

CHALLENGES OF EXTERNAL FINANCIAL AUDIT AGAINST THE MANAGERIAL FRAUD

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Abstract:

Corporate governance is no longer a new topic, but is in a constant controversy. This paper aims to establish the importance of external financial audit in improving corporate governance, a premise for survival, continuation and development of entities in the current economic climate. The core element of the study concerns the active participation that external financial audit must manifest in a governance system to avoid mismanagement and its consequences, especially fraud. For this purpose is performed a synthesis of the current state of knowledge through theoretical and conceptual approach in terms of motivational, of the agency and stakeholders theories, based on specialized literature.

Key words: *external financial audit, management, information, fraud.*

JEL Classification: *G32, G34, M14, M42*

INTRODUCTION

The corporate governance system implies a cycle that extends from steering and monitoring role of the Board of Directors, to the administrative and operational executives and the certification role of internal and external auditors. These roles come from three different levels of governance. Efficiency of a level may influence another one, but also governance on the entire organization. In this sense, the system includes all activities from monitoring, operation and control, so the processes and activities to meet the interests of different stakeholders.

Diversity of economic and financial activities, development of capital markets have led to increasing complexity of accounting works, which can lead to errors in data processing, interpretation and evaluation with some negative consequences for the decision making of accounting information users. Moreover, the accounting information producers are not neutral to the operations and, implicitly, to the annual accounts, which raises doubts about the objectivity of the professional accountant. Susceptibility of the reality of accounting information contained in annual financial statements can be given also by moral and professional qualities of the information producers.

Accounting has been long considered part of a surveillance technology of a company to reduce agency costs. Recent studies claim that timely losses recognition is an important characteristic of accounting, related to stronger governance structures such as independent boards and effective external audit services.

Conflict of interest between users and producers of accounting information must be diminished by the activities of a professional elite in the area, represented by the auditors. The purpose of auditors' work is to restore a reasonable confidence between producers and users of accounting information. So, auditors help to protect the interests of different categories of beneficiaries of accounting information whenever they shall take economic decisions.

Financial audit involves an examination performed by an authorized professional, independent, motivated to express an opinion on the true image of the annual financial statements. According to “Framework for Preparation and Presentation of Financial Statements” issued by the IASB, auditors must consider qualitative characteristics that determine the effectiveness of accounting information in financial statements and the valuation of the elements on which they are prepared.

1. EXTERNAL FINANCIAL AUDIT IN THE CONTEXT OF THE NEW ECONOMIC ENVIRONMENT

Large audit firms provide higher quality services due to increased monitoring capabilities. This is because to the resources at their disposal and the qualified staff, which indicates that audit firms are investing in their reputation, both to keep their good name and to provide income. Therefore, are more independent and less willing to negotiate audit results with their customers.

Audit quality is a concept with different definitions, depending on the interpretation of each person. Quality grade takes into account the auditor's ability to detect accounting errors, but also the independence manifested. Users of financial statements are interested on audit reports to have absolute certainty that the information provided by the company does not have material misstatements and does not favor a fraud intention. Of the audit effectiveness depends minimize business risk, dispute avoidance and limiting depreciation of the audit firm's reputation as a result of a failure. For example, the collapse of Arthur Andersen in 2002, best illustrates the consequences of an audit failure.

Audit quality is an indicator of audit team's efficiency, and firms with the best performance in the area meet the following criteria:

- availability of necessary resources (human and technological);
- control systems to a high standard;
- greater independence to the their clients;
- a significant business risk, for reputation damage;
- charging audit fees to allows the allocation of a lager period of time and effort for each engagement party;
- high economic costs imposed by the auditor, for an eventual failure.

External financial audit is oriented to:

a) verify compliance with the generally accepted conceptual framework of accounting (postulates, principles, standards and evaluation rules), and internal procedures established by management (internal or statutory audit);

b) verification and certification of properly reflection in accounting of financial statements, their fair image, clear and complete throughout the financial year. The audit must follow if procedures for collecting and processing data are well established and if they are continuously applicable.

By fulfilling its role, external financial audit ensures achieving the general objective and goals derived from it, namely:

- reliability of accounting and financial information;
- confirmation that the company complies with a predefined accounting referential.

External auditors are activating now in an environment of zero tolerance as a result of recent financial scandals. Accounting and audit norms are very complex and how the auditors can defend themselves is quite limited. Given that accounting syntheses establish normative references, audit firms want to hold a key role in directing this type of communication. Their political role is the account certification. They are

traditionally involved in this process in terms of legal responsibility, but also they tend to have a new institutional dimension, acting in internal control procedures, too.

