Reporting on Errors and Fraud in Financial Audit Missions

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Abstract

Although in Romania the financial audit is at the beginning of the road, the system of legislative regulations of recent years anticipates new trends and the expansion of its role in the next century. The main responsibility in the prevention of fraud and errors, as well as in their detection, belongs to the management of the entity, but at the same time also to those who are entrusted with the governance. These responsibilities may vary from one country to another, or from one entity to another. The management, under the careful supervision of those delegated with governance, must create an appropriate climate, establish and maintain high ethical standards, a culture of honesty and establish the setting of periodic controls to prevent and detect possible fraud and errors at the level the audited entity.

Key words: report, financial audit, error, fraud, auditor
J.E.L. classification: M 40, M 41, M 42

1. Introduction

The improvement activities of the financial audit are unnecessary, especially in Romania, where such activities are stabilizing, together with the advancement of the reform process and the incorporation of the Romanian economy into the structures of the European Union.

Although in Romania the financial audit is at the beginning of the road, the system of legislative regulations of recent years anticipates new trends and the expansion of its role in the next century. This turn is also substantiated by the numerous changes in the economic environment, such as the evolution of stock market activities, the bankruptcy or merger of some entities, the increase in the number of financial transactions.

From the 20th century, laws begin to be drawn up regarding the official recognition of the importance of verification by means of the audit, and even its obligation is imposed as well as that of the publication of the balance sheet, with the aim that it provides "a true and accurate picture " of heritage. The development of accounting, together with the evolution of auditing and internal control, were the result of activities and conclusions formulated by accountants and auditing firms, as a result of their experiences and not as a result or a legislative imposition.

Financial audit procedures began to be used in our country, during the transition to a market economy, from the aspiration of Romanian specialists to transform and correlate Romanian regulations to international accounting standards.

The financial audit stabilizes with the development of the reform process and the realization of an economy similar to that of the countries within the European Union.

Therefore, Romania imposes the introduction of financial audit techniques harmonized with international ones, and the plurivalence and maintenance of the evolution of economic activities causes the continuous improvement of accounting and financial audit standards, as well as the training of professionals in the field.

2. Literature review

In order to reduce the risk to a minimum satisfactory level, in planning and performing the audit, it is necessary for the auditor to take into account the risk of conclusive distortions in the financial statements, due to fraud.

In financial statements, misstatements arise when errors and frauds occur. The distinction between error and fraud is given by the factor that shows whether the underlying action that resulted in a misstatement of the financial statements is intentional or unintentional.

The term "error" refers to an unintentional misstatement in the financial statements, including the omission of a statement or amount, such as: an erroneous accounting estimate, arising as a result of overlooking or misinterpreting some facts; a mistake in the application of accounting policies regarding the evaluation, classification, recognition, presentation and description of information; a deviation arising in the collection and processing of the data on the basis of which the financial statements are drawn up.

The term "fraud" refers to an act of a willful nature undertaken by a person or a group of persons within the management, among third parties or employees, or those charged with governance, an action that entails the use of deception in order to achieve a unfair or illegal advantage. Although fraud is a broad legal concept, the auditor is more concerned with fraudulent misstatements that cause a material misstatement in the financial statements. There is a possibility that the misstatement of the financial statements is not caused by existing fraud. Auditors are not the ones who legally decide whether a type of fraud is present or not.

In the content of the audit rules, it is stated that the auditor has the duty to inform the management of his findings as soon as possible, in case:

- the presence of an insignificant error or fraud was discovered;
- the auditor suspects the presence of fraud, even if its potential effect is immaterial to the financial statements.

The information must be carried out taking into account the persons who could be complicit in the commission of the respective fraud, either directly or indirectly. That is why it is recommended that these findings be reported directly to the department under which the persons involved in the respective fraud bias are located. The auditor will resort to legal advice, in order to establish the procedures that must be carried out in the situation where there are doubts regarding the persons who have final responsibility regarding the management of the entity as a whole.

If the auditor believes that the error or fraud will have a material effect on the financial statements, he must apply additional procedures or appropriate modified procedures.

The extent to which such additional or modified procedures are applied takes into account the auditor's judgment in relation to: the type of error or fraud indicated; the probability of their occurrence; the possibility that some type of error or fraud will have a material effect on the financial statements.

Unless the circumstances clearly indicate otherwise, the auditor cannot believe that a particular error or fraud is an isolated occurrence. If absolutely necessary, the auditor makes the decision to modify the nature, duration and scope of substantive procedures.

