



AUDIT PROCEDURES FOR DISCLOSURE OF ERRORS AND FRAUD IN FINANCIAL STATEMENTS

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Abstract: Auditors' responsibility regarding errors and fraud disclosure in financial statements is an essential element of the commitment they undertake to the users of information. Although auditors are responsible for expressing reasonable assurance that the financial statement contains no substantial deviations, the standards limit the auditor's opinion without explicit requirement that fraud and errors be identified. Nevertheless, auditors need to apply the adequate procedures to respond to internal and external factors generating errors and fraud, which reflect on the reliability of financial statements. This will contribute to improving the performance of entities and raising the value added of conducted audits.

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Introduction

A series of changes have been introduced into Bulgarian legislation regarding accounting and independent financial audit. The harmonization of statutory acts that govern these two professions implies improved efficiency and increased responsibilities for both economic agents and society as a whole. Management is obliged to ensure the disclosure of information in financial statements, while auditors are expected to form an opinion and give a conclusion regarding the reliability of financial statements.

The object of this study refers to the factors which determine the occurrence of errors and fraud in financial statements and the procedures applied in audit. **The subject** is to describe the characteristics of audit procedures for identifying errors and fraud at various audit stages. **The objective of the study** is to establish the interdependence between the characteristics of errors and fraud in financial statements and the possibility for implementing adequate audit procedures for their identification and disclosure.

The objective of the study may be accomplished by fulfilling the following **specific tasks**:

- Describe the economic factors which predetermine the occurrence of errors and fraud;
- Identify the essential characteristics of errors and fraud in financial statements;
- Analyse audit procedures applied for discovery of error and fraud depending on the stages of the audit process.

The thesis developed in this study is that economic crises increase the potential risks of errors and fraud occurrence in financial statements. Auditors should therefore apply adequate procedures at every single stage of the audit process to identify the factors for untruthful presentation of information.

The methods employed in the study include deduction, induction, analysis, comparison, modeling and research. Their main application is discussing the nature and characteristics of main categories, statutory acts and in processing the data collected from the subjects of research.

1. Economic Environment as a Prerequisite for the Occurrence of Errors and Fraud

Economic environment is a major factor influencing the behaviour of economic agents. According to a survey conducted by PricewaterhouseCoopers (PricewaterhouseCoopers, 2009, 1) [1] in 2009, 25 per cent of participating Bulgarian companies were subject to serious fraud once or on several occasions. 78 per cent of those companies claimed that the major reason was the pressure to achieve certain financial targets and the variable component in employees' remuneration according to the achievement of those targets. The results from a survey on the business climate in Bulgaria show that when the financial situation is uncertain, most companies tend to report lower results in the financial statements (National Centre for Public Opinion Research, 2010, 4) [2]. Some of the reasons are [3]:

- Decrease in turnover (production and/or sales volume) – 85.5 per cent of respondents;
- Serious delay of receivable payments to the surveyed company – 51.3 per cent;
- Cancelling already planned expenditures (for example, purchase of long-term tangible assets, personnel training, know-how) - 33.5 per cent.

As the information presented in financial statements is a starting point for decision-making by stakeholders, auditors should focus their attention on the economic reasoning behind the modeling of financial results. Based on the above the main schemes for fraud in financial statements most often relate to presenting an improved or worsened financial situation than the real one.

Fraud in financial statements which aim to present an **improved financial situation** could be divided into two categories – qualitative and quantitative misstatements. Qualitative deviations might be tendentious or ambiguous names, forgery of figures, etc. Usually, companies overstate assets and revenue and/or understate debts and expenditure. This results in incorrect presentation of the net earnings per share and portraying a more stable financial state than the real one. Fraud can also be committed by omission or untruthful presentation of data in the financial statements, inaccurate disclosure of information, etc.

The schemes applied in committing such fraudulent financial activities include: fictitious sales; revenues recognized in advance, before meeting all conditions of a sale; sales under conditions; incorrect reporting of sales during the reporting period; inaccurate application of the percentage of completion method; unauthorized deliveries and consignment sales etc. Indicators for fraud schemes in the financial statements can be:

- fast growth rate or unusual profitability, especially compared to that of other companies in the same industry ;
- recurrent negative cash flow from operating activities or inability to generate cash from operations, while at the same time profit and profit growth is reported;
- substantial transactions with related parties or special purpose entities which are unusual for the company's business or with enterprises and organizations that are audited by another company;
- substantial and unusual or complicated transactions, especially ones concluded towards the end of the reporting period and therefore posing complex questions as to the application of substance over form rule;
- unusual increase in the number of days for turnover of accounts receivable from sales;
- substantial volume of sales to entities whose substance and ownership are unknown;
- unusual impetus in the sales of a small number of assets within the company or sales accounted for by the head office of the company.

