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Implications of Fraud and Error Risks in the Enterprise Environment and Auditor's Work

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Abstract: The objective of this study is to identify and analyze the main correlations and implications of fraud and error in the business environment and in the financial scandals occurred in the last decade. The approach envisages a synthesis and antithesis of the ideas found on this subject in the specialty literature, of the regulations issued by various international bodies. To achieve the established objectives, we used a constructive methodology to identify criticism, presentations and developed a speech with view to a more efficient and effective fraud and error risk management. The results of the study show that the major financial scandals and hence the global economic crisis are based largely on fraudulent maneuvers of significant proportions. By using "creative accounting" in fraud and error, famous companies have managed to distort reality for their performance and market position, misleading the users' perception. This study is a theoretical having implications for a future empirical study.The study contributes to auditing literature diversification in the field of risk of fraud and error. An additional perspective is gained by addressing the financial crisis and some famous bankruptcies by way of the financial auditors activity and the fraud and error risk.

Keywords: economic crisis; audit perspectives; toxic assets; financial statement; fraud

JEL Classification: M14; M41; M42; M48.

1 Introduction

The financial scandals that occurred in the last 100 years have slowly but surely contributed to a depreciation of confidence in the competence and the responsibility of auditors' activity. However, the audit activity has never experienced such a strong impairment of confidence in the capabilities and the professionalism of auditors, this decay being determined by the succession of bankruptcies and financial scandals that have hit some of the biggest corporations in the global economic specific past decade (Boța, 2009).

The bankruptcies of a series of large corporations that have occurred since 2001 (Enron, WorldCom, Qwest Communications, Parmalat) and the current financial scandals (Merrill Lynch, Satyam, Mardoff, Stanford Financial Group) strongly affected the corporate life bringing about a risk for investors to lose confidence in the assurance of professional accountants on the image fidelity offered by the financial statements of the audited companies. Such an example is the great financial scandal generated by Enron bankruptcy, with really disastrous consequences for the audit specialists, a definite evidence to this effect being the rapid dissolution of the audit company Arthur Andersen, member of the "Big Five" Group.

The amplitude of these negative phenomena that rocked the economies of certain highly developed countries, has generated more and more critics to the independence and competence of the external auditors to have failed in implementing the necessary audit procedures so as to identify the warning signals that could have prevented such events. On the other hand, there are more and more discussions

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about the real commitment to corporate responsibility and the efficiency of corporate governance mechanisms.

According to many researchers in the specialized literature (Fusaro & Gordon, 2002) the impact of such negative phenomena on the audit activities was a significant one, perpetuating the idea among auditors that they could lose credibility, carrying out an audit being perceived as an obligation imposed by the legal frame and not as a service that could add value to the companies, the investors' confidence in the reliability of audit reports being strongly affected, raising numerous questions on the real independence of the auditors in their work.

2 Concerns about the Financial Statement Fraud

Over the last decades, several cases of fraudulent financial reporting have shacken the capital markets. These frauds have a negative impact on the capital markets and erode the trust of investors. Fraudulent financial reporting may also have a devastating impact on the reputation of a company, often putting at risk even its existence.

Although it is generally accepted that the Sarbanes-Oxley Law and the integrated Risk Management Code improved the corporate governance and decreased the incidence of fraud, recent studies and surveys show that investors and managers continue to have concerns about financial statement fraud. For instance:

- The Association of Certified Fraud Examiners, "2010 Report to the Nation on Occupational Fraud and Abuse" found that financial statements fraud, while representing less than five percent of the cases of fraud in its report, was by far the most expensive, with an average loss of $ 1.7 million per incident;
- The Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), in its report on 2010 (Fraud Report) analyzed a total of 347 cases of fraud caused by fraudulent financial reporting in 1998-2007, all cases being investigated by the U.S. Securities and Exchange Commission (SEC) and found out that the average dollar value of each case of fraud has increased three times from an average of 4 ,1 billion dollars, estimated in a study in 1999 to an average of $ 12 million in 2007. In addition, the average size of the company involved in the fraudulent financial reporting has increased nearly six times from $ 16 billion to $ 93 billion in total assets and from $ 13 billion to $ 72 billion, compared to the turnover;
- The KPMG study (Fraud Survey 2009), conducted by interviewing 204 executives of U.S. companies with annual revenues of $ 250 billion or more, revealed that 65 percent of the respondents believe that fraud will be a significant risk to their organizations next year, and more than one third of respondents identified fraudulent financial reporting as one of the greatest risks;
- fifty-six percent of the approximately 2100 business professionals interviewed during a study, "Deloitte Forensic Center Webcast" on reducing the risk of fraud, estimated that frauds in the financial statements will be discovered in 2011, as compared to last three years. Almost half of those surveyed (46 percent) indicated the recession as the main reason for this increase.