Companies oriented towards costly and long-term investment projects are looking for audit services of high quality to meet the claims of creditors and to eliminate the doubts of debt holders regarding the transfer of richness. Therefore, along with increasing debt, is expected to rise audits quality. The higher the debt is, the more risky a company becomes, which increases the possibility of failure, with serious consequences for external auditors. Therefore, they may be less likely to compromise the quality of their work, as leverage increases. According to this idea, company size and agency costs are directly proportional, the latter being attenuated through improved quality of audits. Increasing a company requires delegation of tasks and a lower monitoring creates the risk of moral hazard and opportunistic behavior. Large enterprises are more dependent on external funding and, therefore, they may be more sensitive to the needs of existing and potential investors applying appropriate audit procedures.

Some relevant studies say that there is an ambiguous link between profitability and the activity of audit. A decreased profit could be associated with financial pressure, requiring an enhanced audit activity in order to certify the net asset value and that the company seeks continuity.

Literature attempts an analysis of three specific periods of audit activities, namely the period during the audit itself, the period between signing the audit report and its publication, and the third period may be considered the sum of the previous two. Given the resources at the disposal of large companies and political pressures exerted on them by different stakeholders, they tend to reduce the actual audit periods and intermediate ones, leading to an immediate release of annual reports. Moreover, positive and negative information are factors that determine the audit period, and period of publication. As a result, this information could give to investors an added value, which may include in their decisions. Early publication will indicate that there are positive news on corporate performance and vice-versa. However, it appears that highly indebted firms tend to delay publication of annual statements and to prolong auditing.

2. FRAUD – A MISMANAGEMENT ATTRIBUTE

Fraud can be defined in terms of management's intention to submit misleading information in financial statements. Analyzing the relationship between board structure and fraud financial statements leads to the idea that increasing the number of independent directors and the short period of their mandate increases the incidence of fraud. Entities improving their governance, in compliance with accounting and auditing standards, provide major benefits to their shareholders.

In particular, the development of the selling price of shares and fraud detection are positively related to a more efficient corporate governance system. Even if there are real internal concerns on prevention and detection of fraud intentions, companies which are in such a situation will continue to face problems of credibility from the external environment. Some researches have shown, however, that when a company takes appropriate measures of governance, this leads to increase the price of shares and bonds, because decreases the probability that the enterprise to act maliciously again.

The risk of a significant material misstatement of financial statements is generally greater if accounting estimates are used more often than actual data. Estimates, such as those for goodwill depreciation attesting the acquisitions at fair value, irrecoverable debts and guarantee obligations are subjected to unpredictable future events and errors arising from poor data management.

The decline of a firm is partially determined by the extent to which the restatement reduced its net income. Perceived pervasiveness of the problem (many areas are affected) and persistence (how many years/semesters are restated) also determine the decline in value terms and pervasive and persistent problems may continue for long. Moreover, the nature of the restatement is a relevant factor. Restatements may refer to a number of different accounting issues (revenue recognition, equity, reserves, accounts reconciliation, capitalization, inventory).

Similarly, income recognition is a very important matter on the agenda of Securities and Exchanges Commission (SEC), the most common cause of reprocessing and – in many cases – is the basis for accounting fraud.

Besides reducing a company's prospects, restatements tend to lead to uncertainty, by damaging the credibility of management and reporting system, especially when there are suspicions of fraud. If the leadership is trying to mislead stakeholders decreases investor confidence in the reliability of the presented information.

Certain studies suggest a re-classification of restatement cases according to severity observed, namely: the distortion degree of relevant information and the degree of management intent. The first dimension refers to a decrease perceived value of the company, due to the restatement income effect. The intention is the degree to which management has deliberately distorted the financial data and is likely to do it again. These two dimensions rise to four types of restatements, with different degrees of severity:

- “white lies”, with low distortion of intent and are therefore relatively harmless;

- may also occur, however, aggravated forms, called “gray accounting” and “violet illusion”. The first involves a high degree of distortion, caused more or less accidentally. This will probably reduce the perceived prospects of the company (given the low performance), but not the credibility of future financial reports. On the other side, “violet illusion” involves a low distortion, but deliberately. Business prospects will be greatly reduced, but will be severely affected confidence in these financial statements;

- finally, one can speak of “black magic fraud”, which involves establishing a high level of distortion on purpose. This is the worst case of fraud, because they are reduced prospects for the company and reports its financial credibility. Given the complexity of accounting issues, relevant distortion is not as objective and intent, as their level, as perceived by the market and other stakeholders.

In each case of restatement, there are factors that can worsen the perceived level of distortion and intent and also mitigating factors. For example, the credibility of corporate communication of an entity could be vitally important in determining the public reaction. In accounting, many decisions and estimates are based on a degree of uncertainty, and their accuracy can be evaluated until later.

When there is suspicion of fraud or intention, executives and/or board members are trying, primarily, to convince analysts and media that remedial measures have been implemented, but they do not specify that this think has been done under time pressure, with the sacrifice of some senior managers, without actually identifying the exact causes, risking that measures taken to be unnecessary and unjust. Retrospectively, it can lead to think that new managers will be particularly suspicious of previous management decisions. In addition, the problems already identified concerning the accounting policies (often dating back several years) and estimates will be revised.