According to the PricewaterhouseCoopers (PricewaterhouseCoopers, 2009,1) the report quoted earlier, nearly 33 per cent of the companies included in the survey engaged in fraud that resulted in increasing their revenue by reporting fictitious assets or assets they did not own, capitalization of costs which should have been expensed, overstating the value of available assets by applying higher market values and reducing the allowances for current accounts receivable [4]. Assets which are most often misstated are inventories, trade receivables, buildings, equipment and machinery, current receivables, cash, investments in securities, patents, good-will, licenses and know-how, etc.

The indicators of fraud through overstating the assets' value largely overlap with the above mentioned indicators of revenue. Fraud indicators are often part of schemes. For improving the financial situation the entity's management actions can focus on:

- decrease of costs and liabilities;
- assets misappropriation and misuse;
- inappropriate disclosures, etc.

Other fraud indicators might be:

- the dominance of a single person or a small group of people in the management of the entity with no compensatory controls;
- unusual increase in the gross margin or a margin exceeding that of leading companies in the field;
- provisions for returned goods, customer claims, etc. whose percentage decreases or is different from those of leading companies in the industry;

The other type of fraud in financial statements which aim to present a **worsened financial situation of the entity** usually relate to taxation and tax evasion (tax fraud), forthcoming privatization or sale of a private company to other legal or natural persons, bankruptcy announcement, etc.

2. Characteristics of Financial Statement Errors and Fraud

The term 'error' is used to describe unintended inaccuracies, deviations, or inconsistencies in financial statements, including the omission or disclosure of an amount, such as (International Federation of Accountants, 2008, 367) [5]:

- errors in the collection and processing of data necessary for the preparation of the financial statements;
- inaccurate accounting estimate occurring as a result of negligence or misinterpretation of facts;
- error in the application of accounting principles regarding evaluation, recognition, classification, presentation or disclosure.

The term "fraud" refers to an intended act of one or several executives, persons in charge of the overall management, employees or third parties, including the use of deception in order to gain unfair or illegal advantage. Even though "fraud" is a broad legal concept, auditors focus their attention on fraud which might lead to substantial inaccuracies, deviations or inconsistency in the financial statements. Auditors (including internal auditors) do not engage in the legal definition whether fraud has been actually committed (International Federation of Accountants, 2008a, 44).

Auditors are mainly interested in two types of intended inaccuracies, deviations, and inconsistencies - inaccuracies, deviations, and inconsistencies occurring as a result of fraudulent financial reporting and inaccuracies, deviations, and inconsistencies occurring as a result of illegal appropriation of assets. Fraudulent financial reporting [6] involves intended inaccuracies, deviations, and inconsistencies, including the omission or disclosures of amounts in the financial statements aiming at misleading users of the financial statements [7]. Fraudulent financial reporting might be a result of:

- manipulation, counterfeiting (including forgery) or adjustment of financial records and data or of primary and secondary documents on which the financial statement is based;
- misleading information about events, transactions or other substantial information or their intended omission in the financial statement;
- intended misapplication of accounting principles regarding amounts, classification, presentation and disclosure of information.

Financial statement fraud often implies the circumvention or negligence of controls on behalf of the management, which might otherwise seem to be working efficiently. The circumvention or negligence of controls on behalf of executives might employ techniques such as:

- fictitious entries in the accounting records, especially at the end of the reporting period in order to manipulate performance results or for other purposes;
- inadequate adjustment of assumptions and altering the judgments used in the estimates of accounts balances;
- omission, preliminary or deferred recognition in the financial statement of events and transactions which have occurred during the reporting period;
- concealing or failing to disclose facts which might have an impact on the amounts presented in the financial statements;
- engaging in complex transactions and operations which have been structured so as to present inappropriately the financial situation or the financial results of the entity;
- changing documents and terms related to substantial and unusual transactions and operations.

Fraudulent financial reporting might be the result of the executives' efforts to manage earnings so as to mislead users of financial statements by manipulating their perception of the results achieved by the entity and its profitability. Such management of earnings might start with some insignificant activities or inaccurate adjustments of assumptions and altering the judgments by the executives. Illegal appropriation of assets involves theft of company assets and is often committed by employees with relatively small or insignificant amounts. Top executives, however, may also be involved in similar activities, as

they have more opportunities for concealing or keeping in secret illegal appropriation, in ways which are more difficult to discover. Assets might be illegally appropriated through:

- Assignment of proceeds (for example, misappropriation of collected receivables or diversion of proceeds from unused accounts into private bank accounts);
- Theft of tangible assets or intellectual property (for example theft of inventories for personal consumption or re-sale, stealing scrap metal for re-sale, entering into agreements with competitors to disclose technological information against remuneration);
- Payments made by the entity for goods and services which are received (for example, payments to fictitious suppliers, commissions paid by suppliers to the purchase officers of the entity in exchange for increased prices, payments to fictitious employees);
- Use of the assets of the entity for personal needs (for example, using the assets of the entity as a collateral on personal loans or loans extended to related parties).

