Indian Journal of Economics and Development

Enhancing Financial Statement Audit

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Abstract

Financial earnings manipulation reporting has currently attracted attention. This study starts with an introduction and overview on the concept of auditing. Securities and Exchange Board, India [SEBI] functions as the regulatory board of the capital market in India will be detailed. In describing, two main types of discrepancies will be introduced, namely those resulting from defective financial reporting and from abuse or misappropriation of assets. The study also detects some of the main reasons behind the auditors' failures in detecting defective financial statements. Technically, the main reasons for failures include analytical review application procedures as sufficient audit evidence; deficiencies in audit risk model and risk evaluation as to internal control; audit failure in revenue recognition and the involved party transactions disclosure. The auditors' main ethical issues, independency and the quantum of non-audit services will be defined. Finally, based on the identified reasons, some solutions are suggested to enhance auditing, in identifying financial discrepancies.

Keywords: Auditor, Financial Statement Fraud, Internal Control, Earnings Management, Revenue Recognition SEBI and Financial Fraud.

1. Introduction

Statement on Auditing Standards (SAS) No. 1, in Codification of Auditing Standards and Procedures states, "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud " [1].

This Statement defines the standards and guidelines for auditors' liabilities in discrepancies according to generally accepted auditing standards (GAAS). This statement can be outlined in follow:

- Section on description and characteristics features of discrepancies.
- Section on the importance of exercising professional skepticism: emphasizes auditors skepticism which helps to focus the possibility of financial manipulations.
- Section on discussion among involved personnel on the risks of material manipulation.

  a. By collecting adequate information for detecting risks of material manipulation
  b. Inquiring of management and other personnel in the organization about the risks of manipulation.
  c. Considering the output of the analytical procedures adopted in planning the audit
  d. Considering manipulation risk factors
  e. Utilizing other relevant information.

- Section on detecting risks, utilizing the collected information which may lead to material manipulation. Evaluating risks, utilizing professional skepticism, while

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evaluating a company's programs and controls, which entails collecting and evaluating audit evidence.
- Section on evaluating audit evidence: demands estimation of the risks of material manipulations to conclude whether the final results of auditing procedures as well as other observations affect the evaluation. Moreover the auditors should determine whether the detected misrepresentation of the statements may be suggestive of fraud; if yes the auditors should also estimate the frauds' consequences.
- Section on reporting fraud to the management, the audit committee, and others: This section presents the guideline as to how the auditors can report the frauds to the management, the audit committee, and others [2].

This Statement discusses the auditor's consciousness in dealing with potential manipulations in audit of financial statements; however it is the management's responsibility to plan and conduct the effective programs and controls to deter and detect frauds which is indicated in SAS No. 1 (AU sec. 110.03) as "Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements". In order to reduce the opportunities of committing frauds, managers and supervisors of the financial reporting procedure, namely the auditing committee, board of trustees, board of directors, or the owner in managed companies, should develop a culture of honesty and binding ethical standards along with an efficient control [3].

2. What is SEBI?

In a project guided by Agrawal (2012), SEBI is defined as the regulatory body of the investment market in India, established by the government of India through SEBI Act [1992]. Before SEBI, the Capital Issues (Control) Act, 1947, authorized Controller of Capital Issues as regulatory body. SEBI did not initially have any statutory power, but later in 1995, Government of India accorded SEBI with additional statutory power through an amendment to the Securities and Exchange Board of India Act, 1992. Finally in April, 1998, through a resolution of the Government of India, the SEBI was empowered as the regulator of capital markets developing and implementing regulations for maintaining stability and efficiency in the Indian markets.

The headquarter of SEBI is located in Bandra Kurla Complex in Mumbai, with Northern, Eastern, Southern and Western offices in New Delhi, Kolkata, Chennai, and Ahmadabad respectively.

The SEBI is composed of a chairman, appointed by officers of central ministry, one member from the Reserve Bank of India (RBI), and two more central government appointees [4].