3 The Global Financial Crisis. Key-factors in Triggering the Crisis

The first signs of economic and financial crisis were felt in the United States during the summer of 2007, when financial institutions began to recognize that they were facing significant losses related to sub-prime loans (near-prime, non-prime, second chance Lending), known as involving a high risk. These events have determined the investors to get rid of the financial derivatives based on sub-prime mortgage system. At the same time, the American real estate system has experienced dramatic declines in the price of the real estate transactions that had been done.

Gradually, there was a cash crisis that has spread throughout the financial sector then materialized into bankruptcies, mergers, takeovers, acquisitions, nationalization of the major U.S. financial institutions.

BNP Paribas' shutting down two of its investment funds, claiming *market turmoil in the U.S. sub-prime loans*, and the takeover of the Countrywide Financial by the Bank of America opened the series of negative events that rocked the international financial world. Other financial mortgage institutions, including: Fannie Mac & Freddie Mac in the U.S. and Northern Rock and Bradford & Bingley in the UK, have become dependent on the financial support from government authorities.

The maximum intensity of turbulence on the international financial markets was felt during September-October 2008, when one of the largest investment banks in the United States of America, Lehman Brothers, went bankrupt, as a consequence of Federal Reserve's refusal to financially support it. The scale events that have affected both the economies of the developed countries and of the emergent countries were very well illustrated by (Peston, 2008) who stated: the global financial economy has not been lately subjected to such tests consisting in a mixture the fateful combinations of accidents and tests of confidence.

Figure 1. The mechanism of propagation of subprime loans

Source (Cerna, 2009)

There are many factors that led to this situation. According to (Dăianu, 2008), the determining factor was the severe cut in the interest rates by the Federal Reserve, as a result of the stock exchange crack of the late 1990s and after September 11, 2001, which stimulated great credit. The latter took place amid globalization of financial markets and the intensified widespread use of financial innovations / derivatives.

The BNR Governor refers to two types of causes, both macroeconomic and microeconomic in nature (Isărescu, 2009).The two types of causes intertwined in yielding the crisis. The deep cause of the financial crisis was the abundant liquidity created by the world's major central banks (FED, BOJ) and the willingness of oil and gas exporting countries to limit the currency appreciation. Also, there was an over-saturation of savings generated by the increasing integration into the global economy of some countries (China, South - Eastern Asia în general), with high rates of accumulation and also by the global redistribution of wealth and income to the hard goods exporters (oil, gas, etc..). The abundant liquidity and the over saturation with savings created available resources for investment, including sophisticated financial instruments, not easily understood by some investors. Against this background there have operated, as aggravating, also a series of microeconomic causes: the overly optimistic assessment by rating agencies of the derivative financial products, the increased international competition for deregulation (Isărescu, 2009).

Following an analysis of this crisis' causes in terms of accounting practices, we conclude that an element with a major contribution in the fast perpetuation of this credit crunch was the use in accounting, the concept of "fair value". The director of the Committee for International Accounting Standards Board, Sir David Tweedie, said in a report issued by the IASB (Q1/Q2, 2008) that the role of accounting is to reflect the facts and not to provide stability when there is none. Richard Sexton, manager at PricewaterhouseCoopers in the UK states that: accounting does not create reality, but it actually reflects it.

According to the International Financial Reporting Standards (IFRS), financial instruments are measured at their fair value. Determining this value involves a sufficiently liquid market in order to establish the price of financial instruments. One of the characteristics of the global financial crisis is the very significant decrease in liquidity on the market, leading to a significant depreciation of the derivatives. Volatility of the fair value could not always reflect real changes of the enterprise events and did not allow events to render the reality of transactions and of the financial position.