Misappropriation of assets is often accompanied by counterfeited or misleading papers and documents aiming to conceal the fact that assets are missing or are used as collateral without appropriate approval.

Elements of fraud are (International Federation of Accountants, 2008, 57):

1. A motive (pressure, need);
2. Favourable opportunity;
3. Certain organization.

Fraud is committed in favour of a person or entity or both. ***The motives*** behind fraud might be:

- Financial;
- Character flaws/personality weaknesses;
- Work-related pressure;
- Other types of pressure.

Surveys conducted reveal that nearly 95 per cent of all fraud involves pressure arising due to either financial motives or vices. (Pricewaterhouse Coopers, 2009, 4)

Pressure and motives might lead to a substantial increase in the occurrence of these activities resulting in fraudulent financial reporting. Such situation might arise when due to the pressure to meet market expectations or desire to obtain maximum results-related remuneration, the management deliberately takes positions which result in fraudulent financial reporting through substantial inaccuracies, deviations and inconsistencies in the financial statement, i.e.

fraudulent statements. In other entities the management might be motivated to decrease earnings substantially in order to minimize taxes or to report higher earnings in order to secure bank loans.

Financial pressure is the most common motive for fraud. Usually, when managerial fraud occurs, companies increase the assets in their statements of financial position and the net income in the income statements. The motive in such cases is mainly poor liquidity, bad debt receivables, loss of clients, shrinking markets, obsolete inventories, etc.

A perceived favourable opportunity for committing fraud is the second element of the so-called fraud triangle. The major factors contributing to increase in the opportunities for committing fraud in entities include:

- Lack of or bypassing controls preventing and/or detecting fraudulent behaviour;
- Lack of access to information;
- Negligent behaviour, apathy or lack of capacity;
- Inability to assess performance quality;
- Failure to discipline fraudsters;
- Lack of audit trail, etc.

Fraudsters always *organise* their activity in order to minimize the risk of being identified. This helps them conceal their dishonest behaviour. Employees often commit fraud in response to employer's lack of adequate acknowledgement of their input or due to their perception that they are not adequately paid for the work they do etc.

The means for fraud discovery can be divided into two major groups: incidental fraud discovery and fraud discovery through the systems for risk management. The most successful method for economic fraud discovery in Bulgaria remains internal audit (30 per cent of fraud detected in 2009). However, it is an alarming fact that about one third of fraudulent activities in Bulgaria are detected incidentally (the percentage for Central and Eastern Europe is 32 per cent, while on a global scale the percentage is 40). (Pricewaterhouse Coopers, 2009, 3)

External auditors conducting audit in compliance with the International Auditing Standards should obtain reasonable assurance that the financial statements contain no material inaccuracies, deviations or inconsistencies, regardless whether due to fraud or error. The auditor cannot obtain absolute degree of certainty that material inaccuracies, deviations or inconsistencies will be discovered in the financial statements be disclosed due to factors such as professional judgement, the use of tests, limitations inherent to internal controls and the fact that the majority of audit evidence available to auditors is convincing rather than persuasive in nature.

In order to obtain a reasonable degree of assurance, the auditor must retain an attitude of professional skepticism during the entire audit process, take into account the possibilities for the management neglecting controls, and consider the fact that audit procedures that are efficient in errors identification might not be appropriate within the context of identified risk of material inaccuracies, deviations and inconsistencies due to fraud. Due to the characteristics of fraud this attitude is essential for the auditor especially when ascertaining the risks of substantial inaccuracies, deviations and inconsistencies due to fraud. Professional skepticism is an attitude which implies questioning and critically assessing audit evidence. This requires constantly questioning whether the information and obtained audit evidence imply the possibility of material inaccuracies, deviations and inconsistencies due to fraud.

The best practices recommended for conducting similar activities might involve all or some of the following mechanisms and procedures, depending on the characteristics of the process employed by separate entities:

- Duly record policies, procedures, control mechanisms and monitoring reports;
- Check lists to verify procedures and basic control elements;
- Self-assessments of managers, for example self assessment of control;
- Review draft documents before submitting them;
- Process maps that record the sources of separate data elements to be presented, key control mechanisms and the persons, responsible for each element;
- Subsequent verification of reported problem issues;
- Special or targeted inspections of highly risky, complex or problematic areas, including critical accounting estimates, assessment of reserves, off balance sheet activities, main subsidiaries, joint ventures, and entities with special functions;
- Reports from the internal auditors on inner control issues, submitted at least once a year, or once a quarter where possible.
- Regular meetings of the audit committee and the disclosure committee.

