

MANAGEMENT OF RISK FACTORS IN AUDIT AND THEIR EFFECTS ON ERRORS AND FRAUDS

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Abstract: An audit mission cannot provide an absolute guarantee that financial statements do not contain significant errors or fraud. Errors may arise either from incorrect processing of accounting data or from faulty reasoning in selecting and applying accounting standards. There is a risk that the auditor may not detect these errors, in spite of all the rigor applied in auditing standards.

Keywords: fraud, error, auditors, risk, management.

1. Introduction

To understand the historical context and evolution of financial auditing, it is important to explore the key stages related to the origins of financial auditing. This concept has its roots in antiquity when ancient civilizations, such as the Egyptians and Romans, used rudimentary methods to verify the accuracy of financial records.

After this period, financial auditing began to formalize, especially in Great Britain, where the Industrial Revolution generated a growing need for transparency and financial accountability, the main objective being the prevention and detection of fraud.

In the 20th century, financial auditing evolved significantly, becoming a standardized and regulated practice. In 1933, following the Great Economic Depression, the United States introduced legislation requiring publicly traded companies to present audited financial statements [1].

Starting in the 1990s, financial auditing underwent a revolution due to technological advancements and globalization. In 1993, the New York Stock Exchange required large companies to present financial statements certified by an independent accountant, accompanied by an audit report. Nowadays, the integration of artificial intelligence and other modern technologies has significantly improved the accuracy and efficiency of the auditing process.

Regarding the future of financial auditing, it is anticipated that emerging technologies, such as blockchain and advanced data analytics, will continue to transform financial auditing, making it more transparent and efficient.

These stages reflect how financial auditing has evolved to meet changing economic and social needs.

1.1. Legal Perspective of Financial Audit

To address the legal perspective of financial auditing, it is important to understand the legislative framework and regulations governing this activity. In Romania, financial auditing is regulated by Law no. 162/2017, which establishes the requirements for statutory audits of annual and consolidated financial statements.

This law aligns national regulations with international standards and the requirements of the European Union. Emergency Ordinance no. 75/1999, modified and supplemented over time, is also relevant to financial auditing activities [2].

Financial audits must be conducted in accordance with International Standards on Auditing (ISA), which provide a global framework for auditing practices. These standards are essential for ensuring the quality and consistency of audits at an international level.

The legislation emphasizes the importance of the auditor's independence. Auditors must avoid any conflicts of interest and maintain an objective and impartial position in evaluating financial statements.

Financial auditors have the responsibility to express an opinion on the accuracy and compliance of financial statements. This includes verifying compliance with accounting regulations and identifying any errors or fraud.

The audit report is an essential document that must be attached to the financial statements of publicly traded companies. It provides assurance to external users, such as investors and creditors, that the financial statements accurately reflect the company's financial position.

Recently, there have been introduced regulations that include requirements for reporting on sustainability (ESG - Environmental, Social, and Governance),

reflecting a growing concern for sustainability and social responsibility. These legal aspects are fundamental for understanding and correctly applying financial auditing.

International auditing standards mention that the notion of "fraud" refers to an activity that is entirely intentional, carried out by one person or by two or more individuals from the management structure, among employees, or third parties, an activity that primarily results in a misinterpretation of certain financial situations. In general, fraud aims to obtain financial advantages that are unjust or illegal.

Fraud can occur as a result of events such as:

- manipulation or modification of records or documents (forging them to distort or mask the truth);
- distortion of assets, or theft of them;
- improper allocation of certain assets, which can even worsen the financial situation of the audited company, leading to direct consequences for its operational continuity;
- elimination or omission of the effects of certain transactions within records or documents or recording transactions without substance, for the purpose of cosmetic improvement of certain financial situations;
- intentionally incorrect application of accounting policies in terms of presenting financial situations that could lead to a mislead.