The auditors alert the managers about the questionable nature of the accounting practices used, but the latter is likely to disregard the warnings. Signals of such circumstances might not be understood on the background of an inefficient dialogue

between managers and auditors. Lack of alignment can show to investors a failure of internal controls and that top management has an important guilt in this respect.

When a restatement is announced by auditor and not by enterprise, the market reaction will be more negative and the chances that investors suspect a fraudulent intent would be higher, leading to uncertainty and a loss of company's value. Board and therefore the audit committee should play an active role, not a passive one, through involvement, with management, in verifying financial and reporting matters.

3. PREMISES FOR A MORE POWERFUL EXTERNAL FINANCIAL AUDIT

One possible solution to correct agency problems is to implement within the company a set of best practices of governance. OECD has noted as elements of a good governance, transparency and reducing the reporting period. If ownership is widespread, there is an agency cost caused by asymmetries between managers and equity holders.

Audit activities promote reducing informational risk by attesting the reliability of published financial information for current and potential investors. Companies with dispersed ownership rights must be ready to pay for a more extensive and detailed audit, to ensure their shareholders about the credibility of annual reports.

The concept of reasonable assurance admits that there is a risk that an audit opinion to be inappropriate. The risk that the auditor to express such an opinion when financial statements are materially misstated is known as "audit risk". The auditor needs to plan and carry out the mission in order to reduce the audit risk to an acceptable level consistent with the target. Reducing such a risk is conditioned by obtaining sufficient and appropriate audit evidence for the assertion of reasonable conclusions on which to base an audit opinion.

Audit risk involves that the auditor will not detect existing material misstatements in financial statements. The auditor should use specific procedures to assess the risk of such distortions and also seeks to limit detection risk by performing additional audit procedures. The auditor should consider both qualitative and quantitative factors when assessing the importance of a threat.

Quantity and quality of audit evidence depend on the auditor's evaluation criteria used, resulting in specific principles or standards. In practice, the auditor may use one or more endpoints, depending on the specific scope and audit objectives, and also on law governing the entity audited. The auditor also may determine its own criteria that he considers relevant. If he seeks to express an opinion on managers compliance with rules and standards in preparing and presenting financial statements, but also with the principles of economy, efficiency and effectiveness, good practice recommends the establishment of evaluation criteria for each element and criteria common assessment, to draw conclusions and recommendations on each audit objective.

The auditor should consider that evidence can be useful when applying a criteria of evaluation, but may not be relevant for another criteria. Good practice recommends that for determining the level of confidence for the various types of audit evidence to take into account the circumstances of their obtaining, as follows:

- certainty of audit evidence source increases when it is combined with another source. This requires that the auditor basis a conclusion on evidences from different sources or of different nature;
- audit evidence obtained from independent and competent external sources is more reliable than that obtained within the audited entity;
- documentary audit evidence is more reliable than verbal evidence;
- the original of a document is more credible than its copy;

- audit evidence obtained directly on site, using techniques such as examination, observation, calculation and analysis is more reliable than that obtained indirectly;

- reliability of the evidence provided within the audited entity increases with the quality of internal control;

- verbal evidence obtained has a greater credibility if it is writing confirmed.

The main purpose of the auditor is to formulate meaningful conclusions based on audit evidence obtained by different methods. If the evidence obtained from a source does not coincide with evidence from another source, the auditor should put in doubt the credibility of that evidence to obtain information that will eliminate such suspicion. Using in block the audit evidences provided by various sources allows to obtain a higher confidence level than for individual use of each test.

CONCLUSIONS

Audit function, viewed as a whole to take an active role in improving governance system must operate through the linked components: internal audit, external audit and audit committees. Also must be considered both the internal factors: relationship with the board, organization and supervision of internal control and risk management, financial and non-financial reporting, and also the external factors: the auditor's opinion, public interest and transparency of provided information.

Managers are evaluated based on performance measures and accounting policies have effects on other indicators such as share price. Given the temptation of managers to manipulate financial information for their own benefit, it can be said that entities with weak governance are the most susceptible to fraudulent involvement. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

Implementation of accounting policies in accordance with the rules in force requires managers to recognize losses regarding bad purchases. Such reports can be a negative signal to the market and an incentive to managers to abandon as soon as possible those projects. In conclusion, recognition of a loss, in a timely manner, stimulates better acquisitions and accelerates abandonment of nonperforming investment, avoiding other future losses.

Later reporting of negative information and anticipated communication of favorable ones can be explained in terms of “stakeholder theory”, according to which, without a possibility to hide unfavorable aspects, due the requirements of publishing, management will try to delay their presentation. Thus, managers can provide to investors the opportunity to withdraw or transfer the capital invested in the company’s shares before the bad news to arrive on the market. In practice, also there is the “internal reporting hypothesis” according to which such information about financial performance are primarily provided to higher hierarchical levels, verified, explained, restated and only then presented to entity’s external environment.

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