The characteristics of errors and fraud described above have a considerable impact on the procedures applied by external auditors.

3. Audit Procedures Applied in Identifying Errors and Fraud in Financial Statements

The role of the auditor regarding errors and fraud is related to applying a set of procedures which should recognize the possibility of their occurrence at every stage of the audit process. The International Audit Standards defined it as a key priority of financial statements audit.

A retrospective analysis of the changes introduced in the International Audit Standards which regulate audit procedures in response to identified risk of errors and fraud indicates that once being its primary objective, fraud disclosure has gone beyond the scope of auditor's responsibility in the course of time (Petrova, 2004, 94). In line with increasing public interest in the reliability of financial reporting, when there are some negative consequences for information users more and more frequently the question is raised: "Where were the auditors in the first place?" (Johnson, 2010, 1) If disclosure of substantial errors and fraud is a major audit element, then it is not very clear what value-added service the audit has provided to investors and agents on capital markets. The aim in this respect is to fill the gap between the expectations of shareholders, investors, suppliers and customers and the framework in which the International Audit Standards put audit procedures and auditors' responsibility.

According to the International Audit Standards, "management is responsible for preventing and disclosing fraud and error by introducing a continuously functioning accounting system and an internal control system" (International Federation of Accountants, 2008, 44). We could, therefore, point out that auditors should ascertain the degree to which those two systems could reduce the risk of error and fraud occurrence and whether it is essential to have them. The responsibility of the auditor only goes as far as accounting for the possibility of error occurrence and its potential impact upon the reliability of the financial statement.

The International Audit Standards define auditors' responsibility in terms of their objectives, namely:

- To identify and assess the risk of substantial deviations in the financial statements, which are due to fraud;
- To obtain sufficient and relevant audit evidence about assessed risk of substantial deviations, due to fraud;
- To respond adequately to identified and potential fraud.

As for the responsibility of managers, they should study the facts and circumstances related to (Kostova, 2005, 181):

- The management structure and the possibility of one person dominating it;
- The complex character of corporate structures and the interdependence between their components;
- Negligent attitude on behalf of managers to identified errors in the system, which need to be adjusted.
- High degree of turnover of highly-qualified finance and accountancy staff with core functions in the entity;
- Frequent replacement of advisors and auditors.

Efficient external auditors must be able to recognize potentially fraudulent business practices every time they conduct an audit and recommend the control and procedures required in order to limit the scale of such fraudulent activities. Efficient internal controls are the first form of protecting the entity from fraud (Miller, 2007, 307). An all-inclusive and regularly inspected system of internal control is essential for preventing and disclosing losses which occur as a result of fraud; in addition, internal auditors often identify fraud-related problems.

As required by International Audit Standard 315, in order to gain understanding of the company and its environment, including its internal control, the auditor must implement certain risk assessment procedures. As an element of this activity the auditor conducts the following procedures for obtaining the information which is used in identifying risks of substantial inaccuracies, deviations and inconsistencies due to fraud:

- The auditor interviews managers, the persons responsible for the overall management of the entity and other persons, when this is appropriate, and gains understanding about the way in which persons in charge of the overall management supervise managing processes in order to identify and provide answers about fraud risks and about the internal control system which the management has established in order to reduce those risks.
- The auditor ascertains whether there are one or more factors of fraud risk.
- The auditor examines any unusual or unexpected interrelations, ratios and trends which have been identified during the implementation of analytical procedures.
- The auditor reviews any other information which might be useful for identifying risks of substantial inaccuracies, deviations or inconsistencies due to fraud.

Substantial inaccuracies, deviations or inconsistencies due to fraudulent financial reporting occur as a result of **overstating the revenues** (for example by recognizing earlier the revenues or reporting fictitious earnings) or **understating the revenues** (for example, by the improper transfer of revenues to a later period). Therefore, the auditor usually assumes that there is a risk of fraud in the recognition of revenues and ascertains which revenues, revenue operations or assertions might produce such risks. In cases when the auditor has not identified revenues recognition as a risk of inaccuracies, deviations or inconsistencies due to fraud, he/she records the reasons in support of the conclusion he/she has made.

Substantial inaccuracies, deviations or inconsistencies in the financial statement due to fraud often include manipulating the process of financial reporting by **making inappropriate or unauthorized entries in the accounting records** during the year or at the end of the period by adjusting the

sums recorded in the financial statement, which have so far not been entered officially in the records.