Auditing standards in the United States stipulate, along with fraud and errors, acts or incorrect facts that are carried out with evident malice by the management team and by operational personnel, either alone or together with potential clients. Within these documents, which are considered illegal, a series of facts can be listed:

- transactions or commercial/financial operations with illegal character;
- inadequate, incomplete, or delayed recording of certain types of transactions or documents within management;
- payments from the company's cash register for unidentified objectives; certain types of unspecified services;
- consulting services provided by salaried personnel, by affiliated offices or entities presenting another subject of activity;
- commissions or fees in amounts that are very high compared to amounts that have been regularly paid for the same type of services [3].

Nevertheless, even an audit conducted in accordance with current standards does not guarantee the absence of material misstatements regarding financial information, because deviations often involve attempts at masking that, in certain situations, cannot be detected, even if the planning was adequate regarding the audit and adherence to auditing standards

In conclusion, a distinctive factor between fraud and error is given by an action that fundamentally results in a distortion of various financial situations, specifically,

whether this action is intentional or unintentional. Compared to an error, fraud is intentional and generally involves a deliberate concealment of facts. Even though the auditor may be capable of identifying potential opportunities for committing fraud, it is very difficult, almost impossible, for the person conducting the audit to determine a clear intention, especially in issues involving management reasoning, such as certain accounting estimates, and the appropriate application of accounting principles [4].

1.2. Audit Standards

Audit standards specify that, no matter the regular conduct of audits, compliance with a series of laws and regulations in force must be tested. The auditor is responsible for designing a series of stages and procedures for the audit to obtain reasonable assurance in detecting errors and fraud that could have a direct, implicit, and material effect on the amounts in the financial statements, thereby affecting the results of the auditing process. Similarly, the auditor must be very attentive to the possibility that illegal acts may have an indirect, implicit, and material effect on financial situations or the results of the auditing process.

International Standards on Auditing (ISA) are issued by the International Auditing and Assurance Standards Board (IAASB) and are used globally to guide auditors in conducting audit assignments. ISA standards cover all aspects of the audit process, from planning and risk assessment to reporting results.

Global Internal Audit Standards issued by the Institute of Internal Auditors (IIA) set requirements for the professional practice of internal auditing. They include principles and mandatory requirements for assessing the effectiveness of internal audit assignments [5].

The Code of ethics for auditors is a set of principles and rules that guide the ethical behavior of auditors. It emphasizes the importance of integrity, objectivity, confidentiality, and professional competence.

National audit standards are regulated in Romania by Law No. 162/2017 and Emergency Ordinance No. 75/1999. These regulations establish specific requirements for financial auditors and for conducting audit assignments.

Performance standards and responsibilities describe the nature of audit activities and provide criteria for evaluating the performance of audit services. They are essential for ensuring the quality and efficiency of the audit process. These standards are fundamental for conducting a quality audit and for maintaining users' trust in audited financial statements.

Comparison of Audit Standards and Guidelines

Characteristic	International Standards on Auditing (ISA)	Global Internal Audit Standards	Code of Ethics for Auditors	National Audit Standards (Romania)	Performance Standards and Responsibilities
Issuing Body	IAASB	IIA	N/A	Law No. 192/2017, Emergency Ordinance No. 75/1999	N/A
Purpose	Guide external auditors	Self requirements for internal auditing	Guide ethical behavior	Regulate financial auditors	Describe audit activities
Scope	All aspects of audit	Effectiveness of internal audit	Integrity, objectivity, etc.	Specific requirements	Nature of audit activities

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Fig. 1. Comparison of audit standards and guidelines.

2. Concepts of Fraud and Error. Distinctive Factors

In planning and conducting the audit process to reduce risk to an acceptable level, the auditor must consider the risk of significant misstatements in financial situations due to fraud.

Some misstatements in financial situations can arise from a series of frauds or certain errors. The main factor that ensures the difference between what constitutes fraud and error is the fundamental action that resulted in a misstatement of financial situations, which can be intentional or unintentional.

