

Emerging Markets Queries in Finance and Business

# Addressing Fraud Risk by Testing the Effectiveness of Internal Control over Financial Reporting – Case of Romanian Financial Investment Companies

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## Abstract

The magnitude and complexity of portfolio management operations require that Romanian Financial Investment Companies are to implement and monitor an adequate internal control system over financial reporting. The assessment performed by a public accounting firm in connection with internal control over financial reporting process, provides a major impact upon the reliability of financial statements prepared by these entities and therefore can significantly influence investment decisions. The paper is focused on the relation between the effectiveness of internal controls and risk fraud, involving either misappropriation of financial assets or fraudulent reporting. We based our research on the assumption that an increase of internal controls' effectiveness results in diminishing risk fraud involving financial assets. We attend to identify significant weak points in the chain of internal controls related to financial assets, capable to increase risk fraud and implicitly to alter the reliability on financial reporting process. Projecting reasonable countermeasures designed to respond the assessed fraud risk factors is also a main preoccupation under author artwork.

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*Keywords:* internal control effectiveness, financial reporting process, Financial Investment Companies, SOX compliance, fraud risk oriented audit approach.

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## 1. Literature Review and Problem Formulation

For the purpose of this paper, we focused our research activities on determining and valuating the implications of ineffective internal control system as a source for amplifying the risk of material misstatement of the financial statements prepared by Romanian Financial Investment Companies, due to fraudulent financial reporting. Provided that the entities subject to testing are listed on a regulated capital market (Bucharest Stock Exchange), we assume that fraudulent financial reporting is far more important and has a greater impact upon financial statements than misappropriation of assets, taking into account the coordinates for the investment decision process. According to ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements – Application and Other Explanatory Material (par. A2-A4)*, fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive the users. Most times, this type of misstatement is related to management's efforts to positively influence the users' perceptions as to the entity's performance and profitability. Schwieger and Rittenberg, 2005 concluded that the perpetrator of such fraudulent financial reporting seeks gain through the rise in stock price and the commensurate increase in personal wealth.

From the perspective of auditing financial investments, we acknowledge that there are several factors and relevant circumstances which may significantly increase the risk of fraudulent financial reporting. For instance, Whittington and Pany, 2008 admitted that the liquidity associated to securities may fuel the risk of misappropriation, as well as the complexity of accounting for financial instruments increases the risk that the investments are not valued appropriately. Moreover, the risk of fraud is also fuelled by some other relevant inherent risk factors, such are: the improper use of various valuation techniques for the purpose of hiding or delaying trading losses, the inadequate use of derivatives, or the lack of experience and insufficient knowledge regarding the requirements of financial reporting standards on behalf of the accounting personnel.

Control environment sets the tone of an organization, influencing the control consciousness of its personnel. Some relevant factors directly connected to the possibility of fraudulent reporting refer to integrity and ethical values, audit committee participation, management's philosophy and operating style, and assignment of authority and responsibility (Beasley et al., 2009). Understanding of these control environment factors is relevant to the audit of the investment cycle and allows the auditor to project and perform tests of controls and substantive tests in an effective manner, for the purpose of mitigating the fraud risk. Boynton and Johnson, 2006 considered that the authority and responsibility for investing transactions should be assigned to a company officer. Nevertheless, provided that financial investment companies manage significant amounts related to acquisitions, holdings and disposals of financial assets, our opinion regards an investment committee rather than a single person. Anyway, we admit that such an investment committee should consist of persons, who (i) are of unquestioned integrity; (ii) possess the adequate knowledge and skills required for executing financial investment transactions; (iii) realize the importance of observing all prescribed control procedures; and (iv) can assist other participating members of management in making initial and ongoing assessments of risks associated with individual investments.

Messier et al., 2008 observed that the auditor's approach to the audit of financial investments varies depending on the size of the investment and the amount of investment activity. For an entity that has a large investment portfolio, such as a Financial Investment Company, the auditor is likely to follow a reliance strategy in which internal control is formally evaluated and tests of controls are performed in order to set control risk below the maximum. This assertion is consistent with the assumption that internal controls for Financial Investment Companies are projected, monitored and assessed in compliance with specific NSC regulations (e.g. Regulation no. 15/2004). Nevertheless, such a reliance strategy requires effective internal controls in conjunction with a proper authorization of transactions, a proper record keeping and segregation of duties and an independent registrar and stock transfer agent (Arens et al., 2008). Whenever a reliance strategy may not be projected and performed, the auditor is recommended to fundament a substantive strategy which involves a

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