When elaborating and implementing audit procedures to test the appropriateness of journal entries, records in the ledger and other adjustments made during the preparation of the financial statement, the auditor:

- Gains understanding about the financial reporting process in the entity and the controls on journal entries and other adjustments made;
- Evaluates the designed model of controls on journal entries and the other adjustments and ascertains whether they have been properly introduced for implementation;
- Makes enquiries to people engaged in financial reporting about inappropriate or unusual activities related to processing the entries in the journals and other adjustments;
- Determines the time for conducting the tests;
- Identifies and selects the journal entries and the other adjustments on which the tests will be conducted.

In order to identify and select the journal entries and the adjustments on which the tests will be conducted and to choose an appropriate method for verification of supporting primary documents for the items selected, the auditor takes into consideration the following elements:

- The assessment of risks related to substantial inaccuracies, deviations and inconsistencies, due to fraud;
- Introduced controls to be exercised on journal entries and other adjustments;
- The financial reporting process in the entity (i.e. the preparation of financial statements) and the nature of evidence that might be obtained;
- The characteristics of fraud in journal entries or other adjustments;
- The character and complexity of accounts;
- Records in diaries or other adjustments processed outside the normal course of the activity.

When preparing the financial statement, managers bear responsibility for a number of evaluations and assumptions which influence significant **accounting estimates** and the continuous monitoring of the reasonability of those estimates. Fraudulent financial reporting is often implemented through deliberate inaccuracies, deviations and inconsistencies in the accounting estimates. When inspecting the accounting estimates to check if they contain bias and intent that might lead to substantial inaccuracies, deviations and inconsistencies, due to fraud, the auditor:

- Judges whether the differences between the estimates which are best supported by audit evidence and the estimates included in the financial statement, even if being reasonable when considered separately, exhibit

contents that may show potential bias or intent on behalf of the entity managers, in which case the auditor inspects estimates as a whole; and

- Examines in retrospect those estimates and assumptions made by the managers, which are related to significant accounting estimates, recorded in the financial statement for the previous year. The aim of this examination is to determine whether there are any indications of possible biased or intended contents on behalf of managers. This examination, however, does not question the professional estimates given by auditors the previous year on the basis of information available at that time.

If the auditor identifies possible bias or intent on behalf of managers in defining the accounting estimates, he/she *gives an assessment* whether the circumstances giving rise to that bias pose a risk of substantial inaccuracies, deviations and inconsistencies, due to fraud.

The auditor ascertains whether in determining the accounting estimates managers seem to have understated or overrated all provisions or reserves in the same way, so as to aim at leveling the earnings from two or more accounting periods. Those actions might also have been taken with the intention of producing a certain earnings rate in order to deceive the users of the financial statement and influence their perception of the results achieved by the entity and its profitability.

External auditors disclose errors and fraud by reviewing and assessing **the adequacy and efficiency of the internal control system**, compared to the degree of potential risk exposure of various segments of the entity activities. In assuming this responsibility they should determine whether:

- The environment within the organization encourages conscientious control and whether the targets and objectives set within the organization are realistic;
- There are written documents to account for activities which are not allowed or the assistance required in case some violations are disclosed;
- Communication channels provide adequate and reliable information to managers;
- The appropriate policies for authorizing transactions have been introduced and are conducted;
- It is necessary to make some recommendations for establishing or strengthening cost-effective controls to prevent fraud.

During the preliminary research related to planning the audit, it is necessary to collect relevant material so as to have an idea of the history of the object to be audited. Some information about the past of the entity might be available in the working documents from previous audits conducted or in the correspondence of the entity. During the preliminary study the following documents need to examine:

- Review of previous working documents. This is necessary in order to gain a better understanding of the approaches applied and to get familiar to the results from previous audits;
- Examine the reports from previous audits. The factual findings from an audit conducted earlier must be considered, as well as the degree of management involvement in undertaking the relevant adjusting measures. In order to give instructions for work in other vulnerable areas, the auditor must study the reports from similar objects or functions within the organization. It is important to pay attention to any controversial issues in a previous report;
- The organization of the object. The auditor must examine the organization scheme of the entity which will be subject to audit in order to understand its structure and responsibilities;
- Other materials related to the audit. It is also necessary to examine complementary data from completed, planned or currently conducted audits related to the field.

It is necessary to determine the procedures on which the collection of audit evidence will be based to ensure that there are no substantial inaccuracies, deviations or inconsistencies in the financial statement. The factors which influence the volume of evidence relate to:

- The special characteristics of the external environment in which the entity is functioning;
- The specific features of the organization and management of the economic entity;

In terms of external environment, risk factors relate to the conditions in the branch and the economic and regulatory environment in which the entity functions. It is necessary to study possible impacts on the financial statement of:

- New accounting, legal and regulatory requirements which might deteriorate the financial situation of the entity;
- Deteriorated relations with suppliers and clients;
- Difficulty faced by the managers in handling competitive pressure;
- Low adaptability of the entity to the rapidly changing environment;
- A considerable number of transactions with related parties beyond the normal course of the business.