The term "error" refers to unintended misstatements that occurred within certain situations. In contrast, "fraud" refers to activities based on intentionality, carried out by one or more members of the company's management structure, those responsible for governance, employees, or third parties, involving evident deceit to gain an unjust or illegal advantage [6].

Errors can be generated by:

- mathematical or accounting mistakes that occurred in estimates, calculations, or accounting records.
- overlooked or misinterpreted facts that significantly impact financial situations.
- incorrect application of accounting policies due to lack of knowledge.

Even though fraud is a broad legal concept, the auditor is very concerned with fraudulent actions that cause significant misstatements in financial situations. It is very possible that the process of misstatement of certain financial situations does not represent an object of significant fraud. Auditors do not legally determine whether this fraud has occurred.

Fraud involves one or more members of the management structure or those responsible for governance, referred to as "management fraud"; fraud that exclusively involves employees of an entity is termed "employee collusion fraud." In either case, there may be a series of associations with third parties outside the entity related to the commission of fraud.

Financial Misstatements in Audits

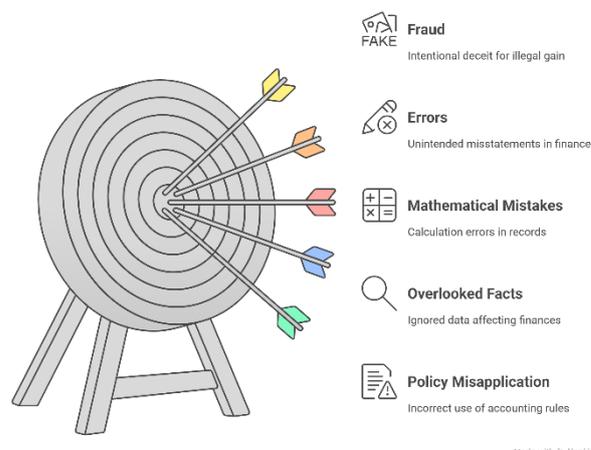


Fig. 2. Financial misstatements in audits.

2.1. Typology of Fraud

Fraud involves the motivation for committing fraud and an evident opportunity to do so.

People may be motivated to embezzle assets because, for example, there is a tendency to overspend, beyond what is permissible. A fraudulent financial report may be generated because the management team is under significant pressure, from outside or inside the entity, to achieve an anticipated (possibly unrealistic) profit target - especially considering that, for management, the consequences of not meeting certain financial objectives can be significant. An evident opportunity for fraudulent financial reporting or embezzling assets may exist when a person believes he/she can evade internal control because he/she is in a position of trust or has knowledge of specific deficiencies in the internal control system [7].

There are two relevant types of intentional misstatements:

- misstatements arising from fraudulent financial reporting;
- misstatements arising from asset embezzlement.

Asset embezzlement involves the theft of an entity's assets. It can be carried out through a variety of means (fraudulent receipts, theft of physical or intangible assets to compel an entity to make payments for goods and services not received). Embezzlement is often accompanied by the recording of false or misleading documents, primarily aimed at concealing the lack of assets.

According to Standard 240 – Fraud and error: in the planning and execution of audit procedures, including the evaluation of audit results, the auditor must consider the risk of certain statements being materially misstated in financial situations as a result of fraud or errors. This standard focuses on the auditor's responsibilities in terms of fraud in the audit of financial statements [9].

If we talk about the duration for developing the audit plan, establishing procedures, evaluating findings, and reporting certain results, the auditor is the authority that must consider the risk of detecting certain significant anomalies in financial situations caused by fraud, errors, or a series of illegalities.

2.2. Cases of Economic Crime at the International Level

Throughout history, financial scandals have led to profound crises in public trust towards economic institutions, governments, and corporations. These events have not only caused massive financial losses but have also shaken the ethical foundations of global economic systems.

In the 19th and 20th centuries, many scandals were possible due to a lack of clear regulations and transparency. Examples such as the South Sea Bubble scandal (1720) or the Savings and Loan crisis (USA, 1980s) demonstrated how greed, lack of oversight, and political complicity can destabilize entire economies [10].