A report published by Association of Chartered Certified Accountants (ACCA, 2008) on the financial crisis has identified two major categories of determinants that led to the U.S. credit crisis started, namely:

- ***key factors:***
  - the failure of institutions to properly assess and manage the existent interconnections between inherent business risks the bonus and the incentives;
  - the failure of corporate governance (the interests of shareholders should be placed on the forefront);
  - errors in the risk identification and management process;
  - the weak influence or even a minimum output of risk management departments in banks;
  - weaknesses in financial reporting and regulatory systems..
- ***secondary factors:***
  - lack of a proper understanding by the management of the business models design, leading to poor managerial supervision;
  - the lack of rigorous oversight on the part of non-executive directors as a result of poor understanding of the complexity of business conducted;
  - human errors embodied in failures in assessing cultural influences and motivational factors such as rigidity in thinking and unwillingness to adapt to changes;
  - a high degree of complexity of the financial products, accompanied by poor training of managers across the risks associated with these products;
  - environment for running speculative transactions.

4 Enron

Founded in 1985 by the merger of two companies producing natural gas, Enron, in only 15 years time, has become one of the largest U.S. energy companies with a market value of over 70 billion dollars, with nearly 21,000 employees in over 40 countries. It holds 25% of the world's electricity and natural gas, launching in 1999 Enron Online, the largest index of e-business world.

The scandal began on October 16, 2001 when Enron, admitted for the first time, that they were facing financial difficulties and reported a quarterly loss of 618 billion dollars. Moreover, during the same period, Enron stated that due to an error in accounting, the net income was overstated by over a billion dollars. The share price crashed at once. The U.S. authorities were notified and the Securities and Exchange Commission (SEC-Securities and Exchange Commission) began an investigation on the partnerships and investments of the company. In December 2001, the corporation declared bankruptcy being placed under bankruptcy protection law, becoming the largest bankruptcy in U.S. history, "although a year before had announced a profit of over 100 billion dollars″.

The corporate management had been showing for some years, financial statements that would hide the huge company debts and "swelled" profit, using "***creative accounting***". Skilling satirizes the accounting system "VVI", nicknaming it "the hypothetical future value". In order to maintain a high price for its shares, Enron invented high quarterly profits. Thus, if Enron was associated with another firm and together they could make 50 million dollars in 10 years, Enron claimed that those 50 billion represented current income (Horomnea, 2012). In addition to that, Enron used to create false off-shores in order to transfer the losses on them, out of the accounts.

Internal and external controls have not been able to ascertain the real situation that Enron was facing and detect the huge losses. The internal audit function was mostly formal, as it was not involved in the intricate and occult money transactions led by the Enron management and Arthur Andersen auditing company that had to validate correctly the financial statements, protected in fact the corporate image. Enron has created, in fact, an energy market that it bet on and manipulated. Its brokers have lost huge amounts from bad trades, and then covered their losses by not reporting them and by drawing up false profit reports, which raised further the share price. The corporation knowingly created a false energy crisis in California, which had never existed before, being responsible for the shutting down - for a long time – of over 50% of the power plants when the electricity prices increased nine times. The company would buy energy at a very low price and resold it to other regions at a much higher price.

Summarizing the data presented, we may asses that the main causes of the Enron scandal are:

- the legal and the regulatory system structure (primarily the applicable laws and regulations of U.S. Securities and Exchange Commission (SEC); the audit companies as Arthur Andersen, which provided consulting services and at the same time provided an audit report on the financial results of these activities of enterprise consulting, this being an obvious conflict of interests;
- a private company such as Enron, currently employs and pays the external auditors. This is a conflict of interests built around the legal system, because auditors are "encouraged" not to issue an adverse report to the company contracting the audit company;
- another conflict of interests lies in the fact that large corporations, such as Enron, are allowed to manage pension funds of their own employees.

The Enron bankruptcy, and other major financial scandals of the early 2000s, prompted reactions from governments which have initiated a series of legislative initiatives to protect investors. Consequently, new laws have been enacted: the Reform of Accounting for Public Companies and Investor Protection Act since 2002. These new regulations brought significant changes to accounting practices and the increased role played by the Securities and Exchange Commission (SEC), within which the Board of Supervisors of Public Companies Accounting was created and by the American Government over the financial reporting. This board has to establish new accounting standards, to investigate whether companies, the certified public accountants respectively, comply with the legal regulations (PCAOB, 2010).

According to the new regulations, the CFOs and the executives should consider more carefully the accuracy of financial statements, otherwise risking criminal punishments for covering voluntarily potential frauds or errors. Another important regulation is the separation of consulting and auditing activities in the case of audit companies so that conflicts of interest should be avoided.