The assessment of the above-mentioned factors equips the auditor with some preliminary idea about the business and the interdependencies in the branch. After studying those features, managers are interviewed in order to assess the characteristics of the organization and the management, in terms of reducing the errors and fraud risk in the financial statement. The objective is to ascertain whether managers have provided the necessary prerequisites for

limiting the number of material errors and fraud in the financial statement. Attention is then focused on:

- Assessment of risk management regarding errors and fraud;
- The activities undertaken by managers in order to establish and ensure the functioning of internal control systems and accounting reporting systems;
- The efficiency of the internal control system.

Those procedures are closely related to the specific characteristics of the entity. In some entities, annual assessments are made which are then announced in the managers' report. Such activities help the auditor assess the control environment and the risk related to clients [8] (Bozhkov, 2003, 81). In other entities, managers' assessments are not official and are only formally made, which increases considerably the control risk and results in an increased number of substantial procedures in order to minimize the disclosure risk.

The assessment should take into account the fact that errors represent an unintended action and frequent deviations and inconsistencies are related to the low efficiency of the internal control system, the system of accounting reporting or poor qualification of the personnel. In such cases, attention is shifted on managers' motivation to engage in a real assessment of all the factors which create conditions for errors and fraud. Auditors examine whether there is *adequate behaviour* in terms of internal control and accounting. That includes compliance with ethical principles, ongoing monitoring of the systems, due adjustment of errors, keeping the accounting personnel well qualified, using the appropriate accounting software, etc.

As a result of the preliminary assessment, the risk zones where the danger of errors or fraud is biggest are identified. Then on the basis of all the information collected, certain tests and procedures are initiated that aim to reduce the audit risk. Those include detailed test and analytical procedures.

Detailed tests are applied to different accounts and account balances. The attention of the auditor is focused on the susceptibility of assets to misappropriation. The basic principle applied is that of surprise spot checks. Those checks give some real idea about the current situation and make it possible to improve the audit quality. The auditor may change his audit approach and demand written rather than verbal support of the account balances. The aim is to collect sufficient and reliable evidence in cases when there are:

- Incomplete accounting records;
- Unsubstantiated transactions;
- Material inconsistencies in the documents related to the transactions;
- Accounts for suspicious estimates which have not been reconciled, etc.

Regarding the account entries, documents and records are subject to verification. The objective is to find out whether a lot of adjustments have been

made and whether all accounting regulations have been observed. Elaborated and processed documents, attached supporting documents for transactions and the availability of required signatures are verified. In cases when there are significant differences between the accounting records and third parties acknowledgement, the auditor interviews managers which should then reply with a written statement.

In such cases, the auditor must focus his/her attention to the verification of any unusual transactions made at the end of the reporting period, complex transactions and accounting treatments, transactions with related parties and payments for services which largely exceed the volume of the services provided.

The assessment of the IT environment is very important. It must be reliable so as to enable the auditor to refer to it. The following circumstances have a negative effect on the reliability of audit evidence:

- Inability to obtain information from computer files;
- Outdated software, not adequate for the purposes of accounting;
- A large number of modifications in the programmes, which have not been recorded;
- Inadequate overall reconciliation of computer operations and data base with the accounts.

According to Sawyer (Sawyer, *et al*, 2003, pp. 282-295), there are six categories of procedures applied during an audit engagement. The first five relate to measuring and the sixth one is related to assessing.

Monitoring is a deliberate visual examination which includes mentally comparing the activities traced with existing standards and assessment. Monitoring must then be documented. Its quality will depend on the experience and qualifications of the external auditor. The better qualifications and the longer experience he/she has, the more likely it is that he/she will notice differences from desirable situations. Monitoring usually precedes the verification of facts by means of other procedures, as the latter impedes successful monitoring. It is conducted during the preliminary examination of the object of audit and the work processes or it might take place during the interviews. It might help establish the existence of risks such as inefficient controls, untapped resources, non-compliance with safety regulations, etc.

Interviews might be made verbally or in written form. This is the procedure most widely applied in the verification of operations. Verbally asked questions are the most common variety of the procedure, and in addition, the most difficult one. It requires that the auditor be skillful in human relations and in formulating the questions so as to obtain the most useful information. The external auditor must be able to avoid unnecessary contradiction with or embarrassment of the interviewees. Nevertheless, he/she must pertain to his/her

objective to find out the truth. This information must be confirmed by at least one more person. The standardized questionnaire on operational procedures helps not only the external auditor but the clients as well. The questions included in it must be limited to major issues, updated and clarified with the client's management.