In contemporary times, financial scandals have become more complex, often involving advanced technologies, global markets, and international networks. Cases like Enron, Lehman Brothers, Wirecard, 1MDB, WorldCom, and Ponzi schemes have shown that despite modern regulations, vulnerabilities persist. These scandals have resulted in billions of dollars in losses, corporate collapses, major legislative reforms, and sometimes criminal convictions of those involved.

In an interconnected world, a financial scandal in one country can have ripple effects globally. Therefore, transparency, ethics, and effective regulation remain essential for economic stability.

Currently, risks extend into new areas such as cryptocurrencies (e.g., FTX), artificial intelligence, and transaction automation, cyber fraud, and attacks on financial infrastructure.

Sophisticated financial fraud in the modern era has become increasingly difficult to detect and prevent, having a significant global impact. They involve advanced technologies (e.g., artificial intelligence, blockchain, deepfakes), international networks of shell companies and offshore accounts, complex financial instruments (e.g., derivatives, structured products), and accounting manipulations that are hard to detect even by experienced auditors.

Despite the scale of sophisticated fraud, the Enron incident remains one of the largest financial scandals in history, leading to the bankruptcy of the American energy company Enron Corporation in 2001, based on a long internal fraud. Founded in 1985, Enron quickly became one of the largest energy companies in the United States. Under the leadership of Kenneth Lay and Jeffrey Skilling, the company used a variety of accounting practices and special companies to hide billions of dollars in debt [8]. Among the methods used, derivative instruments were

employed to protect transient assets in its quarterly reports and to artificially inflate the value of the assets held [11].

In its 2000 annual report, Enron highlighted the need for professional judgment in interpreting market data and using a variety of assumptions and valuation methods that could affect estimated fair values.

From another perspective, the Ponzi scheme is one of the largest financial frauds. The Madoff case led to a reevaluation of regulations and monitoring of financial markets. The Securities and Exchange Commission (SEC) was criticized for not examining Madoff's activities in detail, despite repeated warnings. This case highlighted the importance of investment vigilance and skepticism.

3. Conclusions

The primary goal of a financial audit has been to detect this type of fraud. The initial purpose has evolved over time, the current role being to attest the accuracy of the information presented in financial statements and the compliance with International Accounting Standards.

Financial audit practices have been introduced in Romania during the transition period to a market economy, driven by the desire of specialists in our country to correlate and adapt regulations in Romania to internationally recognized accounting standards.

The importance of financial audit grows with the development of reforms and the effective realization of an economy similar to that of the European Union states.

Thus, Romania is a country that mandates the implementation of financial audit techniques, which should be harmonized with international practices. The complexity and continuous evolution of economic activities need a permanent improvement of standards in accounting and auditing, as well as in the knowledge of professionals in this field of interest.

Specialized literature emphasizes that summary financial statements (such as the balance sheet, income statement, and cash flow statement) cannot be 100% accurate due to ambiguous concepts in accounting. Terms like "fair value," "control," and "future economic benefit" are subject to interpretation. Additionally, many accounting results based on estimates cannot be more precise than the methods used to calculate them. For example, it is challenging to predict the outcomes of a future event, such as production, exchange rates, or market price trends, with high accuracy. Therefore, accounting estimates that rely on uncertain outcomes of future events are inherently inaccurate. Sometimes, reports are influenced by the desire to attract investors, obtain loans, or avoid taxes. This can lead to the "cosmetic" presentation of financial statements (a phenomenon known as "window dressing").

During the preparation of the audit plan, to establish certain sets of procedures, the auditor must also consider the risk of detecting significant anomalies within financial statements. Fraud is a well-developed legal concept, but auditors are primarily concerned with fraud

that causes material misrepresentation in financial statements.

All things considered, audited annual accounts cannot possess a very high degree of accuracy due to the inherent limitations of accounting concepts.

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