3. Role of SEBI

In 1991 announcement of reforms package has promoted business in both the primary and secondary sections of the capital market. In 1992, a high-profile securities scam, known as Harshad Mehta Scam, shocked India's financial system and revealed the inadequacies of existing regulatory system, enforcing the demand for an autonomous, statutory, and integrated organization to guarantee the secured performance of capital market, viz., the market for equity and debt securities. The Securities and Exchange Board of India (S.E.B.I), of April 1988, was empowered by an enactment on 30 January 1992 to statutory powers including "the authority to prohibit inside trading and regulate substantial acquisition of shares and takeover of business".

The SEBI Act, 1992 entitled SEBI to four-fold objectives: safeguarding the interests of investors in securities, developing and regulating, matters associated with the securities market. The SEBI is a full-fledged authority to monitor and regulate the capital market, conferred under the securities contracts regulation Act (SCRA), the SEBI Act, and the Depositories Act. These Acts frame regulations for SEBI's administration and regulation of all market intermediaries, deterring fraudulent trade practices, and insider trading. Government and the SEBI's notifications, guidelines and circulars need to be collected by market participants [5].

4. What is Fraud?

Fraud can be defined as a deliberate and planned practice, whether done or failed, intends to earn an illicit benefit. It involves a purposeful manipulation of statements to deprive a company of property or the legal right to the property.

Examples of fraud include:

- Corruption
- Cash capital embezzlement
- Non-cash capital embezzlement

- Fraudulent statements and reports
- Fraudulent practices by customers, vendors or others including kickbacks or bribes, and fraudulently misrepresented invoices from suppliers or information from customers

Fraud is a deceptive practice or process, a purposeful misrepresentation of a fact to (1) obtain unlawful or illicit benefit, (2) deceive others to give away some valuable item or dispose of a legal right, or (3) cause damage in some way. "Fraud is a criminal offence which calls for severe penalties, and its prosecution and punishment (like that of a murder) is not bound by the statute of limitations." It is noteworthy that unintentional ignorance or blunder in management or a careless waste of an entity's assets (for example through investing in the stock market) is not generally considered as a fraud unless proved done willfully [6].

5. Description and Characteristics of Fraud

Fraud is a broad legal notion and auditors are rather interested in tracing and revealing what led to a financial discrepancy. Auditors consider two types of discrepancies relevant in their dealing with frauds: misstatements resulting from fraudulent financial reporting, and misstatements resulting from misappropriation of assets. The two aforesaid types are elaborated below:

- Misstatements resulting from fraudulent financial reporting consists deliberate misstatements or deletion of data in financial statements with an aim to swindle. In this case the financial statements do not follow the generally accepted accounting principles (GAAP). Financial statement may be misrepresented through the following:
    a. Manipulation, falsification, or change of the records of accounting or the associated documents of financial statements.
    b. Manipulation or intentional deletion of some financial accounts of transactions, or other determining information.
    c. Deliberate abuse of accounting principles on amounts, classification, manner of presentation, or exposure [7]

  Fraudulent financial reporting may simply include the management representatives' rationalizing the appropriateness of a misstatement either as an aggressive rather than indefensible interpretation of a complicated accounting rules, or as an interim manipulation of financial reports to be corrected later as the operational results improve.
- Misstatements resulting from abuse of assets involving the swindling of an entity's assets causing a misrepresentation of financial statements according to GAAP. Misappropriation of assets can be done in the forms of embezzling receipts, stealing assets, or making a firm to pay for goods or services that have not been received.

Frauds generally happen under three conditions: First, when management or other personnel have the motivation or are under pressure; second, due to circumstances potential to fraud such as the absence of controls, ineffective controls, or the ability of management to overrule the controls; third, when those involved are able to rationalize committing a fraud.

Besides those who regularly allow themselves knowingly and intentionally to commit fraudulent acts, there are normally honest individuals who may commit frauds under sufficient pressure. The greater the motive or pressure, the more possibility of individuals justifying the acceptability of perpetrating frauds.

Management and other personnel involved in fraudulent practices may try to hide it through suppressing evidences or manipulating information for enquiries or through counterfeiting documentation. For example, management involving in fraudulent financial reporting may change shipping documents. Other personnel or members of management who hide assets through fake signatures or counterfeit electronic approvals. If an audit process follows GAAS, it negates the authentication of such documentation. Moreover management, employees, and a third party may hide the fraud through an agreement with the untrained auditors who cannot detect such authentication. [8]

6. Discussion among Personnel Regarding the Risks of Material misstatement due to Fraud

Members of the audit team should discuss the possibilities of material misstatement in frauds. They should highlight the limit of auditor responsibilities; the mode of a firm's financial statements prone to fraudulent material misrepresentation; the management adopted methods to commit

and conceal fraudulent financial statements; and also how the assets of the firm can be misused. The significance of preserving the proper state of mind during the audit in search of the potential fraudulent material misstatement must be emphasized in the discussion.