The interview is an organised and structured process of collecting information by applying selected strategies for asking questions and obtaining answers with information which will then be used at the next stages of the verification, fraud investigation and the preparation of the report with the conclusions and findings of the auditor.

Analysis is applied to examine the parts of the whole. It is implemented through adequate analytical procedures which are practically useful regardless of the subject analysed. Those procedures verify documents in terms of policy, contracts, regulations, etc. The analysis includes comparisons, reports on trends and acknowledgement of differences from expected data.

Analytical procedures involve vertical and horizontal analysis as well as the analysis of ratios. Yet they could be misleading to both their user and a lot of auditors who have not applied them. Analytical procedures are conducted in order to verify the financial situation and the profitability of the entity. Items put to verification include the possibility for generating cash flows and their interdependence with reported earnings, growth of profitability in comparison to other entities in the same field, sale methods, risk of inevitable bankruptcy or deteriorated financial situation, etc.

While conducting analytical procedures several factors which might expose the entity to pressure should be considered. Those could be:

- a declining industry with progressively growing losses;
- deficient capital due to decreasing earnings;
- investment instability and dramatic changes in the product structure;
- the significant dependence of the company on one or several products, one or several suppliers or clients.

Analytical procedures involve examination or comparison of the relationships between two or more indicators in order to determine the rationality of each of them. There are six types of analytical procedures which help identify unusual trends, errors or fraud: analysis of the BSC table; horizontal analysis or analysis of ratios; vertical analysis; analysis of deviations; analysis of ratios or tags; comparison with other operative information.

These varieties of analysis are applied when recognizing motives or opportunities for applying financial result management and its results equip the auditor with some idea about possible risks or fraud indicators.

Verification is a process of confirmation or comparison. Attention is focused on documents compliance with statements of the managers, outstanding amounts in the ledger and analytical reports, deliveries and orders for deliveries, approved quantities, production plans, delivery and acceptance certificates.

Investigation is in essence a systematic search for hidden facts when there is some violation or other suspicious circumstances. It is focused on violations (crimes). Poorly conducted investigation might have negative legal and punitive consequences.

Assessment refers to giving an opinion about the work done. This conclusion is based on the adequacy, efficiency and effectiveness of the measures adopted by managers in response to identified fraud risks. Assessment takes into account the so-called collateral damage such as detriment to the entity's image, lower confidence in the entity, deteriorated relationships with contractors and decreased staff motivation.

The audit procedures thus conducted are recorded in the working documents which represent the records made by the external auditor (documents, reports, correspondence and other sample papers). It is a general feature of all working documents that they represent evidence used to exemplify the results from the external audit. Those should be stored so that the rationality of reported conclusions and recommendations from the audit can be supported.

The working documents of the external audit are the only records of the audit work done and might be used as evidence in future to show what was or was not done during an audit conducted at a specific time. Their common objective is to support with documents the fact that audit has been conducted appropriately and in compliance with professional standards. The auditor's report is a formal document in which the auditor summarises the work he/she has done and reports on findings and recommendations based on that work. The auditor's report is the primary source of information for stakeholders both within the entity and outside it, which is based on the results of the external audit conducted.

When as a result of the audit conducted there is fraud disclosure this must be reported to managers through various verbal or written messages. The report must contain the conclusion of the external auditor whether there has been sufficient information available for conducting the audit and it must summarize the findings and recommendations on which this conclusion has been based. After presenting the Board of Shareholders with the report verbally, a written report may be prepared in order to record the findings of the audit. The written report must include all findings, conclusions, recommendations and measures adopted to eliminate negative consequences.

The International Auditing Standards give an interpretation how to present the results of a fraud investigating engagement. Further aspects of reporting committed fraud include:

- When major fraud can be ascertained, senior managers and the Board must be informed immediately;
- The results of the investigation might be indicative of fraud whose negative effect on the financial situation or the operation results of the entity for a year or more have not been disclosed earlier, while financial statement have already been elaborated.
- The final results of a fraud-related verification must be confirmed by a lawyer before being announced. Special attention must be paid to submitting the report to lawyers in cases when the external auditor is willing to guarantee for his client's rights.

As a result of these additional verifications, the potential effects of errors and fraud on the reliability of the financial statement are identified and the adjustments which must be made are discussed with the managers. Depending on the degree of materiality and the measures adopted by managers, the auditor forms an opinion which is recorded as a conclusion in the auditor's report.

When inaccuracies, deviations and inconsistencies are below the materiality level, the executives must be informed about their presence and the possibility of their recurrence (Dodge, 2002, 30). Those inaccuracies might be stated in the auditor's report in an emphasized of matter paragraph(s) in order to present real information to external users of the financial statement.