5 Arthur Andersen

Arthur Anderson LLP (the current name) was founded in 1913 by Arthur Andersen and Clarence Delany, as a limited company in Chicago. Until the Enron scandal, that was involved in, the company was part of the "Big Five", along with other famous companies such as: PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG, and has provided audit, tax consultancy and accounting services to major corporations.

Andersen has been a constant supporter of high quality standards in the accounting profession, in full compliance with a number of ethical principles in the company management. Over time, the Andersen company motto was "Think straight, talk straight". After the 1980s, most of the company revenues came from consulting activities, highly disproportionate as compared to the revenues from auditing, tax and accounting services, barely managing to resolve the conflict of interest, generated by carrying out simultaneous audits and accounting advice. The company was accused several times of having certified financial statements containing errors or frauds of certain companies such as: WorldCom, Enron, Sunbeam Products, Waste Management. On June 15, 2002, Andersen was accused of preventing justice from acting, by destructing essential documents in hardcopy and in electronic format, related to the Enron audit engagement. Andersen pleaded not guilty, pretending that the destruction of documents was part of the company's domestic politics. On August 31, 2001, the Securities and Exchange Commission officially declared the company out of business on the U.S. market. Although in 2005, the U.S. Supreme Court decided to change radically the verdict, claiming an error on the part of the jury, the company was no longer able to operate, since its reputation had been irreparably damaged and an essential element in the auditing activity is exactly the reputation.

6 Sarbanes-Oxley Law. The Governance and the Corporate Responsibility Law

Sarbanes-Oxley Act of 2002 was adopted in response to corporate scandals in the late 1990s and the early 2000s. The law was aimed at implementing significant reforms for the corporate governance structures and for the public supervision of audit companies. Many of its provisions were intended to raise the standard of corporate governance quality and reduce the risk of fraudulent financial reporting. Main regulations aimed at (CAQ, 2010):

- increasing the responsibility of the integrity officers in terms of accuracy and completeness of financial reporting and adds a public certification requirement of each periodic report filed with the SEC, including the financial statements. The financial and executive managers must certify that each such report is in accordance with the law and that the financial statements present a fair image of the financial position and performance;
- establishing criminal penalties for intentionally and knowingly certifying the financial statements containing errors and / or fraud;
- a compulsory requirement for an internal audit organization for American companies, which has to be verified by an external audit;
- establishing regulations on information management, with the scope of tracking workflows (initiation, authorization, processing, reporting significant business transactions) that occur in the company;
- prohibiting the companies providing auditing services to deliver other kinds of services to the client-entities;
- creation and implementation of control methods to prevent and detect fraud, as well as assigning responsibilities to people having this role;
- increasing the role of the audit committee and enhancing responsibility for supervising the company by external auditor.

7 Conclusions

During the recent decades, both internationally and nationally there was an increase in the number of companies that have entered into improper and even fraudulent financial combinations, thus becoming the protagonists of well-known financial scandals, with significant effects on the current or potential investors' confidence in the viability of the business.

An overview of these issues through the work of professional accountants, there may be noticed that every scandal produced in the recent decades has slowly but surely contributed to damaging the confidence in the competence and responsibility of auditors in conducting audits and not only. But it seems that the succession of bankruptcies and financial scandals, which is the result of unprofessional or even fraudulent behavior of top managers, which shook the economies of developed countries led to an unprecedented loss of confidence in the professionalism of auditors, but on the other hand it would be unfair to minimize the importance of the "added value" brought by their activity. Undoubtedly, one of business risks is represented by fraud, a phenomenon that executives and particularly audit committees have faced in time, which is manifested in many ways on organizations, with implications on the financial status, the reputation, and having also psychological and social implications. The financial losses due to fraud implications on business environment are significant. However, the total cost is immeasurable in terms of time, productivity, reputation, including customer relationships. How can the risk of fraud be managed efficiently and effectively within an organization is a major topic of concern for management, investors, internal auditors, external auditors, government leaders, regulating authorities and other stakeholders. In many cases, new laws and regulations around the world have forced organizations to consider more carefully this issue of real interest for the stakeholders involved in the entity development. The management statements, the very much publicized codes of ethics, the professional training are the necessary means to educate employees, third parties so that everyone has a role in the anti-fraud program.

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