Both the external and internal factors, which may turn out as a motive or pressure leading to the managers' or other employees' perpetrating frauds, as well as the culture giving rise to fraud must be included in the discussion.

Finally, the discussion should include how the auditor may safeguard the vulnerability of the company's financial statements to fraudulent material misrepresentation [9].

7. Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

SAS No. 22 (AU sec. 311.06–311.08), offers a guideline on the manner of the auditors' acquiring knowledge regarding the company's business and the industry in which it operates.

Significant for the auditors is in detecting the risks of fraudulent material misstatement; to acquire information to be utilized in detecting the risks of fraudulent material misstatement Making inquiries of management and other personnel of the entity to know their opinions on the risks of fraud and the way they are addressed.

The auditors should follow the following steps:

1. Being cautious of any irregular or unexpected relationships detected through analytical procedures in audit planning
2. Investigating for any existing fraud risk factors
3. Taking into account other information that may aid in fraudulent material misstatement risk detection. [2]

8. Making Inquiries of Management and Other Personnel of the Entity on the Risks of Fraud

The auditors should make inquiries of management on:

- The management's having knowledge of any fraud or potential fraud affecting the entity
- The management's being aware of the charge of fraud or potential fraud affecting the entity, for instance, received in contact with employees, ex-employees, analysts, regulators, short sellers, or others
- The management's knowledge of the risks of fraud in the entity, from any certain fraud risks detected by the entity to the account balances or classes of transactions for which a risk of fraud may potentially exist
- The plans and controls the entity has developed to decrease specific fraud risks detected by the entity or otherwise to help in deterring or detecting frauds, and the way management monitors the plans and controls

The auditors should also inquire directly the audit committee (or at least its chairman) to obtain the audit committee's opinions regarding the risks of fraud and if the audit committee has knowledge of any fraud or potential fraud in the entity. The audit committees of entities sometimes have an effective role in supervising the entity's assessment of the risks of fraud as well as the plans and controls the entities have developed in decreasing these risks. The auditor must acquire an insight on how the audit committees apply the relevant supervising activities.

In companies with an internal audit function, the auditor should also conduct an inquiry of appropriate internal audit employees to obtain their opinions regarding the risks of fraud; their implying any procedures to detect fraud throughout the year; the management's satisfactorily response to any findings of these procedures; and the internal auditors' knowledge of any executed or potential fraud [10].

9. Considering Fraud Risk Factors

Identifying the fraudulent material misrepresentation is not an easy task as frauds are always concealed. However an auditor may find the fraud risk factors such as the motives or pressures for committing frauds, the opportunities to commit the frauds, or the justification for fraudulent practices. Although risk factors are detected, they do not necessarily denote that a fraud has happened. The competence of the auditors has to work out the frequency of the fraud risk factors available while information processing and utilizing their expertise and judgment to identify the potential risks of a fraud [11].

10. Considering Other Information Possibly Helpful in Identifying Risks of Material Misstatement Due to Fraud

The auditors must generally consider other possibly helpful information in detecting the risks of fraudulent material misstatement; considering the discussions of the work team, may specifically offer useful cues in detecting the risks. The auditors should also consider the data derived from (*a*) procedures on the acceptance and persistence of clients and engagements and (*b*) reviews of interim financial records and statements.

Finally, as part of the consideration of audit risk at the individual account balance or class of transaction level (see SAS No. 47, AU sec. 312.24 to 312.33), the auditors should distinguish if the detected risks would substantiate the risks of fraudulent material misstatement.

11. A Presumption that Improper Revenue Recognition is a Fraud Risk

The auditors should generally presume that detected improper revenue may indicate the risk of fraud existence as fraudulent material misrepresentation in financial statements is mostly either due to overstated revenues or understated revenues [12].