When fraud and errors influence significantly the financial statement, those must be discussed with the executives so that they can be accurately presented and adjusted.

The auditor prepares a table with the errors which gives a reference to working documents and the contents of the adjustments. These details are given in separate columns about the balance sheet and the income statement. The table also contains the sums of adjustments and the net effect, the tax effect and the amount of error. In case there are unadjusted material errors, a qualified opinion must be given or the auditor may refuse to express an opinion.

The activities of the auditor might also be related to withholding from the commitment when the entity refuses to make the necessary adjustments regarding fraud in its financial reporting. Since fraud is a deliberate activity, an accurate assessment from the auditor is essential as to which level of management he/she should inform about it.

The concluding procedures conducted by the auditor in relation to errors and fraud disclosure in the financial statement may have a preventive effect on the further development of the audited entity. The preventive character is in terms if

undertaking actions whose aim is to prevent fraud or minimize the effects of committing fraud. Counteracting fraud in financial statements is more complicated than countering fraud through misappropriation and misuse of assets or other fraud, as they are committed by senior-level managers and owners, usually assisted by auditors, consultants and lawyers.

If in result of inaccuracy, deviation or inconsistency due to fraud or suspected fraud, the auditor is faced by extraordinary circumstances which make questionable his/her ability to continue the audit, then he/she should:

- Take into account the professional and legal responsibilities applicable under the specific circumstances, including whether to report in front of the person or persons who have hired him/her, or in some cases, in front of the regulators.
- Consider the possibility to withdraw from his/her commitment.
- Should the auditor decide to withdraw, he/she must discuss with the appropriate level of managers and the persons in charge of general management his/her withdrawal and the reasons behind it.

On this basis, the auditor determines whether there is a professional or legal requirement to report in front of the person or persons who have hired him/her, or as the case may be – in front of the regulators about his/her withdrawal from commitment and the reasons for that.

Conclusion

A distinctive characteristic of the auditor's profession is assuming responsibility in favour of the public. Therefore, it is not merely a profession related to meeting the demands of individual clients or employers.

Auditors work in circumstances which may put to risk the compliance with some fundamental principles. It would be impossible to identify every situation which poses similar threats or to suggest appropriate actions for alleviating the threat. Increased staff fraud in audited entities has proved to be an even greater impediment for the normal conduction of audit procedures. Those problems render auditors' working environment slightly different and demand that solutions be found to solve related problems.

To conclude with, the role of the auditor in errors and fraud disclosure is on the one hand related to the compliance with ethical principles, and on the other hand, to high professionalism demonstrated in response to changes in the economic environment in which entities operate. The audit procedures must aim at identifying the factors which are indicative of errors and fraud and at initiating the appropriate activities to reduce audit risk.

Notes

1. The survey includes 3 037 companies from 54 countries and 59 leading entities in Bulgaria.
2. The survey was conducted in the period from May to June 2010.
3. The survey included 580 Bulgarian enterprises from different branches. The total percentage of responses exceeds 100 per cent because more than one answer could be given to each question.
4. The percentage referred to here is about the year 2009. In comparison, in 2005 the percentage of fraud was 16, and in 2007 fraud accounted to 15 per cent.
5. After the revision of the standards in 2009 the explicit definition of the term “error” has become obsolete.
6. The terms “fraudulent reporting” and “fraudulent financial statement” refer to cases of financial statements which aim to deliberately mislead users of those statements about the real situation of the entities presented in those statements.
7. In as much as the auditor expresses his/her opinion as to the reliability of the financial statement as a whole, the term ‘fraudulent financial reporting’ in a more narrow sense will be interpreted as ‘fake financial statement’.
8. This is the combination of internal and control risk as both risks refer to the client.

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PROCEDURE REVIZIJE ZA OTKRIVANJE GREŠAKA I PRONEVERA U FINANSIJSKIM IZVEŠTAJIMA

Apstrakt: Odgovornost revizora kada je reč o otkrivanju grešaka i pronevera u finansijskim izveštajima je važan element posvećenosti koji oni pokazuju prema korisnicima informacija. Iako su revizori odgovorni za iskazivanje razumnog ubeđenja da finansijski izveštaji ne sadrže značajne devijacije, standardi ograničavaju mišljenje revizora bez eksplicitnih zahteva da se greške i pronevere identifikuju. Ipak, revizori treba da upotrebljavaju adekvatne procedure da odgovore na unutrašnje i spoljašnje faktore koji generišu greške i pronevere, što se oslikava na pouzdanost finansijskih izveštaja. Ovo će doprineti poboljšanju performansi entiteta i podići dodatnu vrednost sprovedenih revizija.

Ključne reči: revizijska procedura, greške, pronevere, identifikovanje pronevera, odgovornost revizora, finansijska situacija