Typically, the application of additional sets of procedures or modified procedures gives the auditor the opportunity to confirm or disprove suspected error or fraud. If the doubt of error or fraud does not cease, the auditor must have a discussion with the management of the audited entity regarding this issue and analyze whether it has been corrected or properly reflected in the financial statements. The auditor intends the possible impact on his report caused by such a problem. Thus, the following two situations can arise:

- ✓ the situation in which the auditor is confused by the entity to carry out sufficient and appropriate audit tests and evidence in order to assess the possibilities of the development of an error or fraud that exerts a significant influence on the financial statements, then he is forced to express his opinion with reservations or even announce the lack of possibility to express an opinion on the financial statements, caused by the limitation of the scope of the audit.

- ✓ the situation in which the auditor is confused by the entity to carry out sufficient and appropriate audit tests and evidence in order to assess the possibilities of the development of an error or fraud that exerts a significant influence on the financial statements, then he is forced to express his opinion with reservations or even announce the lack of possibility to express an opinion on the financial statements, caused by the limitation of the scope of the audit.

Naturally, the auditor's duty of confidentiality prevents him from reporting errors and fraud to third parties. However, in certain situations by law, statute or court decision, decisions can be made regarding the waiver of confidentiality, but the auditor may seek legal advice in such situations, taking into account the auditor's responsibility regarding the public interest.

The auditor may conclude that it is useful to withdraw from the engagement in the situation where the entity does not take actions to improve the frauds, which the auditor considers indispensable in the respective circumstances, even if the frauds are not significant for the financial statements. The author's conclusion may be affected by the involvement of the highest authority within the entity, a situation in which confidence in the management's statements is affected, and the auditor's credibility may also be affected, if he continues the association with that entity.

The national and international audit norms mention that the auditor has to notify the management of his findings as soon as possible, when:

- The auditor suspects the presence of a possible fraud, even if the consequences are insignificant for the financial statements;
- The presence of an insignificant error or fraud has been disclosed.

The communication is necessarily made, taking into account the persons who are likely to have an implication in the commission of the respective fraud, either with a direct or indirect contribution. Therefore, it is more favorable that these remarks are reported directly to the upper management, under whose authority the persons in favoring or perpetrating the respective fraud are located. In conditions where there are doubts regarding the persons who are directly liable within the entity, the auditor will naturally resort to legal advice to establish the procedures that must be followed.

In the situation where the auditor believes that the error or fraud is likely to create significant effects on the financial statements, he will require the application of appropriate changed procedures or additional procedures.

The extent to which such changed or additional procedures are used depends on the auditor's consideration of:

- The category of error or fraud indicated;
- The probability of their production;
- The likelihood that a particular category of error or fraud will have a material influence on the financial statements.

Unless the circumstances clearly show otherwise, the auditor cannot accept that a situation of error or fraud is an isolated occurrence. If it is useful, the auditor turns to the processing of substantive procedures, from the point of view of duration, nature and degree of coverage.

The use of changed procedures or additional procedures normally enables the auditor to certify or not to certify the suspected error or fraud. If the suspicion of error or fraud persists, the auditor should discuss the matter with the management of the audited company and examine whether this matter has been properly represented or rectified in the financial statements. The auditor is required to consider the possible consequences of such a problem to his report. Therefore, two situations can be outlined:

- Situation in which the auditor concludes that the error or fraud has a suggestive influence on the financial statements and that it has not been adequately reflected or rectified in the financial statements, the auditor proceeds to express a qualified opinion or an adverse opinion.
- Situation in which the auditor is retained by the company to procure consistent and sufficient audit evidence in order to assess the possibility of errors or frauds that suggestively worsen the financial statements, then it is required that he formulate a point of view with reservations or even to support the impossibility of formulating an opinion on the financial statements, due to the narrowing of the area of applicability of the audit.

Naturally, the auditor's duty of confidentiality restrains him from reporting errors and fraud to third parties. However, in certain circumstances, by law, statute or court decision, it is possible for the auditor to opt out of confidentiality. In such situations, the auditor may seek legal advice, bearing in mind the auditor's public interest responsibility.