12. A Consideration of the Risk of Management Override of Controls

The auditor may not find any specific risks of fraudulent material misstatement, but still there is a possibility of the managements' overriding of controls. Accordingly, the auditor should investigate this risk besides any other findings showing the existence of other more precisely detected risks [11].

13. Assessing the Identified Risks after Taking into Account an Evaluation of the Company's Programs and Controls that Address the Risks

According to SAS No. 55 the auditor should acquire an understanding of all the five elements of internal audit control. It also highlights that "such knowledge should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, design tests of controls when applicable, and design substantive tests." SAS No. 55 also states that controls, whether manual or automated, may be overridden by fraudulent collaboration of two or more people or the management's overriding of internal controls.

A sufficiently comprehensive understanding of the internal control requires designing the audit plan, the auditors should investigate the efficiency of the design and practical approach of the company's programs and controls in dealing with the identified risks of fraudulent material misstatement; The programs and controls may involve (*a*) certain controls developed to reduce certain risks of fraud (*b*) broader programs developed to deter, and detect frauds.

The auditors should investigate whether such plans and controls reduce the risks of fraudulent material misstatement or control inadequacies may intensify the risks.

The Statement finally provides some examples of the programs and controls an entity might apply to develop a culture of honesty and ethical behavior, in the path of deterring and detecting fraudulent practices.

After investigating the suitability and practicality of the entity's programs and controls in identifying the risks of fraudulent material misstatement, the auditors should evaluate these risks considering the very investigation. This evaluation should be taken into consideration when developing the auditor's response to the identified risks of fraudulent material misstatement [13].

14. Responding to the Results of the Evaluation

While responding to the evaluation of the risks of fraudulent material misstatement, the auditors should utilize their professional skepticism, which is an attitude that includes a critical investigation of the competency and sufficiency of audit evidence, throughout the process of gathering and investigating the very evidences. Utilizing the professional skepticism in responding to the risks of fraudulent material misstatement can include: (*a*) developing complementary auditing programs to acquire more reliable evidence backing up certain financial statement account balances, classes of transactions, and the relevant declarations, (*b*) achieving extra support through the management's explanations or representations on material issues, through third-party

verification, the use of experts, analytical procedures, investigation of documentation from independent sources, or inquiries of others within or outside the entity.

It is noteworthy that the nature and significance of the risks detected as well as the entity's programs and controls that deal with these detected risks influence the auditor's response in their evaluation of the risks of fraudulent material misstatement.

The auditors generally respond to the risks of fraudulent material misstatement in the following three ways:

1. A response with an overall effect on the way the audit is executed i.e., a response including more general considerations besides the specific procedures planned
2. A response to the identified risks including the nature, timing, and size of the auditing procedures to be conducted
3. A response including application of specified procedures to deal with the risk of fraudulent material misstatement involving management override of controls, and providing the unpredictable ways in which such override may happen

If the auditors conclude that it would not be viable to plan effective auditing procedures in dealing with the risks of fraudulent material misstatement, withdrawing from the engagement with communication to the suitable parties may be an efficient measure [2].

15. Conclusion

Identification of the risk of fraudulent material misstatement entails a professional judgment and the consideration of different features of the risk, involving:

- The type of risk i.e., whether it includes fraudulent financial statements or abuse of assets
- The significance of the risk i.e., whether it is of a size that may cause material misrepresentation of the financial statements
- The possibility of the risk i.e., the possibility of leading to material misrepresentation of the financial statements
- The extent of the risk, i.e., whether the potential risk is extended to the whole financial statements or to a specific statement, account, or level of transactions

Technically, the main reasons behind the auditors' failures in detecting fraudulent financial statement are the application of analytical review procedures as "sufficient audit evidence"; deficiencies in audit risk models and risk evaluation as to internal control; and audit insufficiencies in revenue recognition and involved parties' transaction disclosure.

Observing the ethics in detection of frauds, the auditors must be independent and the amount of the auditors' non-audit services must be evaluated. The determined reasons are decisive in the solutions recommended to improve the detection of fraudulent financial statements.

The SEBI got statutory authority through an ordinance enacted on January 30, 1992; Based on the ordinance, SEBI was entitled to wide-ranging powers, such as the power to ban the insider trading and to regulate the significant acquisition of shares and takeover of business.

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