falsification in relation with other audit aspects, especially those related to the credibility of the leadership’s declarations.

The auditor’s responsibilities are different in each country and the obligation to confidentiality can be evaded in certain situations through a legal status, law or court order.

In some countries, the auditor is compelled to report the emergence of frauds to the authorities when the leadership and the management of the entity do not take corrective measures.

5. Conclusions

Aspects that lead to significant falsification consequent to fraud can emerge during the process of auditing the financial situations.

The auditor will communicate and argument his communication to the entity’s leadership and management the fraud aspects that lead to the significant falsification of the financial situations. The auditor, after consulting a legal expert:

- may give up the audit mission;
- makes the audit report after he communicates his discoveries to the entity’s management which decides, if it is the case, to redo the accounting documents;
- reports to the authorities the fraud aspects discovered depending on the legislation in use.

The collaboration between auditors and the audited entity's managers has a major importance in the prevention of frauds and errors concerning:

- the correction of the weak points in the control of the entity whenever they are identified by the auditor;
- the improvement of internal control system and accounting system;
- the elaboration of a set of proposes and recommendations for improving the activity in its assembly.

REFERENCES

1. Acton R. (2007) - „Responsabilitățile auditorului financiar în perspectiva internațională”, *Revista Auditul financiar*, nr. 12;
2. Ali N. (2007) – „Considerații asupra rolului auditului intern în prevenirea şi detectarea fraudei”, *Revista Audit financiar*, nr. 6;
3. Avram M. (1996) - *Auditul financiar – teorie şi practică,* Ed. Echinocțiu, Drobeta Turnu Severin;
4. Bostan I. (2000) - *Controlul financiar*, Ed. Polirom, Iaşi;
5. Collins L., Valin G. (1992) - *Audit et contrôl intern*, Ed. Dalloz, Paris;
6. Florea I., Florea R., Macovei C., Berheci M. (2005) - *Introducere în expertiza contabilă şi auditul financiar*, Ed. CECCAR, Bucureşti;
7. Munteanu V. (coordonator) (2001) - *Control şi audit financiar*, Ed. Economică, Bucureşti;
8. Stoian A., Țurlea E. (2001) - *Auditul financiar contabil*, Ed. Economică, Bucureşti;
9. Toma M., (2007) - *Inițiere în auditul situațiilor financiare ale unei entități,* Ed. CECCAR, Bucureşti;
10. *** *Audit financiar 2006 – Standarde. Codul etic,* Ed. Irecson, Bucureşti;
11. *** *Standarde Internaționale de Raportare Financiară*, Ediția 2006, emise de Consiliul pentru Standarde Internaționale de Contabilitate (IASB), tipărite de CECCAR;
12. ***Legea 31/1990 completată şi modificată;
13. www.iassb.org.