The auditor may conclude that it is useful to withdraw from the task in the situation where the company does not carry out actions regarding the correction of frauds, which the auditor finds indispensable in the respective circumstances, even if the said frauds are not conclusive for the financial statements. The involvement of the highest authority within the company may prejudice the auditor's conclusion, a circumstance in which the credibility of management's statements is also affected, and the auditor may also be prejudiced if he does not cease association with the entity. It is required that the auditor investigate the fraud risk factors recognized as existing throughout the assessment action performed by the auditor and investigate the auditor's response to each such factor. If during the audit it is noted that the factors recognized for the occurrence of the risk of fraud cause the auditor to consider that additional audit procedures are indispensable, in the situation where it is required that the auditor investigate the existence of such risk factors and the response to these factors provided by auditor.

3. Research methodology

One of the requirements of this article is to present and analyze the reporting of error and fraud discovered in audit engagements, the empirical part of the research presents the reporting, communication and statements of the management.

For the collection of data and information, the main method used was the observation method, this being evaluated as one of the most and often used methods in research activities. Through the use of scientific observation one perceives the thorough and systematic tracking of specific actions with the aim of understanding the essential and differential aspects.

A very important source of ideas discussed and analyzed, and also of information in this paper, was the articles, books and articles on error and fraud discovered as a result of the audit missions. A large part of these materials were taken into account for the drafting of this paper, in the research carried out and the debate on the issue of financial audit. Special emphasis is placed on management communication and statements.

4. Findings

The auditor is required to obtain written representations from management that:

- ✓ Management attests to its obligations regarding the introduction and operation of internal control systems and accounting systems that have the mission of warning and detecting the occurrence of errors and frauds.
- ✓ Management is of the opinion that the consequences of those uncorrected misstatements of the financial statements gathered by the auditor during the audit process are inconclusive, both individually and in the aggregate, for the financial statements as a whole. A summary of such elements is required to be included in the written statements or attached to them;
- ✓ Management informs the auditor of all significant actions taken to remove any suspected errors or fraud that could harm the entity, known to management;
- ✓ The management informs the auditor about the effects of their own assessment of the danger that the financial statements will be significantly distorted as a result of the existence of frauds;
- ✓ Due to the fact that management is responsible for adjusting the financial statements to correct material misstatements, it is essential that the auditor obtain written statements from management that any uncorrected misstatements resulting from either error or fraud are, in management's opinion, not suggestive. both individually and in aggregate. Such representations are not a substitute for obtaining appropriate and sufficient audit evidence. In some circumstances, management may not consider certain uncorrected misstatements of the financial statements collected by the auditor throughout the audit to be misstatements.

Because of this, management may use wording in written statements such as, "We do not agree that items ... and ... constitute misstatements because [specify reasons].

5. Conclusions

An audit engagement may not be able to provide absolute assurance that the content of the financial statements is free from material error or fraud. Errors can arise either as a consequence of processing accounting data in an incorrect way, or due to the application of erroneous reasoning in the selection and use of accounting standards, thus there is a risk that the auditor will not be able to discover them, regardless of the conscientiousness with which apply these auditing standards.

The specialized literature affirms the fact that the synthesized financial statements cannot be of perfect accuracy, or perhaps because of some unclear concepts existing in accounting. Thus, most of the results calculated in accounting based on the estimation principle cannot provide greater precision than the methods used for their sizing allow. For example, one cannot accurately predict the results of a future event, the evolution of market prices or the value of the exchange rate at a given time. Because of this, whenever accounting estimates relate to uncertain outcomes of future events, these approximations will be inherently inaccurate. Consequently, the annual accounts that are subject to audit cannot have a very high degree of precision either, due to the inherent restrictions brought by the accounting concepts.

During the course of the study, I had the chance to make contact with the specialized literature, especially with the international standards used in this field, but it was necessary to familiarize myself with cosacrate, but older methods.

Secondly, during the preparation of the project I had to deal with the aspects and stages of auditing an entity, all of which were carried out under the guidance of the scientific coordinator.

In Romania, economic agents have not yet managed to reach the indispensable degree of awareness or, in some situations, they have no interest in calling on professional financial audit services. Therefore, their general lack of interest in the financial audit is justified, as a way of reflecting the manner of compliance with the provisions of the International Accounting Standards and the correct delivery of the acquired financial results.

In conclusion, the auditing of the annual financial statements of a company, by a financial auditor, represents complex and systematic work, which presupposes special responsibilities of the participants. The purpose of the financial audit activity consists in: notifying the results, respecting certain professional rigors in terms of the formulation of the audit report and the clear and concise expression of the formulated opinion and the beneficiaries' understanding of the future responsibilities.

6. References

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